

2011 TVA Retirement System Year in Review

In 2011 the TVA Retirement System (TVARS or System) Board focused on strengthening our investment and risk management processes, our governance practices and policies, and our communication efforts. This letter is a summary of our work in those areas and other items of interest.

Investment and Risk Management

Over the long-term, the allocation of the System's assets is expected to be the single greatest contributor of return and risk to the Retirement System. On September 15, 2011, the TVARS Board reviewed and approved a new long-term asset allocation policy and investment strategy for fund assets. The asset allocation policy reflects the TVARS Board's decisions about what proportions of the Retirement System's assets shall be invested in various asset classes. In reaching this decision, the TVARS Board spent six months analyzing various asset allocation and investment strategies with the assistance of System staff; the System's investment consultant, Wilshire Associates; Michael Brakebill, a non-voting member and advisor to the Investment Committee; and other outside experts.

The asset allocation determination process involved the review of long-term expected returns, risks, and correlations of various asset classes. As a part of this new asset allocation policy and investment strategy, the TVARS Board has adopted a "de-risking" strategy focused on the volatility of the System's funded status. The objective of the de-risking strategy is to reduce the volatility of the funded status of the System over time as funded status improves. Additional information about this process can be found in the Investment Policy on the TVARS website.

Investment performance for fund assets was positive for fiscal year and calendar year 2011 in a difficult market environment. Political gridlock in Washington over the U.S. debt ceiling led to the first downgrade of U.S. debt by Standard & Poor's (S&P) from AAA to AA+. The debt crisis in Europe continued with many countries requiring assistance to avoid debt defaults. The domestic and international economy remains challenging. This resulted in significant financial market volatility. The domestic equity market as measured by the S&P 500 was down 16 percent from May to September 2011. Over the same period, international equity markets as measured by various indices declined 23 percent. For the fiscal year ended September 30, 2011, TVARS earned 1.44 percent, a level that ranked TVARS in the top 23rd percentile compared to other public plan sponsors. TVARS outperformed 77 percent of the other 157 public plans in the database. For the calendar year, the fund earned an estimated 0.80 percent vs. the policy benchmark return of 0.13 percent. Investment earnings for the calendar year totaled approximately \$81 million, with approximately \$600 million paid in benefits to retirees and beneficiaries.

In September 2011, TVA contributed \$270 million to the System. As part of TVA's budget approvals for fiscal year 2012, the TVA Board of Directors approved delegations of authority to TVA's Chief Executive Officer that allow the CEO to approve discretionary contributions by TVA to the System for fiscal year 2012 up to \$300 million.

Board Governance

One of the major initiatives for the TVARS Board in 2011 was to strengthen Board governance and organizational performance. In November 2010, the TVARS Board hired Hewitt EnnisKnupp to provide fiduciary training and assist the Board in developing governance policies. The governance policies will establish a framework by which the TVARS Board operates, allowing the Board to carry out its responsibilities as prudently as possible. Below is a brief description of each governance policy adopted in 2011.

Investment Policy (Amended September 15, 2011)

This policy defines the investment objectives and policies for the management and oversight of TVARS assets. It sets forth the objectives of the System, the strategies to achieve these objectives, procedures

for monitoring and control, and the duties and responsibilities of the various entities responsible for the System's investments.

Service Provider Evaluation and Interaction Policy (Adopted April 22, 2011)

This policy establishes guidelines within which the Board will evaluate, communicate with, and interact with current and potential service providers, including the System's actuary, investment consultant(s), custodians, recordkeepers, auditors, outside legal counsel, and investment managers.

Ethics and Code of Conduct Policy (Adopted April 22, 2011)

This policy is intended to provide Directors and System staff with further guidance, in addition to the Standards of Ethical Conduct as issued by the Office of Government Ethics, on expected actions and reporting requirements related to ethics and conduct when acting in their official capacities as System Directors and staff.

Board Self Evaluation Policy (Adopted June 17, 2011)

This policy provides all Directors an opportunity to evaluate and discuss the Board's performance with candor and from multiple perspectives. The Board believes this regular evaluation process will increase the effectiveness of the Board as a governing body.

Executive Secretary Evaluation Policy (Adopted December 2, 2011)

This policy is to help support and guide the Board's oversight, supervision, and evaluation of the performance of the Executive Secretary.

