



Memorandum from the Office of the Inspector General

October 22, 2014

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FINAL REPORT – AUDIT 2014-15030 – TVA’S EXECUTIVE RETENTION

Over the last several years, there has been anecdotal information indicating a high level of turnover among the Tennessee Valley Authority’s (TVA) executives. We initiated this audit to review the costs associated with the hiring and dismissal of executives brought in from outside TVA since the change to TVA’s part-time Board of Directors. For the purposes of this audit, we considered an executive to be an employee with the title of vice president or above.

To perform our audit, we reviewed TVA’s documentation of personnel who were classified as executives for the period March 2005 through May 2014. Also, we reviewed TVA’s recruiting, hiring, and severance expense information for executives who were hired and departed during the period. In summary, we found:

- As of March 1, 2005, TVA had 46 executives compared to 54 executives as of May 31, 2014. During the period, TVA hired 47 executives and promoted 55 employees to executive level positions. TVA also demoted and/or reclassified 15 executives to nonexecutive level positions and 79 executives departed TVA.
- Executives who were promoted from within appeared to remain a TVA executive longer than those who were hired from outside TVA.
- TVA incurred approximately \$7.4 million in recruiting, hiring, and severance expenses for 20 executives who were hired and also departed TVA during the period. We estimate it costs TVA an average of almost \$400,000 when an executive leaves TVA and another executive is recruited and hired to fill the vacancy.

We also compared the number of TVA’s executive departures as reported to the Securities and Exchange Commission (SEC) to the reported departures of TVA’s compensation peer group for the period of January 2007 through May 2014. Although we found TVA reported more executive departures than most of the peers, companies may interpret SEC filing requirements differently, making it difficult to ensure the information reported by TVA’s peer group was consistent with TVA’s reporting.

BACKGROUND

Over the last 10 years, TVA has had seven restructurings with three of those being major reorganizations. In 2004, TVA's corporate governance structure was changed by Congress for the first time in TVA's history through legislation that established a nine-member part-time TVA Board in place of the three-member full-time TVA Board. Whereas the previous three full-time members were tasked with daily management responsibility, the new corporate-like part-time body of nine members was tasked with setting agency policy and direction. The TVA Board appoints a Chief Executive Officer to oversee the day to day operations. In March 2005, TVA hired Tom D. Kilgore as President and Chief Operating Officer. He was appointed as TVA's first Chief Executive Officer in October 2006.

Among the duties of the TVA Board is the responsibility for approving the Compensation Plan for TVA employees. The Compensation Plan is based on an annual survey of the prevailing compensation for similar positions in private industry, including engineering and electric utility companies, publicly-owned electric utilities, and federal, state, and local governments. The compensation peer group is the comparator group used to establish market references for executive compensation. The compensation peer group consists of 24 companies.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our audit objective was to review the costs associated with the hiring and dismissal of executives brought in from outside TVA since the change to TVA's part-time Board. For the purposes of this audit, we considered an executive to be an employee with the title of vice president or above. The objective of this audit was not related to TVA's system of internal control; therefore, internal controls were not tested as part of this audit. To achieve our audit objective, we:

- Obtained information from TVA concerning executives who were hired and/or terminated during the audit period.
- Analyzed information received, identified retention periods, and reviewed any documented causes for terminations to identify trends.
- Reviewed publically available information from TVA's fiscal year (FY) 2014 compensation peers to compare TVA's retention of executives to those peers where possible.
- Obtained and analyzed cost information related to recruitment, retention, and termination of identified executives to identify overall and average costs associated with recruiting and terminating TVA executives.

The scope of our audit was TVA employees in the position of vice president or above who were hired or terminated from March 2005 through May 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit

objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions.

