

U.S.\$500,000,000

Tennessee Valley Authority

4.70% Global Power Bonds 2003 Series B Due July 15, 2033



Interest Payable January 15 and July 15

The 4.70% Global Power Bonds 2003 Series B Due July 15, 2033 (the "Bonds") of the Tennessee Valley Authority ("TVA") will not be subject to redemption prior to maturity. The Bonds will be issued in minimum denominations of U.S.\$1,000 and integral multiples thereof.

The Bonds will be issued, maintained and transferred only on the book-entry system of the U.S. Federal Reserve Banks as described herein. Transactions in the Bonds will be cleared and settled in book-entry form by Euromarket participants through the facilities of Clearstream, Luxembourg (as defined herein) and Euroclear (as defined herein). See "Clearance and Settlement." The Bonds will not be exchangeable for definitive securities.

The Bonds may be separated ("stripped") into their separate Interest and Principal Components (as defined herein) and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. The components of each stripped Bond are: each future interest payment (each an "Interest Component") and the principal payment (the "Principal Component") and, together with the Interest Components, hereinafter collectively referred to as the "Strips" or "Interest and Principal Components"). See "Description of Bonds" — "Stripping" and "United States Tax Matters."

Application has been made to list the Bonds on the Luxembourg Stock Exchange and the New York Stock Exchange (collectively, the "Stock Exchanges"). Application also has been made to list the Strips on the Luxembourg Stock Exchange.

The Bonds and Strips are considered to be obligations in registered form for United States federal tax purposes. Beneficial owners of the Bonds or Strips that are not United States persons must certify that they are non-United States persons in order to receive payments on the Bonds or Strips free of United States withholding tax. See "United States Tax Matters." TVA will not pay additional interest or other amounts in respect of any withholding or other tax that may be imposed by any jurisdiction on payments on the Bonds or Strips as a result of a change in law or otherwise.

TVA is a wholly owned corporate agency and instrumentality of the United States of America and has no subsidiaries. Principal and interest will be payable solely from TVA's Net Power Proceeds (as defined herein).

The Bonds will not be obligations of, nor will payment of the principal thereof or the interest thereon be guaranteed by, the United States of America. TVA is not required and does not intend to register the Bonds under the U.S. Securities Act of 1933 or to file periodic reports with the U.S. Securities and Exchange Commission under the U.S. Securities Exchange Act of 1934.

	Price to Public(1)	Discount to Managers	Net Proceeds to TVA(1) (2)
Per Bond	99.677%	.400%	99.277%
Total	U.S.\$498,385,000	U.S.\$2,000,000	U.S.\$496,385,000

- (1) Plus accrued interest, if any, from June 23, 2003 to date of delivery.
(2) Before deducting expenses payable by TVA estimated at U.S.\$250,000.

The Bonds offered by this Offering Circular are offered by the Managers (as defined herein) subject to prior sale, withdrawal, cancellation or modification of the offer without notice, to delivery to and acceptance by the Managers and to certain further conditions. It is expected that delivery of the Bonds, in book-entry form, will be made through the book-entry system of the U.S. Federal Reserve Banks on or about June 23, 2003, against payment therefor in immediately available funds.

Joint Book-running Managers

BEAR, STEARNS & CO. INC.

LEHMAN BROTHERS

The date of this Offering Circular is June 16, 2003.

LEHMAN BROTHERS INC. MAY ENGAGE IN TRANSACTIONS THAT STABILIZE, MAINTAIN OR OTHERWISE AFFECT THE PRICE OF THE BONDS. SPECIFICALLY, LEHMAN BROTHERS INC. MAY OVERALLOT IN CONNECTION WITH THE OFFERING AND MAY BID FOR, AND PURCHASE, BONDS IN THE OPEN MARKET AND MAY IMPOSE PENALTY BIDS. SUCH TRANSACTIONS MAY BE EFFECTED IN AN OVER-THE-COUNTER MARKET OR OTHERWISE.

Neither of the Stock Exchanges takes any responsibility for the correctness of any statements made or opinions expressed in this Offering Circular or any other document incorporated by reference herein or makes any representation as to its accuracy or completeness. Each of the Stock Exchanges expressly disclaims any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of this Offering Circular or any other document incorporated by reference herein. Neither the quotations of, or permission to deal in, the Bonds nor an admission to the official lists of either of the Stock Exchanges should be taken as an indication of the merits of TVA or the Bonds.

No dealer, salesperson or any other person has been authorized by TVA to give any information or to make any representations on behalf of TVA other than those contained in this Offering Circular, the current Quarterly Report (as defined herein), the current Information Statement (as defined herein), or any supplement to any of the foregoing prepared by TVA for use in connection with the offer made by this Offering Circular and, if given or made, such information or representations must not be relied upon as having been authorized by TVA. Neither the delivery of this Offering Circular, the current Quarterly Report or the current Information Statement nor any sale of Bonds described herein shall under any circumstances create an implication that the information provided herein is correct at any time subsequent to its date, and TVA assumes no duty to update this Offering Circular, the current Quarterly Report or the current Information Statement except as it deems appropriate. This Offering Circular does not constitute an offer to sell or a solicitation of an offer to buy the Bonds described herein in any jurisdiction to any person to whom it is unlawful to make such offer or solicitation in such jurisdiction.

The distribution of this Offering Circular and the offering of the Bonds may, in certain jurisdictions, be restricted by law. Persons into whose possession this Offering Circular comes are required by TVA and the Managers to inform themselves of and observe all such restrictions.

This Offering Circular should be read in conjunction with TVA's Power Quarterly Report for the quarterly period ended March 31, 2003 (the "current Quarterly Report") and TVA's current Information Statement, dated January 13, 2003 (the "current Information Statement"), which are attached hereto and incorporated herein. Any statement contained in the current Quarterly Report or the current Information Statement shall be deemed to be modified or superseded for all purposes of the current Quarterly Report, the current Information Statement, and this Offering Circular to the extent that a statement contained in this Offering Circular modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified, to constitute a part of the current Quarterly Report or the current Information Statement. Additional copies of this Offering Circular, the current Quarterly Report and the current Information Statement may be obtained (free of charge) upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations, or by calling 1-888-882-4975 in the United States. Copies may also be obtained (free of charge) from Kredietbank S.A. Luxembourgeoise (the "Special Agent" or "Listing Agent"), 43 Boulevard Royal L-2955, Luxembourg, R.C. Luxembourg B6395. The then-current Information Statement and other information concerning TVA may be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

This Offering Circular has been prepared by TVA solely for use in connection with the offering of the Bonds described herein and for purposes of listing the Bonds on the Stock Exchanges. TVA has taken reasonable care to ensure that the information contained in this Offering Circular is true and accurate in all material respects and that there are no material facts the omission of which would make misleading any statements herein, in light of the circumstances under which such statements are made. TVA accepts responsibility accordingly.

In this Offering Circular, the current Quarterly Report and the current Information Statement, references to “U.S. dollars,” “U.S.\$,” “dollars” and “\$” are to United States dollars.

FORWARD-LOOKING STATEMENTS

This Offering Circular, the current Quarterly Report and the current Information Statement contain forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions or assumptions or otherwise relating to future events or performance may be forward-looking.

In certain cases, forward-looking statements can be identified by the use of words such as “may,” “will,” “should,” “expect,” “anticipate,” “believe,” “intend,” “project,” “plan,” “predict,” “assume,” “estimate,” “objective,” “possible,” “potential” or other similar expressions. Some examples of forward-looking statements include statements regarding TVA’s projections of future power and energy requirements; future costs related to environmental compliance; impacts of potential legislation on TVA and the likelihood of enactment of such legislation; strategic objectives; anticipated availability of nuclear waste storage facilities; projections of nuclear decommissioning costs; and impacts of pending litigation and various administrative orders which have been or may be issued.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations and administrative orders, especially those related to the restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA’s generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; changes in accounting standards; and unforeseeable events. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA’s business or cause results to differ from those contained in any forward-looking statement.

TVA undertakes no obligation to update any forward-looking statement to reflect developments that occur after the statement is made.

TABLE OF CONTENTS

Offering Circular

	<u>Page</u>
Forward-Looking Statements	C-4
Summary of Offering	C-6
Tennessee Valley Authority	C-10
Use of Proceeds	C-10
Recent Developments	C-11
Description of Bonds	C-13
Clearance and Settlement	C-17
Legality of Investment in the United States	C-19
United States Tax Matters	C-19
Subscription and Selling	C-27
General Information	C-29
Validity of Bonds	C-30

Power Quarterly Report for the Quarterly Period Ended March 31, 2003

Forward-Looking Statements	1
FINANCIAL INFORMATION	
Financial Statements	2
Statements of Income—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	2
Balance Sheets—Power Program (unaudited) as of March 31, 2003 and September 30, 2002	3
Statements of Cash Flows—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	4
Statements of Changes in Proprietary Capital—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	5
Statements of Comprehensive Income (Loss)—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	5
Notes to Financial Statements (unaudited)	6
Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Qualitative and Quantitative Disclosures about Market Risk	16
Controls and Procedures	17
OTHER INFORMATION	
Legal Proceedings	18
Debt Securities	18
Board Actions	19
Other Information	19
Subsequent Events	21
CERTIFICATIONS	22
CONTACT INFORMATION	24

Information Statement

PART I

Business	1
Properties	5
Legal Proceedings	7
Certain Provisions of the Tennessee Valley Authority Act and Related Legislation	8
The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness	11

PART II

Selected Financial Data	16
Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Qualitative and Quantitative Disclosures about Market Risk	37
Financial Statements and Supplementary Data	46
Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	74

PART III

Directors and Executive Officers	74
Controls and Procedures	76

PART IV

Statistical & Financial Summaries	76
Certifications	79

SUMMARY OF OFFERING

The information below is qualified in its entirety by the detailed information appearing in TVA's current Quarterly Report and TVA's current Information Statement (and any supplements thereto) and elsewhere in this Offering Circular. Capitalized terms used and not defined herein have the meanings defined in the current Information Statement and elsewhere in this Offering Circular.

Issuer	TVA is a wholly owned corporate agency and instrumentality of the United States of America established by the Tennessee Valley Authority Act of 1933, as amended.
Capitalization	Total capitalization of TVA at March 31, 2003, as adjusted for the Bonds offered hereby, would have been U.S.\$26,290 million. In addition, since March 31, 2003, and through the date of this Offering Circular, TVA has issued U.S.\$107 million of Power Bonds and £150 million of Power Bonds for power program purposes and has redeemed U.S.\$146 million of Power Bonds. Except as set forth above, there has been no material change in TVA's capitalization since March 31, 2003.
Securities Offered	U.S.\$500,000,000 aggregate principal amount of 4.70% Global Power Bonds 2003 Series B Due July 15, 2033 (the "Bonds").
Interest	The Bonds will bear interest from June 23, 2003, at the annual rate set forth on the cover page hereof, payable semiannually in arrears on each January 15 and July 15, commencing January 15, 2004.
Redemption	The Bonds will not be subject to redemption prior to maturity.
Fiscal Agent	U.S. Federal Reserve Banks.
Listing	Application has been made to list the Bonds on the Luxembourg Stock Exchange and the New York Stock Exchange. Application also has been made to list the Strips on the Luxembourg Stock Exchange.
Use of Proceeds	The net proceeds received by TVA from the sale of the Bonds will be used for power program purposes.
Source of Payment	The interest and principal on the Bonds are payable solely from Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" in Part I of the current Information Statement.
Form and Denomination of Bonds ..	The Bonds will be issued and maintained and may be transferred by Holders (as defined herein) only on the book-entry system of the U.S. Federal Reserve Banks. See "Description of Bonds" — "Book-Entry System." The Bonds will not be exchangeable for definitive securities. The Bonds will be issued and must be maintained and transferred in minimum denominations of U.S.\$1,000 and integral multiples thereof.
Stripping	The Bonds may be stripped into their separate Interest and Principal Components and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. The components of each stripped Bond are: each future interest payment and the principal payment. Each Interest Component and the Principal Component will have a Common Code, an identifying designation and CUSIP number. See "Description of Bonds" — "Stripping" and "United States Tax Matters."

Delivery of Strips	The Managers immediately upon their acceptance of the Bonds may, but are not obligated to, strip some or all of the Bonds and deliver Strips rather than Bonds to investors purchasing Strips. Sales of any such Strips would be at negotiated prices. See “Subscription and Selling.” In addition, a Holder may strip Bonds at any time prior to maturity. See “Description of Bonds” — “Stripping.”
Clearance and Settlement	The Bonds must be held in accounts with institutions having access in the United States to the book-entry system of the U.S. Federal Reserve Banks. Transactions in the Bonds will be cleared and settled by Euromarket participants through the facilities of Euroclear and Clearstream, Luxembourg. See “Clearance and Settlement.”
Legality of Investment in the United States	Each person or entity is advised to consult with its own counsel with respect to the legality of investment in the Bonds or in Strips, which could be subject to restrictions or requirements that do not apply to Power Bonds held in their fully constituted form. The following generally describes the legality of investment in the United States in TVA Power Bonds in their fully constituted form. Power Bonds are: • acceptable as security for all fiduciary, trust and public funds, the investment or deposit of which shall be under the authority or control of any officer or agency of the United States of America; • eligible as collateral for U.S. Treasury tax and loan accounts; • among those obligations which U.S. national banks may deal in, underwrite and purchase for their own accounts in an amount up to 10 percent of unimpaired capital and surplus; • eligible as collateral for advances by U.S. Federal Reserve Banks to member banks; • legal investments for U.S. federal savings associations and U.S. federal savings banks to the extent specified in applicable regulations; • eligible as collateral for advances by U.S. Federal Home Loan Banks to members for which Power Bonds are legal investments; and • legal investments for U.S. federal credit unions, subject to applicable regulations. See “Legality of Investment in the United States.”
No Acceleration Rights	The Bonds will not contain any provisions permitting the Holders to accelerate the maturity thereof on the occurrence of any default or other event. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Events of Default” in Part I of the current Information Statement.
Taxation	United States federal income tax generally will not be withheld from payments on Bonds or Strips that are beneficially owned by non-U.S. beneficial owners (as defined under “United States Tax Matters”), provided that an appropriate United States Internal Revenue Service Form W-8BEN (or other appropriate form) is completed and provided. See “United States Tax Matters.” The

Bonds are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA will have no obligation to pay additional interest or other amounts in respect of any such tax that may be imposed on payments on the Bonds or Strips as a result of a change in law or otherwise, including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form. For further discussion of United States tax consequences with respect to the purchase, ownership or disposition of the Bonds and Strips, see “United States Tax Matters.”

Common Code 017126580
 ISIN US880591DV18
 CUSIP Number 880591DV1

If the Bonds are stripped into their separate Interest and Principal Components, the following Common Code, ISIN and CUSIP numbers will apply:

	<u>Common Code</u>	<u>ISIN</u>	<u>CUSIP</u>
Interest Components			
July 15, 2004	13373477	US88059E LP78	88059E LP7
January 15, 2005	17138979	US88059E LQ51	88059E LQ5
July 15, 2005	17138995	US88059E LR35	88059E LR3
January 15, 2006	17139029	US88059E LS18	88059E LS1
July 15, 2006	17139037	US88059E LT90	88059E LT9
January 15, 2007	17139053	US88059E LU63	88059E LU6
July 15, 2007	17139070	US88059E LV47	88059E LV4
January 15, 2008	16596221	US88059E LW20	88059E LW2
July 15, 2008	17139100	US88059E LX03	88059E LX0
January 15, 2009	17139169	US88059E LY85	88059E LY8
July 15, 2009	17139185	US88059E LZ50	88059E LZ5
January 15, 2010	17139223	US88059E MA90	88059E MA9
July 15, 2010	17139258	US88059E MB73	88059E MB7
January 15, 2011	17139606	US88059E MC56	88059E MC5
July 15, 2011	17139614	US88059E MD30	88059E MD3
January 15, 2012	17139649	US88059E ME13	88059E ME1
July 15, 2012	17139673	US88059E MF87	88059E MF8
January 15, 2013	17139690	US88059E MG60	88059E MG6
July 15, 2013	17139720	US88059E MH44	88059E MH4
January 15, 2014	17139797	US88059E MJ00	88059E MJ0
July 15, 2014	17139851	US88059E MK72	88059E MK7
January 15, 2015	17139894	US88059E ML55	88059E ML5
July 15, 2015	17140221	US88059E MM39	88059E MM3
January 15, 2016	17140302	US88059E MN12	88059E MN1
July 15, 2016	17140361	US88059E MP69	88059E MP6
January 15, 2017	17140582	US88059E MQ43	88059E MQ4
July 15, 2017	17140655	US88059E MR26	88059E MR2
January 15, 2018	17140728	US88059E MS09	88059E MS0
July 15, 2018	17140752	US88059E MT81	88059E MT8
January 15, 2019	17140825	US88059E MU54	88059E MU5
July 15, 2019	17140833	US88059E MV38	88059E MV3

	Common Code	ISIN	CUSIP
January 15, 2020	17140892	US88059E MW11	88059E MW1
July 15, 2020	17140914	US88059E MX93	88059E MX9
January 15, 2021	17140957	US88059E MY76	88059E MY7
July 15, 2021	17140981	US88059E MZ42	88059E MZ4
January 15, 2022	17141015	US88059E NA81	88059E NA8
July 15, 2022	17141058	US88059E NB64	88059E NB6
January 15, 2023	17141074	US88059E NC48	88059E NC4
July 15, 2023	17141082	US88059E ND21	88059E ND2
January 15, 2024	17141112	US88059E NE04	88059E NE0
July 15, 2024	17141139	US88059E NF78	88059E NF7
January 15, 2025	17141155	US88059E NG51	88059E NG5
July 15, 2025	17141171	US88059E NH35	88059E NH3
January 15, 2026	17141180	US88059E NJ90	88059E NJ9
July 15, 2026	17141198	US88059E NK63	88059E NK6
January 15, 2027	17141228	US88059E NL47	88059E NL4
July 15, 2027	17141309	US88059E NM20	88059E NM2
January 15, 2028	17141333	US88059E NN03	88059E NN0
July 15, 2028	17141368	US88059E NP50	88059E NP5
January 15, 2029	17141414	US88059E NQ34	88059E NQ3
July 15, 2029	17141872	US88059E NR17	88059E NR1
January 15, 2030	17141473	US88059E NS99	88059E NS9
July 15, 2030	17141503	US88059E NT72	88059E NT7
January 15, 2031	17141520	US88059E NU46	88059E NU4
July 15, 2031	17141546	US88059E NV29	88059E NV2
January 15, 2032	17141554	US88059E NW02	88059E NW0
July 15, 2032	17141562	US88059E NX84	88059E NX8
January 15, 2033	17141597	US88059E NY67	88059E NY6
July 15, 2033	17141643	US88059E NZ33	88059E NZ3
Principal Component	017127543	US88059F BK66	88059F BK6

TENNESSEE VALLEY AUTHORITY

The Tennessee Valley Authority is one of the nation's largest wholesale producers of electricity in the United States of America, having produced nearly 152 billion kilowatt-hours ("kWh") of electricity in fiscal 2002. The TVA system supplies electric power to a region containing about eight million people located in parts of Tennessee, Kentucky, Mississippi, Alabama, Georgia, North Carolina and Virginia.

TVA is a wholly owned corporate agency and instrumentality of the United States of America established pursuant to the Tennessee Valley Authority Act of 1933, as amended (the "Act"), primarily to develop and manage the resources of the Tennessee Valley region. Historically, the programs of TVA have consisted of power and nonpower programs. The Act requires TVA's electric system operations to be self-supporting from power system revenues, which were about \$6.8 billion in fiscal 2002. The U.S. Congress ("Congress") does not appropriate funds to TVA for its power program. The Act authorizes TVA to issue bonds, notes and other evidences of indebtedness, the proceeds of which TVA may only use to finance its power program. TVA's nonpower activities have included responsibilities associated with operation of the Tennessee River system, land management, economic development and the environment. While Congress historically appropriated amounts to fund TVA's nonpower programs (including \$50 million for fiscal 1999), Congress passed legislation in 1997 providing for the funding of these programs with revenues from TVA's power program and other TVA revenue sources when appropriations are insufficient. Consequently, during 2000, 2001 and 2002, TVA paid \$71 million, \$72 million and \$83 million, respectively, for essential stewardship activities primarily with power revenues. For a further discussion of this matter, see "Certain Provisions of the Tennessee Valley Authority Act and Related Legislation" — "Other Legislation" in Part I of the current Information Statement.

USE OF PROCEEDS

TVA will use the net proceeds from the sale of the Bonds of U.S.\$496,135,000 (after deducting expenses estimated to be U.S.\$250,000) for power program purposes.

RECENT DEVELOPMENTS

In June 2003, TVA issued in the public markets £150 million of Power Bonds (due 2043). At the time TVA issued these British pound sterling Evidences of Indebtedness, TVA entered into a currency swap agreement to hedge its currency risk.

Since March 31, 2003, TVA has sold five issues of electronotes® totaling \$107 million. During that same period, TVA redeemed four issues of electronotes® totaling \$123 million and also redeemed \$23 million of other Power Bonds. At May 31, 2003, TVA had short-term debt outstanding with the U.S. Treasury of \$150 million.

On June 11, 2003, John M. Hoskins assumed the position of Acting Chief Financial Officer in addition to his position as Senior Vice President and Treasurer. TVA is continuing its search for a permanent Chief Financial Officer.

As of March 31, 2003, the total amount of TVA's contingent liabilities was approximately \$8 million.

Accounting Changes

Effective October 1, 2002, the TVA Board of Directors (the "TVA Board") approved a change in the methodology for estimating unbilled revenue from electricity sales. The change was from a method using cumulative generation to a method using generation from the current billing period only as a basis for calculating the unbilled energy. The impact of this change resulted in an increase in accounts receivable of \$412 million with a corresponding cumulative effect gain for the change in accounting for unbilled revenue.

On October 1, 2002, TVA adopted Statement of Financial Accounting Standards ("SFAS") No. 143, *Asset Retirement Obligations*, which requires the recognition of a liability, and corresponding asset retirement unit, for "legal obligations" associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of long-lived assets. TVA identified and reviewed all relevant information in the determination of its potential asset retirement obligations ("AROs"). In accordance with the standard, TVA calculated the net present value of the obligations as of the current period, the original and incremental cost of the long-lived assets at the time of initial operation, and the cumulative effect of depreciation on the adjusted asset base and accretion of the liability from the date of initial operation to the current period. The effect of the adoption included a cumulative effect charge to income of \$178 million and a corresponding additional long-term liability of \$717 million in addition to an increase in assets of \$745 million and related accumulated depreciation of \$206 million. See Note 1 in the current Quarterly Report.

Pro forma net income amounts, assuming that the changes in accounting described above related to the adoption of SFAS No. 143 and the change in the methodology for estimating unbilled revenue had been applied retroactively, are as follows:

	For the Years Ended September 30		
	2002	2001	2000
	(In millions)		
Historical Net Income (Loss)	\$ 73	\$(3,311)	\$ 24
Accounting Changes:			
Adoption of SFAS No. 143	(10)	(10)	(10)
Unbilled Revenue	71	31	56
Pro Forma Net Income (Loss)	<u>\$134</u>	<u>\$(3,290)</u>	<u>\$ 70</u>

Amounts recorded prior to adoption of SFAS No. 143, which related to nuclear unit decommissioning obligations, and pro forma amounts of TVA's total asset retirement obligations, assuming that SFAS No. 143 had been adopted retroactively, are approximately as follows:

	<u>Historical</u>	<u>Pro forma</u>
	<u>(In millions)</u>	
September 30, 2002	\$891	\$1,607
September 30, 2001	804	1,521
September 30, 2000	742	1,440
October 1, 1999	882	1,363

DESCRIPTION OF BONDS

General

The Bonds are to be issued pursuant to authority vested in TVA by the Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution adopted on October 6, 1960, as amended on September 28, 1976, October 17, 1989 and March 25, 1992 (the “Basic Resolution”), and the Supplemental Resolution authorizing the Bonds adopted on June 16, 2003 prior to the pricing of the Bonds and the completion of this Offering Circular (the “Supplemental Resolution” and together with the Basic Resolution, the “Resolutions”). TVA has entered into a Fiscal Agency Agreement dated as of October 7, 1997 (the “Fiscal Agency Agreement”) with the U.S. Federal Reserve Banks, as fiscal agents (together, the “Fiscal Agent”). The U.S. Secretary of the Treasury has approved the time of issuance of, and the maximum rate of interest to be borne by, the Bonds in compliance with Section 15d(c) of the Act. The Bonds represent obligations of TVA payable solely from TVA’s Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America.

The Act authorizes TVA to issue and sell bonds, notes and other evidences of indebtedness (hereinafter collectively referred to as “Evidences of Indebtedness”) to assist in financing its power program and to refund such Evidences of Indebtedness. Evidences of Indebtedness issued pursuant to Section 2.2 of the Basic Resolution designated as Tennessee Valley Authority Power Bonds are herein referred to as “Power Bonds.” The aggregate amount of Evidences of Indebtedness at any one time outstanding is limited to U.S.\$30 billion. As of March 31, 2003, TVA had approximately U.S.\$23.3 billion, DM1.5 billion (issued in September 1996) and £450 million (£200 million issued in December 1998 and £250 million issued in July 2001) of Evidences of Indebtedness outstanding. At the time TVA issued the DM and British pound sterling Evidences of Indebtedness, TVA entered into currency swap agreements to hedge against fluctuations in such currencies. For information with respect to TVA’s Power Bonds and the Basic Resolution, see “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Issuance of Additional Bonds and Other Evidences of Indebtedness” in Part I of the current Information Statement.

The summaries herein of certain provisions of the Act, the Resolutions and the Fiscal Agency Agreement do not purport to be complete and are qualified in their entirety by reference to all the provisions of the Act, the Resolutions and the Fiscal Agency Agreement, copies of which may be obtained upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations, or by calling 1-888-882-4975 in the United States as well as from the Special Agent. See “General Information.”

The Bonds will be Power Bonds as defined above and will be payable as to both principal and interest solely from TVA’s Net Power Proceeds, which are defined as the remainder of TVA’s Gross Power Revenues (as defined in the Basic Resolution) after deducting the costs of operating, maintaining and administering its power properties (including multiple-purpose properties in the proportion that multiple-purpose costs are allocated to power) and payments to states and counties in lieu of taxes, but before deducting depreciation accruals or other charges representing the amortization of capital expenditures, plus the net proceeds of the sale or other disposition of any Power Facility (as defined in the Basic Resolution) or interest therein. The Act also requires TVA to make certain payments to the U.S. Treasury each year from Net Power Proceeds in excess of those required for debt service as a return on and reduction of the Appropriation Investment (as defined in the Basic Resolution). See “Certain Provisions of the Tennessee Valley Authority Act and Related Legislation” — “Payments to the Treasury” in Part I of the current Information Statement.

The Bonds rank equally as to the application of Net Power Proceeds with all other Power Bonds and all other outstanding Evidences of Indebtedness. For a further discussion of the application of Net Power Proceeds, see “Certain Provisions of the Tennessee Valley Authority Act and Related Legislation” and “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Application of Net Power Proceeds” and — “Fourth Amendatory Resolution to the Basic Resolution” in Part I of the current Information Statement.

There is no limit on other indebtedness or securities which may be issued by TVA and no financial or similar restrictions on TVA, except as provided under the Act, the Basic Resolution and the Supplemental Resolution. TVA issues its Discount Notes pursuant to Section 15d of the Act and in accordance with

Section 2.5 of the Basic Resolution. TVA may also issue Other Indebtedness in addition to Power Bonds and Discount Notes. Other Indebtedness is issued pursuant to Section 15d of the Act and under appropriate authorizing resolutions. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” in Part I of the current Information Statement.