Director Election/Selection Policy (Adopted December 2, 2011)

This policy provides guidance, in addition to the System's Rules and Regulations, in the election/selection process of Directors. The Board recognizes the importance of Director elections and the selection of the 7th Director and strives to ensure processes related to filling open Director positions are fair, efficient, and in the best interest of the members, retirees, and beneficiaries.

Governance Policy (Adopted December 2, 2011)

This policy is intended to establish the general governance framework in which the Board will operate to carry out its responsibilities in an appropriate and efficient manner in accordance with the System's Rules and Regulations, Bylaws, other System policies, and applicable laws.

Board Education Policy (Adopted December 2, 2011)

This policy ensures that all Directors have an appropriate understanding of the issues facing the System and their responsibilities as Directors so that they may properly oversee the administration of the System. Education is essential in ensuring that all Directors have the knowledge necessary to carry out their duties and to comply with the Rules and Regulations governing the System.

Administrative Claims and Appeals Procedures

The Board established Administrative Claims and Appeals Procedures, which are specific procedures within the Rules detailing how members, retirees, or beneficiaries file a claim or appeal with TVARS and how such claim or appeal will be reviewed. The Board adopted similar Administrative Claims and Appeals Procedures for the 401(k) Plan.

Annual Audits

An important part of the TVARS Board's governance and oversight duties is the annual audit to assess controls related to System operations. For the period from August 1, 2010, to July 31, 2011, E. H. Johnson & Company, P.C., conducted an assessment of the System's controls (SSAE 16 audit report). The report resulted in no significant findings and was accepted by the Board.

Crowe Horwath LLP is currently auditing the System's financial statements for the fiscal year ended September 30, 2011. A detailed description of the audited financial statements will be provided in the 2011 TVARS Annual Report, which will be available in April.

Legal Representation

The TVARS Board approved an engagement letter with the law firm Bradley Arant Boult Cummings to serve as outside legal counsel regarding administration, operation, and maintenance of the System. As previously communicated, the TVARS Board hired Bradley Arant Boult Cummings to represent the System in the lawsuit related to August 2009 amendments to the TVARS Rules and Regulations which, among other things, made changes to the cost-of-living adjustments (COLA) over a four-year period (2010-2013).

Lawsuit Update

In *Duncan, et al. v. TVA and TVARS*, Plaintiffs, TVA, and TVARS recently joined in asking the Court to extend the various case deadlines to allow the parties four additional months to continue to discuss settlement of the parties' claims. On December 21, 2011, the Court granted the parties' request.

Communication

In cooperation with the TVA Retirees Association (TVARA), the TVARS Board implemented a communication plan during 2011. The TVARS Board provided greater visibility to both retirees and employees by providing timely information that may impact members and retirees. The Board utilized both the TVA Today newsletter and TVARS website for employee communications, while providing updates via the TVARA newsletter and chapter meetings to communicate with retirees.

401(k) Plan Offerings

Beginning in 2012, TVARS and Fidelity Investments added a managed account option, the Portfolio Advisory Service at Work (PASW), to the 401(k) Plan. The managed account option is a fee-based option that includes professional guidance with your financial portfolio. All participants with a balance in the 401(k) Plan were mailed an introduction letter regarding the PASW option in December 2011.

Board Composition

During 2011, the three elected and three appointed directors selected Allen Stokes as the 7th Director. The selection of Mr. Stokes strengthened the Board, completing the seven-member governance structure mandated by the Rules. Mr. Stokes is a current TVA retiree, having last served as senior manager of Special Projects in Human Resources' Information Services. Tony Troyani was re-elected to the TVARS Board for a three-year term ending October 31, 2014. At the December 2011 quarterly Board meeting, Les Bays and Allen Stokes were selected chair and vice chair of the Board, respectfully.

Elected by Membership (3 directors)

Les Bays	(elected 06/13/2008)
Leonard Muzyn	(elected 11/01/2003)
Tony Troyani	(elected 11/01/2008)

Appointed by TVA (3 directors)

Janet Herrin	(appointed 05/16/2005)
John Hoskins	(appointed 07/28/2003)
Tammy Wilson	(appointed 05/10/2010)

Selected by Board Members (1 director)

Allen Stokes	(selected 03/08/2011)
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Summary

While 2011 was not a particularly good year for absolute investment performance, relative performance to the policy benchmark and other plans was very good during a period of extreme market volatility. The TVARS Board made excellent progress in the areas of investment strategy, risk management, Board governance, and communication, and we plan to continue that progress in 2012.