FINDINGS

TVA provided listings of personnel classified as executives for the period of March 2005 through May 2014 and recruiting, hiring, and severance expense information for executives who were hired and departed during the period. We summarized and analyzed the information provided and found the following:

- At the beginning of the period, March 1, 2005, TVA had 46 executives compared to 54 executives at the end of the period, May 31, 2014.
- TVA hired 47 executives and promoted 55 employees to executive level positions between March 2005 and May 2014. TVA also demoted and/or reclassified 15 executives to nonexecutive level positions and 79 executives departed TVA. Resignations and no-fault separations accounted for the majority of the noted reasons or departure.
- Executives who were promoted from within appear to remain a TVA executive longer than those who were hired from outside TVA. Employees who were promoted to the executive level remained a TVA executive for an average of 7 years while executives hired from outside TVA remained a TVA executive for an average of 5 years.
- For 20 executives who were hired and also departed during the period, TVA incurred expenses of approximately \$7.4 million in recruiting, hiring, and severance expenses. Excluding retirements, we estimate it costs TVA an average of almost \$400,000 when an executive leaves TVA and another executive is recruited and hired to fill the vacancy.

Using SEC filings for TVA and TVA's compensation peer group, we also compared TVA's reported executive departures to the peers' reported executive departures for the period of January 2007 through May 2014. We found TVA reported more executive departures than most of the peers and more than the average departures for all of the peers. However, companies may interpret SEC filing requirements differently, making it difficult to ensure TVA's peer group members' reported terminations, retirements, and resignations are consistent with TVA's reporting. Additionally, because of the limited amount of publicly available information on TVA's peers' corporate structures, we were unable to draw comparisons between the peer group and TVA's corporate structures and the percentages of high-level executive departures.

TVA EXECUTIVE TURNOVER

TVA provided listings of executives for the period of March 2005 through May 2014. On March 1, 2005, TVA had 46 executives compared to 54 executives on May 31, 2014. During the period, 47 executives were hired, 55 employees were promoted to executive positions, 15 executives were demoted and/or reclassified to nonexecutive positions, and 79 executives departed TVA.

Explanations for executive departures were limited to the reason codes assigned in TVA's People Lifecycle Unified System. For the 79 executives who departed TVA from March 2005 through May 2014, resignations and no-fault separations accounted for the majority (i.e., 63 percent) of the noted reasons for departure. Specifically, 34 executives (i.e., 43 percent) were noted as resignations, 16 executives (i.e., 20 percent) were noted as no-fault separations, and 24 executives (i.e., 30 percent) were noted as retirements. The reasons noted for departure of the remaining 5 executives (i.e., 6 percent) were involuntary reduction in force, discharge, or death. According to TVA's Senior Vice President, Human Resources and Communications, no-fault separations were used as a tool in the most recent reorganizations. We noted the highest number of departures occurred in calendar years 2008, 2012, and 2013. Figure 1 illustrates executive departures over the period.