In accordance with Public Law No. 105-62, enacted in 1997, TVA is required, in the absence of sufficient appropriations, to fund nonpower programs that constitute “essential stewardship activities” with revenues derived from one or more of various sources, including power program revenues, notwithstanding provisions of the Act and Resolutions to the contrary. See the discussion of Public Law No. 105-62 in “Certain Provisions of the Tennessee Valley Authority Act and Related Legislation” — “Other Legislation” in Part I of the current Information Statement. Under the Supplemental Resolution, actions taken pursuant to Public Law No. 105-62 shall not be considered an event of default or breach under the Resolutions.

Possible Future Issuances

The Supplemental Resolution provides that, at the option of TVA, additional Bonds may be issued in one or more future installments pursuant to an amendment to the Supplemental Resolution not requiring the consent of Holders (as such term is defined under “Book-Entry System”) of the Bonds. Additional Bonds so issued shall be identical in all respects to the Bonds offered hereby (except for any appropriate related changes, including changes in the issue date, issue price and interest commencement date).

Payment of Principal and Interest

The Bonds will consist of U.S.\$500,000,000 aggregate principal amount of 4.70% Tennessee Valley Authority Global Power Bonds 2003 Series B Due July 15, 2033 (the maturity date being hereinafter referred to as the “Maturity Date”). The Bonds will be issued in minimum denominations of U.S.\$1,000 and integral multiples thereof in book-entry form only through the U.S. Federal Reserve Banks as described below under “Book-Entry System.” Interest will be payable semiannually in arrears on January 15 and July 15 (each an “Interest Payment Date”), commencing on January 15, 2004. Such interest payments will include any interest accrued from and including June 23, 2003, or the preceding Interest Payment Date, as the case may be, to but excluding the relevant Interest Payment Date. Interest shall be computed on the basis of a 360-day year of twelve 30-day months. The Bonds will be repaid at 100 percent of the principal amount thereof, together with the interest accrued and unpaid thereon, on the Maturity Date. The Bonds are not entitled to the benefit of any sinking fund. Payments of principal and interest on the Bonds will be made on the applicable payment dates to Holders of the Bonds which are Holders as of the close of business on the Business Day preceding such payment dates, by credit of the payment amount to the Holders’ accounts at the U.S. Federal Reserve Banks. The Holder and each other financial intermediary in the chain to the beneficial owner will have the responsibility of remitting payments for the accounts of their customers.

In any case in which an Interest Payment Date or the Maturity Date is not a Business Day, payment of principal or interest, as the case may be, by TVA to the Holders shall be made on the next succeeding Business Day with the same force and effect as if made on such Interest Payment Date or the Maturity Date. The term “Business Day” shall mean any day other than a Saturday or Sunday or a day on which banking institutions in New York City are authorized or required by law or executive order to be closed.

Certain certification requirements are applicable to payments of interest on the Bonds and Strips. The Holder or other persons otherwise required to withhold tax may require the beneficial owner of a Bond or Strip, as a condition of payment of amounts due with respect to such Bond or Strip, to present on a timely basis an appropriate United States Internal Revenue Service Form W-8BEN (or other appropriate form) to enable such person to determine its duties and liabilities with respect to any taxes or other charges that may be required to be deducted or withheld under U.S. law or any reporting or other requirements thereunder. See “United States Tax Matters.” In the event that any withholding or other tax or information reporting requirements should be imposed by any jurisdiction, TVA has no obligation to pay additional interest or other amounts as a consequence thereof or to redeem the Bonds prior to their stated maturity.

Redemption

The Bonds will not be subject to redemption prior to maturity.

Book-Entry System

The Bonds will be issued and maintained in registered form and may be transferred only on the book-entry system of the U.S. Federal Reserve Banks in minimum principal amounts of U.S.\$1,000 and additional integral multiples thereof. The U.S. Federal Reserve Banks will maintain book-entry accounts with respect to the Bonds and will make payments, on behalf of TVA, of interest on and principal of the Bonds on the applicable payment dates by crediting Holders' accounts at the U.S. Federal Reserve Banks. The Bonds will not be exchangeable for definitive securities.

Regulations governing the use of the book-entry system for the Bonds are contained in 18 C.F.R. Part 1314. These regulations and procedures relate primarily to the registration, transfer, exchange and pledge of such obligations. The accounts of Holders on the U.S. Federal Reserve Banks book-entry system are governed by applicable operating circulars of the U.S. Federal Reserve Banks. The U.S. Federal Reserve Banks' handling of, and rights, duties and obligations with respect to, the Bonds will be governed exclusively by the applicable operating circulars of the U.S. Federal Reserve Banks, TVA's book-entry regulations and such other Federal book-entry regulations as may be applicable, notwithstanding any inconsistent procedures or requirements of any depository or organized exchange.

The Bonds may be held of record only by entities eligible to maintain book-entry accounts with the U.S. Federal Reserve Banks. Such entities whose names appear on the book-entry records of a U.S. Federal Reserve Bank as the entities for whose accounts the Bonds have been deposited are herein referred to as "Holders." A Holder is not necessarily the beneficial owner of a Bond. Beneficial owners will ordinarily hold Bonds through one or more financial intermediaries, such as banks, brokerage firms and securities clearing organizations. A Holder that is not the beneficial owner of a Bond, and each other financial intermediary in the chain to the beneficial owner, will have the responsibility of establishing and maintaining accounts for their respective customers. The rights of the beneficial owner of a Bond with respect to TVA and the U.S. Federal Reserve Banks may be exercised only through the Holder thereof. TVA and the U.S. Federal Reserve Banks will have no direct obligation to a beneficial owner of a Bond that is not also the Holder of such Bond. The U.S. Federal Reserve Banks will act only upon the instructions of Holders in recording transfers of the Bonds. See "Clearance and Settlement" with respect to entities holding Bonds through the international clearance and settlement systems.

Stripping

At the request of a Holder, a Bond may be separated ("stripped") into its Interest and Principal Components and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. (Note, the Managers immediately upon their acceptance of the Bonds may also, but are not obligated to, strip some or all of the Bonds. See "Summary of Offering.") The components of each stripped Bond are: each future interest payment (each an "Interest Component") and the principal payment (the "Principal Component"). Each Interest Component and the Principal Component will have a common code, identifying designation and CUSIP number as listed in the "Summary of Offering" above.

A Bond may be separated into its Interest and Principal Components at the option of the Holder at any time prior to the maturity date. In order for a U.S. Holder to have its Bonds stripped, such Holder must submit a request for separation to the Federal Reserve Bank of New York ("FRBNY") in accordance with the applicable requirements, if any, of the FRBNY. Requests for separation from Euromarket participants or customers must be directed through Euroclear or Clearstream, Luxembourg; accordingly, Euromarket participants and customers must comply with the relevant clearing system's rules and procedures for requesting the separation of Bonds. See "Clearance and Settlement" — "The Clearing Systems." Currently, the FRBNY does not charge a fee for stripping Bonds.

For a Bond to be stripped into its Interest and Principal Components as described above, the minimum principal amount of the Bond must be U.S.\$2,000,000 or integral multiples thereof. This minimum principal amount is the amount, based on the stated interest rate of the Bonds, that will produce a semiannual interest payment of U.S.\$1,000 or integral multiples thereof. Interest and Principal Components will be obligations of TVA payable solely from TVA's Net Power Proceeds.

Once a Bond has been stripped into its Interest and Principal Components, the Interest and Principal Components may be maintained and transferred on the book-entry system of the U.S. Federal Reserve Banks in integral multiples of U.S.\$1,000. Payments on the Interest and Principal Components will be made on the applicable payment dates on the related Bonds by crediting Holders' accounts at the FRBNY. At the request of a Holder and on the Holder's payment of a fee (currently the FRBNY's fee applicable to on-line book-entry securities transfers), the FRBNY will restore ("reconstitute") the unmatured Interest and Principal Components of a stripped Bond to their fully constituted form. Holders wishing to reconstitute the unmatured Interest and Principal Components of a stripped Bond to their fully constituted form must (i) produce all outstanding Interest and Principal Components for a Bond and (ii) comply with all applicable requirements of the FRBNY governing the stripping and reconstitution of securities. Only stripped Bonds with a minimum original principal amount of U.S.\$2,000,000 or integral multiples thereof may be reconstituted. Reconstitution requests from Euromarket participants must be directed through Euroclear or Clearstream, Luxembourg to the FRBNY; accordingly, Euromarket participants and customers must comply with the relevant clearing system's rules and procedures for requesting the reconstitution of Bonds. See "Clearance and Settlement" — "The Clearing Systems."

The selling prices of the Interest and Principal Components could be at substantial discounts from their face amounts and, as a result, these components may be subject to greater interest rate volatility than the fully constituted Bonds or other obligations bearing current interest. There also may be a less liquid secondary market for such Interest and Principal Components as compared to the secondary market for the fully constituted Bonds.

The Luxembourg Stock Exchange will be notified regularly of the amount of Bonds stripped and the amount of Bonds reconstituted, as applicable, so long as the Bonds are listed on such exchange.

Agents

TVA has agreed, in each case subject to applicable laws and regulations and the provisions of the Fiscal Agency Agreement, the Bonds and the Resolutions, so long as the Bonds are outstanding, to maintain a Fiscal Agent and, so long as the Bonds are listed on the Luxembourg Stock Exchange, a Special Agent in Luxembourg, which will act as an intermediary between TVA and investors in the Bonds. The Fiscal Agent will be the U.S. Federal Reserve Banks. The Special Agent initially will be Kredietbank S.A. Luxembourg. TVA and the Fiscal Agent may amend, modify or supplement, in any respect, or may terminate, substitute or replace, the Fiscal Agency Agreement without the consent of any Holder. In acting under the Fiscal Agency Agreement, the Fiscal Agent acts solely as a fiscal agent of TVA and does not assume any obligation or relationship of agency or trust for or with any Holder of the Bonds except as set forth in applicable operating circulars and letters of the U.S. Federal Reserve Banks. The addresses of the Fiscal Agent and the Special Agent for the Bonds are set forth on the back cover page hereof.

Governing Law

The Fiscal Agency Agreement and the Bonds shall be governed by and construed in accordance with the laws of the State of New York, to the extent such laws are not inconsistent with U.S. federal law. Any litigation regarding the Fiscal Agency Agreement or the Bonds would have to be brought in a court with competent venue and jurisdiction.

Listing

Application has been made to list the Bonds on the Luxembourg Stock Exchange and the New York Stock Exchange. Application also has been made to list the Strips on the Luxembourg Stock Exchange.

Notices

Notices and other communications will be given by transmission to a Holder through the communication system linking the U.S. Federal Reserve Banks. Notices will be deemed to have been sufficiently given or made, for all purposes, upon such transmission.

Copies of notices by TVA regarding the Bonds will also be published (a) in a leading daily newspaper in the English language and of general circulation in New York, (b) in a leading daily newspaper in the English language and of general circulation in London, and (c) so long as the Bonds are listed on the Luxembourg Stock Exchange and the rules of such Stock Exchange require, in a leading daily newspaper of general circulation in Luxembourg. It is expected that copies of such notices will normally be published in *The Wall Street Journal* in New York, *The Financial Times* in London and the *Luxemburger Wort* in Luxembourg.

Modification and Amendment

TVA may modify or amend any of the terms or provisions of the Bonds in accordance with the provisions for such modifications and amendments contained in the Basic Resolution. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Modifications of Resolutions and Outstanding Bonds” in Part I of the current Information Statement.

CLEARANCE AND SETTLEMENT

The Clearing Systems

Clearstream Banking, *société anonyme*, Luxembourg (“Clearstream, Luxembourg”) and Euroclear Bank as the operator of the Euroclear System (“Euroclear”) each holds securities for its customers and facilitates the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services, including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depository and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are world-wide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

Initial Settlement

On initial issue, all Bonds will be issued and settled through the U.S. Federal Reserve Banks book-entry system and held by Holders designated by the Managers. After initial issue, all Bonds will continue to be held by such Holders in the U.S. Federal Reserve Banks book-entry system unless an investor arranges for the transfer of its Bonds to another Holder.

TVA understands that investors electing to hold their Bonds through Euroclear or Clearstream, Luxembourg accounts will follow the settlement procedures applicable to conventional Eurobonds in registered form. Bonds will be credited to the securities custody accounts of Euroclear and Clearstream, Luxembourg holders on the business day following the settlement date against payment for value on the settlement date.

Secondary Market Trading

With respect to secondary market trading in the Bonds, TVA understands the following procedures will apply. Transactions in the Bonds will be cleared and settled by Euromarket participants through the facilities of Euroclear and Clearstream, Luxembourg, the principal Euromarket securities clearance and settlement organizations. The Bonds may be held of record only by entities eligible to maintain book-entry accounts with the U.S. Federal Reserve Banks. Select entities will hold the Bonds in their book-entry accounts with the FRBNY, as the depositories for Euroclear and Clearstream, Luxembourg. The identity of and certain information about the Euroclear or Clearstream, Luxembourg depositories may be obtained by contacting

Euroclear or Clearstream, Luxembourg. Transfers of the Bonds between Clearstream, Luxembourg customers or Euroclear participants and investors holding directly or indirectly through the U.S. Federal Reserve Banks book-entry system (“Fed Users”) will be effected through the book-entry accounts of such depositaries as Holders with the FRBNY, thereby increasing or decreasing their respective holdings of the Bonds on behalf of Euroclear or Clearstream, Luxembourg.

Transfers between Fed Users will occur in accordance with applicable Book-Entry Regulations promulgated by the U.S. Department of the Treasury. Transfers between Clearstream, Luxembourg customers and Euroclear participants will be settled using the procedures applicable to conventional Eurobonds in same-day funds in accordance with their applicable rules and operating procedures.

Cross-market transfers between Fed Users, on the one hand, and persons holding Bonds directly or indirectly through Euroclear or Clearstream, Luxembourg, on the other, will be effected on behalf of the relevant international clearing system by its U.S. depositary; however, such cross-market transactions will require delivery of instructions to the relevant international clearing system by the system customer or participant in accordance with the system’s rules and procedures and within its established deadlines (European time). The relevant international clearing system will, if the transaction meets its settlement requirements, deliver instructions to its U.S. depositary to take action to effect final settlement on its behalf by delivering or receiving Bonds through its U.S. Federal Reserve account, and making or receiving payment in accordance with normal procedures for immediately available funds settlement. Instructions of Clearstream, Luxembourg customers and Euroclear participants with respect to such transfers must be delivered to Euroclear or Clearstream, Luxembourg, as the case may be, and not to their U.S. depositaries.

Because of time-zone differences, credits of Bonds received in Euroclear or Clearstream, Luxembourg as a result of a transaction with a Fed User will be made during the securities settlement processing for the business day following the U.S. Federal Reserve Banks book-entry system settlement date. Such securities credits will be reported to the relevant Clearstream, Luxembourg customer or Euroclear participant on such following business day with the cash debt back-valued to, and the interest accruing from, the U.S. Federal Reserve Banks book-entry system settlement date. If, however, settlement is not completed on the intended value date (that is, if the trade fails), the trade would be valued as of the actual settlement date. Cash received in Euroclear or Clearstream, Luxembourg as a result of sales of Bonds by or through a Clearstream, Luxembourg customer or a Euroclear participant to a Fed User will be received with value on the U.S. Federal Reserve Banks book-entry system settlement date but will be available in the relevant Euroclear or Clearstream, Luxembourg cash account only as of the business day following settlement on the U.S. Federal Reserve Banks book-entry system.

From a Fed User’s standpoint, a cross-market transaction will settle no differently from a trade between two Fed Users.

Distributions of interest and principal with respect to the Bonds held through Euroclear or Clearstream, Luxembourg will be credited to the cash accounts of Clearstream, Luxembourg customers or Euroclear participants on the same day (European time) as payment is made to Fed Users, subject to the relevant system’s rules and procedures, to the extent received and applied by its U.S. depositary. Such distributions will be subject to tax reporting in accordance with relevant United States tax laws and regulations. See “United States Tax Matters.”

Although Euroclear and Clearstream, Luxembourg have agreed to the foregoing procedures in order to facilitate transfers of the Bonds among Fed Users, Euroclear and Clearstream, Luxembourg, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued at any time. None of TVA, the Managers or the Fiscal Agent will have any responsibility for the performance by Euroclear or Clearstream, Luxembourg or their respective participants or customers or indirect participants or customers of their obligations under the rules and procedures governing their operations.

LEGALITY OF INVESTMENT IN THE UNITED STATES

Each person or entity is advised to consult with its own counsel with respect to the legality of investment in the Bonds or in any stripped Interest and Principal Components thereof (see “Description of Bonds” — “Stripping”), which could be subject to restrictions or requirements with respect to the legality of investment that do not apply to Power Bonds held in their fully constituted form. Generally the following describes the legality of investment in the United States in Power Bonds in their fully constituted form.

Power Bonds are lawful investments and may be accepted as security for all fiduciary, trust and public funds, the investment or deposit of which shall be under the authority or control of any officer or agency of the United States of America. 16 U.S.C. § 831n-4(d).

Power Bonds are acceptable as collateral for U.S. Treasury tax and loan accounts pursuant to 31 C.F.R. § 203.24(e) and 31 C.F.R. § 380.3.

U.S. national banks may deal in, underwrite and purchase Power Bonds for their own accounts in an amount not to exceed 10 percent of unimpaired capital and surplus. 12 U.S.C. § 24, seventh paragraph.

U.S. Federal Reserve Banks may accept Power Bonds as eligible collateral for advances to member banks. 12 U.S.C. § 347 and 12 C.F.R. § 201.108(b)(13).

U.S. federal savings associations and U.S. federal savings banks may, to the extent specified in applicable regulations, invest in Power Bonds without regard to limitations generally applicable to investments. 12 U.S.C. § 1464(c)(1)(F).

Power Bonds are eligible as collateral for advances by U.S. Federal Home Loan Banks to members for which Power Bonds are legal investments. 12 U.S.C. § 1430(a) and 12 C.F.R. § 935.9(a)(2).

U.S. federal credit unions may purchase Power Bonds, subject to applicable regulations. 12 U.S.C. § 1757(7)(E) and 12 C.F.R. Part 703.

Power Bonds are “obligations of a corporation which is an instrumentality of the United States” within the meaning of Section 7701(a)(19)(C)(ii) of the Internal Revenue Code for purposes of the 60 percent of assets limitation applicable to U.S. building and loan associations.

UNITED STATES TAX MATTERS

Tax Considerations Applicable to Bonds

The following summary of certain United States federal income and estate tax and certain limited state and local tax consequences (where specifically noted) of the purchase, ownership and disposition of the Bonds has been prepared by Orrick, Herrington & Sutcliffe LLP, as special U.S. tax counsel to TVA, and is based upon laws, regulations, rulings and decisions, which are subject to change at any time, possibly with retroactive effect. The discussion in this subsection does not address the tax consequences associated with stripping a Bond into its Interest and Principal Components or of the purchase, ownership or disposition of an Interest or Principal Component. For a discussion of such tax matters, see “Tax Considerations Applicable to Strips.” The discussion does not address all aspects of United States federal income and estate taxation that may be relevant to a particular investor in light of its personal investment circumstances or to certain types of investors subject to special treatment under the United States federal income tax laws (for example, brokers, security dealers, traders in securities that elect to mark to market, banks, life insurance companies, tax-exempt organizations and, with limited exceptions, foreign investors), and generally does not address state and local taxation. Further, the discussion is limited to persons who will hold the Bonds as capital assets and does not deal with United States federal income tax consequences applicable to persons who will hold the Bonds in the ordinary course or as an integral part of their trade or business, or as part of a hedging, straddle, integrated or conversion transaction or persons whose functional currency is not the U.S. dollar. Furthermore, it does not address alternative minimum tax consequences or the indirect effects on the holders of equity interests in a Bondholder. Each prospective owner of a Bond is urged to consult with its own tax advisor with respect to the

United States federal, state and local tax consequences associated with the purchase, ownership and disposition of a Bond, as well as the tax consequences arising under the laws of any other taxing jurisdiction, and may not construe the following discussion as legal advice. In this regard, it should be noted that the Bonds are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA has no obligation to pay additional interest or other amounts if any withholding or other tax is imposed on payments on the Bonds (including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form).

For purposes of this subsection (“Tax Considerations Applicable to Bonds”), “U.S. Person” means a citizen or resident of the United States, a corporation or (except as may be provided in Treasury Regulations) partnership organized in or under the laws of the United States or any political subdivision thereof, an estate the income of which is includible in gross income for United States tax purposes regardless of its source or a trust if a United States court is able to exercise primary supervision over administration of the trust and one or more U.S. Persons have authority to control all substantial decisions of the trust. The term “U.S. beneficial owner” means a U.S. Person that is a beneficial owner of a Bond and any other person which is a beneficial owner of a Bond that is otherwise subject to United States federal income taxation on a net basis in respect of income attributable to a Bond.

U.S. Beneficial Owners

A U.S. beneficial owner is subject to federal income taxation on income on a Bond. The Act, however, provides that bonds issued by TVA are “exempt both as to principal and interest from all taxation now or hereafter imposed by any State or local taxing authority except estate, inheritance and gift taxes.” This exemption might not extend to franchise or other nonproperty taxes in lieu thereof imposed on corporations or to gain or loss realized upon the sale or exchange of a Bond, notwithstanding that such gain might in some cases be treated as interest income for United States federal income tax purposes.

Interest on a Bond will be taxable to a U.S. beneficial owner at the time that it is received or accrued, depending upon the U.S. beneficial owner’s method of accounting for United States federal income tax purposes. The Bonds are not exempt from United States federal income, estate or gift tax.

Upon a sale or exchange of a Bond, a U.S. beneficial owner generally will recognize capital gain or loss equal to the difference between the amount realized on the sale or exchange (not including any amounts attributable to accrued and unpaid interest) and the U.S. beneficial owner’s adjusted basis for the Bond for federal income tax purposes.

If a U.S. beneficial owner purchases a Bond for less than its stated redemption price at maturity, in general, that difference will be market discount (unless the discount is less than $\frac{1}{4}$ of 1 percent of the stated redemption price at maturity of the Bond multiplied by the number of complete years remaining to maturity). In general, under the market discount rules, unless the U.S. beneficial owner elects to include market discount in income currently, any gain on a disposition of a market discount Bond will be ordinary income to the extent of accrued market discount, and deductions for some or all of the interest on any indebtedness incurred or continued to purchase or carry the Bond may be deferred until the disposition of the Bond. Generally, any election to include market discount in income currently applies to all debt instruments acquired by the electing U.S. beneficial owner during or after the first taxable year to which the election applies and is irrevocable without the consent of the United States Internal Revenue Service. A U.S. beneficial owner should consult a tax advisor before making the election.

A U.S. beneficial owner who purchases a Bond for an amount greater than the amount payable at maturity of the Bond may elect to treat the excess as amortizable bond premium. In the case of a U.S. beneficial owner that makes an election to amortize bond premium or has previously made an election that remains in effect, amortizable bond premium on the Bond generally will be treated as a reduction of the interest income on a Bond on a constant-yield basis (except to the extent regulations may provide otherwise) over the term of the Bond. The basis of a debt obligation purchased at a premium is reduced by the amount of amortized bond premium. An election to amortize bond premium generally applies to all debt instruments (other than tax-exempt obligations) held by the electing U.S. beneficial owner on the first day of the first

taxable year to which the election applies or thereafter acquired by such owner, and is irrevocable without consent of the United States Internal Revenue Service. A U.S. beneficial owner should consult a tax advisor before making the election.

A U.S. beneficial owner may elect to include in gross income all interest that accrues on a debt instrument using the constant-yield method described below under the heading “Tax Considerations Applicable to Strips.” For purposes of this election, interest includes stated interest, original issue discount (“OID”), market discount, de minimis market discount and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. If this election is made with respect to a debt instrument with amortizable bond premium, the electing U.S. beneficial owner will be deemed to have elected to apply amortizable bond premium against interest with respect to all debt instruments with amortizable bond premium (other than debt instruments the interest on which is excludible from gross income) held by the electing U.S. beneficial owner as of the beginning of the taxable year in which the debt instrument with respect to which the election is made is acquired or thereafter acquired. The deemed election with respect to amortizable bond premium may not be revoked without the consent of the United States Internal Revenue Service. If this election is made with respect to a debt instrument with market discount, the electing U.S. beneficial owner will be deemed to have elected to include market discount in income currently (as discussed above) with respect to all debt instruments acquired by the electing U.S. beneficial owner during or after the first taxable year to which the election applies, which election may not be revoked without the consent of the United States Internal Revenue Service.

Non-U.S. Beneficial Owners

Generally, a Bondholder that is not a U.S. Person and that has no connection with the United States other than holding the Bond (a “non-U.S. beneficial owner”) will not be subject to United States federal withholding tax on interest paid by TVA on a Bond provided that the last U.S. Person in the chain of payment prior to payment to the non-U.S. beneficial owner has received in the year in which the payment occurs, or in either of the two preceding years, a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is not a U.S. beneficial owner and (iii) provides the name and address of the beneficial owner. The statement may be made on a United States Internal Revenue Service Form W-8BEN or, in the case of certain non-U.S. beneficial owners, Form W-8EXP (collectively, “Form W-8”) or substantially similar substitute form, and the beneficial owner must inform the withholding agent of any change in the information on the statement within 30 days of such change. In certain circumstances, the above-described certification can be provided by a securities clearing organization or by certain other financial institutions and qualified intermediaries provided that the non-U.S. beneficial owner of the Bond has provided such entity with the appropriate certification or documentation establishing its foreign status. Additionally, in the case of Bonds held by a foreign partnership (a) the certification described above must be provided by the partners rather than by the foreign partnership and (b) the partnership must provide certain information.

Generally, any amount which constitutes capital gain to a non-U.S. beneficial owner upon retirement or disposition of a Bond will not be subject to U.S. federal income taxation. Certain exceptions may be applicable and individual non-U.S. beneficial owners are particularly urged to consult a tax advisor. Generally, the Bonds will not be includible in the U.S. federal estate of a non-U.S. beneficial owner.

Backup Withholding

Backup withholding of United States federal income tax, currently at a rate of 28 percent, may apply to payments made in respect of the Bonds to beneficial owners who are not exempt recipients and who fail to provide certain identifying information (such as the beneficial owner’s taxpayer identification number) in the manner required. Generally, individuals are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients. Payments made in respect of the Bonds to a U.S. beneficial owner must be reported to the United States Internal Revenue Service, unless such U.S. beneficial owner is an exempt recipient or establishes an exemption. Compliance with the identification procedures (described in the

preceding section) would generally establish an exemption from backup withholding for those non-U.S. beneficial owners who are not exempt recipients.

In addition, upon the sale of a Bond to (or through) a broker, the broker must withhold, currently at a rate of 28 percent, of the reportable payment, unless either (i) the broker determines that the seller is a corporation or other exempt recipient or (ii) the seller provides, in the required manner, certain identifying information and, in the case of a non-U.S. beneficial owner, certifies that such seller is a non-U.S. beneficial owner (and certain other conditions are met). Such a sale must also be reported by the broker to the United States Internal Revenue Service, unless either (i) the broker determines that the seller is an exempt recipient or (ii) the seller certifies its non-U.S. status (and certain other conditions are met). Certification of the beneficial owner's non-U.S. status usually would be made on Form W-8 under penalties of perjury, although in certain cases it may be possible to submit other documentary evidence. The term "broker" generally includes all persons who, in the ordinary course of a trade or business, stand ready to effect sales made by others, as well as brokers and dealers registered as such under the laws of the United States or a state. These requirements generally will apply to a United States office of a broker, and the information reporting requirements generally will apply to a foreign office of a United States broker, as well as to a foreign office of a foreign broker if the broker is (i) a controlled foreign corporation within the meaning of Section 957(a) of the Internal Revenue Code, (ii) a foreign person 50 percent or more of whose gross income from all sources for the 3-year period ending with the close of its taxable year preceding the payment (or for such part of the period that the foreign broker has been in existence) was effectively connected with the conduct of a trade or business within the United States or (iii) a foreign partnership if it is engaged in a trade or business in the United States or if 50 percent or more of its income or capital interests are held by U.S. Persons.