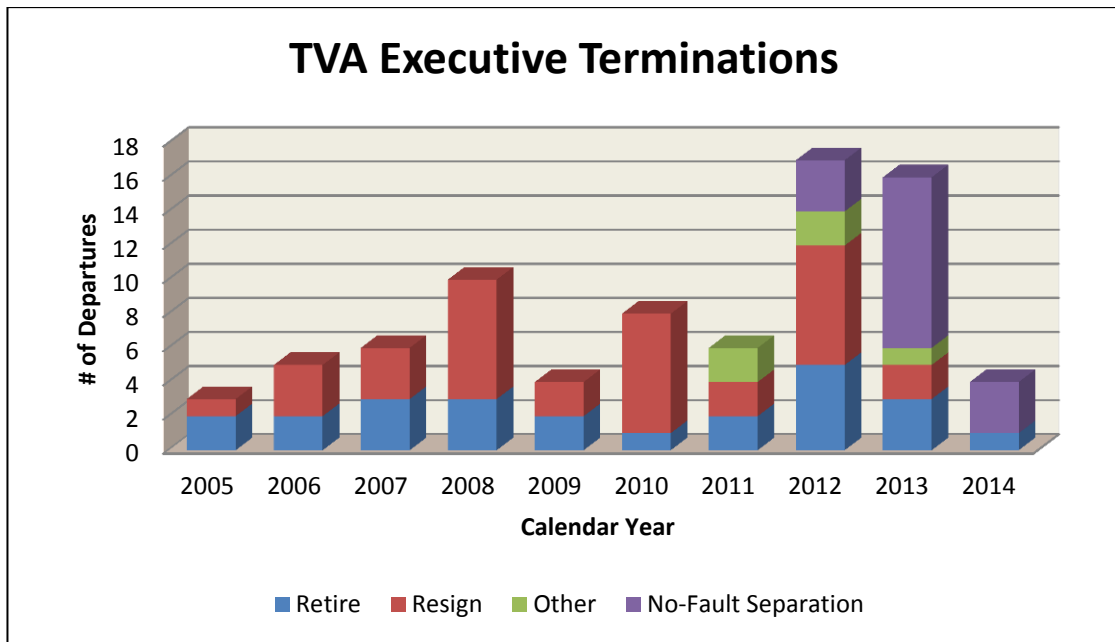


Figure 1

EXECUTIVES PROMOTED FROM WITHIN STAY LONGER THAN EXTERNAL HIRES

Executives who were promoted from within appear to remain a TVA executive longer on average than those hired from outside TVA. We calculated the average tenure as an executive for all of the 79 executives who departed during the period and also those 15 who were demoted and/or reclassified from an executive position. We found 56 of those 94 executives were promoted to the executive level and remained a TVA executive for an average of 7 years. The other 38 of those 94 executives were hired from outside TVA and remained a TVA executive for an average of 5 years. We also noted that less than half of the 47 executives hired between March 2005 and May 2014 remained a TVA executive as of May 31, 2014.¹

¹ The Office of the Inspector General (OIG) currently has two audits scheduled for FY2015 to address key initiatives for retention of TVA executives, the Supplemental Executive Retirement Plan and TVA's Executive Incentives.

In recent years it appears TVA has made filling executive positions internally a priority. A previous OIG Evaluation report on TVA's Succession Planning noted that in 2011 TVA began using metrics to track succession planning at the executive level.² One of the metrics tracked is key positions filled with succession planning candidates. The majority of key positions identified are executive level positions. The established goals for key positions filled with succession planning candidates were 75 percent in 2012 and 80 percent in 2013.

EXPENSES OF RECRUITING, HIRING, AND TERMINATING EXECUTIVES

We requested recruiting, hiring, and severance expense information from TVA for the 23 executives who were hired and also departed between March 2005 and May 2014. TVA provided the requested information for 20 of those executives with the exception of actual relocation expenses. To calculate total hiring costs where actual cost information was not available, we used estimated relocation costs based on the type of relocation offered to each executive.

In total, TVA incurred approximately \$7.4 million in recruiting, hiring, and severance expenses for the 20 executives. Recruiting and hiring expenses accounted for approximately \$4.2 million of the total which is an average of about \$210,000 per executive. Severance expenses accounted for the remaining \$3.2 million, which is an average of about \$161,000 per executive. When retirements were excluded from the calculations, the average severance expense rose to about \$189,000 per executive.

Using the information above, we estimate it costs TVA an average of almost \$400,000 when an executive leaves TVA for reasons other than retirement, and another executive is recruited and hired to fill the vacancy. In addition to monetary expenses, there are qualitative costs associated with executive turnover such as negatively impacting employee trust and morale and TVA's overall productivity.

TVA'S REPORTED EXECUTIVE DEPARTURES HIGHER THAN PEER AVERAGE

As previously stated, the compensation peer group consists of 24 companies and is the comparator group used to establish market references for executive compensation. Almost all of the companies listed in the compensation peer group are listed or file reports with the SEC.³ Companies file a current report (i.e., Form 8-K) with the SEC if a high-level executive retires, resigns, or is terminated. According to the filing instructions for the Form 8-K, companies must disclose when the principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer, retires, resigns, or is terminated from that position. However, companies may interpret the Form 8-K filing requirements differently, making it difficult to ensure TVA's peer group members' reported terminations, retirements, and resignations under Item 5.02(b) of Form 8-K reporting requirements are consistent with TVA's reporting.