Generally, any amounts withheld under the backup withholding rules from a payment to a beneficial owner would be allowed as a refund or credit against such beneficial owner's United States federal income tax.

Tax Considerations Applicable to Strips

The following discussion of the United States federal income and estate tax and certain limited state and local tax consequences (where specifically noted) of the purchase, ownership and disposition of Strips has been prepared by Orrick, Herrington & Sutcliffe LLP, as special U.S. tax counsel to TVA, and is based upon laws, regulations, rulings and decisions, which are subject to change at any time, possibly with retroactive effect. The discussion does not address all aspects of United States federal income and estate taxation that may be relevant to a particular investor in light of its personal investment circumstances or to certain types of investors subject to special treatment under the United States federal income tax laws (for example, brokers, security dealers, traders in securities that elect to mark to market, banks, life insurance companies, tax-exempt organizations and, with limited exceptions, foreign investors), and generally does not address state and local taxation. Further, the discussion is limited to persons who will hold the Strips as capital assets, and does not deal with United States federal income tax consequences applicable to persons who will hold the Strips in the ordinary course or as an integral part of their trade or business, or as part of a hedging, straddle, integrated or conversion transaction or persons whose functional currency is not the U.S. dollar. Furthermore, it does not address alternative minimum tax consequences or the indirect effects on the holders of equity interests in a holder of a Strip. Each prospective owner of a Strip is urged to consult with its own tax advisor with respect to the United States federal, state and local tax consequences associated with the purchase, ownership and disposition of a Strip, as well as tax consequences arising under the laws of any other taxing jurisdiction, and may not construe the following discussion as legal advice. In this regard, it should be noted that the Strips are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA has no obligation to pay additional interest or other amounts if any withholding or other tax is imposed on payments on the Strips (including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form).

For purposes of this subsection ("Tax Considerations Applicable to Strips"), "U.S. Person" means a citizen or resident of the United States, a corporation or (except as may be provided in the Treasury Regulations) a partnership organized in or under the laws of the United States or any political subdivision thereof, an estate the income of which is includible in gross income for United States tax purposes regardless

of its source or a trust if a United States court is able to exercise primary supervision over administration of the trust and one or more U.S. Persons have authority to control all substantial decisions of the trust. The term “U.S. beneficial owner” means a U.S. Person that is a beneficial owner of a Strip and any other person which is a beneficial owner of a Strip that is otherwise subject to United States federal income taxation on a net basis in respect of income attributable to a Strip.

U.S. Beneficial Owners

A U.S. beneficial owner is subject to United States federal income taxation on the income of a Strip, and there is no special exemption from United States federal income, estate or gift tax with respect to Strips. The Act provides that bonds issued by TVA are “exempt both as to principal and interest from all taxation now or hereafter imposed by any State or local taxing authority except estate, inheritance and gift taxes.” This exemption might not extend to franchise or other non-property taxes in lieu thereof imposed on corporations or to gain or loss realized upon the sale or exchange of a Bond, notwithstanding that such gain might in some cases be treated as interest income for United States federal income tax purposes. It is unclear whether this exemption applies at all to the income on a Strip. If all of the income on a Strip were to be exempt from state and local taxation, the amount of income exempted from such taxation could be in excess of the amount that would have been exempted had the Bonds not been separated into their Interest and Principal Components. It is unclear whether or not this was intended. Therefore, while it is believed that the income includible by a U.S. beneficial owner with respect to a Strip should qualify for the exemption provided in the Act at least to the extent of the rate of interest payable on the Bonds, there is no controlling precedential authority and, therefore, each owner of a Strip is urged to consult its own tax advisor as to whether or not the income of a Strip qualifies in whole or in part for the exemption provided in the Act.

A U.S. beneficial owner that elects to strip a Bond into its Interest and Principal Components and to dispose of one or more of such Components will be required to include in income all interest and market discount accrued on the Bond to the date of disposition (to the extent that such income has not previously been included in income), and the U.S. beneficial owner’s basis in the Bond will be increased, immediately prior to the disposition of one of the Strips, by the amount so included in income. Upon the disposition of a Strip, the U.S. beneficial owner will be required to recognize gain or loss equal to the difference between the amount realized on the disposition of the Strip and the U.S. beneficial owner’s basis in the Strip immediately prior to the disposition of one of the Strips. For purposes of determining that basis, the U.S. beneficial owner will be required to allocate its tax basis in the Bond immediately prior to the sale (as adjusted in the manner detailed above) between the Interest and Principal Components based on their respective fair market values on the date of the sale.

A U.S. beneficial owner of a Strip will accrue income on the Strip in accordance with the OID rules set forth in the United States Internal Revenue Code of 1986, as amended. In this regard, the application of the OID rules to the Strips is subject to significant uncertainty, and therefore purchasers of the Strips are urged to consult with their own tax advisors. Generally, however, it is anticipated that each U.S. beneficial owner of a Strip will be required to include in income, as OID, the difference between (1) the stated redemption price at maturity of the Interest or Principal Component owned by such person (which generally would include all payments to be made on the Component subsequent to the date that the strip was effected or, if later, the date of the U.S. beneficial owner’s purchase of the Component) and (2) the U.S. beneficial owner’s purchase price for the Component (or, in the case of a person who effects a strip and disposes of one or more of the Components, the portion of the person’s basis in the Bond which is allocable to the retained Components, as determined pursuant to the rules set forth in the preceding paragraph).

The amount of OID on a Strip (determined as set forth above) will be includible on a constant-yield basis in the income of a U.S. beneficial owner of a Strip over the life of the Strip (excluding, with respect to certain U.S. beneficial owners, Strips having a maturity of one year or less from the date of purchase — which Strips would be subject to special OID rules which are discussed below), even in years in which the owner of the Strip does not receive any actual payment. The amount of OID that must be included in income each year by the U.S. beneficial owner of a Strip will be equal to the sum of the daily portions of the OID that accrued during each day of the year during which the U.S. beneficial owner owned the Strip. The daily portions will be

determined by allocating to each day of the accrual period, as defined below, a pro rata portion of an amount equal to the adjusted issue price of the Strip at the beginning of the accrual period, also as defined below, multiplied by the yield to maturity of the Strip, determined by compounding at the close of each accrual period and properly adjusted for the length of the accrual period. For purposes of these calculations, (i) the accrual periods will, generally, be of any length and may vary in length over the term of the Strip, provided that each accrual period is no longer than a year and that each scheduled payment of principal and interest occurs either on the final day of an accrual period or on the first day of an accrual period, and (ii) the adjusted issue price of a Strip will be the U.S. beneficial owner's purchase price for the Strip (or, in the case of a person who effects a strip and disposes of one or more of the Components, the portion of the person's basis in the Bond which is allocable to the retained Components, as determined pursuant to the rules set forth above), increased by the OID accrued by the U.S. beneficial owner in previous accrual periods and decreased by any payments received by the U.S. beneficial owner in prior accrual periods. The amount of OID allocable to an initial short accrual period may be computed using any reasonable method if all other accrual periods other than a final short accrual period are of equal length. The amount of OID allocable to the final accrual period is the difference between (x) the amount payable at the maturity of the Strip and (y) the Strip's adjusted price as of the beginning of the final accrual period. The foregoing rules will generally be applied to each Strip acquired separately. In certain circumstances, Strips acquired (or retained by the person stripping a Bond) may be treated as a single instrument for tax purposes.

In general, a cash basis U.S. beneficial owner who purchases a Strip the payment with respect to which is due not later than one year from the date of issuance ("short-term Strips") is not required to accrue OID (as determined under the special rule described below for the purposes of this paragraph) for United States federal income tax purposes unless it elects to do so. Accrual basis U.S. beneficial owners and certain other U.S. beneficial owners (including certain pass-through entities and electing cash basis U.S. beneficial owners) who purchase a short-term Strip and any U.S. beneficial owners who strip a Bond into its Interest and Principal Components and who retain one or more such Components are required to accrue OID on short-term Strips on either a straight-line basis or under the constant-yield method (based on daily compounding), at the election of the U.S. beneficial owner. In the case of a U.S. beneficial owner not required and not electing to include OID on a short-term Strip in income currently, any gain realized on the sale or retirement of the short-term Strip will be ordinary income to the extent of the OID accrued on a straight-line basis (unless an election is made to accrue the OID under the constant-yield method) through the date of sale or retirement. U.S. beneficial owners who are not required and who do not elect to accrue OID on short-term Strips will be required to defer deductions for interest on borrowings allocable to short-term Strips in an amount not exceeding the deferred income until the deferred income is realized.

Upon the sale or exchange of a Strip, a U.S. beneficial owner generally will recognize capital gain or loss equal to the difference between the amount realized on the sale or exchange and the U.S. beneficial owner's adjusted tax basis in the Strip. A U.S. beneficial owner's adjusted tax basis in a Strip will generally be its cost, increased by the amount of the OID included in the U.S. beneficial owner's income with respect to the Strip.

TVA is selling the Bonds (and not Strips) to the Managers; it is possible, however, that the Managers may elect to strip the Bonds and sell Interest and Principal Components (as well as Bonds) immediately upon their acceptance of the Bonds. Such Strips might be viewed, for United States federal income tax purposes, as OID bonds issued by TVA to the purchasers of the Strips. If the United States Internal Revenue Service were to characterize the transaction in this fashion, the rules set forth above would generally apply to the Bonds stripped by the Managers, except that (1) the amount of OID on each Strip so sold would be measured, and the adjusted issue price would be determined, by reference to the first price at which a substantial amount of each Strip was sold, rather than by reference to the price paid by the purchaser for the Strip (not only in the case of an initial purchaser of the Strip, but also in the case of any transferee thereof) and (2) the stated redemption price at maturity would be determined by reference to all payments to be made on the Strip subsequent to the date of the closing relating to the Bonds offered hereby rather than by reference to the payments to be made subsequent to the U.S. beneficial owner's acquisition of the Strip. Each U.S. beneficial owner is urged to consult with its own tax advisor as to the likelihood of such a characterization, as well as to

the application of the “acquisition premium” and “market discount” rules which would apply to those Bonds stripped by the Managers if the transaction were to be so characterized.

Recombinations. The OID rules are also unclear as to the treatment of a U.S. beneficial owner who acquires a Principal Component and all the associated Interest Components; it is believed, however, that such a person would not treat the Components as a Bond, but would instead recognize income on each of the Components in the manner detailed above. However, if such a person requests the FRBNY to reconstitute the Components into a Bond and that Bond is then sold to another person, it is believed that the new purchaser would be treated as having acquired a Bond (rather than Interest and Principal Components) with the result that the rules set forth above, under “Tax Considerations Applicable to Bonds,” would apply. Each purchaser of a Strip is urged to consult its own tax advisor as to this issue.

Non-U.S. Beneficial Owners

A non-U.S. beneficial owner of a Strip will not be subject to United States federal withholding tax on TVA’s payment of income on a Strip provided that the last U.S. person in the chain of payment prior to payment to the non-U.S. beneficial owner has received in the year in which the payment occurs, or in either of the two preceding years, a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is a non-U.S. beneficial owner and (iii) provides the name and address of the beneficial owner. The statement may be made on an United States Internal Revenue Service Form W-8BEN or in the case of certain non-U.S. beneficial owners, Form W-8EXP (collectively, “Form W-8”) or substantially similar substitute form, and the beneficial owner must inform the withholding agent of any change in the information on the statement within 30 days of such change. In certain circumstances, the above-described certification can be provided by a securities clearing organization or by certain other financial institutions and qualified intermediaries provided that the non-U.S. beneficial owner of the Strip has provided such entity with the appropriate certification or documentation establishing its foreign status. Additionally, in the case of Strips held by a foreign partnership, (a) the certification described above must be provided by the partners rather than by the foreign partnership and (b) the partnership must provide certain information.

Generally, any amount which constitutes capital gain to a non-U.S. beneficial owner upon retirement or disposition of a Strip will not be subject to United States federal income taxation. Certain exceptions may be applicable and individual non-U.S. beneficial owners are particularly urged to consult their own tax advisors.

Generally, the Strips will not be includible in the U.S. federal estate of a non-U.S. beneficial owner.

Backup Withholding

Backup withholding of United States federal income tax, currently at a rate of 28 percent, may apply to payments made in respect of the Strips to beneficial owners who are not exempt recipients and who fail to provide certain identifying information (such as the beneficial owner’s taxpayer identification number) in the manner required. Generally, individuals are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients. Compliance with the identification procedures described in the preceding section would generally establish an exemption from backup withholding for those non-U.S. beneficial owners who are not exempt recipients.

In addition, upon the sale of a Strip to (or through) a broker, the broker must withhold, currently at a rate of 28 percent, of the reportable payment, unless either (i) the broker determines that the seller is a corporation or other exempt recipient or (ii) the seller provides, in the required manner, certain identifying information and, in the case of a non-U.S. beneficial owner, certifies that such seller is a non-U.S. beneficial owner (and certain other conditions are met). Such a sale must also be reported by the broker to the Internal Revenue Service, unless either (i) the broker determines that the seller is an exempt recipient or (ii) the seller certifies its non-U.S. status (and certain other conditions are met). Certification of the beneficial owner’s non-

U.S. status usually would be made on Form W-8 under penalties of perjury, although in certain cases it may be possible to submit other documentary evidence. The term “broker” generally includes all persons who, in the ordinary course of a trade or business, stand ready to effect sales made by others, as well as brokers and dealers registered as such under the laws of the United States or a state. These requirements generally will apply to a United States office of a broker, and the information reporting requirements generally will apply to a foreign office of a United States broker, as well as to a foreign office of a foreign broker if the broker is (i) a controlled foreign corporation within the meaning of Section 957(a) of the Internal Revenue Code, (ii) a foreign person 50 percent or more of whose gross income from all sources for the 3-year period ending with the close of its taxable year preceding the payment (or for such part of the period that the foreign broker has been in existence) was effectively connected with the conduct of a trade or business within the United States or (iii) a foreign partnership if it is engaged in a trade or business in the United States or if 50 percent or more of its income or capital interests are held by U.S. Persons.

Generally, any amounts withheld under the backup withholding rules from a payment to a beneficial owner would be allowed as a refund or a credit against such beneficial owner’s United States federal income tax.

SUBSCRIPTION AND SELLING

Subject to the terms and conditions set forth in the Subscription Agreement dated June 16, 2003 (the “Subscription Agreement”) relating to the Bonds, TVA has agreed to sell to each of the Managers named below (the “Managers”), and each of the Managers has severally agreed to purchase, the principal amount of Bonds set forth opposite its name below:

<u>Manager</u>	<u>Principal Amount</u>
Bear, Stearns & Co. Inc.	\$250,000,000
Lehman Brothers Inc.	\$250,000,000
Total.....	<u>U.S.\$500,000,000</u>

The Subscription Agreement provides that the obligations of the Managers are subject to certain conditions precedent and that the Managers will be obligated to purchase all of the Bonds if any are purchased.

The Managers have advised TVA that they propose to offer all or part of the Bonds directly to the public initially at the offering prices set forth on the cover page of this Offering Circular and to dealers at such prices less a concession not in excess of 0.225% of the principal amount thereof. The Managers may allow and such dealers may realow discounts not in excess of 0.100% of the principal amount of the Bonds to certain other dealers. After the initial offering, the public offering price and concession may be changed.

The Managers immediately upon their acceptance of the Bonds may, but are not obligated to, strip some or all of the Bonds and deliver Interest and/or Principal Components rather than Bonds to investors purchasing Strips. Sales of any such Strips would be at negotiated prices.

Each Manager represents, warrants and agrees to and with TVA that such Manager and its Affiliates (as defined herein) (i) have not offered or sold Bonds and, prior to six months after the issuance of the Bonds, will not offer or sell any Bonds to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Financial Services and Markets Act 2000 (the “FSMA”) and the Public Offers of Securities Regulations 1995 (as amended); (ii) have complied and will comply with all applicable provisions of the FSMA and the rules and regulations thereunder with respect to anything done by them in relation to the Bonds in, from or otherwise involving the United Kingdom; and (iii) have only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by them in connection with the issue or sale of any Bonds in circumstances in which Section 21(1) of the FSMA does not apply to TVA.

The term “Affiliate” means any person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with a Manager. For purposes of this definition of Affiliate, the term “control” (including the terms “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies, including without limitation the investment or trading decisions of a person, whether through ownership of voting securities, by contract or otherwise.

Purchasers of Bonds or Strips may be required to pay stamp taxes and other charges in accordance with the laws and practices of the country of purchase in addition to the issue price set forth above.

All secondary trading in Bonds and Strips will settle in immediately available funds. See “Clearance and Settlement” — “Secondary Market Trading.”

TVA has agreed to indemnify the Managers against certain civil liabilities.

It is expected that delivery of the Bonds will be made against payment therefor on or about the date specified in the last paragraph of the cover page of this Offering Circular, which will be the fifth Business Day following the date of pricing of the Bonds (such settlement cycle being herein referred to as “T + 5”). Trades in the secondary market generally are required to settle in three Business Days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade Bonds on the date of pricing or the next Business Day will be required, by virtue of the fact that the Bonds initially will settle in T + 5, to specify an alternate settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of Bonds who wish to trade Bonds on the date of pricing or the next Business Day should consult their own advisors.

GENERAL INFORMATION

1. The issuance of the Bonds was authorized pursuant to the Resolutions. At the date of issue, all necessary legal authorizations for issuance of the Bonds will have been obtained by TVA.
2. The Bonds and Strips have been accepted for clearance by Euroclear and Clearstream, Luxembourg. The identifying numbers are as set forth beginning on page C-8.
3. There has been no material adverse change in the financial position of TVA since March 31, 2003.
4. There is no litigation, actual or threatened, which relates to TVA and to which TVA is a party or of which TVA has been notified that it will be made a party which is material in the context of the issuance of the Bonds which is not described in the Offering Circular, the current Quarterly Report or the current Information Statement.
5. In connection with the Luxembourg Stock Exchange listing application, copies of the Act, the Resolutions and a legal notice relating to the issuance of the Bonds will be deposited prior to listing with the *Registre de Commerce et des Sociétés à Luxembourg*, where copies thereof may be obtained upon request. Copies of the Act, the Resolutions, the Fiscal Agency Agreement, annual and quarterly financial reports, and Information Statements and supplements thereto of TVA will be available for inspection and may be obtained at the office of the Special Agent, free of charge, as long as the Bonds are listed on the Luxembourg Stock Exchange.

VALIDITY OF BONDS

The validity of the Bonds will be passed upon for TVA by Maureen H. Dunn, Esq., Executive Vice President and General Counsel of TVA, and for the Managers by Sullivan & Cromwell LLP, 1701 Pennsylvania Avenue, N.W., Washington, D.C. 20006, U.S.A.

* * * * *

Any statements in this Offering Circular involving matters of opinion, whether or not expressly so stated, are intended as such and not as representations of fact. This Offering Circular is not to be construed as a contract or agreement with the purchaser of any of the Bonds.

TENNESSEE VALLEY AUTHORITY

By: /s/ JOHN M. HOSKINS

John M. Hoskins
*Acting Chief Financial Officer and Senior Vice
President and Treasurer*

Dated June 16, 2003

Tennessee Valley Authority

A Wholly Owned Corporate Agency and Instrumentality of the United States of America

Power Quarterly Report

For the quarterly period ended March 31, 2003



Tennessee Valley Authority

Power Quarterly Report

For the quarterly period ended March 31, 2003

This document contains the Quarterly Report of TVA's Power Program for the quarterly period ended March 31, 2003. TVA is not required to register securities under the Securities Act of 1933 or to make periodic reports to the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. Accordingly, TVA does not intend to file this report with the SEC. In addition, several portions of this Quarterly Report contain forward-looking statements, and reference is made to page one for the location and character of such statements.

INDEX	Page
Forward-Looking Statements	1
FINANCIAL INFORMATION	
Financial Statements.....	2
Statements of Income—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	2
Balance Sheets—Power Program (unaudited) as of March 31, 2003 and September 30, 2002	3
Statements of Cash Flows—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	4
Statements of Changes in Proprietary Capital—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	5
Statements of Comprehensive Income (Loss)—Power Program (unaudited) for the three months and six months ended March 31, 2003 and 2002	5
Notes to Financial Statements (unaudited)	6
Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Qualitative and Quantitative Disclosures about Market Risk	16
Controls and Procedures	17
OTHER INFORMATION	
Legal Proceedings	18
Debt Securities	18
Board Actions	19
Other Information	19
Subsequent Events.....	21
CERTIFICATIONS	22
CONTACT INFORMATION	24

Forward-Looking Statements

TVA's 2003 Quarterly Report on its Power Program for the quarterly period ended March 31, 2003, contains forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions, assumptions or otherwise relating to future events or performance may be forward-looking.

In certain cases, forward-looking statements can be identified by the use of the words such as "may," "will," "should," "expect," "anticipate," "believe," "intend," "project," "plan," "predict," "assume," "estimate," "objective," "possible," "potential," or other similar expressions.

Some examples of forward-looking statements include statements regarding TVA's projections of future power and energy requirements; future costs related to environmental compliance; impacts of potential legislation on TVA and the likelihood of enactment of such legislation; strategic objectives; anticipated availability of nuclear waste storage facilities; projections of nuclear decommissioning costs; and impacts of pending litigation and various administrative orders which have been or may be issued.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations and administrative orders, especially those related to restructuring of the electric power industry, and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA's generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; changes in accounting standards; and unforeseeable events. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA's business or cause results to differ from those contained in any forward-looking statement.

TVA undertakes no obligation to update any forward-looking statement to reflect developments that occur or come to TVA's attention after the statement is made.

FINANCIAL INFORMATION

STATEMENTS OF INCOME—POWER PROGRAM (unaudited)

	Three months ended March 31		Six months ended March 31	
	2003	2002	2003	2002
	(in millions)		(in millions)	
Operating revenues				
Sales of electricity				
Municipalities and cooperatives	\$ 1,526	\$ 1,403	\$ 2,972	\$ 2,704
Industries directly served	217	190	403	352
Federal agencies and other	39	38	81	80
Other revenue	<u>21</u>	<u>22</u>	<u>40</u>	<u>38</u>
Total operating revenues	1,803	1,653	3,496	3,174
Operating expenses				
Fuel and purchased power	557	449	980	834
Operating and maintenance	479	439	964	864
Depreciation, amortization and accretion	264	254	527	507
Accelerated amortization	—	17	—	33
Tax-equivalents	<u>81</u>	<u>81</u>	<u>163</u>	<u>163</u>
Total operating expenses	<u>1,381</u>	<u>1,240</u>	<u>2,634</u>	<u>2,401</u>
Operating income	422	413	862	773
Other income, net	3	5	6	8
Loss on plant cancellation	—	(150)	—	(150)
Interest expense				
Interest on debt	347	368	700	736
Amortization of debt discount, issue and reacquisition costs, net	6	5	14	11
Allowance for funds used during construction	<u>(18)</u>	<u>(16)</u>	<u>(33)</u>	<u>(30)</u>
Net interest expense	335	357	681	717
Income (loss) before cumulative effects of accounting changes	90	(89)	187	(86)
Cumulative effect of change in accounting for unbilled revenue	—	—	412	—
Cumulative effect of change in accounting for asset retirement obligations	<u>—</u>	<u>—</u>	<u>(178)</u>	<u>—</u>
Net income (loss)	<u>\$ 90</u>	<u>\$ (89)</u>	<u>\$ 421</u>	<u>\$ (86)</u>

The accompanying notes are an integral part of these financial statements.

BALANCE SHEETS—POWER PROGRAM (unaudited)

	March 31 2003	September 30 2002
(in millions)		
ASSETS		
Current assets		
Cash and cash equivalents	\$ 521	\$ 397
Accounts receivable	884	655
Inventories at average cost and other		
Fuel	193	173
Other	304	305
Total current assets	1,902	1,530
Property, plant and equipment		
Completed plant	31,860	31,207
Less accumulated depreciation	(11,853)	(11,162)
Net completed plant	20,007	20,045
Construction in progress	1,606	1,040
Deferred nuclear generating units	4,115	4,113
Nuclear fuel and capital leases	519	481
Total property, plant and equipment	26,247	25,679
Investment funds	524	659
Deferred charges and other assets		
Loans and other long-term receivables	156	138
Debt issue and reacquisition costs	196	193
Other deferred charges	2,556	1,959
Total deferred charges and other assets	2,908	2,290
Total assets	<u>\$ 31,581</u>	<u>\$ 30,158</u>
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	\$ 585	\$ 700
Accrued liabilities	194	220
Accrued interest	401	397
Short-term debt	3,269	3,492
Current maturities of long-term debt	400	—
Total current liabilities	4,849	4,809
Other liabilities		
Deferred liabilities	2,959	2,413
Asset retirement obligation	1,652	891
Total other liabilities	4,611	3,304
Long-term debt		
Public bonds	21,283	21,763
Unamortized discount and other adjustments	(169)	(405)
Total long-term debt	21,114	21,358
Commitments and contingencies (see note 5)		
Proprietary capital		
Appropriation investment	478	488
Retained earnings	760	349
Accumulated other comprehensive loss	(231)	(150)
Total proprietary capital	1,007	687
Total liabilities and proprietary capital	<u>\$ 31,581</u>	<u>\$ 30,158</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CASH FLOWS – POWER PROGRAM (unaudited)

	Three months ended March 31		Six months ended March 31	
	2003	2002	2003	2002
	(in millions)		(in millions)	
Cash flows from operating activities				
Net income (loss)	\$ 90	\$ (89)	\$ 421	\$ (86)
Items not requiring (providing) cash				
Depreciation and amortization	277	263	561	529
Accelerated amortization	—	17	—	33
Allowance for funds used during construction	(18)	(17)	(33)	(30)
Nuclear fuel amortization	29	37	64	75
Loss on plant cancellation	—	150	—	150
Gain on accounting changes	—	—	(234)	—
Other, net	11	6	33	(6)
Changes in current assets and liabilities				
Accounts receivable	32	8	183	217
Inventories and other	(6)	(17)	(27)	(40)
Accounts payable and accrued liabilities	92	102	(104)	(200)
Accrued interest	101	90	5	14
Other	(20)	(27)	(3)	(75)
Net cash provided by operating activities	588	523	866	581
Cash flows from investing activities				
Construction expenditures	(383)	(285)	(782)	(632)
Allowance for funds used during construction	18	16	33	30
Nuclear fuel	(39)	(26)	(108)	(131)
Other, net	(1)	121	142	120
Net cash used in investing activities	(405)	(174)	(715)	(613)
Cash flows from financing activities				
Long-term debt				
Issues	142	164	298	856
Redemptions	(381)	(1)	(381)	(419)
Short-term redemptions, net	37	(497)	(223)	(995)
Proceeds from combustion turbine financing	—	—	163	320
Payment on lease/leaseback financing	(23)	—	(33)	—
Proceeds from call monetization	175	—	175	—
Financing costs, net	(2)	(3)	(5)	(33)
Payments to U.S. Treasury	(10)	(12)	(21)	(25)
Net cash used in financing activities	(62)	(349)	(27)	(296)
Net change in cash and cash equivalents	121	—	124	(328)
Cash and cash equivalents at beginning of period	400	11	397	339
Cash and cash equivalents at end of period	<u>\$ 521</u>	<u>\$ 11</u>	<u>\$ 521</u>	<u>\$ 11</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL—POWER PROGRAM (unaudited)

	Three months ended March 31		Six months ended March 31	
	2003	2002	2003	2002
	(in millions)		(in millions)	
Retained earnings reinvested at beginning of period	\$ 675	\$ 302	\$ 349	\$ 306
Net income (loss)	90	(89)	421	(86)
Return on appropriation investment	(5)	(8)	(10)	(15)
Retained earnings reinvested at end of period	760	205	760	205
Accumulated other comprehensive loss	(231)	(13)	(231)	(13)
Appropriation investment at beginning of period	483	503	488	508
Return of appropriation investment	(5)	(5)	(10)	(10)
Appropriation investment at end of period	478	498	478	498
Proprietary capital at end of period	\$ 1,007	\$ 690	\$ 1,007	\$ 690

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF COMPREHENSIVE INCOME (LOSS)—POWER PROGRAM (unaudited)

	Three months ended March 31		Six months ended March 31	
	2003	2002	2003	2002
	(in millions)		(in millions)	
Net income (loss)	\$ 90	\$ (89)	\$ 421	\$ (86)
Other comprehensive income (loss)				
Change in fair value of interest rate swap	12	12	10	11
Change in fair value of foreign currency swaps	(19)	18	(91)	82
	(7)	30	(81)	93
Comprehensive income (loss)	\$ 83	\$ (59)	\$ 340	\$ 7

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Organization

TVA is a wholly owned corporate agency and instrumentality of the United States. It was established by Congress in 1933 by the TVA Act with the objective of developing the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense by providing: (1) an ample supply of power within the region, (2) navigable channels and flood control for the Tennessee River System, and (3) agricultural and industrial development and improved forestry in the region. TVA carries out these regional and national responsibilities in a service area that centers on Tennessee and includes parts of Alabama, Georgia, Kentucky, Mississippi, North Carolina, and Virginia.

Substantially all TVA revenues and assets are attributable to its power program. The revenues and expenses of the power program have historically been segregated and distinct from TVA's nonpower programs. The TVA Act requires the power program to be self-supporting from power revenues and proceeds from power program financings.

Power rates are established by the TVA Board of Directors (Board) as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; payments to states and counties in lieu of taxes; debt service on outstanding indebtedness; and annual payments to the U. S. Treasury in repayment of and as a return on the government's appropriation investment in TVA's power facilities. Rates set by the Board are not subject to review or approval by any state or federal regulatory body. In a future restructured electric power industry, it is possible, however, that the ability of the Board to set TVA's rates as specified in the TVA Act could be adversely affected by legislative changes or by competitive pressures.

Basis of Presentation

TVA prepares its interim financial statements in conformity with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Because the accompanying interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements, they should be read in conjunction with the audited financial statements for the period ended September 30, 2002, and the notes thereto.

The amounts included in the interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary to fairly present TVA's financial position and results of operations for the interim periods. Due to seasonal weather variations, the timing of planned and unanticipated maintenance and refueling outages of electric generating units and other factors, the results of operations for interim periods are not necessarily indicative of results for the entire year.

In preparing financial statements that conform with generally accepted accounting principles, management must make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and amounts of revenues and expenses reflected during the reporting period. Actual results could differ from those estimates.

The financial statements presented include only the financial results of TVA's power program.

Fiscal Year

TVA's fiscal year ends September 30. Unless otherwise indicated, years (2003, 2002, etc.) refer to TVA's fiscal years.

Accounts Receivables

Accounts receivable primarily consist of amounts due from customers for power sales. The table below summarizes the type and amount of receivables:

	At March 31, 2003 (in millions)	At September 30, 2002 (in millions)
Power receivables billed	\$ 291	\$ 315
Power receivables unbilled	569	309
Total power receivables	860	624
Other receivables	37	44
Allowance for uncollectible accounts	(13)	(13)
Net accounts receivable	<u>\$ 884</u>	<u>\$ 655</u>

Change in Accounting for Unbilled Revenue

Effective October 1, 2002, the Board approved a change in the methodology for estimating unbilled revenue from electricity sales. The change was from a method using cumulative generation to a method using generation for the current billing period only as a basis for calculating the unbilled energy. The impact of this change resulted in an increase in accounts receivable of \$412 million with a corresponding cumulative effect gain for the change in accounting for unbilled revenue.

Regulatory Assets

Regulatory assets, costs capitalized under the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation*, which are included in Other deferred charges, consisted of certain charges related to the closure and removal of nuclear generating units, losses related to market-to-market valuation of purchase power options and an adjustment related to minimum pension liability.

	At March 31, 2003 (in millions)	At September 30, 2002 (in millions)
Decommissioning costs	\$ 852	\$ 556
Changes in fair value of derivative contracts	86	—
Adjustment to accrue minimum pension liability	896	896
	<u>\$ 1,834</u>	<u>\$ 1,452</u>

Impact of New Accounting Standards

On October 1, 2002, TVA adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*, which requires the recognition of a liability, and capitalization of the associated asset retirement cost as part of the carrying amount of the long-lived asset, for "legal obligations" associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or normal operation of long-lived assets. TVA identified and reviewed all relevant information in the determination of its potential asset retirement obligations (AROs). TVA identified four categories of AROs which represent legal obligations of TVA under the requirements set forth in the standard. Costs associated with retirement of coal-fired and gas/oil turbine generating plants and ash/waste ponds are being expensed as period costs while costs associated with retirement of nuclear generating plants are receiving SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, treatment based on the funded status of the obligation.

Nuclear Generating Plants. In prior years, TVA had recognized a decommissioning liability related to its nuclear generating plants in accordance with Nuclear Regulatory Commission requirements. This previously recorded liability represents the pre-SFAS No. 143 obligation for TVA's nuclear plant AROs. The adoption of SFAS No. 143 resulted in a change in the methodology of quantifying this nuclear decommissioning obligation in accordance with the new standard. TVA has increased the nuclear decommissioning liability on the balance sheet to the new estimate, but has retained its regulatory accounting treatment of capturing all changes in the liability, investment funds, and regulatory asset as changes in the regulatory asset instead of recording these items on the income statement.

Coal-Fired Generating Plants. The activities associated with coal plant retirement include plant shutdown, securing the physical property, closure of storage and/or waste areas, maintenance of stack lights, security patrols, and measures to contain asbestos and other hazardous materials from release into the environment. The estimated costs of these activities have been included in the calculation of TVA's coal plant AROs.

Gas/Oil Turbine Generating Plants. The activities associated with gas and oil turbine plant retirement include annual operating costs for site security, lighting, powerhouse and grounds maintenance, containment of asbestos, paint, and other materials, and groundwater monitoring. The estimated costs of these activities have been included in the calculation of TVA's combustion turbine plant AROs.

Ash/Waste Ponds. Most of the ARO components at TVA's coal plants have estimated useful lives that correspond to the overall estimated life of the plant, and these components were included in the coal plant AROs described above. However, certain ash ponds and waste areas have estimated useful lives that are independent of the lives of the coal plants themselves. Accordingly, these specific ash/waste pond areas were considered to be separate AROs and were quantified based on their specific estimated useful lives.

For each ARO identified, TVA calculated the net present value of the obligation as of the current period, the original and incremental cost of the long-lived asset at the time of initial operation, the cumulative effect of depreciation on the adjusted asset base and accretion of the liability from the date of initial operation to the current and pro-forma period. The following table summarizes for each ARO category the original asset cost, the current and pro-forma ARO liability, the current fair market value of any assets legally restricted for purposes of settling the obligation (see Management's Discussion and Analysis of Financial Condition and Results of Operations—Financing Activities), and the estimated future liability at the time of closure.

ARO Category	Original Asset Cost	March 31, 2003 ARO Obligation	Pro-Forma September 30, 2002 Obligation	Pro-Forma March 31, 2002 Value of Assets	Fair Market Obligation	Estimated Future Liability
(in millions)						
Nuclear Plants	\$ 461	\$ 1,461	\$ 1,421	\$ 1,383	\$ 518	\$ 10,446
Coal-Fired Plants	13	148	144	140	N/A	818
Gas/Oil Turbine Plants	1	2	2	2	N/A	51
Ash/Waste Ponds	4	41	40	39	N/A	85
Total	<u>\$ 479</u>	<u>\$ 1,652</u>	<u>\$ 1,607</u>	<u>\$ 1,564</u>	<u>\$ 518</u>	<u>\$ 11,400</u>

The effect of the adoption of SFAS No. 143 during the first quarter of 2003 included a cumulative effect charge to income of \$178 million, a corresponding additional long-term liability of \$717 million, an increase in assets of \$745 million, and related accumulated depreciation of \$206 million.

Pro-Forma Effects of Accounting Changes

Pro-forma net income amounts, assuming that the changes in accounting described above related to the change in methodology for estimating unbilled revenue and the adoption of SFAS No. 143 had been applied retroactively, are as follows:

	For the Three Months Ended March 31, 2002	For the Six Months Ended March 31, 2002
(in millions)		
Historical net loss	\$ (89)	\$ (86)
Accounting changes		
Unbilled revenue	52	39
Adoption of SFAS No. 143	(2)	(5)
Pro-Forma net loss	<u>\$ (39)</u>	<u>\$ (52)</u>

Other

Certain reclassifications have been made to the 2002 financial statements to conform to the 2003 presentation.

2. Proprietary Capital

Accumulated Other Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, requires the disclosure of comprehensive income to reflect changes in capital that result from transactions and economic events from nonpower sources. The losses for the six months ended March 31, 2003, are due to market valuation adjustments for certain derivative instruments.

Total Other Comprehensive Income (Loss) Activity (in millions)

Accumulated other comprehensive loss, September 30, 2002	\$ (150)
Change in fair value of interest rate swap	10
Change in fair value of foreign currency swaps	(91)
Accumulated other comprehensive loss, March 31, 2003	<u>\$ (231)</u>

3. Debt

From October 1, 2002 to March 31, 2003, TVA issued \$298 million of electronotes[®] with an average interest rate of 4.50 percent. During this period TVA redeemed \$39 million of electronotes[®] carrying an average interest rate of 4.81 percent. TVA also redeemed three other debt issues totaling \$342 million with an average interest rate of 6.61 percent.

4. Risk Management Activities and Derivative Transactions

During the second quarter of 2003, TVA monetized the call provisions on a \$1 billion public bond issue by entering into a swaption agreement with a third party in exchange for approximately \$175 million. The swaption essentially grants the third party the right to exercise the embedded call provision of the bond while TVA continues to pay the holder of the swaption pursuant to the original bond issuance. The swaption is recorded in other liabilities on the balance sheet and is designated as a hedge of the future changes in the fair value of the original call provision. Under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, TVA will mark-to-market both the swaption and the embedded call. These values historically have been highly correlated; however, to the extent that the values do not perfectly offset, any differences will be recognized currently through earnings.

TVA is exposed to market risks, including changes in interest rates, foreign currency exchange rates, and volatility of certain commodity and equity market prices. To manage the volatility attributable to these exposures, TVA has entered into various nontrading derivative transactions, principally an interest rate swap agreement, foreign currency swap contracts, and option and swaption contracts.

The recorded amounts of these derivative financial instruments are as follows:

Mark-to-Market of Derivative Transactions At March 31, 2003 and September 30, 2002

	Asset/(Liability)	
	March 31, 2003 (in millions)	September 30, 2002 (in millions)
Interest rate swap	\$ 35	\$ 22
Currency swaps:		
Deutschemark	(349)	(328)
Sterling (GBP200 million)	(27)	(35)
Sterling (GBP250 million)	18	13
Swaption	(212)	—
Debt-embedded call	176	—
Coal contracts—volume options	41	1
Purchase power contracts	(86)	—
	<u>\$ (404)</u>	<u>\$ (327)</u>

5. Commitments and Contingencies

New agreements

TVA entered into a lease/leaseback transaction during the first quarter of 2003 resulting in proceeds of about \$163 million for four combustion turbine units completed in 2002. The proceeds represented the appraised values of the facilities. Annual payment obligations under all combustion turbine lease/leaseback transactions as of March 31, 2003, total \$28 million for the remainder of 2003, \$57 million annually for 2004 and 2005, \$55 million annually for 2006 and 2007, and \$807 million thereafter, for a total commitment of \$1,059 million. Of this amount, \$349 million represents interest.

The estimated commitments for TVA as of March 31, 2003 are as follows:

	2003*	2004	2005	2006	2007	Thereafter	Total
	(in millions)						
Debt	\$ 3,269	\$ 2,336	\$ 2,000	\$ 2,621	\$ 1,024	\$ 13,702	\$ 24,952
Leases	20	40	39	39	39	121	298
Lease/leaseback transactions	28	57	57	55	55	807	1,059
Power purchase obligations	68	113	136	136	124	2,390	2,967
Other obligations	11	30	17	16	13	117	204
Fuel purchase obligations	<u>747</u>	<u>1,078</u>	<u>654</u>	<u>430</u>	<u>322</u>	<u>518</u>	<u>3,749</u>
Total	<u>\$ 4,143</u>	<u>\$ 3,654</u>	<u>\$ 2,903</u>	<u>\$ 3,297</u>	<u>\$ 1,577</u>	<u>\$ 17,655</u>	<u>\$ 33,229</u>

*Period April 1 - September 30, 2003

6. Benefit Plans

Other Postretirement Benefits

TVA sponsors an unfunded postretirement plan that provides for non-vested contributions toward the cost of certain retirees' medical coverage. This plan formerly covered all retirees participating in the TVA medical plan, and TVA's contributions were a flat dollar amount based on the participants' ages and years of service and certain payments toward the plan costs. This plan now operates on a much more limited basis, covering only certain retirees and surviving dependents who do not qualify for TVA Retirement System (TVARS) benefits.

During 2000, these postretirement benefits were enhanced to help covered retirees offset the cost of medical coverage resulting in approximately \$16 million in additional postretirement benefit obligations.

Effective July 1, 2002 (applied retroactively to January 1, 2002), TVA changed its retiree medical plan to provide an enhanced benefit for certain retirees who retired with 20 or more years of service and are eligible for the original plan pension supplement from TVARS. The benefit is in the form of a credit provided by TVA to eligible retirees to help offset the cost of medical premiums. The additional benefit increased the accumulated postretirement benefit obligation approximately \$199 million at the end of 2002. Pursuant to SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the increase in cost is combined with the existing net unrecognized prior service cost and amortized to expense over future periods. Expense for 2003 will increase approximately \$34 million (from \$19 million in 2002 to \$53 million in 2003) due primarily to the additional prior service cost amortization and corresponding increases in service cost and interest cost coupled with changes in demographic information and actuarial assumptions.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) explains the results of operations and general financial condition of TVA. The MD&A should be read in conjunction with the accompanying Financial Statements and the 2002 Information Statement dated January 13, 2003.

Results of Operations

Net income for the second quarter was \$90 million, an increase of \$179 million compared to the second quarter of 2002. The increase resulted in part from an increase in overall operating income in conjunction with a decrease in interest expense, as described below; additionally, TVA recognized a loss on plant cancellation of \$150 million in March 2002 which resulted in a net loss for the second quarter of 2002, not present in the current year.

Year-to-date net income was \$421 million compared to an \$86 million net loss for the same period last year, an improvement of \$507 million. A significant portion of the improvement relates to accounting changes effective for 2003. Two significant accounting changes in the first quarter of 2003 resulted in a \$412 million gain related to a change in accounting for unbilled revenue and a \$178 million charge related to a change in accounting for asset retirement obligations. In addition, TVA recognized a loss on plant cancellation of \$150 million in March 2002 which resulted in a net loss for the six months ending March 2002, not present in the current year.

Operating Revenues. Total sales increased approximately 2.1 billion kilowatt-hours (or 5.2 percent) for the quarter ended March 31, 2003, over the same period of 2002. The increase was primarily weather related with 13.6 percent more heating degree days during the second quarter of 2003 than 2002. The increase in total sales for the six month period ended March 31, 2003, over the same period of 2002 was approximately 5.5 billion kilowatt-hours (or 7.3 percent) and was also weather related. The TVA service territory experienced colder weather resulting in 19.7 percent more heating degree days for the six month period ended March 31, 2003, over the same period last year. A detailed table of electricity sales for the three and six month periods ended March 31, 2003, and 2002 is as follows:

	Three months ended March 31		Six months ended March 31	
	2003	2002	2003	2002
Sales of electricity (millions of kWh)				
Municipalities and cooperatives	33,051	30,991	63,935	59,633
Industries directly served	7,933	7,427	15,176	13,548
Federal agencies and other utilities	<u>844</u>	<u>1,337</u>	<u>2,250</u>	<u>2,648</u>
Total sales of electricity	<u>41,828</u>	<u>39,755</u>	<u>81,361</u>	<u>75,829</u>

Total operating revenues increased to \$1,803 million in the quarter ended March 31, 2003, compared to \$1,653 million in the quarter ended March 31, 2002. This is an increase of \$150 million or 9.1 percent.

	Three months ended March 31		Percent Change
	2003	2002	
	(in millions)		
Sales of electricity			
Municipalities and cooperatives	\$ 1,526	\$ 1,403	8.8%
Industries directly served	217	190	14.2%
Federal agencies and other	39	38	2.6%
Other revenue	<u>21</u>	<u>22</u>	<u>-4.5%</u>
Total operating revenues	<u>\$ 1,803</u>	<u>\$ 1,653</u>	<u>9.1%</u>

For the six months ended March 31, 2003, revenues increased to \$3,496 million, compared to \$3,174 million for the same period in 2002, an increase of \$322 million or 10.1 percent.

	Six months ended March 31		
	2003	2002	Percent Change
	(in millions)		
Sales of electricity			
Municipalities and cooperatives	\$ 2,972	\$ 2,704	9.9%
Industries directly served	403	352	14.5%
Federal agencies and other	81	80	1.3%
Other revenue	<u>40</u>	<u>38</u>	<u>5.3%</u>
Total operating revenues	<u>\$ 3,496</u>	<u>\$ 3,174</u>	<u>10.1%</u>

The increase in total operating revenues for the three month and six month periods ended March 31, 2003, over the same period in 2002 resulted from increased sales to municipalities and cooperatives and increased sales to industries directly served (see Note 1 – Change in Accounting for Unbilled Revenue). Sales to residential customers, which account for approximately 45 percent of total municipality and cooperative sales, and sales to firm power customers, which account for approximately 48 percent of directly served customers, increased mainly due to colder temperatures as compared with the prior year. Directly served industries revenue increased due to higher average prices resulting from changes in product mix and service mix to certain customers.

Fuel and Purchased Power. Fuel and purchased power costs increased to \$557 million in the quarter ended March 31, 2003, compared to \$449 million in the quarter ended March 31, 2002, an increase of \$108 million or 24.1 percent. For the six months ended March 31, 2003, fuel and purchased power costs increased to \$980 million, compared to \$834 million for the same period in the prior year, an increase of \$146 million or 17.5 percent. The increase for both periods resulted from increased purchased power costs due to several longer-term forced outages at three generating facilities. Although demand for electricity increased primarily due to weather, fuel expense decreased because of reduced system availability. Demand was met by purchasing power at higher prices.

Operating and Maintenance Expenses. Operating and maintenance expenses increased \$40 million; or 9.1 percent, from \$439 million to \$479 million for the quarters ended March 31, 2002 and 2003, respectively. This increase was primarily due to increased pension costs of \$26 million and increased outage and project costs of \$10 million.

Operating and maintenance expenses increased \$100 million or 11.6 percent, from \$864 million to \$964 million for the six month periods ended March 31, 2002, and 2003. The increase included higher pension expense of \$50 million, increased benefit costs of \$12 million, and increased nuclear outage costs of \$29 million.

Depreciation, Amortization, and Accretion. Depreciation, amortization, and accretion decreased from \$271 million to \$264 million for the quarters ended March 31, 2003, and 2002, respectively. The decrease resulted primarily from accelerated amortization of \$17 million in the prior year which was not incurred in 2003, offset by increased depreciation expense of \$7 million for increased capital projects placed in service during the current quarter, and accretion expense of \$5 million related to the adoption of SFAS No. 143, *Accounting for Asset Retirement Obligations*.

Depreciation, amortization, and accretion decreased for the six month periods ended March 31, 2003, and 2002, respectively, from \$540 million in the prior year to \$527 million. The decrease primarily resulted from accelerated amortization of \$33 million in the prior year which was not incurred in 2003, offset by increased depreciation expense of \$15 million for increased capital projects placed in service during the year, and accretion expense of \$5 million related to the adoption of SFAS No. 143, *Accounting for Asset Retirement Obligations*.

Loss on Plant Cancellation. Due to changes in the market forecast, TVA elected during 2002 not to complete a gas-fired combined-cycle plant that would have provided 510 megawatts of power in 2004. Accumulated costs of the project totaled approximately \$150 million, which TVA recognized as a loss on plant cancellation during the quarter ended March 31, 2002.

Interest Expense. Interest expense was \$335 million in the quarter ended March 31, 2003, compared to \$357 million in the quarter ended March 31, 2002. This reduction reflects lower average interest rates on short-term debt and a lower level of total outstanding long-term debt during the second quarter of fiscal year 2003. Total outstanding indebtedness, as of March 31, 2003, was \$25 billion with an average year-to-date long-term interest rate of 6.37 per-

cent and an average short-term interest rate of 1.40 percent; as of March 31, 2002, total debt outstanding was approximately \$25 billion with an average long-term interest rate of 6.37 percent and an average short-term interest rate of 2.08 percent.

Interest expense decreased \$36 million for the six months ended March 31, 2003, from \$717 million in the prior year to \$681 million this year. This reduction reflects lower average interest rates on total outstanding debt during the first six months of fiscal year 2003. Interest rates for long-term debt averaged 6.30 percent for the first six months of 2003 compared with 6.38 percent for the same period of 2002. Interest rates for short-term debt averaged 1.26 percent for the first six months of 2003 compared with 1.76 percent for the same period of 2002.

Cumulative Effects of Accounting Changes. The net gain of \$234 million from accounting changes during the first quarter of 2003 included a gain from the change in accounting for unbilled revenues of \$412 million, partially offset by a change in accounting for asset retirement obligations of \$178 million (see note 1 – Impact of New Accounting Standards).

Material Changes in Liquidity and Capital Resources

Comparative Cash Flow Analysis

Net cash provided by operating activities increased \$65 million from \$523 million to \$588 million for the three month periods ended March 31, 2002, and 2003, respectively. The increase includes greater electricity sales of \$151 million primarily to municipalities and cooperatives due to weather conditions. The increase in sales was partially offset by a corresponding increase in fuel and purchased power expenses of \$108 million due to greater generation and purchased power costs incurred to meet demand. Working capital requirements increased \$36 million primarily as a result of a lower level of accounts receivable of \$24 million and a smaller increase in inventories and other of \$11 million.

Net cash provided by operating activities increased \$285 million for the six month period ended March 31, 2003, compared with the same period of 2002. The increase includes greater electricity revenues of \$320 million primarily from municipalities and cooperatives due to weather conditions in the Valley and to new contract terms and pricing for industries directly served. The increase in sales was partially offset by a corresponding increase in fuel and purchased power expenses of \$146 million due to greater generation and purchased power costs incurred to meet demand and an increase in operating and maintenance cost due to planned maintenance and unplanned outages (see Other Information—Operations—Outages). Other items requiring cash decreased by \$72 million for the six months ended March 31, 2003 from the same period last year due to lower spending on outages as a result of deferrals to future periods and a decrease in distributor prepayments.

Cash used in investing activities increased \$231 million for the three month period ended March 31, 2003, compared to the same period in 2002. This was primarily due to increased capital spending of \$98 million including clean air initiatives and Browns Ferry Unit 1 restart. The increase is also related to \$119 million of investments that were liquidated in the second quarter of the prior year, not present in the current year.

Cash used in investing activities increased \$102 million for the first six months of 2003 compared to the same period in 2002. This was primarily due to increased capital spending of \$150 million including clean air initiatives and the Browns Ferry Unit 1 restart. This was partially offset by a decrease in nuclear fuel fabrication costs of \$23 million and a \$22 million increase in proceeds from the maturity of long-term notes receivable.

Net cash used in financing activities decreased \$287 million for the three month period ended March 31, 2003, compared to the same period of 2002. Redemptions of long-term debt increased \$380 million and issuances of long-term debt decreased \$22 million. Additionally, payments on lease/leaseback obligations were \$23 million. This was offset by a decrease in net short-term debt redemptions of \$534 million, respectively, from 2002 to 2003. During the second quarter of 2003, TVA monetized the call provisions on a \$1 billion public bond issue by entering into a swap-tion agreement with a third party in exchange for approximately \$175 million (see note 4).

Net cash used in financing activities decreased \$269 million for the six months ended March 31, 2003, compared to the same period of 2002. Long-term debt issues decreased by \$558 million and net proceeds from combustion turbine financing were \$190 million less during the first six months of 2003. Redemptions of long-term debt and net redemptions of short-term debt declined \$38 million and \$772 million, respectively, from 2002 to 2003 while financing costs were also \$28 million less in the first six months of 2003 than the same period in 2002. In addition, TVA received \$175 million proceeds from a call monetization in 2003 (see note 4).

Working Capital

At March 31, 2003, TVA had negative working capital of nearly \$2,947 million, largely attributable to \$3,269 million in short-term indebtedness. The table below summarizes the components of working capital and discount notes with maturities of less than 90 days. It is TVA's cash management policy to use these short-term notes to meet current obligations and TVA plans to continue to use such financing instruments as long as short-term interest rates remain favorable and interest coverage levels are met.

	At March 31 2003	At September 30 2002
	(in millions)	
Current assets	\$ 1,902	\$ 1,530
Current liabilities	(4,849)	(4,809)
Working capital	<u>\$ (2,947)</u>	<u>\$ (3,279)</u>
Discount notes <90 days	<u>\$ 3,269</u>	<u>\$ 3,492</u>

Financing Activities*Capital Resources*

From October 1, 2002 to March 31, 2003, TVA issued \$298 million of electronotes[®] with an average interest rate of 4.50 percent. During this period TVA redeemed \$39 million of electronotes[®] carrying an average interest rate of 4.81 percent. TVA also redeemed three other issues totaling \$342 million with an average interest rate of 6.61 percent (see Other Information—Debt Securities).

Discounted Energy Units

During October of 2002, TVA introduced the Discounted Energy Units (DEU) program as another way of doing business with their customers. The goal of the program is to create a financial partnering between TVA and its customers to help finance the restart of Browns Ferry Unit 1. Annually for fiscal years 2003-2007, TVA customers may purchase DEU in \$1 million increments which entitles them to a 0.025 \$/kWh discount on a specified quantity of firm load over a period of years (10, 15, or 20) for each kilowatt-hour in the prepaid block. The remainder of the price of the kilowatt-hours delivered is due upon billing. This program will allow customers to use the DEU to reduce their overall rates, lock in power supply without taking asset ownership risk and provide a higher return for available cash.

As of March 31, 2003, TVA had entered into sales agreements for 47.25 DEU totaling \$47.25 million. TVA is accounting for the prepaid power as unearned revenue in Other liabilities on the March 31, 2003, Balance Sheet and is recognizing revenue as electricity is delivered to customers.