² OIG Evaluation 2013-14950, Review of TVA's Succession Planning, issued September 19, 2013.

³ One international company did not appear to be required to file reports with the SEC.

We obtained 8-K filings for TVA and the 23 companies in TVA's compensation peer group and compared the number of reported executive departures. TVA began voluntarily filing reports with the SEC beginning in January 2007; therefore, we restricted our comparison period to January 2007 through May 2014. While we could determine the number of high-level executive departures at each company, public information was not available on how many high-level executive positions exist at each company. Therefore, we were unable to draw comparisons between the peer group and TVA's corporate structures and the percentages of high-level executive departures.

We summarized the number of departures per company, including TVA, in the respective 8-K filings. We found TVA reported more executive departures than most of the compensation peers. Specifically, TVA reported 8 departures while the 23 compensation peers had an average of 5 departures. The compensation peers reported a range from 1 to 10 departures per company for the time period. TVA's reported departures are higher than 78 percent of the compensation peers overall. Figure 2 illustrates TVA's reported departures compared to the compensation peers.

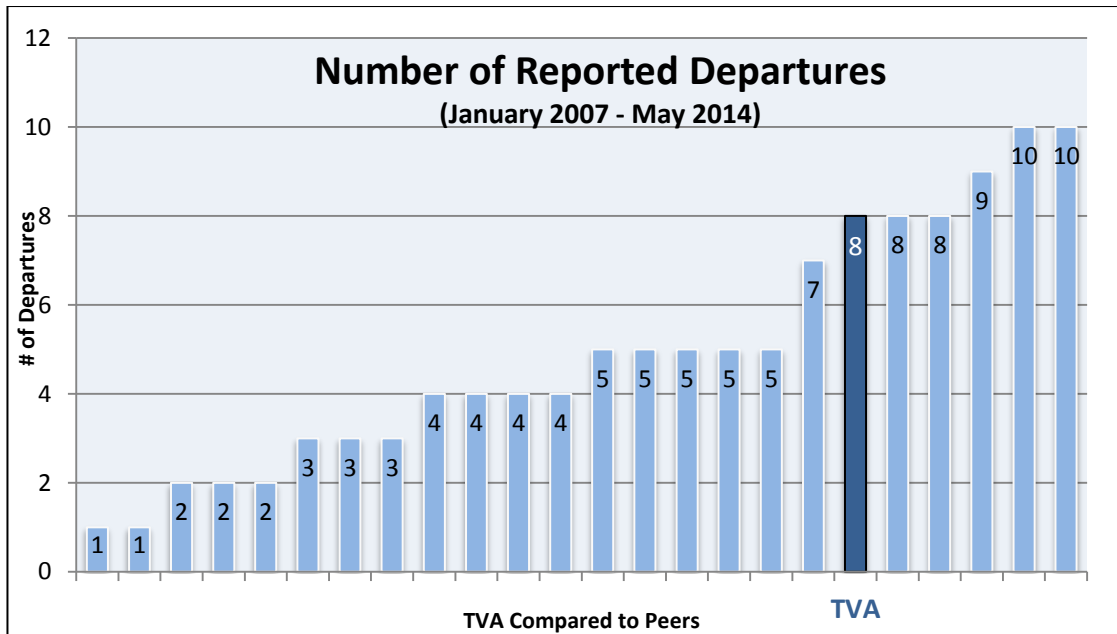


Figure 2

In summary, TVA has had a high level of executive turnover since the change to TVA's part-time Board structure. If TVA continues with their recent commitment to place a greater emphasis on succession planning for key positions, the high level of executive turnover may be reduced in the future.

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This report is for your review and information. No response to this report is necessary. Information contained in this report may be subject to public disclosure. Please advise us of any sensitive information that you recommend be withheld. If you have any questions or wish to discuss our observations, please contact me at (865) 633-7373 or Rick C. Underwood, Director, Corporate Governance and Finance Audits, at (423) 785-4824. We appreciate the courtesy and cooperation received from your staff during the audit.



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