Lease/Leaseback Transactions

During the summer of 2002, TVA completed construction of two sets of four combustion turbine units which were part of a series of new peaking combustion turbine units. Of the financing options available to TVA for these units, long-term lease and leaseback arrangements provided outcomes that were the most economically favorable to TVA. The lease/leaseback for the first set of four units was finalized during the first quarter of 2003 and provided about \$163 million in lease proceeds. The cost of the first lease agreement approximated a full-term implicit rate just above four percent. (See Subsequent Events for a discussion of the lease/leaseback of the second of four units).

TVA accounted for the respective lease proceeds as financing obligations in accordance with SFAS No. 66, *Accounting for Sales of Real Estate*, and SFAS No. 98, *Accounting for Leases*. Accordingly, the outstanding financing obligations of \$559 million in 2002 are included in Current liabilities (\$16 million) and Other liabilities (\$543 million), respectively in TVA's 2002 year-end Balance Sheet. During the first quarter of 2003, TVA received about \$163 million in lease proceeds which were recorded as additional financing obligations in accordance with SFAS Nos. 66 and 98. The outstanding financing obligations of \$710 million are included in Current liabilities (\$34 million) and Other liabilities (\$676 million), respectively; in TVA's Balance Sheet for the quarter ended March 31, 2003.

Cash Requirements and Contractual Obligations

The estimated commitments for TVA as of March 31, 2003 are as follows:

	2003*	2004	2005	2006	2007	Thereafter	Total
	(in millions)						
Debt	\$ 3,269	\$ 2,336	\$ 2,000	\$ 2,621	\$ 1,024	\$13,702	\$24,952
Leases	20	40	39	39	39	121	298
Lease/leaseback transactions	28	57	57	55	55	807	1,059
Power purchase obligations	68	113	136	136	124	2,390	2,967
Other obligations	11	30	17	16	13	117	204
Fuel purchase obligations	747	1,078	654	430	322	518	3,749
Total	<u>\$ 4,143</u>	<u>\$ 3,654</u>	<u>\$ 2,903</u>	<u>\$ 3,297</u>	<u>\$ 1,577</u>	<u>\$17,655</u>	<u>\$33,229</u>

*Period April 1 - September 30, 2003

As of March 2003, the nuclear decommissioning trust funds totaled approximately \$518 million, which is approximately \$396 million less than the present value of the estimated future decommissioning costs calculated in accordance with Nuclear Regulatory Commission (NRC) requirements. In March 2003, TVA submitted its biennial letter to the NRC on the funding status of the Nuclear Decommissioning Trust versus its liabilities. In the letter, TVA states that it is considering several alternatives to provide additional funding assurance methods and is assessing the need for future action on an ongoing basis. The current status of the fund has been primarily influenced by sizable declines in the stock market as well as increases in the projected decommissioning costs. Moderate market recovery along with the achievement of planned license renewal of Browns Ferry Nuclear Plant within the near term will restore overall funding adequacy. These factors will have a significant impact on the status of the fund and prudent planning obligates TVA to take them into account.

New Accounting Pronouncements

On October 1, 2002, TVA adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*, which requires the recognition of a liability, and corresponding asset retirement unit, for "legal obligations" associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or normal operation of long-lived assets. TVA identified and reviewed all relevant information in the determination of its potential asset retirement obligations (AROs). TVA identified four categories of AROs which represent legal obligations of TVA under the requirements set forth in the standard. Costs associated with retirement of coal-fired and gas/oil turbine generating plants and ash/waste ponds are being expensed as period costs while costs associated with retirement of nuclear generating plants are receiving SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, treatment based on the funded status of the obligation.

Nuclear Generating Plants. In prior years, TVA had already recognized a decommissioning liability related to its nuclear generating plants in accordance with NRC requirements. This previously recorded liability represents the pre-SFAS No. 143 obligation for TVA's nuclear plant AROs. The adoption of SFAS No. 143 resulted in a change in the methodology of quantifying this nuclear decommissioning obligation in accordance with the new standard. TVA has increased the nuclear decommissioning liability on the balance sheet to the new estimate, but has retained its regulatory accounting treatment of capturing all changes in the liability, investment funds, and regulatory asset as changes in the regulatory asset instead of recording these items on the income statement.

Coal-Fired Generating Plants. The activities associated with coal plant retirement include plant shutdown, securing the physical property, closure of storage and/or waste areas, maintenance of stack lights, security patrols, and measures to contain asbestos and other hazardous materials from release into the environment. The estimated costs of these activities have been included in the calculation of TVA's coal plant AROs.

Gas/Oil Turbine Generating Plants. The activities associated with gas and oil turbine plant retirement include annual operating costs for site security, lighting, powerhouse and grounds maintenance, containment of asbestos, paint, and other materials, and groundwater monitoring. The estimated costs of these activities have been included in the calculation of TVA's combustion turbine plant AROs.

Ash/Waste Ponds. Most of the ARO components at TVA's coal plants have estimated useful lives that correspond to the overall estimated life of the plant, and these components were included in the coal plant AROs described above. However, certain ash ponds and waste areas have estimated useful lives that are independent of the lives of the coal plants themselves. Accordingly, these specific ash/waste pond areas were considered to be separate AROs

and were quantified based on their specific estimated useful lives.

For each ARO identified, TVA calculated the net present value of the obligation as of the current period, the original and incremental cost of the long-lived asset at the time of initial operation, the cumulative effect of depreciation on the adjusted asset base and accretion of the liability from the date of initial operation to the current period.

The effect of the adoption of SFAS No. 143 during the first quarter of 2003 included a cumulative effect charge to income of \$178 million, a corresponding additional long-term liability of \$717 million, an increase in assets of \$745 million, and related accumulated depreciation of \$206 million.

QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Value at Risk

TVA does not engage in wholesale trading operations for the purposes of speculation. Rather, when necessary, in order to supplement generation to meet its native load, TVA will engage in some aspects of physical trading. Further, TVA employs commodity-based instruments which include forwards and option contracts to manage risks associated with the market fluctuations in the price and transportation costs of certain commodities and fuels including, but not limited to, coal, natural gas and electricity.

Mark-to-Market Valuation

TVA has not made any changes to its valuation methodology from prior years. As of March 31, 2003, TVA's twelve-month forward position on a mark-to-market (MTM) basis for all energy assets for all hours is as follows:

Source of Fair Value	April 2003 – March 2004 (in millions)
Owned Assets	\$ —
Actively Quoted	—
Prices Provided by External Sources	3,826
Modeled	—
Total	<u>\$ 3,826</u>

Note that prices quoted by external sources reflect independent broker quotations and publicly posted prices on electronic media such as the Intercontinental Exchange.

Based on March 31, 2003 closing prices, the MTM value of TVA's energy portfolio for April 2003 to March 2004 is shown in the table above. The fair value calculation determines a profit or loss for each source of fair value, e.g. load, based on market prices. Since TVA is almost completely hedged, only a small portion of power is bought and sold in the market so the market price has little impact on TVA margins.

Effective October 1, 2002, TVA adopted consensus two of the Emerging Issues Task Force Issue (EITF) 02-03, *Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities*. EITF Issue 02-03 rescinded EITF Issue 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, and reached two general conclusions:

- Energy trading contracts that do not meet the definition of a derivative under SFAS No. 133 should not be marked to fair market value, and
- Revenues should be shown in the income statement net of costs associated with trading activities, whether or not the trades are physically settled.

TVA's energy trading activities qualify as normal sales and purchases under SFAS No. 133, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and accordingly, adoption of EITF Issue 02-03 Issue had no impact on previously reported net income or proprietary capital.

Cash Flow Hedges Included in Accumulated Other Comprehensive Loss on the Balance Sheet
 March 31, 2003
 (in millions)

	Accumulated Other Comprehensive Loss
Interest Rate	\$ (9)
Foreign Currency	(222)
Total	<u>\$ (231)</u>

CONTROLS AND PROCEDURES

TVA's management, including the Chief Financial Officer and the members of the Board of Directors (Board), have conducted an evaluation of the effectiveness of TVA's disclosure controls and procedures as of a date within 90 days prior to the date of this quarterly report. Based on that evaluation, the members of the Board and the Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information necessary and appropriate in this quarterly report has been made known to them in a timely fashion. TVA's disclosure controls and procedures are effective in ensuring that information disclosed in TVA's periodic financial reports is accumulated and communicated to management, including the members of the Board and the Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the members of the Board and the Chief Financial Officer completed their evaluation.

OTHER INFORMATION

LEGAL PROCEEDINGS

On February 20, 2003, the federal district court in Florence, Alabama, dismissed the Alabama Environmental Council and the Sierra Club's claim for civil penalties for alleged violations of Clean Air Act opacity limits applicable to the Colbert Fossil Plant (Colbert). These groups are still seeking a court order (1) declaring TVA in violation of these opacity limits and (2) requiring TVA to bring Colbert into continuous compliance with these limits. These two claims are set for trial in July 2003.

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the U.S. District Court for the Northern District of Alabama challenging TVA's charges for economy surplus power (ESP) during the summer of 1998. The lawsuit purports to be a class action on behalf of industrial customers who participate in TVA's ESP program. Under ESP contracts, the hourly ESP energy price is calculated using TVA's actual incremental cost of supplying the ESP load in each hour. The plaintiff alleges that TVA overcharged for ESP during the summer of 1998 by including in the price of ESP in some hours certain costs that the plaintiff contended were not properly charged to ESP customers under the terms of the contracts. The plaintiff is seeking over \$100,000,000 in damages on behalf of itself and the other proposed class members. In September 2002, the U.S. District Court for the Northern District of Alabama decertified the class action and then dismissed the lawsuit without prejudice on a jurisdictional issue, and the plaintiff appealed to the U.S. Court of Appeals for the Eleventh Circuit. Oral argument on the appeal occurred on June 5, 2003.

DEBT SECURITIES

TVA issues power bonds pursuant to Section 15d of the TVA Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution. Power Bonds in each series must be further authorized by Supplemental Resolution. The table below summarizes TVA's debt securities activity for the period from October 1, 2002, to March 31, 2003.

Activity October 1, 2002 to March 31, 2003
(in millions)

	Date	Amount	Coupon
Redemptions:			
1998 Series A	1/2/2003	\$ 242	6.350%
2000 Series A	1/18/2003	65	7.150%
2000 Series B	1/18/2003	35	7.400%
electronotes®	3/2/2003 and 3/15/2003	39	4.375% – 5.875%
		<u>\$ 381</u>	
Issues:			
electronotes®	First Quarter 2003	\$ 156	4.600% - 5.050%
	Second Quarter 2003	142	3.050% - 5.000%
		<u>\$ 298</u>	

TVA announced in early May 2003 that the coupon rate for the 1998 Series D PARRS (Putable Automatic Rate Reset Securities) will reset to 5.952 percent effective June 1, 2003, and will be reflected in the quarterly interest payments beginning on September 1, 2003. Bondholders have the option of retaining the bonds at the new rate or returning the bonds to TVA. Bondholders who choose to return the bonds will receive the \$25 par value of each bond.

TVA priced a £150 million 40-year British pound sterling-denominated global power bond offering on May 20, 2003. The bonds were priced with a coupon of 4.625 percent and mature in 2043. The bonds are non-callable and pay interest annually. Proceeds from the sale will be used for power program purposes. When TVA issued the £150 mil-

lion global power bonds, TVA entered into a currency swap agreement to hedge against inflation in the USD-GBP exchange rate.

BOARD ACTIONS

As of October 6, 2002, the Board approved such actions as may be necessary or desirable to effect the sale and leaseback or the lease and leaseback of eight combustion turbines, four for TVA's Lagoon Creek Combustion Turbine Plant and four for TVA's Kemper County, Mississippi site, and to enter into any agreements, to make such certifications, and to take such other actions as may be necessary or desirable to effect any such leasing arrangements.

As of January 10, 2003, the Board approved (1) regulatory accounting treatment of TVA's fiscal year 2002 minimum unfunded pension liability; (2) adoption of SFAS No. 143, *Accounting for Asset Retirement Obligations*; and (3) a change in methodology for estimating and recording unbilled revenue.

As of February 3, 2003, the TVA Board of Directors approved a Corporate Accountability and Disclosure Plan to establish additional policies and procedures to better ensure the accuracy and completeness of TVA's financial and non-financial disclosure and the integrity of its financial reporting. Additionally, the Board authorized a Disclosure Control Committee and delegated to the Disclosure Control Committee the authority to develop and implement the policies, controls, and procedures required to execute the Corporate Accountability and Disclosure Plan. In the same action, the Board approved the Disclosure and Financial Ethics Code.

As of February 6, 2003, the Board approved the sale on an Option to enter into an interest rate swap associated with a call provision which TVA has on \$1 billion of TVA Power Bonds.

OTHER INFORMATION

Rates

Rate Adjustments

TVA has begun preliminary discussions with distributor representatives about the need for a rate adjustment and a change in the structure of TVA's rates for fiscal year 2004. An overall wholesale rate increase of 5.9 percent is being explored, which could generate about \$365 million in additional revenue annually for TVA. If approved by the Board, the adjustment would likely take effect in October 2003.

Products

Flat Price Interruptible

Flat Price Interruptible (FPI), a new five-minute interruptible product offering, was recently approved by the TVA Board and is now available for qualifying loads greater than one megawatt. FPI provides a credit to a customer's demand charge in exchange for interruption rights. The product offers an option for some manufacturers who previously have not had an opportunity to participate in TVA's interruptible programs and provides TVA with up to 300 megawatts of additional five-minute interruptible power to use as supplemental reserves.

Discounted Energy Unit Program

TVA has offered and plans to offer again a discounted energy unit (DEU) program whereby a distributor can prepay a portion of the price of a block of power to be taken and will subsequently receive credit on its power bill over a period of years (10, 15, or 20) for each kilowatt-hour in the prepaid block. As of March 31, 2003, DEUs totaling over \$47 million have been sold and are included in Other liabilities on the Balance Sheet.

Customers

Contract Termination Notice

TVA received notice from Warren Rural Electric Cooperative Corporation (Warren RECC) in Bowling Green, Kentucky, which terminates its power contract with TVA in April 2008. During fiscal year 2002, sales to Warren RECC generated approximately one percent of TVA's total revenues. Once a power contract is terminated, the terminating distributor would have neither the obligation nor the right to take power or obtain transmission from TVA, absent the negotiation of new arrangements.

Wholesale Power Contracts

The Board and the board of the Tennessee Valley Public Power Association (TVPPA), an organization representing almost all of the distributors of TVA power, have recently been in discussions to develop a common

approach to energy legislation currently being considered in Congress. In connection with those discussions, TVPPA asked for, and TVA agreed to offer, additional flexibility under the wholesale power contract with respect to contract termination. Previously, if requested by a distributor, TVA would execute an amendment allowing the wholesale power contract to be terminated in its entirety upon five years' notice. The Board has sent all distributors a letter offering to enter into a wholesale power contract amendment under which, in the event the existing statutory provisions that restrict TVA's ability to make off-system sales and protect TVA from wholesale competition are repealed, each distributor would have the right at any time, upon five years' notice, to elect to take any amount of power that it chooses from another source. In the event of such a notice, TVA would remain obligated to supply only the remaining portion of the distributor's load, however large or small.

Operations

Outages

During the first and second quarters of 2003, TVA had approximately 2,000 megawatts of capacity at three different generating facilities in longer-term forced outage. TVA returned to service approximately 500 megawatts near the end of March, and an additional 144 megawatts at the beginning of May. The remaining megawatts returned to service in early June. TVA had adjusted other outage schedules and budgets to accommodate the impacts of these forced outages.

During the planned refueling outage of Sequoyah Unit 1, plant personnel inspected the top of the reactor vessel and found the existence of boron residue which could be explained by a reactor coolant system leak. Following the completion of extensive inspections, TVA determined that there was no leak in the reactor vessel head and that there was no cracking in either the penetration tube or the weld in the area where a trace of boron residue was found. For added assurance, the Electric Power Research Institute independently analyzed TVA's inspection results and concurred with TVA's determination.

Browns Ferry Unit 1

In May 2002, the Board initiated activities for the return of Browns Ferry Unit 1 to service in order to meet long-term energy needs in the Tennessee Valley. It is anticipated the Browns Ferry Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately \$1.8 billion and will take five years to complete. When Unit 1 returns to service, it is expected its additional generation will help lower TVA's average cost of power. As of March 31, 2003, TVA had incurred approximately \$140 million of costs on the Browns Ferry Unit 1 restart project, slightly under the planned amount for this period. The restart project was about 16 percent complete at that date.

Transmission

On April 16, 2003, TVA entered into a Memorandum of Understanding (MOU) with the Midwest Independent Transmission System Operator, Inc. (MISO), and the PJM Interconnection (PJM). The MOU is intended to serve as a framework for the development of a multiregional coordination agreement among TVA, MISO, and PJM designed to facilitate wholesale electricity competition and transmission services through a significant portion of the Eastern Interconnection. The Eastern Interconnection refers to North America's electric system east of the Rocky Mountains, excluding most of Texas, and it includes 622,000 megawatts of peak electric load when fully developed. The scope of the area that encompasses TVA, MISO, and PJM would include about 270,000 megawatts of peak load (about 43 percent of the peak load in the Eastern Interconnection), about 295,000 megawatts of generating capacity, about 150,000 miles of transmission lines, and more than 57 million customers or end users.

Legislation

Debt Ceiling

On February 3, 2003, the Bush Administration released its fiscal year 2004 budget plan. Among other things, the plan charges TVA with developing a plan to significantly reduce its debt and proposes legislation that would include certain financial transactions, such as lease-leaseback obligations, that result in increasing TVA's long-term liabilities in the calculation of TVA's \$30 billion debt ceiling.

Business Outlook and Strategic Plan

On February 5, 2003, Senator Trent Lott (R-MS) reintroduced a bill in the Senate that would require TVA to provide Congress and the Administration with a 10-year business outlook and strategic plan. Under the bill, restrictions would be placed on new generating capacity and debt issuances.

Energy Bill

On April 11, 2003, the House of Representatives passed an energy bill (H.R. 6) that, among other things would (1) authorize TVA to voluntarily join a regional transmission organization in a manner consistent with its statutory obliga-

tions and limitations, and (2) subject TVA and other nonjurisdictional utilities to FERC transmission service oversight to assure that such utilities provide transmission service to others at comparable rates and on comparable terms and conditions to those that apply when they provide transmission service to themselves. The bill does not change restrictions on the TVA service area or affect TVA's authority to set its own rates. The Senate Committee on Energy and Natural Resources is also developing energy legislation, but it is unclear at this time what the contents of that legislation will be.

Stewardship Responsibilities

During 2003, TVA continued to conduct certain nonpower programs including managing navigable river channels, providing flood control and overseeing certain recreation facilities. TVA's responsibilities include general stewardship of land, water, and wildlife resources. Historically, Congressional appropriations provided most of the funding for TVA's nonpower programs, and TVA has obtained additional funds from revenues and user fees from the nonpower programs. In October 1997, Congress passed legislation that directed TVA to fund essential stewardship activities related to its management of the Tennessee River system and TVA properties with power funds in the event that there were insufficient appropriations or other available funds to pay for such activities in any year. Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. TVA primarily is using power funds (along with user fees and other forms of nonpower revenues) to continue to fund these stewardship activities. TVA spent a total of approximately \$41 million on essential stewardship activities during the first six months of fiscal 2003.

Management

On February 24, 2003, the Board announced that TVA Chief Financial Officer David Smith is retiring from TVA effective June 30, 2003. TVA has begun a search for a successor, and Mr. Smith will assist in the transition to new financial leadership at TVA.

SUBSEQUENT EVENTS

On May 9, 2003, Richard Moore was sworn in as TVA's first Presidentially appointed TVA Inspector General. Mr. Moore previously served as assistant U.S. attorney and as the Anti-Terrorism Task Force Coordinator in the southern district of Alabama.

Financing for the second set of four combustion turbine units was completed on May 5, 2003, and provided \$162.5 million in proceeds to TVA. The financing costs of the lease agreements approximated a full term implicit rate slightly less than four percent.

certifications of the members of the TVA board of directors

Glenn L. McCullough, Jr., Skila Harris and Bill Baxter individually certify that:

1. I have reviewed the Tennessee Valley Authority Power Quarterly Report (Report) for the second quarterly period ended March 31, 2003;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the unaudited financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. I and the other members of the Tennessee Valley Authority Board of Directors are responsible for establishing the Tennessee Valley Authority's Disclosure Control Committee which is documenting the Tennessee Valley Authority's disclosure controls and procedures and which has reviewed this Report;
5. I and the other certifiers have disclosed, based on our most recent evaluation, to the Tennessee Valley Authority's independent auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies in the design or operation of internal controls that could adversely affect the Tennessee Valley Authority's ability to record, process, summarize and report financial data and have identified for the Tennessee Valley Authority's independent auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal controls; and
6. I and the other certifiers have indicated in this Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: 06/09/2003


Chairman


Director


Director

certification of chief financial officer

I, David N. Smith, certify that:

1. I have reviewed the Tennessee Valley Authority Power Quarterly Report (Report) for the second quarterly period ended March 31, 2003;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the unaudited financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. I chair the Tennessee Valley Authority's Disclosure Control Committee which is documenting the Tennessee Valley Authority's disclosure controls and procedures and which has reviewed this Report;
5. I and the other certifiers have disclosed, based on our most recent evaluation, to the Tennessee Valley Authority's independent auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies in the design or operation of internal controls that could adversely affect the Tennessee Valley Authority's ability to record, process, summarize and report financial data and have identified for the Tennessee Valley Authority's independent auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal controls; and
6. I and the other certifiers have indicated in this Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: 06/09/2003



Chief Financial Officer and Executive Vice President of Financial Services

CONTACT INFORMATION

GENERAL INQUIRIES

Ellen Robinson
*Executive Vice President,
Communications and Government Relations*
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902

Phone: 865-632-6263
Fax: 865-632-4760
E-mail: tvainfo@tva.com
Home Page: www.tva.com

INVESTOR INQUIRIES

Sylvia H. (Sissy) Caldwell
Vice President, Investor Relations
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902

Phone/Fax Numbers

888-882-4795 (toll-free inside the U.S.)
888-882-4967 (toll-free outside the U.S.)
Fax: 865-632-3225

Web Site and E-mail Address

www.tva.com/finance
investor@tva.com

E-mail Alert

E-mail alerts are messages that are conveniently delivered to a subscriber's e-mail address whenever certain new information is posted to TVA's Investor Resources Web pages. To learn more about how to subscribe to e-mail alerts, visit TVA's Web site at:
www.tva.com/finance

(This page intentionally left blank)

(This page intentionally left blank)

2002 INFORMATION STATEMENT

TENNESSEE VALLEY AUTHORITY

A Wholly Owned Corporate Agency and Instrumentality of the United States of America

The Tennessee Valley Authority ("TVA" or the "Corporation") presents this Information Statement (this "Statement") for the information of stakeholders and potential purchasers of (1) its Power Bonds ("Power Bonds"), (2) its Discount Notes ("Discount Notes"), and (3) any other evidences of indebtedness ("Other Indebtedness") it may issue pursuant to the Tennessee Valley Authority Act of 1933, as amended, 16 U.S.C. §§831-831ee(2000) (the "Act" or the "TVA Act"). TVA issues Power Bonds pursuant to the Act and the Basic Tennessee Valley Authority Power Bond Resolution adopted by the Board of Directors of TVA (the "Board" or the "TVA Board of Directors" or "TVA's Board of Directors") on October 6, 1960, as amended on September 28, 1976, October 17, 1989, and March 25, 1992 (the "Basic Resolution"). TVA issues Discount Notes and Other Indebtedness pursuant to the Act and their authorizing resolutions. Power Bonds, Discount Notes and Other Indebtedness are collectively referred to in this Statement as "Evidences of Indebtedness."

TVA may offer Power Bonds and Other Indebtedness from time to time. TVA may offer Discount Notes for sale on a continuous basis by direct placement or through selected investment dealers, dealer banks, underwriters or underwriting syndicates. For each offering of Power Bonds, except for Power Bonds offered under a program on a continuous basis, TVA will prepare an offering circular describing the specific terms and conditions of the Power Bonds offered. For Power Bonds offered under a program on a continuous basis, TVA will prepare a single offering circular that describes the general terms and conditions common to all securities issued under the program. TVA will also prepare a single offering circular describing the general terms and conditions common to all Discount Notes offerings. For offerings of Other Indebtedness, TVA will either prepare an offering circular describing the specific terms and conditions of the particular offering or a more general offering circular, as TVA deems appropriate. For any offerings made through a program under which Other Indebtedness, Discount Notes or Power Bonds are offered on a continuous basis, the offering circular will describe how, if at all, the offering circular will be supplemented in order to reflect, among other things, the specific terms and conditions of the securities being offered. You should read this Statement, as it may be supplemented or amended, together with the appropriate offering circular, as it may be supplemented or amended, for each offering.

For each offering of an Evidence of Indebtedness, you should rely only on the information contained in (1) this Statement, (2) the relevant offering circular, and (3) any supplements or amendments to these documents approved by TVA. TVA has not authorized anyone to provide you with any information that is different from that found in this Statement and each relevant offering circular and any supplements or amendments to such documents. This Statement does not constitute an offer to sell or a solicitation of an offer to buy any Evidences of Indebtedness in any jurisdiction to any person to whom it is unlawful to make an offer or solicitation.

This Statement is accurate only as of its date. TVA may supplement, amend or replace this Statement from time to time, generally no more often than annually, to reflect its annual financial results or otherwise as TVA deems appropriate. However, TVA assumes no further duty to update this Statement. You should rely on the most recent supplements or amendments to or replacement of this Statement over different information in this Statement.

You may obtain additional copies of this Statement by writing to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations or by calling 1-888-882-4975.

Evidences of Indebtedness are not obligations of the United States of America, and the United States of America does not guarantee the payment of the principal of or interest on any Evidences of Indebtedness. TVA is not required to register Evidences of Indebtedness under the Securities Act of 1933 or to make periodic reports to the Securities and Exchange Commission under the Securities Exchange Act of 1934.

The date of this Information Statement is January 13, 2003.

TABLE OF CONTENTS

Information Statement

	<u>Page</u>
PART I	
Business	1
Properties	5
Legal Proceedings	7
Certain Provisions of the Tennessee Valley Authority Act and Related Legislation	8
The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness	11
PART II	
Selected Financial Data	16
Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Qualitative and Quantitative Disclosures about Market Risk	37
Financial Statements and Supplementary Data	46
Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	74
PART III	
Directors and Executive Officers	74
Controls and Procedures	76
PART IV	
Statistical & Financial Summaries	76
Certifications	79

PART I

BUSINESS

General

Forward Looking Information

This Statement contains forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions, assumptions or otherwise relating to future events or performance may be forward-looking.

In certain cases, forward-looking statements can be identified by the use of the words such as “may,” “will,” “should,” “expect,” “anticipate,” “believe,” “intend,” “project,” “plan,” “predict,” “assume,” “estimate,” “objective,” “possible,” “potential,” or other similar expressions.

Some examples of forward-looking statements include statements regarding TVA’s projections of future power and energy requirements; future costs related to environmental compliance; impacts of potential legislation on TVA and the likelihood of enactment of such legislation; strategic objectives; anticipated availability of nuclear waste storage facilities; projections of nuclear decommissioning costs; and impacts of pending litigation and various administrative orders which have been or may be issued.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations, and administrative orders, especially those related to the restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA’s generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; changes in accounting standards; and unforeseeable events. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA’s business or cause results to differ materially from those contained in any forward-looking statement.

TVA undertakes no obligation to update any forward-looking statement to reflect developments that occur after the statement is made.

Fiscal Year

Unless otherwise indicated, years (2002, 2001, etc.) in this Statement refer to TVA’s fiscal years ended September 30.

Notes

References to “notes” are to the Notes to Financial Statements contained in PART II.

The Corporation

TVA is a corporate agency and instrumentality of the United States government created in 1933 by the Act and charged with providing navigation, flood control and agricultural and industrial development, while providing electric power to the Tennessee Valley region. TVA has developed and operates one of the largest electric power systems in the United States, having produced nearly 152 billion kilowatt-hours (“kWh”) of electricity in 2002. TVA is wholly owned by the United States government and is administered by a board of three persons appointed by the President and confirmed by the United States Senate. Appointments are for nine-year staggered terms, with one term expiring each three-year interval.

Historically, the programs at TVA have consisted of power and nonpower programs. Revenues and expenses of the power program are segregated from other revenues and expenses. Substantially all of TVA's revenues and assets are attributable to its power program. For a discussion of the funding of TVA's nonpower programs, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Stewardship Responsibilities."

The Act requires the power program to be self-supporting from power system revenues and capital TVA raises through its power program financings. The Act authorizes TVA to issue Evidences of Indebtedness in an amount not exceeding \$30 billion outstanding at any one time, the proceeds of which may be used only for the power program. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness."

Under certain circumstances, the Act permits TVA to borrow up to \$150 million for a period of one year or less from the United States Treasury (the "Treasury"). The Act requires TVA to obtain the approval of the Secretary of the Treasury of the issue date and maximum interest rate for any issuance of an Evidence of Indebtedness with a term of one year or longer. The Office of Management and Budget ("OMB") includes TVA's finances as part of the budget of the United States.

The Act requires TVA to annually file a financial statement and complete report as to its business with the President and Congress. The Government Corporation Control Act authorizes the Comptroller General of the United States to periodically audit the transactions of TVA.

The Area Supplied by the Tennessee Valley Authority

TVA supplies power in most of Tennessee, northern Alabama, northeastern Mississippi and southwestern Kentucky, and in small portions of Georgia, North Carolina and Virginia. TVA serves a population of about eight million people. Subject to certain minor exceptions, TVA may not without specific authorization by act of Congress enter into contracts which would have the effect of making it or the distributors of its power a source of power supply outside the area for which TVA or the distributors were the primary source of power supply on July 1, 1957.

Rates and Customers

TVA is primarily a wholesaler of power. Its customers comprise three major groups: (1) distributors, consisting of municipalities and cooperatives; (2) industries that have large or unusual loads; and (3) federal agencies. Additionally, TVA has entered into exchange power arrangements with most of the electric systems that surround it.

The Act gives the Board sole responsibility for establishing the rates that TVA charges for power and authorizes the Board to include in power contracts terms and conditions that it judges necessary or desirable for carrying out the purposes of the Act. The Act requires TVA to charge rates for power which, among other things, will produce gross revenues sufficient to provide funds for (1) operation, maintenance and administration of its power system; (2) payments to states and counties in lieu of taxes; (3) debt service on outstanding Evidences of Indebtedness; and (4) annual payments to the Treasury in repayment of and as a return on the government's appropriation investment in TVA power facilities (the "Appropriation Investment"). See "Certain Provisions of the Tennessee Valley Authority Act and Related Legislation" and "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" — "Rate Covenant." Rates set by the Board are not subject to review or approval by any state or federal regulatory body. In a future restructured electric power industry (discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "TVA and Competition"), it is possible, however, that the ability of the Board to set TVA's rates as specified in the TVA Act could be adversely affected by legislative changes or by competitive pressures.

A summary of power program operating revenues by customer type for each of the last five years ended September 30 is shown in "Selected Financial Data."

Municipal and Cooperative Distributors

Sales to municipal and cooperative distributors accounted for approximately 86 percent of TVA's total revenues in 2002. TVA has long-term wholesale power contracts with 158 municipal and cooperative distributors. All of these contracts require distributors to purchase substantially all of their electric power and energy requirements from TVA.

All distributors purchase power under one of three basic arrangements. Fifty-five distributors purchase power under contracts that require 10 years' notice to terminate and further provide that on each anniversary beginning on the tenth anniversary, one additional year is automatically added to the term. Four distributors have contracts that require 15 years' notice to terminate the contract. On each anniversary of these contracts, beginning on the fifth anniversary, one additional year is automatically added to the term. TVA has also offered distributors the option of moving from 10- or 15-year termination notice periods to a 5-year termination notice period. Ninety-nine distributors, including two of the largest, have entered into contractual arrangements of this type. Sales to these two distributors generated approximately 13 percent of TVA's total operating revenues in 2002. TVA has agreed that all of these term arrangements are deemed to provide for adequate recovery by TVA of any investment in generation and transmission facilities for service to the distributor.

TVA has received notice from one distributor which terminates its power contract with TVA in October 2007. A second distributor has also given a notice which seeks to so terminate its power contract in October 2007 conditioned upon the availability of transmission service from TVA. During 2002, sales to these distributors generated approximately one percent of TVA's total operating revenues. Once a power contract is terminated, the terminating distributor would have neither the obligation nor the right to take power or obtain transmission from TVA, absent the negotiation of new arrangements.

TVA's wholesale power contracts contain standard provisions specifying the wholesale rates, resale rates and terms and conditions under which power is to be distributed. Under these contracts, TVA, on a quarterly basis, may determine and make adjustments in the wholesale rate schedules necessary to enable TVA to meet all requirements of the Act and the financial covenants and provisions of its bond resolutions. The contracts provide for agreement between the parties on general or major changes in the wholesale schedules. If, however, agreement is not reached, the contracts permit TVA to make changes in these schedules to carry out the objectives of the Act, to meet financial requirements and covenants and to comply with the provisions of its bond resolutions.

Most of the power contracts between TVA and the distributors of TVA power specify the resale rates that distributors charge the ultimate power consumers. These rates are revised from time to time to reflect changes in costs, including changes in the wholesale cost of power. They are designed to promote the Act's objective of providing an adequate supply of power at the lowest feasible rates.

A number of TVA distributors, including some with the largest loads, have expressed interest in further revising their wholesale power contracts to allow them more options respecting contract term and other matters, such as purchasing a portion of their power requirements from suppliers other than TVA. TVA agreed to work with distributors to develop additional contract flexibility and outlined a framework for additional contract options in June 2001. Distributors and the Tennessee Valley Public Power Association ("TVPPA"), an association which includes almost all distributors of TVA power, agreed to work with TVA to draft the new contract arrangements. Two teams are working to develop proposals, one on long-term contract options and the other on partial requirement options. TVA and the distributors have reached substantial agreement on long-term contract options. Under these arrangements, TVA would offer distributors a choice of 10-, 15-, and 20-year rolling-term contract options in exchange for certain benefits. The partial requirements option would permit distributors to buy up to 10 percent of their power from other suppliers or to generate a comparable amount themselves, following a two-year notice to TVA. Progress on this option has slowed due to uncertainty regarding transmission issues.

TVA has also entered into agreements with two distributors that significantly reduce TVA's involvement with their resale rates and which provide for TVA's termination notice period to generally be 10 years even if the distributor has chosen the 5-year option described above.

TVA is offering a discounted energy unit ("DEU") program to its distributors through which a distributor prepays a portion of the price of a block of kWhs and receives a credit on its power bill over a period of years (10, 15 or 20) for each kWh in the prepaid block. TVA has received expressions of interest from over 40 distributors interested in participating in this program. The amount of their indicated participation totals more than \$50 million. TVA expects to enter into power contract supplements to implement the DEU program beginning in January 2003. Upon termination of the power contract, the DEU agreement will terminate unless TVA and the distributor agree to other supply arrangements. The number of distributors that ultimately decides to participate in the DEU program and the dollar amount of their participation may be more or less than that described above.

For a discussion of the effects of competition in the restructured electric power market, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "TVA and Competition."

Other Sources of Revenues

Revenues from industries and federal agencies directly served and from exchange power arrangements with other power systems and other revenue accounted for approximately 14 percent of TVA's total power revenues in 2002. Contracts with industries directly served by TVA are normally for 10-year terms. These contracts are subject to termination by TVA or the customer upon a minimum notice period that varies according to the customer's contract demand and the period of time service has been provided to the location where it is to be terminated. TVA establishes the rates it charges to industrial customers it directly serves. These rates normally are the same as those charged by the distributors of TVA power to large industries (those with demand greater than 25,000 kilowatts).

TVA generally sells power to federal agencies under the same contract terms and rates as directly-served industries. Contracts with federal agencies are normally for 10-year terms and are subject to termination by TVA or the federal agency upon a minimum notice period that varies according to the customer's contract demand and period of time service has been provided to the location where it is to be terminated.

TVA also has exchange power arrangements with 11 neighboring power systems. As part of the TVA self-financing legislation enacted by Congress in 1959, TVA was restricted to selling power outside of the TVA service area to what was then 14 power generating companies. Due to a number of mergers and acquisitions over the years, there are now 11 of these grandfathered organizations remaining. The agreements are open-ended but do have termination provisions.

Power and Energy Requirements

TVA prepares annual forecasts of future power and energy requirements as part of its planning and budgeting process. TVA's forecast procedure involves producing a range of load forecasts for the explicit purpose of bounding the range of uncertainty associated with load growth. TVA produces the load forecasts probabilistically. TVA believes that there is a 90 percent probability that the actual load will be less than the high load forecast, a 50 percent probability that the actual load will be less than medium load forecast and a 10 percent probability that actual load will be less than the low load forecast. TVA's current load forecast through 2004 reflects an average annual peak growth rate of 3.1 percent, 2.2 percent and 0.6 percent for the high, medium and low load forecasts, respectively. TVA's current forecast of total system energy requirements through 2004 reflect an average annual energy growth rate of 3.7 percent, 2.8 percent and 1.1 percent for the high, medium and low load forecasts, respectively. Numerous factors, such as weather conditions and the health of the regional economy, could cause actual results to differ materially from TVA's forecasts.

Fuel

Management believes the sources and availability of fuel materials essential to its business should be adequate for the foreseeable future.

Coal consumption during 2002 was 42.4 million tons. Coal is purchased under contracts ranging from a single delivery to deliveries over several years. TVA coal inventory levels vary from plant to plant based upon a simulated inventory model. As of September 30, 2002, TVA had 19.7 days' system-wide coal supply in inventory at full burn. Coal inventory at September 30, 2002 and 2001 was \$173 million and \$170 million, respectively.

TVA has in place term coal contracts that for 2002 supplied 81 percent of TVA's total coal requirements. The remaining 19 percent was purchased in the spot coal market under contracts with terms of one year or less. Thirty-four percent of TVA's coal supply comes from western states; the remainder comes from Illinois, Kentucky, Pennsylvania, Tennessee, Virginia and West Virginia. Thirty-four percent of TVA's coal supply is delivered by train, 28 percent is delivered by barge, and 25 percent is delivered by barge in combination with trains. The remainder is delivered by truck.

During 2002, TVA purchased approximately 87 percent of its natural gas requirements in the spot market and 13 percent pursuant to option contracts with maturities of one year or less. TVA purchases substantially all of its natural gas to operate combustion turbine peaking units. These combustion turbine units, which can also operate on distillate fuel, produced less than 1 percent of the electricity that TVA generated during 2002.

TVA owns all nuclear fuel held for its operating and deferred nuclear units. The net book value of this fuel was \$319 million as of September 30, 2002. TVA will fill future uranium requirements by a combination of term and spot purchase contracts while maintaining diversity of supply source. TVA currently has approximately 90 percent of its forward five-year (2003-2007) uranium requirements either in inventory or under contract.

Under an interagency agreement entered into in 2001, DOE is to transfer to TVA at no cost a total of approximately 33 metric tons of surplus highly enriched uranium ("HEU"). However, TVA is responsible for the subsequent costs required to down blend and convert the HEU material to a form of material usable in the nuclear fuel assembly manufacturing process. In April 2001, TVA entered into a contract with Framatome ANP for down-blending and conversion services for the HEU material through Framatome ANP's subcontractor Nuclear Fuel Services and for fabricating the blended-down material into fuel assemblies to be used in TVA's nuclear plants. The estimated costs TVA will incur under this contract are not expected to exceed \$525 million. TVA will defer the HEU down-blending and fuel assembly fabrication costs until such time as sufficient fuel is available for reactor unit reload. Deferred costs will be allocated to the reload assemblies and amortized as fuel expense over the fuel burn period in accordance with TVA's current nuclear fuel accounting policy.

PROPERTIES

TVA's power system is one of the largest in the United States in capacity and in energy production. Its size permitted the construction of large facilities which resulted in lower unit costs. Most of TVA's dams were completed years ago when construction costs were far below present-day levels. In accordance with the Act, all real estate acquired by TVA is acquired in the name of the United States. See "Certain Provisions of the Tennessee Valley Authority Act and Related Legislation."

TVA's power generating facilities at September 30, 2002, included 29 hydroelectric plants, 11 coal-fired plants, 3 nuclear plants, 1 pumped storage hydroelectric plant, 6 combustion turbine plants, 1 windpower site, 2 methane gas generation sites and 14 solar photovoltaic sites. Energy is delivered to TVA customers over a transmission system of approximately 17,000 miles of lines, including 2,400 miles of extra-high-voltage (500,000 volt) transmission lines. The system interconnects with neighboring power systems at numerous points. TVA has various types of interchange arrangements with these systems. The extent and types of interchange transactions depend upon the characteristics of the systems' loads, the management policies of the

systems and other factors. Interchange arrangements are an essential part of TVA's efforts to minimize investment in electrical facilities, increase the reliability of service, effect operating economies and minimize the cost of electric energy.

While not generally subject to Federal Energy Regulatory Commission ("FERC") jurisdiction, TVA is voluntarily seeking ways to meet FERC's objectives to improve regional transmission control in a manner consistent with TVA's responsibilities under the TVA Act. TVA is moving forward on two initiatives. First, TVA is working to create a coordination agreement with other public power providers to develop a regional partnership that will allow its members to continue their public service mission and integrate with surrounding regional transmission organizations ("RTOs") for a seamless market. Second, TVA is working with neighboring utilities and RTOs — including Southern Company, Entergy Corporation and the Midwest Independent System Operator — to create a contractual arrangement that would encourage a seamless wholesale power market for much of the eastern interconnection.

Generating Resources

During 2002, 64 percent of the power generated by the TVA coordinated system was by coal-fired plants and combustion turbines, 30 percent by nuclear and 6 percent by hydro.

The following table summarizes the winter net dependable capacity ("NDC") in megawatts ("MW") on TVA's coordinated system as of September 30, 2002:

	Generating Units	Winter Net Dependable Capacity (MW) ⁽¹⁾
TVA-Owned/Leased Facilities		
Hydro	109	3,305
Pumped Storage	4	1,624
Coal-fired	59	15,023
Nuclear	5	5,751
Combustion Turbine	72	4,643 ⁽²⁾
		<u>30,346</u>
Other Facilities		
TAPOCO, Inc.		326 ⁽³⁾
U.S. Army Corp. of Engineers		405 ⁽⁴⁾
Choctaw Generation, L.P.		440 ⁽⁵⁾
		<u>440⁽⁵⁾</u>
Total Capacity		<u><u>31,517</u></u>

(1) NDC as stated is the net power output which can be obtained for a period adequate to satisfy the daily load patterns under expected conditions of operation with equipment in an average state of maintenance excluding any fluctuations in capacity that may occur due to planned outages, unplanned outages and deratings. For planning purposes, TVA currently estimates summer dependable total hydro capacity, including generation supplied under agreements with TAPOCO, Inc., and the Southeastern Power Administration, of approximately 5,917 MW; coal-fired capacity, including Choctaw Generation plant capacity, of approximately 15,116 MW; nuclear power capacity of approximately 5,601 MW; and combustion turbine capacity (on oil at 95 degrees Fahrenheit) of approximately 3,843 MW, for a total summer NDC of approximately 30,477 MW.

(2) Combustion turbine capacity includes 9 MW for Meridian Naval Air Station diesel generators, 14 MW for Bellefonte Nuclear Plant diesel generators and 4,620 MW for turbines (on oil at 25 degrees Fahrenheit). As of September 30, 2002, 16 of TVA's combustion turbine units were leased to private entities and leased back to TVA under long-term leases. In December 2002, TVA leased and leased back 4 more of its combustion turbine units under long-term leases.

- (3) Four hydro plants owned by TAPOCO, Inc., a subsidiary of the Aluminum Company of America (“Alcoa”), are operated as part of the TVA power system. Under contractual arrangements with TAPOCO, Inc., electric power generated at these facilities is supplied to TVA. In return, TVA supplies electric power for Alcoa’s aluminum plant operations located in Tennessee.
- (4) The U.S. Army Corps of Engineers’ eight hydro plants on the Cumberland River System have a total installed capacity of 975 MW, of which 405 MW of capacity is available to TVA under a marketing agreement with the Southeastern Power Administration.
- (5) TVA has contracted with Choctaw Generation, L.P., for 440 MW from a lignite-fired generating plant in Chester, Mississippi. The contract has a 30-year term.

Under arrangements among TVA, the U.S. Army Corps of Engineers (the “CORPS”) and the Southeastern Power Administration (“SEPA”), eight hydro plants of the CORPS on the Cumberland River System are operated in coordination with the TVA system. These arrangements further provide for capacity (405 MW) and energy from the Cumberland River System to be supplied to TVA by SEPA at the points of generation and the price paid for the power to be based on the operating and maintenance expenses and amortization of the power facilities. A portion of the output of the Cumberland River System is also made available to SEPA’s customers outside the TVA region. The agreement with SEPA covering these arrangements for power from the Cumberland River System can be terminated upon three years’ notice. This notice may be given beginning June 30, 2017.

TVA has also supplemented its existing generation portfolio with additional renewable resource assets (wind, solar and methane gas technologies). These assets account for about 5 MW of capacity. Current power projections indicate that in the near term ample power from generation sources within the TVA service area should be available to meet TVA’s power needs at competitive prices.

LEGAL PROCEEDINGS

The Environmental Protection Agency (“EPA”) has commenced judicial and administrative actions against a number of utilities in the eastern U.S., including TVA, alleging that they have modified their coal-fired units without complying with new source review (“NSR”) requirements. TVA contends EPA’s enforcement action is based on a new interpretation of an old rule and that TVA has routinely maintained its power plants to ensure efficient, reliable power generation while complying with all requirements. EPA issued TVA an administrative order directing TVA to put new source controls on 14 of its coal-fired units and to evaluate whether more controls should be installed on other units. TVA has challenged the validity of this order in the Eleventh Circuit Court of Appeals, and the court has stayed the order pending review, has upheld its jurisdiction over the case, and heard oral argument on the merits in May 2002. The outcome of this litigation and the EPA proceedings is uncertain. It is not possible to predict with certainty what impact implementation of EPA’s order would have on TVA if TVA’s challenge is unsuccessful. If EPA substantially prevails, TVA could be required to incur capital costs in excess of \$3 billion by 2010 to 2012. Any additional controls that TVA could be required to install on units as a result of this matter would, however, also be sufficient to comply with reduction requirements that are anticipated under the other air quality programs (discussed under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “Environmental Matters”) through the 2010-2012 time period. Thus, because of the other environmental program requirements, TVA would, in any event, likely have to incur a substantial portion of the costs that might result from the EPA enforcement action, albeit the schedule for the installation of the controls could be somewhat accelerated by the EPA enforcement action. TVA fully supports the need to further reduce emissions from coal-fired plants and seeks a resolution that will not put TVA customers and the region at a disadvantage.

The National Parks Conservation Association (“NPCA”) and the Sierra Club filed cases in federal district courts raising the same NSR allegations at TVA’s Bull Run Fossil Plant and Colbert Fossil Plant Unit 5 as were raised in the EPA proceedings. Both cases have been stayed pending a decision from the Eleventh Circuit.

Environmental groups are taking legal action against TVA, as well as against other utilities across the country, for allegedly violating opacity limits applicable to coal-fired plants.

- The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated Clean Air Act opacity limits applicable to Colbert Fossil Plant between July 1, 1997 and June 30, 2002. The groups seek a court order requiring TVA to bring Colbert Fossil Plant into continuous compliance with the opacity limits, which would require TVA to incur substantial costs in addition to the costs TVA is already planning to incur for environmental controls and to pay civil penalties of up to approximately \$250 million. TVA filed its answer to the lawsuit in November 2002.
- The Sierra Club gave notice in a September 26, 2002, letter that it intends to sue TVA for violating Clean Air Act opacity limits applicable to the John Sevier and Kingston Fossil Plants. The notice claims that TVA violated opacity standards at the two plants from July 1, 1997, to the present. The alleged opacity violations substantially overlap those that were challenged in a lawsuit filed by the NPCA two years ago in federal court in Knoxville, Tennessee. TVA ultimately prevailed in that lawsuit.

On December 28, 2001, Bowater Incorporated and Bowater Newsprint South, Inc. (together, “Bowater”) filed a lawsuit against TVA in federal court in Knoxville challenging TVA’s charges for Economy Surplus Power (“ESP”) and Testing and Restart Power (“TRP”) for two Bowater plants. In its complaint, Bowater alleges that in violation of the contract provision which states that TVA will charge ESP and TRP customers based on TVA’s actual hourly incremental cost of providing ESP (1) TVA included certain alleged nonincremental costs in the prices for ESP and TRP and (2) when calculating such prices TVA used the cost of providing the most expensive 100 MWs of ESP sold during a given hour instead of the average cost in that hour of serving the entire ESP load. The complaint also alleges that TVA has been unjustly enriched as a result of these overcharges. The lawsuit seeks, among other things, compensatory damages in excess of \$25 million and interest of more than \$10 million. TVA believes that it will prevail in this lawsuit based on the information presently available.

TVA is a party to various other civil lawsuits and claims that have arisen in the ordinary course of its business. Although the outcome of these other civil lawsuits and claims cannot be predicted with any certainty, it is TVA’s belief that their ultimate outcome should not have a materially adverse effect on TVA’s financial position or results of operations.

CERTAIN PROVISIONS OF THE TENNESSEE VALLEY AUTHORITY ACT AND RELATED LEGISLATION

*The following summaries of certain provisions of the Act and related legislation are **not complete** and are qualified in their entirety by reference to the full texts of the Act and the related legislation.*

Payments in Lieu of Taxes

TVA is not subject to federal income taxes or to taxation by states or their subdivisions. However, the Act requires TVA to make payments in lieu of taxes to states and counties in which the Corporation conducts power operations and in which the Corporation has acquired properties previously subject to state and local taxation. The basic amount of these payments is 5 percent of gross revenues from the sale of power during the preceding year excluding payments to other federal agencies and off-system sales with other utilities, with a provision for minimum payments under certain circumstances. During 2002 and 2001, TVA made payments totaling \$328 million and \$315 million, respectively, to the states of Alabama, Georgia, Illinois, Kentucky, Mississippi, North Carolina, Tennessee and Virginia.

Payments to the Treasury

The Act requires TVA to make certain payments to the Treasury each year from Net Power Proceeds in excess of those required for debt service, as a return on and reduction of the Appropriation Investment. The

Appropriation Investment totaled \$488 million as of September 30, 2002. Net Power Proceeds are defined as the remainder of gross power revenues from TVA's power program

after deducting

- the costs of operating, maintaining and administering its power properties (including multiple-purpose properties in the proportion that multiple-purpose costs are allocated to power) and
- payments to states and counties in lieu of taxes,

but before deducting

- depreciation accruals or other charges representing the amortization of capital expenditures,

plus

- the net proceeds of the sale or other disposition of any interest in TVA's power properties that constitute an operating unit or system.

Acquisition of Real Estate

The Act empowers TVA to acquire real estate in the name of the United States of America by purchase or by exercise of the right of eminent domain, "and thereupon all such real estate shall be entrusted to the Corporation as the agent of the United States to accomplish the purposes of [the] Act." Thus, all references in this Statement to TVA properties, and to the amounts invested in TVA properties, should be read and construed in the light of this provision of the Act.

Other Legislation

In October 1997 Congress enacted the Energy and Water Development Appropriations Act, 1998, Pub. L. No. 105-62, 111 Stat. 1320, 1338 (1997). The paragraph captioned "TENNESSEE VALLEY AUTHORITY" in Title IV of this act (the "Appropriations Act Paragraph") requires TVA, beginning with 1999, to fund nonpower programs that constitute "essential stewardship activities" with revenues derived from one or more of various sources, including power revenues, notwithstanding provisions of the TVA Act and power bond covenants to the contrary. These programs historically had been funded with appropriated funds rather than power revenues.

The Appropriations Act Paragraph states:

For the purpose of carrying out the provisions of the Tennessee Valley Authority Act of 1933, as amended (16 U.S.C. ch. 12A), including hire, maintenance, and operation of aircraft, and purchase and hire of passenger motor vehicles, \$70,000,000, to remain available until expended, of which \$6,900,000 shall be available for operation, maintenance, surveillance, and improvement of Land Between the Lakes; and for essential stewardship activities for which appropriations were provided to the Tennessee Valley Authority in Public Law 104-206, such sums as are necessary in fiscal year 1999 and thereafter, to be derived only from one or more of the following sources: nonpower fund balances and collections; investment returns of the nonpower program; applied programmatic savings in the power and nonpower programs; savings from the suspension of bonuses and awards; savings from reductions in memberships and contributions; increases in collections resulting from nonpower activities, including user fees; or increases in charges to private and public utilities both investor and cooperatively owned, as well as to direct load customers: Provided, That such funds are available to fund the stewardship activities under this paragraph, notwithstanding sections 11, 14, 15, 29, or other provisions of the Tennessee Valley Authority Act, as amended, or provisions of the TVA power bond covenants: Provided further, That the savings from, and revenue adjustments to, the TVA budget in fiscal year 1999 and thereafter shall be sufficient to fund the aforementioned stewardship activities such that the net spending authority and resulting outlays for these activities shall not exceed \$0 in fiscal year 1999 and thereafter.

Since 1999, Congress has provided no appropriations for TVA's nonpower programs. In compliance with the Appropriations Act Paragraph, TVA is and will continue funding its essential stewardship activities with funds from its power program (and other available funds) to the extent that Congress does not make appropriations for these activities. In 1999, the last year TVA received appropriated funds, it spent a total of approximately \$75 million on essential stewardship activities, \$30 million of which amount was power funds. In 2002, TVA spent a total of approximately \$83 million on essential stewardship activities, virtually all of which was power funds (see note 10 — *Stewardship Responsibilities*), and TVA expects in 2003 to spend approximately the same amount of power funds on such activities as it did in 2002.

In 1998 Congress enacted legislation (Public Law No. 105-277, 112 Stat. 2681-543(1998)) that authorized TVA to prepay certain indebtedness TVA then owed to the Federal Financing Bank (the "FFB"). TVA prepaid the indebtedness in that same year. The legislation specifies that TVA shall not be permitted to obtain future financing from the FFB and requires TVA to use the savings from the prepayment to reduce its debt.

THE BASIC RESOLUTION; POWER BONDS, DISCOUNT NOTES AND OTHER INDEBTEDNESS

TVA issues Power Bonds pursuant to Section 15d of the Act and pursuant to the Basic Resolution. Power Bonds of each series must be further authorized by Supplemental Resolution. At September 30, 2002, TVA had US\$20.1 billion, DM1.5 billion (issued in September 1996) and £450 million (£200 million issued in December 1998 and £250 million issued in July 2001) principal amount of Power Bonds outstanding. TVA may issue Power Bonds only to provide capital for TVA's power program (including refunding any Evidences of Indebtedness issued for like purposes) and only as authorized by law at the time of issuance. Power Bonds are payable as to both principal and interest solely from Net Power Proceeds, but TVA may, at its option, pay Power Bonds from the proceeds of refunding obligations or other funds legally available for such payment. Net Power Proceeds for 2002, 2001 and 2000 were \$2.8 billion, \$3.3 billion and \$3.0 billion, respectively. *Power Bonds are not obligations of, or guaranteed by, the United States of America.*

TVA intends from time to time to issue new Power Bonds with maturities and on terms determined in light of market conditions at the time of sale. TVA may sell new Power Bonds to dealers or underwriters, who may resell the new Power Bonds in public offerings or otherwise. Additionally, TVA may sell new Power Bonds directly or through other entities.

The offering circular, and any appropriate amendment or supplement to the offering circular, for each offering of new Power Bonds, except for new Power Bonds offered under a program on a continuous basis, will set forth the following information: (1) the aggregate principal amount, (2) maturity, (3) interest rate or method for determining such rate, (4) interest payment date(s), (5) purchase price to be paid to TVA, (6) any terms for redemption or other special terms, (7) form and denomination of new Power Bonds, (8) information as to any stock exchange listing, (9) the names of any dealers, underwriters or agents, (10) a description of any amendments or supplements to the Basic Resolution in connection with the sale of the new Power Bonds, and (11) other terms of the new Power Bonds.

For Power Bonds offered under a program on a continuous basis, TVA will prepare a single offering circular that describes the general terms and conditions common to all Power Bonds issued under the program. The offering circular will describe how, if at all, the offering circular will be supplemented in order to reflect, among other things, the specific terms and conditions of the Power Bonds being offered. At the time of each sale, TVA will determine if the Power Bonds being sold will be subject to redemption prior to the maturity date and will establish the purchase price, principal amount, interest rate or interest rate formula, maturity date and certain other terms of such sale.

TVA also issues Discount Notes pursuant to Section 15d of the Act and in accord with Section 2.5 of the Basic Resolution. As of September 30, 2002, TVA had approximately \$3.5 billion in Discount Notes outstanding. Discount Notes are payable solely from Net Power Proceeds, but TVA may, at its option, pay Discount Notes from the proceeds of refunding obligations or other funds legally available for such payment. TVA intends to offer Discount Notes for sale on a continuous basis to a group of securities dealers selected by TVA, who will generally resell the notes. TVA will issue Discount Notes in a form and upon terms and conditions as it deems appropriate. Certain information respecting Discount Notes will be set forth in a Discount Notes offering circular and any appropriate supplement to the offering circular. *Discount Notes are not obligations of, or guaranteed by, the United States of America.*

TVA may issue Other Indebtedness pursuant to Section 15d of the Act and in accordance with Section 2.5 of the Basic Resolution. An offering circular, and any appropriate amendment or supplement to the offering circular, for each offering of Other Indebtedness will set forth the following information: (1) the aggregate principal amount, (2) maturity, (3) interest rate or method for determining such rate, (4) interest payment date(s), (5) purchase price to be paid to TVA, (6) any terms for redemption or other special terms, (7) form and denomination of Other Indebtedness, (8) information as to any stock exchange listing, (9) the names of any dealers, underwriters or agents, and (10) other terms of Other Indebtedness. *Other Indebtedness will not be obligations of, or guaranteed by, the United States of America.*

Income on Evidences of Indebtedness issued by TVA is subject to United States federal income taxation and various other federal tax consequences. There is no special exemption for Evidences of Indebtedness from federal estate and gift taxes. Under the Act, Evidences of Indebtedness are exempt both as to principal and interest from all taxation now or hereafter imposed by any state or local taxing authority except estate, inheritance and gift taxes. This exemption might not extend to franchise or other nonproperty taxes imposed on corporations or to gain or loss realized upon the sale or exchange of an Evidence of Indebtedness even though such gain might in some cases be treated as interest income for federal income tax purposes.

*The following summary of certain provisions of the Basic Resolution is **not complete** and is qualified in its entirety by reference to the full text of the Basic Resolution. See also “Certain Provisions of the Tennessee Valley Authority Act and Related Legislation” — “Other Legislation.”*

Application of Net Power Proceeds

Section 2.3 of the Basic Resolution provides as follows:

Net Power Proceeds shall be applied, and the Corporation hereby specifically pledges them for application, first to payments due as interest on Bonds, on Bond Anticipation Obligations, and on any Evidences of Indebtedness issued pursuant to Section 2.5 which rank on a parity with Bonds as to interest; to payments of the principal due on Bonds for the payment of which other provisions have not been made and on any Evidences of Indebtedness issued pursuant to Section 2.5 which rank on a parity with Bonds as to principal and for the payment of which other provisions have not been made; and to meeting requirements of sinking funds or other analogous funds under any Supplemental Resolutions. The remaining Net Power Proceeds shall be used only for:

- (a) Required interest payments on any Evidences of Indebtedness issued pursuant to Section 2.5 which do not rank on a parity with Bonds as to interest.
- (b) Required payments of or on account of principal of any Evidences of Indebtedness which do not rank on a parity with Bonds as to principal.
- (c) Minimum payments into the United States Treasury required by the Act in repayment of and as a return on the Appropriation Investment.
- (d) Investment in Power Assets, additional reductions of the Corporation’s capital obligations, and other lawful purposes related to the Power Program; provided, however, that payments into the United States Treasury in any fiscal year in reduction of the Appropriation Investment in addition to the minimum amounts required for such purpose by the Act may be made only if there is a net reduction during such year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes, and only to such extent that the percentage of aggregate reduction in the Appropriation Investment during such year does not exceed the percentage of net reduction during the year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes.

Section 2.4 of the Basic Resolution provides as follows:

The Corporation, having first adopted a Supplemental Resolution authorizing the issuance of a series of Bonds and pending such issuance, may issue Bond Anticipation Obligations and renewals thereof (including Interim Obligations to the Secretary of the Treasury) to be paid from the proceeds of such series of Bonds when issued or from other funds that may be available for that purpose.

Section 2.5 of the Basic Resolution provides as follows:

To assist in financing its Power Program the Corporation may issue Evidences of Indebtedness other than Bonds and Bond Anticipation Obligations, which may be payable out of Net Power Proceeds subject to the provisions of Section 2.3 hereof. Such other Evidences of Indebtedness may rank on a parity with but shall not rank ahead of the Bonds as to payments on account of the principal thereof or the interest thereon.

See “Certain Provisions of the Tennessee Valley Authority Act and Related Legislation” — “Other Legislation” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “Stewardship Responsibilities” for a discussion of legislation relating to appropriations for TVA’s nonpower programs and the funding of such programs, including the use of power revenues.

Rate Covenant

Section 3.2 of the Basic Resolution provides as follows:

The Corporation shall fix, maintain, and collect rates for power sufficient to meet in each fiscal year the requirements of that portion of the present subsection (f) of section 15d of the Act which reads as follows:

The Corporation shall charge rates for power which will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; payments to States and counties in lieu of taxes; debt service on outstanding bonds, including provision and maintenance of reserve funds and other funds established in connection therewith; payments to the Treasury as a return on the appropriation investment pursuant to subsection (e) hereof; payment to the Treasury of the repayment sums specified in subsection (e) hereof; and such additional margin as the Board may consider desirable for investment in power system assets, retirement of outstanding bonds in advance of maturity, additional reduction of appropriation investment, and other purposes connected with the Corporation’s power business, having due regard for the primary objectives of the Act, including the objective that power shall be sold at rates as low as are feasible.

For purposes of this Resolution, “debt service on outstanding bonds,” as used in the above provision of the Act, shall mean for any fiscal year the sum of all amounts required to be (a) paid during such fiscal year as interest on Evidences of Indebtedness, (b) accumulated in such fiscal year in any sinking or other analogous fund provided for in connection with any Evidences of Indebtedness, and (c) paid in such fiscal year on account of the principal of any Evidences of Indebtedness for the payment of which funds will not be available from sinking or other analogous funds, from the proceeds of refunding issues, or from other sources; provided, however, that for purposes of clause (c) of this definition Bond Anticipation Obligations and renewals thereof shall be deemed to mature in the proportions and at the times provided for paying or setting aside funds for the payment of the principal of the authorized Bonds in anticipation of the issuance of which such Bond Anticipation Obligations were issued.

The rates for power fixed by the Corporation shall also be sufficient so that they would cover all requirements of the above-quoted provision of subsection (f) of section 15d of the Act if, in such requirements, there were substituted for “debt service on outstanding bonds” for any fiscal year the amount which if applied annually for 35 years would retire, with interest at the rates applicable thereto, the originally issued amounts of all series of Bonds and other Evidences of Indebtedness, any part of which was outstanding on October 1 of such year.

Rates set by the Board are not subject to review or approval by any state or federal regulatory body. In a future restructured electric power industry (discussed in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “TVA and Competition”), it is possible, however, that the ability of TVA’s Board to set TVA’s rates as specified in the TVA Act and the Basic Resolution could be adversely affected by legislative changes or by competitive pressures.

Covenant for Protection of Bondholders’ Investment

Under the Act and Section 3.3 of the Basic Resolution, TVA must, in each successive five-year period beginning October 1, 1960, use an amount of Net Power Proceeds at least equal to the sum of (1) depreciation accruals and other charges representing the amortization of capital expenditures and (2) the net proceeds from any disposition of power facilities for either (a) the reduction of its capital obligations (including Evidences of Indebtedness and the Appropriation Investment) or (b) investment in Power Assets.

Issuance of Additional Bonds and Other Evidences of Indebtedness

The Act limits the issuance of Evidences of Indebtedness by TVA to a total of \$30 billion outstanding at any one time. At September 30, 2002, TVA had approximately US\$23.6 billion (including \$3.5 billion of Discount Notes), DM1.5 billion (issued in September 1996) and £450 million (£200 issued in December 1998 and £250 million issued in July 2001) of Evidences of Indebtedness outstanding. The Basic Resolution and the Act permit the issuance of Power Bonds only to provide capital for TVA's power program, including the refunding of any Evidences of Indebtedness issued for that purpose.

Power Bonds, the terms and conditions of which may not be inconsistent with the Basic Resolution, must also be authorized by Supplemental Resolution. The Basic Resolution provides that each Supplemental Resolution authorizing the issuance of Power Bonds must contain a finding by the Board that after the authorized Power Bonds have been issued, gross revenues from TVA's power program will be adequate to meet the requirements of the Basic Resolution with respect to rates and the application of depreciation accruals. These requirements are described under "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" — "Rate Covenant" and "Covenant for Protection of Bondholders' Investment."

Pending the issuance of Power Bonds authorized by a Supplemental Resolution, TVA may issue Bond Anticipation Obligations and renewals of Bond Anticipation Obligations (including Interim Obligations to the Secretary of the Treasury), to be paid from the proceeds of such Power Bonds when issued or from other funds that may be available for that purpose.

TVA may also issue Evidences of Indebtedness other than Power Bonds and Bond Anticipation Obligations, such as Discount Notes, to assist in financing TVA's power program. They may be payable out of Net Power Proceeds subject to the provisions of Section 2.3 of the Basic Resolution. They may not rank ahead of the Power Bonds as to principal or interest.

Mortgaging and Disposal of Power Properties

TVA may not mortgage any part of its power properties and may not dispose of all or any substantial portion of these properties unless it provides for a continuance of the interest, principal and sinking fund payments due and to become due on all outstanding Evidences of Indebtedness, or for the retirement of such Evidences of Indebtedness.

Modifications of Resolutions and Outstanding Bonds

The Basic Resolution provides for amendments to it, to any Supplemental Resolution and to any outstanding Power Bonds. Generally, TVA may make amendments to the respective rights and obligations of TVA and the bondholders with the written consent of the holders of at least 66⅔ percent in principal amount of the outstanding Power Bonds to which the amendment applies. However, TVA may not make changes in the maturity, principal amount, redemption premium or rate of interest or maturity of any interest installment, with respect to any Power Bond, or in the above percentage for any such consent, without the consent of the holder of such Power Bond.

Additionally, TVA may amend the Basic Resolution or any Supplemental Resolution without the consent of the bondholders in order (1) to close the Basic Resolution against the issuance of additional Power Bonds or to restrict such issuance by imposing additional conditions or restrictions; (2) to add other covenants and agreements to be observed by TVA or to eliminate any right, power or privilege conferred upon TVA by the Basic Resolution; (3) to modify any provisions to release TVA from any of its obligations, covenants, agreements, limitations, conditions or restrictions, provided that such modification or release shall not become effective with respect to any Power Bonds issued prior to the adoption of such amendment; (4) to correct any defect, ambiguity or inconsistency in, or to make provisions in regard to matters or questions arising under, the Basic Resolution or any Supplemental Resolution, so long as such amendments are not contrary to, or inconsistent with, the Basic Resolution or such Supplemental Resolution; or (5) to make any other modification or amendment which the Board by resolution determines will not materially and adversely affect the interests of holders of the Power Bonds.

Events of Default

Any of the following shall be deemed an Event of Default under the Basic Resolution: (1) default in the payment of the principal or redemption price of any Power Bond when due and payable at maturity, by call for redemption or otherwise; (2) default in the payment of any installment of interest on any Power Bond when due and payable for more than 30 days; or (3) failure of TVA to duly perform any other covenant, condition or agreement contained in the Power Bonds or in the Basic Resolution or any Supplemental Resolution for 90 days after written notice specifying such failure has been given to TVA by the holders of at least five percent in aggregate principal amount of the then-outstanding Power Bonds.

Upon any such Event of Default, the holders of the Power Bonds may proceed to protect and enforce their respective rights, subject to the restrictions described below. The holders of at least five percent in aggregate principal amount of Power Bonds then outstanding shall, subject to certain restrictions, have the right and power to institute a proceeding (1) to enforce TVA's covenants and agreements, (2) to enjoin any acts in violation of the rights of holders of Power Bonds, and (3) to protect and enforce the rights of holders of Power Bonds. Such holders have no right to bring any such action or proceeding against TVA unless they have given TVA written notice of an Event of Default and TVA has had a reasonable opportunity to take appropriate corrective action with respect thereto and has failed or refused to do so. *Power Bonds do not provide for acceleration upon an Event of Default.*

Holders of a majority in aggregate principal amount of the outstanding Power Bonds have the right to direct the time, method and place of conducting any proceeding for any remedy available and may waive any default and its consequences, except a default in the payment of the principal of or premium, if any, or interest on any Power Bonds.

Fourth Amendatory Resolution to the Basic Resolution

On March 25, 1992, TVA adopted a resolution amending the Basic Resolution, entitled "Fourth Amendatory Resolution to Basic Tennessee Valley Authority Power Bond Resolution" (the "Fourth Amendatory Resolution"), that (1) deleted from the Basic Resolution limitations on issuance of Power Bonds formerly set forth as Section 3.4 thereof and (2) amended the Basic Resolution to permit issuance of other Evidences of Indebtedness under Section 2.5 thereof that rank on a parity with Power Bonds as to principal and interest. With the deletion of Section 3.4 of the Basic Resolution, Sections 3.5 through 3.10 were renumbered as appropriate. This amendatory resolution became effective December 16, 1999, with retroactive application to all Power Bonds issued after March 25, 1992.

PART II

SELECTED FINANCIAL DATA

The following selected financial data of TVA's power program for the years 1998 through 2002 have been derived from TVA's audited financial statements. These data should be read in conjunction with the audited financial statements and notes thereto (collectively the "Financial Statements") presented in "Financial Statements and Supplementary Data."

Condensed Statements of Income (in millions)

	For the Years Ended September 30				
	2002	2001	2000	1999	1998
Operating revenues	\$ 6,835	\$ 6,999	\$ 6,762	\$ 6,595	\$ 6,729
Operating expenses	(5,186)	(5,506)	(5,019)	(4,926)	(4,549)
Operating income	1,649	1,493	1,743	1,669	2,180
Other income, net	7	248	17	10	12
Interest expense, net	(1,429)	(1,633)	(1,736)	(1,777)	(1,959)
Income/(loss) before loss on impairment of assets/plant cancellation and cumulative effect of change in accounting principle	227	108	24	(98)	233
(Loss)/gain on impairment of assets/plant cancellation and cumulative effect of change in accounting principle	(154)	(3,419)	—	217	—
Net income (loss)	<u>\$ 73</u>	<u>\$ (3,311)</u>	<u>\$ 24</u>	<u>\$ 119</u>	<u>\$ 233</u>

Condensed Balance Sheets (in millions)

	At September 30				
	2002	2001	2000	1999	1998
Assets					
Current assets	\$ 1,530	\$ 1,501	\$ 1,426	\$ 1,318	\$ 1,656
Property, plant and equipment	25,679	25,643	28,314	28,417	28,891
Investment funds	659	725	840	731	578
Deferred assets and other assets	2,290	1,830	2,601	2,920	2,490
TOTAL ASSETS	<u>\$30,158</u>	<u>\$29,699</u>	<u>\$33,181</u>	<u>\$33,386</u>	<u>\$33,615</u>
Liabilities and proprietary capital					
Current liabilities	\$ 4,809	\$ 6,334	\$ 4,793	\$ 3,117	\$ 4,440
Other liabilities	3,304	2,806	2,455	2,156	2,007
Long-term debt	21,358	19,851	21,753	23,903	23,020
Total liabilities	29,471	28,991	29,001	29,176	29,467
Retained earnings	349	306	3,652	3,662	3,580
Other proprietary capital	338	402	528	548	568
Total proprietary capital	687	708	4,180	4,210	4,148
TOTAL LIABILITIES AND PROPRIETARY CAPITAL	<u>\$30,158</u>	<u>\$29,699</u>	<u>\$33,181</u>	<u>\$33,386</u>	<u>\$33,615</u>

**COMPARATIVE FIVE-YEAR DATA
STATISTICAL AND FINANCIAL SUMMARIES**

	For the Years Ended September 30				
	2002	2001	2000	1999	1998
Sales (millions of kWh) (a)					
Municipalities and cooperatives	128,600	129,760	125,991	122,880	123,330
Industries directly served	26,478	23,306	22,204	22,885	18,514
Federal agencies and other	5,013	8,355	11,376	10,190	21,293
Total sales	<u>160,091</u>	<u>161,421</u>	<u>159,571</u>	<u>155,955</u>	<u>163,137</u>
Operating revenues (millions of dollars) (a)					
Electric					
Municipalities and cooperatives	\$ 5,856	\$ 5,908	\$ 5,676	\$ 5,510	\$ 5,554
Industries directly served	732	659	626	642	523
Federal agencies and other	159	330	361	357	556
Other	88	102	99	86	96
Total revenues	<u>\$ 6,835</u>	<u>\$ 6,999</u>	<u>\$ 6,762</u>	<u>\$ 6,595</u>	<u>\$ 6,729</u>
Electric revenue per kWh (cents)	4.21	4.27	4.18	4.17	4.07
Winter net dependable generating capacity (megawatts)					
Hydro(b)	5,660	5,677	5,544	5,492	5,491
Coal-fired fossil(c)	15,463	15,050	15,042	15,049	15,003
Nuclear units in service	5,751	5,715	5,729	5,729	5,620
Combustion turbine(d)	4,643	3,923	3,154	2,232	2,384
Total capacity(e)	<u>31,517</u>	<u>30,365</u>	<u>29,469</u>	<u>28,502</u>	<u>28,498</u>
System peak load (megawatts) — summer	29,052	27,368	29,344	28,295	27,253
System peak load (megawatts) — winter	26,061	27,163	25,940	26,388	23,204
Percent gross generation by fuel source					
Coal-fired fossil	63%	64%	63%	63%	62%
Hydro	6%	6%	6%	7%	10%
Nuclear	30%	29%	31%	30%	28%
Combustion turbine	1%	1%	NM	NM	NM
Fuel cost per kWh (cents)					
Coal-fired fossil	1.39	1.32	1.27	1.28	1.25
Combustion turbine	4.65	6.07	6.22	3.94	4.01
Nuclear	0.41	0.44	0.49	0.51	0.71
Aggregate fuel cost per kWh net thermal generation	1.11	1.08	1.05	1.05	1.10

	For the Years Ended September 30				
	2002	2001	2000	1999	1998
Fuel data					
Net thermal generation (millions of kWh)	141,272	146,806	143,224	137,169	139,727
Billion Btu	1,458,367	1,505,504	1,470,452	1,403,110	1,426,151
Fuel expense (millions of dollars)	1,564	1,588	1,504	1,434	1,538
Cost per million Btu (cents)	107.25	105.47	102.29	102.21	107.81
Net heat rate	10,323	10,255	10,267	10,229	10,207

- (a) Sales and revenues have been adjusted to include sales to other utilities.
- (b) Includes 405 megawatts of capacity from the Corps of Engineers projects on the Cumberland River System and 326 megawatts of capacity from four hydro plants owned by TAPOCO, Inc.
- (c) Includes 440 megawatts of capacity from a power purchase agreement under which TVA has contracted with Choctaw Generation, L.P., for power from a lignite-fired generation plant in Chester, Mississippi.
- (d) As of September 30, 2002, includes sixteen 85 MW units subject to lease/leaseback arrangements.
- (e) Total summer NDC for 2002, 2001, 2000, 1999 and 1998 was approximately 30,477 MW, 29,405 MW, 28,612 MW, 28,076 MW and 27,950 MW, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") explains the results of operations and general financial condition of TVA. The MD&A should be read in conjunction with the accompanying Financial Statements.

Results of Operations

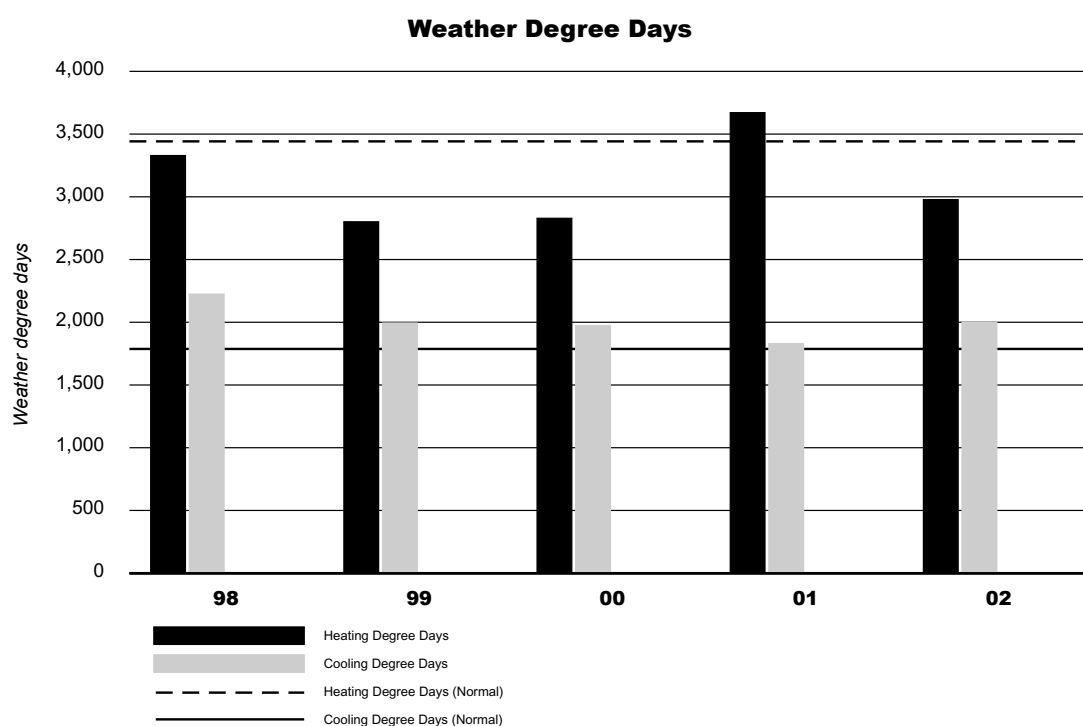
The following table compares operating results and selected statistics (dollars in millions) for TVA for the years ended September 30:

	2002	2001	2000
Operating revenues	\$ 6,835	\$ 6,999	\$ 6,762
Operating expenses	(5,186)	(5,506)	(5,019)
Operating income	1,649	1,493	1,743
Other income, net	7	248	17
Interest expense	(1,429)	(1,633)	(1,736)
Loss on impairment of assets/plant cancellation	(154)	(3,419)	—
Net income (loss)	<u>\$ 73</u>	<u>\$(3,311)</u>	<u>\$ 24</u>
Sales (millions of kWh)	160,091	161,421	159,571
Heating degree days	2,978	3,671	2,829
Cooling degree days	1,999	1,830	1,974

2002 Compared to 2001

Net income for 2002 was \$73 million compared with a net loss of \$3,311 million for 2001. The \$3,384 million increase in earnings resulted primarily from a loss on impairment of long-lived assets of \$3,419 million in 2001.

Operating Revenues. Operating revenues, consisting of sales of electricity and other power revenues, were \$6,835 million in 2002, and \$6,999 million in 2001, including sales of electricity of \$6,747 million in 2002 and \$6,897 million in 2001. The \$150 million decrease in sales was primarily due to a \$170 million decline in interchange revenue due to lower market prices influenced by new independent power producer generating plants coming on line in 2002. In addition, energy sales to municipalities and cooperatives declined by \$52 million primarily as a result of the warmer winter weather during 2002. There were 19 percent fewer heating degree days in 2002 as compared to 2001. Sales to directly served industries increased by \$73 million from 2001 to 2002 due to changes in product and service mix to certain customers. Accordingly, total kWh sales to all customers decreased 1.3 billion kWh, from 161.4 billion in 2001 to 160.1 billion in 2002. Other power revenues consist of energy related services and miscellaneous revenues. The \$14 million decrease from 2001 to 2002 is primarily due to a decline in wheeling revenues as a result of a lower level of interchange sales.



A Weather Degree Day is a unit of measure used to express the extent to which temperatures vary from a specific reference temperature during a given period. Companies may use standard reference figures of 80 degrees Fahrenheit for cooling degree days and 60 degrees Fahrenheit for heating degree days. Others sometimes use 65 degrees Fahrenheit as the standard reference for both heating and cooling degree days. TVA uses 65 degrees Fahrenheit.

Operating Expenses. Total operating expenses, which are composed of fuel and purchased power, operating and maintenance, depreciation and amortization, and tax-equivalents, decreased \$320 million, or 6 percent, from \$5,506 million in 2001 to \$5,186 million in 2002. Fuel and purchased power decreased by \$64 million, or 3 percent. This was primarily due to a corresponding 3 percent decrease in generation resulting in a reduction in fuel expense of \$23 million and a decrease in the amount of power purchased of \$41 million due to lower power demand in 2002. Additionally, depreciation and amortization expense was \$285 million lower in 2002 reflecting a \$325 million reduction in amortization of regulatory assets, net of increased depreciation expense of \$40 million for capital projects placed in service in 2002. Accelerated amortization of regulatory assets decreased \$164 million from \$230 million in 2001 to \$66 million in 2002 (see “Critical Accounting Policies” — “Amortization Adjustments” below and note 1 — *Other Deferred Charges — Accelerated Amortization*). The decreases in fuel and depreciation were partially offset by an increase in operating and maintenance expenses of \$180 million in 2002 over 2001 as a result of increased outage and other costs. Tax equivalent payments increased \$13 million in 2002 due to a higher revenue base in 2001, the measuring year for the 2002 payments.

Other Income. TVA had net other income of \$7 million in 2002 compared with net other income of \$248 million in 2001. The 2001 net other income resulted primarily from a purchased power contract settlement in excess of \$200 million.

Interest Expense. Net interest expense declined \$204 million from \$1,633 million in 2001 to \$1,429 million in 2002. Total outstanding indebtedness, as of September 30, 2002, was \$25.3 billion, with an average interest rate of 5.89 percent; as of September 30, 2001 this amount outstanding was \$25.4 billion, with an average interest rate of 6.57 percent.

Loss on Impairment of Assets/Plant Cancellation. In 2001, TVA identified certain assets for which estimated future cash flows provided through future rates were likely to be less than recorded book values. Accordingly, TVA reduced the carrying amount of these assets by a total of \$3,419 million, of which \$2,220 million was attributable to deferred nuclear generating units, \$789 million was attributable to deferred debt refinancing costs and \$410 million was attributable to plant held for future use (see note 1 — *Impairment of Assets*).

Due to changes in the market forecast, TVA elected during 2002 not to complete a gas-fired combined-cycle plant that would have provided 510 megawatts of power in 2004. Accumulated costs of the project totaled approximately \$154 million, which TVA recognized as a loss on plant cancellation.

2001 Compared to 2000

Net loss for 2001 was \$3,311 million compared with net income \$24 million for 2000. The reduction in earnings resulted primarily from a loss on impairment of long-lived assets of \$3,419 million in 2001 (see “Loss on Impairment of Assets/Plant Cancellation” below and note 1 — *Impairment of Assets*).

Operating Revenues. Operating revenues were \$6,999 million in 2001 compared with \$6,762 million in 2000. The \$237 million increase was primarily due to a \$232 million increase in energy sales to municipalities and cooperatives as a result of the cold winter weather during 2001. Total kWh sales to municipalities and cooperatives increased 3.8 billion kWh, from 126.0 billion in 2000 to 129.8 billion in 2001. Sales to directly served industries increased by \$33 million from 2000 to 2001 primarily due to implementation of a fixed-rate contract with a large manufacturing customer. Interchange sales were \$27 million less in 2001 than in 2000 due to a decrease in interchange sales of 30 percent or 2.9 billion kWh.

Operating Expenses. Operating expenses increased \$487 million, or 9 percent, from \$5,019 million in 2000 to \$5,506 million in 2001. Fuel and purchased power costs increased \$27 million primarily due to higher fossil fuel costs of \$110 million due to a 5 percent increase in fossil generation, offset by lower nuclear and purchased power expense of \$83 million. Operating and maintenance expenses of \$1,660 million in 2001 were \$217 million higher than in 2000. This is a result of an increase in power production of 3 percent. Depreciation and amortization expense of \$1,185 million in 2000 increased \$127 million to \$1,312 million in 2001 primarily due to additional depreciation of \$23 million on projects placed in service and amortization of regulatory assets of \$104 million. The increase in tax equivalent payments of \$7 million in 2001 was due to a higher revenue base in 2000, the measuring year for 2001 payments. Accelerated amortization increased \$109 million from 2000 to 2001 (see note 1 — *Other Deferred Charges — Accelerated Amortization*).

Other Income. TVA had net other income of \$248 million in 2001 compared with net other income of \$17 million in 2000. The 2001 net other income resulted primarily from a purchased power contract settlement in excess of \$200 million.

Interest Expense. Net interest expense declined \$103 million from \$1,736 million in 2000 to \$1,633 million in 2001. Total outstanding indebtedness, as of September 30, 2001, was \$25.4 billion, with an average interest rate of 6.57 percent; as of September 30, 2000 this amount outstanding was \$26.0 billion, with an average interest rate of 6.83 percent.

Loss on Impairment of Assets/Plant Cancellation. The net change of \$3,419 million in loss on impairment of assets/plant cancellation is due to actions taken as a result of TVA’s periodic financial reviews. In 2001, TVA identified certain assets for which estimated future cash flows provided through future rates

were likely to be less than recorded book values. Accordingly, TVA reduced the carrying amount of these assets by a total of \$3,419 million, of which \$2,220 million was attributable to deferred nuclear generating units, \$789 million was attributable to deferred debt refinancing costs and \$410 million was attributable to plant held for future use (see note 1 — *Impairment of Assets*). No such assets were written off during 2000.

Liquidity and Capital Resources

Capital Structure

Primarily during the first 25 years of TVA's existence, the U.S. government made appropriation investments in TVA power facilities. In 1959, TVA received congressional approval to issue bonds in order to finance its growing power program. Since that time, TVA's power program has been required to be self-supporting. As a result, TVA funds its capital requirements through internal cash generation, through borrowings (subject to a congressionally-mandated \$30 billion limit on the amount of outstanding Evidences of Indebtedness) or through other financing arrangements including lease/leaseback transactions.

TVA is required to pay the U.S. government a return on the appropriation investment in TVA power facilities, plus a repayment of the investment as specified by law. The combined payment for 2002 was \$50 million. Cumulative repayments and return on investment paid by TVA to the U.S. Treasury exceed \$3.4 billion on the government's appropriation investment of \$1.4 billion, approximately \$955 million of which TVA has repaid.

TVA's liquidity and capital measurements (dollars in millions) for its power program for the years ended September 30 are:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Cash flow from operations	\$1,347	\$1,914	\$1,584
Construction expenditures	\$1,231	\$1,015	\$ 867
Operating cash flow to construction expenditures	1.09x	1.89x	1.83x
Times interest earned	1.92x	2.20x	1.93x

Comparative Cash Flow Analysis

TVA's summary cash flows for its power program for the years ended September 30 are:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Cash provided by/ (used in):			
Operating activities	\$ 1,347	\$ 1,914	\$ 1,584
Investing activities	(1,346)	(1,191)	(1,035)
Financing activities	<u>57</u>	<u>(732)</u>	<u>(304)</u>
Net increase (decrease) in cash and cash equivalents	<u>\$ 58</u>	<u>\$ (9)</u>	<u>\$ 245</u>

2002 Compared to 2001

Net cash provided by power program operating activities decreased \$567 million from 2001 to 2002. The decrease includes a decline in interchange revenue due to lower market prices influenced by new independent power producer generating plants. In addition to lower sales, operating and maintenance expenses increased due to planned (budgeted) maintenance and unplanned outages. Funds were also used to pay current liabilities, which declined 24 percent during 2002.

Cash used in investing activities increased \$155 million due to additional expenditures for capital projects of \$216 million and fabrication of nuclear fuel of \$52 million, partially offset by cash received from other investing activities of \$113 million primarily due to a decrease in long-term investments during 2002.

Net cash provided by financing activities increased \$789 million from 2001 to 2002 as a result of reduced debt repayments of \$495 million and proceeds from a lease/leaseback of \$320 million, partially offset by an increase in financing costs of \$29 million related to bond issues.

2001 Compared to 2000

Cash provided by power program operating activities increased \$330 million from 2000 to 2001. This is primarily the result of increased sales to municipalities and cooperatives due to 15 percent greater weather degree days in 2001 and collection of a contract settlement offset by an increase in operating and maintenance expenses due to greater generation and purchased power to meet sales demands as well as funds provided by operating assets and liabilities.

Cash used in investing activities increased \$156 million due to additional expenditures for capital projects of \$148 million and an increase in long-term investments of \$100 million. Cash provided by investing activities increased \$90 million for a decrease in fabrication of nuclear fuel from the prior year.

Cash used by financing activities increased \$428 million from 2000 to 2001 from an increase in debt repayments of \$217 million and a decrease in net lease/leaseback proceeds of \$329 million, offset by a decrease in financing costs of \$119 million related to bond issues.

Capital Resources

For purposes of refinancing outstanding debt, TVA continued to access capital markets through cost-effective, long-term financing structures and continued to expand its global investor base, as well as its domestic retail investor base. TVA offered global securities in December 2001, issuing \$600 million of 15-year bonds with a put option in 2006. In April, TVA issued \$936 million of new 10-year bonds with a lower coupon and a put option in 2004 in exchange for outstanding 10-year bonds with a higher coupon and a put option in May 2002. The extension of the early redemption feature motivated investors to exchange the existing bonds for the new bonds with a lower coupon. TVA continued to target retail investors through its medium-term note program, *electronotes*®, offering 23 issues ranging in size from \$6 million to more than \$61 million, for a total of \$584 million for the current year. Total *electronotes*® outstanding at September 30, 2002, was \$869 million. During 2002, TVA redeemed outstanding long-term issues totaling approximately \$2.7 billion.

Lease/Leaseback Transactions

In an effort to meet the growing demand for power in its service area, TVA has been involved in the construction of a series of several new peaking combustion turbine units. The first set of eight units was completed in the summer of 2000, and a second set of eight units was completed in the summer of 2001. TVA completed two additional sets of four units each during the summer of 2002. Of the financing options available to TVA, leasing alternatives provided outcomes that were the most economically favorable to TVA. At the commencement of the long-term lease and leaseback arrangements, the equity participant paid TVA rent in the amounts of \$300 million for the first set of units and \$320 million for the second set of units, representing the appraised values of the facilities. The financing costs of the lease agreements approximated a full-term implicit rate slightly below 6 percent in the case of the first lease and just above 4 percent in the case of the second lease.

TVA accounted for the respective lease proceeds as financing obligations in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 66, *Accounting for Sales of Real Estate*, and SFAS No. 98, *Accounting for Leases*. Accordingly, the outstanding financing obligations of \$559 million in 2002 and \$271 million in 2001 are included in Current Liabilities (\$16 million and \$6 million, respectively) and Other Liabilities (\$543 million and \$265 million, respectively) in TVA’s 2002 and 2001 year-end Balance Sheets.

Cash Requirements and Contractual Obligations

TVA estimates future cash requirements for capital expenditures for property, plant and equipment additions, including clean air projects and new generation, will be as follows:

	<u>Actual</u> <u>2002</u>	<u>Estimated Expenditures</u>		
		<u>2003</u>	<u>2004</u>	<u>2005</u>
		(in millions)		
Capital expenditures	\$1,231	\$1,580	\$1,484	\$1,482

TVA also has contractual cash obligations, including minimum payments on operating leases and obligations, power purchase contracts and fuel purchase contracts (see note 9). TVA expects that cash provided by operating activities and new financing activities will be adequate to meet these estimated cash requirements, as well as capital expenditures. As of September 30, the amounts of contractual cash obligations maturing in each of the next five years and thereafter are shown below:

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
	(in millions)						
Leases	\$ 40	\$ 40	\$ 39	\$ 39	\$ 39	\$ 121	\$ 318
Lease/leaseback transactions	44	44	46	44	44	640	862
Power purchase obligations	137	113	136	136	124	2,390	3,036
Other obligations	441	379	330	293	215	—	1,658
Fuel purchase obligations	1,515	999	641	178	99	374	3,806
Debt	<u>3,492</u>	<u>2,336</u>	<u>2,065</u>	<u>2,621</u>	<u>1,051</u>	<u>13,690</u>	<u>25,255</u>
	<u>\$5,669</u>	<u>\$3,911</u>	<u>\$3,257</u>	<u>\$3,311</u>	<u>\$1,572</u>	<u>\$17,215</u>	<u>\$34,935</u>

Leases

Certain property, plant and equipment are leased under agreements with terms ranging from one to 30 years. Obligations under capital lease agreements in effect at September 30, 2002 total \$36 million annually through 2007 and an aggregate of \$121 million thereafter, for a total commitment of \$301 million. Of this amount, \$138 million represents the cost of financing. Obligations under non-cancelable lease agreements in effect at September 30, 2002, total \$4 million for each of 2003 and 2004 and \$3 million for each of 2005-2007. There are no non-cancelable operating lease agreements in effect after that period. TVA also has cancelable lease agreements in effect at September 30, 2002, which total \$2 million for 2003, \$3 million for each of 2004 and 2005, \$2 million for 2006 and \$1 million for each of 2007-2013. Because of the nature of these cancelable lease agreements, they are not included in the commitment table above.

Lease/Leaseback Transactions

Obligations under lease/leaseback transactions in effect at September 30, 2002 total \$44 million annually for 2003 and 2004, \$46 million for 2005, and \$44 million annually for 2006 and 2007 and an aggregate of \$640 million thereafter, for a total commitment of \$862 million. Of this amount, \$301 million represents the cost of financing (see notes 7 and 9).

Power Purchase Obligations

TVA has an agreement for the purchase of power from a 440-megawatt, lignite-fired electric generating plant that requires TVA to purchase the plant's output for a 30-year period that began in April 2002. Pricing of the contract includes fixed and variable components with estimated power purchases approximating \$3 billion for the remainder of the contract term. TVA also entered into long-term power supply agreements with a generator for supply from a facility that has a current generating capacity of 500 megawatts. These commitments extend through May 2007 with a future obligation for demand charges in the amount of \$136 million. Agreements are in place with respect to five other projects. These five contracts are for durations of 2

to 12 years, the earliest of which began in 2000. Payments for the remainder of the terms of these five contracts are estimated to be approximately \$38 million.

Under the Public Utility Regulatory Policies Act of 1978, TVA is obligated to purchase power from qualifying facilities. In 2002, a new facility qualified under this program, and as a result TVA could be required to take up to 800 MW of power during certain on-peak hours from the facility.

Other Obligations

TVA has approximately \$1.7 billion in long-term commitments consisting primarily of construction of generating assets and emission control facilities. Terms of the contracts extend into 2008.

Fuel Purchase Obligations

TVA has approximately \$2.7 billion in long-term fuel purchase commitments ranging in terms of up to seven years for the purchase and transportation of coal, and approximately \$1.1 billion in long-term commitments ranging in terms of up to 10 years for the purchase of enriched uranium and fabrication of nuclear fuel assemblies.

Debt

At September 30, 2002, TVA had outstanding short-term debt of \$3,492 million and long-term debt at varying maturities and interest rates of \$21,763 million for a total outstanding indebtedness of \$25,255 million (see note 6).

Capital Requirements

TVA has incurred and continues to incur substantial capital expenditures and operating expenses to comply with environmental requirements. Because these requirements change frequently, the total amount of these costs in the future is not now determinable. It is anticipated that environmental requirements will become more stringent and that compliance costs will increase, perhaps by substantial amounts. Although TVA cannot, with certainty, project the costs of additional nitrogen oxide, sulfur dioxide and particulate matter emissions controls beyond those required by the acid rain provisions of the 1990 Clean Air Act Amendments, the costs of these additional reductions could exceed \$3 billion through 2020, exclusive of approximately \$2 billion for planned scrubbers and selective catalytic reduction systems discussed in "Environmental Matters" below.

In March 2002, TVA's nuclear staff reported to the Board the results of a detailed cost and planning study which concluded that TVA can return Browns Ferry Unit 1 to service safely and economically. In May 2002, the Board initiated activities for the return of Browns Ferry Unit 1 to service. It is anticipated the project will cost approximately \$1.8 billion and will take five years to complete. It is anticipated that Browns Ferry Unit 1 will provide approximately 1,280 MWs of capacity.

Significant Balance Sheet Changes

Total power assets increased nearly \$460 million during 2002 primarily due to the transition of a prepaid pension asset of approximately \$800 million to a minimum pension liability of approximately \$500 million due to valuation of the pension balances by independent actuaries. An intangible asset of approximately \$400 million has been recognized to properly account for the required pension changes. The offsetting charge of approximately \$900 million has been recorded as a regulatory asset, as the Board has determined that these costs will be recovered through future revenues in compliance with the Act (see "Critical Accounting Policies" — "Regulatory Assets and Liabilities" below).

Critical Accounting Policies

TVA prepares its financial statements in conformity with generally accepted accounting principles accepted in the United States of America applied on a consistent basis and, in some cases, reflects amounts based on the best estimates and judgment of management, giving due consideration to materiality.

Revenue Recognition Policies

Revenues from power sales are recorded as power is delivered to customers. TVA accrues estimated unbilled revenues for power sales provided to customers for the period of time from the end of the billing cycle to the end of the month (see note 12).

Regulatory Assets and Liabilities

TVA accounts for the financial effects of regulation in accordance with SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. As a result, TVA records certain regulatory assets and liabilities that would not be recorded on the balance sheet under generally accepted accounting principles for non-regulated entities.

TVA has approximately \$1,452 million of regulatory assets (see note 1 — *Other Deferred Charges and Debt Issue and Reacquisition Costs*) along with approximately \$4.1 billion of deferred nuclear units as of September 30, 2002 (see note 1 — *Impairment of Assets* and note 2). In the event that restructuring of the utility industry changes the application of SFAS No. 71, TVA would be required to evaluate such regulatory assets and deferred nuclear units under the provisions of SFAS No. 101, *Accounting for the Discontinuation of Application of SFAS No. 71*. SFAS No. 101 establishes reporting criteria for an enterprise that ceases to meet the criteria for application of SFAS No. 71.

Actuarial Assumptions

Net periodic pension cost is determined using assumptions as of the beginning of each year. Funded status is determined using assumptions as of the end of each year. The valuations performed at the end of 2001 were based on actuarial assumptions that were consistent for all of TVA's benefit plans. For 2002, TVA recognized pension income of about \$40 million, postretirement benefit expense of \$19 million, and workers compensation expense of approximately \$64 million.

Effective with the September 30, 2002 measurement date for funded status, the discount rate was reduced from 7.5 percent to 7.05 percent and the cost of living rate was reduced from 3.0 percent to 2.3 percent to reflect current market and demographic conditions. Additionally, TVA modified its assumption related to mortality based on results of an experience study performed during the year and converted from 1994 to 1983 mortality tables. As a result of these changes, the September 30, 2002 projected benefit obligation decreased by nearly \$128 million. The changes in assumptions had no effect on pension income for 2002, 2001 or 2000 but will reduce pension expense for 2003 by approximately \$37 million (see note 8).

Derivatives

Effective October 1, 2000, TVA adopted the provisions of SFAS Nos. 133, *Accounting for Derivative Instruments and Hedging Activities*, and 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. Qualifying derivative contracts consisted of various purchased power option contracts and certain currency and interest rate swap agreements (see note 5 — *Foreign Currency and Interest Rate Swaps*). In accordance with SFAS No. 133, these contracts qualify for cash-flow hedge treatment. Accordingly, the effective portion of gains and losses related to such contracts is reported in accumulated other comprehensive income, while the ineffective portion is recognized through the creation of a regulatory asset/liability. The amounts accumulated in other comprehensive income and regulatory asset/liability are recognized in earnings upon settlement of the related contracts. Such treatment reflects TVA's ability and intent to account for these derivative instruments on a settlement basis for rate-making purposes.

Amortization Adjustments

Annual provisions for amortization of deferred charges are adjusted as necessary in order to achieve certain earnings levels. Such earnings levels are set forth in resolutions adopted annually by the TVA Board of Directors in connection with the rate review process. The targeted earnings levels are based on requirements of the TVA Act and the Basic Resolution.

Normal Purchases and Normal Sales Special Exemption

A unique characteristic of the electric utility industry is that electricity cannot readily be stored in significant quantities, and, as a result, some contracts to buy and sell electricity afford the buyer some flexibility in determining when to take electricity, and in what quantity, to meet fluctuating demands. These contracts would normally qualify as derivatives, but because electricity cannot be readily stored and an entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customers, an option contract for the purchase of electricity qualifies for the normal purchases and sales exemption described in Paragraph 10 of SFAS No. 133 and Derivatives Implementation Group (“DIG”) Issue No. C15, *Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts in Electricity*. Contracts for the sale or purchase of power in future periods that meet the criteria of DIG Issue C15 have been categorized as “normal purchase, normal sales” contracts and are exempted from recognition in the financial statements until power is delivered.

Nuclear Decommissioning Costs

TVA’s current accounting policy for nuclear decommissioning costs recognizes all obligations related to closure and removal of its nuclear units as incurred (see note 1 — *Decommissioning Costs*). TVA measures the liability for closure at the present value of the estimated cash flows required to satisfy the related obligation, discounted at a determined rate of interest in effect at the time of original fuel load. Earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset and interest expense on the decommissioning liability are deferred in accordance with SFAS No. 71 (see note 1 — *Decommissioning Costs* and note 9 — *Contingencies — Decommissioning Costs*).

At September 30, 2002, the present value of the estimated future decommissioning cost of \$891 million was included in other liabilities, and the unamortized regulatory asset of \$556 million was included in deferred charges. The decommissioning cost estimates are based on prompt dismantlement and removal of a plant from service. The actual decommissioning costs may vary from the estimates because of changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology and changes in the cost of labor, materials and equipment.

TVA maintains a decommissioning trust fund to provide funding for the ultimate decommissioning of its nuclear power plants. The fund is invested in securities selected to achieve a return in line with overall equity market performance. As of September 30, 2002, the decommissioning trust funds totaled approximately \$500 million, and as of November 30, 2002, the decommissioning trust funds totaled approximately \$570 million. This amount is less than the present value of the estimated future decommissioning costs. TVA is closely monitoring the status of its decommissioning trust fund in light of recent market performance and believes that, over the long term before the cessation of plant operations and the commencement of decommissioning activities, adequate funds from investments will be available to support decommissioning. (TVA’s nuclear power plants are currently authorized to operate until 2013-2035, depending on the facility, with an additional 20 years of operation at each plant in the event of license renewal (see “Nuclear Power Program” — “Operating License Extensions” below).)

New Accounting Standards and Pronouncements

In June 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, which requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. TVA is currently developing a policy related to the retirement of its long-lived assets and is evaluating the nature and scope of plant site and other long-lived asset retirements. Upon completion of the evaluation, cost estimates will be developed and used in the determination of all related asset retirement obligations. The associated asset retirement costs will be capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The impact of adoption of SFAS No. 143 is not currently known.

In October 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which replaces SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. The statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. It also developed one accounting model for long-lived assets to be disposed of by sale, based on the framework established in SFAS No. 121, and addressed significant implementation issues. SFAS No. 144 requires that those long-lived assets be measured at the lower of the carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, are to be applied prospectively. The impact of adoption of SFAS No. 144 is not currently known.

The purpose of Emerging Issues Task Force (“EITF”) Issue 02-3, *Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, is to codify and reconcile the Task Force consensuses on previously issued EITF Issues No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, and No. 00-17, *Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10*, and EITF Abstracts, Topic No. D-105, *Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10*. These EITF Issues and Abstracts address various aspects of the accounting for contracts involved in energy trading and risk management activities. At a special October 25, 2002 meeting, the Task Force reached a consensus to rescind EITF Issue No. 98-10, the impact of which is to preclude mark-to-market accounting for all energy trading contracts not within the scope of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Task Force also reached consensus that gains and losses on derivative instruments within the scope of SFAS No. 133 should be shown net in the income statement if the derivative instruments are held for trading purposes. The consensuses reached effectively supercede the consensuses reached on this Issue at the June 19-20, 2002 EITF meeting. The consensus regarding the rescission of Issue 98-10 is applicable for fiscal periods beginning after December 15, 2002. Energy trading contracts not within the scope of SFAS No. 133 purchased after October 25, 2002, but prior to the implementation of the consensus are not permitted to apply mark-to-market accounting. The adoption of EITF Issue 02-3 will have no impact on TVA’s current operations.

TVA and Competition

The electric utility industry has become increasingly competitive over the last decade. Competition is expected to continue to intensify, and restructuring legislation may dramatically change the way electric utilities do business in the future. Among the early initiatives that have begun to promote industry competition is the Energy Policy Act of 1992 (the “Energy Act”). The Energy Act and related FERC orders already allow competitors of a utility to access that utility’s transmission system to sell electricity to other electric power suppliers and wholesale customers. In TVA’s case, some special provisions apply.

Under the TVA Act, subject to certain minor exceptions, TVA may not currently enter into contracts that would have the effect of making it or the distributors of its power a source of power supply outside a statutorily specified area. However, under a special provision of the Energy Act (the “Anti-Cherry-picking Provision”), TVA is not required to provide its competitors access to its transmission system to transmit power for consumption within the area that TVA or the distributors of its power may serve. Thus, while TVA may not sell power outside its current service area, TVA cannot be compelled to permit its competitors to use its transmission system to sell power within TVA’s service area.

In the future, it is likely that the current law that serves to limit competition between TVA and its competitors will change. In the past four years, numerous bills have been introduced in Congress designed to restructure the electric utility industry and mandate or promote competition in the industry. Within the context of restructuring legislation, some of the key issues for TVA are: (1) whether TVA rates and transmission system will be regulated by FERC, (2) whether TVA and the distributors of TVA power will be able to sell power outside the TVA service area and whether TVA will be required to provide its competitors access to its transmission system to transmit power for consumption within the TVA service area, (3) whether Congress will attempt to shorten the terms of TVA’s present wholesale power contracts with the

distributors of its power, and (4) whether TVA will have the right to recover its power system investments that would no longer be economical under full and open market competition (stranded costs).

In the spring of calendar year 2000, TVA and the Tennessee Valley Public Power Association, an association comprising almost all of the distributors of TVA power, and the Tennessee Valley Industrial Committee ("TVIC"), an organization representing industries that TVA directly serves, reached consensus on draft legislation regarding the relationships between TVA and its customers in a restructured electric power industry. This draft legislation provided for: (1) simultaneous repeal on the effective date of the restructuring legislation of the Anti-Cherrypicking Provision and the provision that limits the area in which TVA and the distributors of TVA power can be a source of power supply, (2) renegotiation of power contract terms with a minimum termination notice period of three years, and a distributor option to take partial requirements from other suppliers with advance notice to TVA, (3) new limitations on TVA retail sales in TVA's current service area, (4) stranded cost recovery, (5) FERC regulation of TVA's transmission system, (6) TVA subjection to antitrust laws (with the exception of civil damages and attorney's fees), (7) reduction of most of TVA's existing regulatory role with respect to distributors, and (8) limitation on new TVA generation to that needed to meet demand within the current TVA service territory. Reacting to changes within the electric power industry and regulatory developments in the restructuring of the industry, TVA has determined that it may be appropriate to reassess certain features of the draft legislation and is in the process of opening discussions in that regard with TVA's customers.

On July 31, 2002, FERC issued its Notice of Proposed Rulemaking on "Remedying Undue Discrimination and Open Access Transmission Service and Standard Electricity Market Design," Docket No. RM01-12-000, which, if ultimately implemented, would have far-reaching effects on electricity markets across the nation. FERC's overall objective is to create competitive wholesale electricity markets for the entire United States. FERC has stated it believes that a standard market design is needed to eliminate perceived undue discrimination in the provision of transmission service, eliminate inconsistent rules across the country, mitigate the exercise of market power, and, ultimately, drive down the price of power in wholesale markets. Because TVA is not currently subject to FERC's general jurisdiction, it will not be required to implement the standard market design rule if it is adopted by FERC. Nonetheless, to the extent that surrounding electric power systems continue transitioning toward markets with standard market design features, TVA will need to ensure that its future purchases of power from those markets will be made in accordance with any new market rules and practices and that any of TVA's future sales of power into those markets will continue to be in accordance with the limitations of the Act.

Reactions to the FERC proposal have been mixed. Reactions from high-cost states in the Northeast, which have had a long history of centralized power pools, have been relatively more positive on both the market fundamentals and the need for a standardized market model than reactions from low-cost states. Some low-cost states fear that the proposal would lower prices in high-cost states at the expense of low-cost regions like the Southeast. Other critics have noted that the proposed rule would (1) unfairly eliminate native load preference, i.e., the policy of giving highest priority use of the transmission system to native load customers who have historically paid for that system; (2) lead to jurisdictional conflicts between state and federal regulators; and (3) lead to cost-shifting by failing to propose workable mechanisms for participant funding of new transmission investments. In addition to these substantive issues, criticism of FERC's aggressive timetable has been widespread. Reactions to the proposed rule have been so strong that draft legislation has been proposed that would constrain FERC's authority to move ahead.

The ultimate outcome of restructuring is highly uncertain at this time, making it extremely difficult to predict the ultimate market structure that will evolve, the timing of its evolution, and its ultimate impact on TVA. In February 2001, the United States General Accounting Office ("GAO") issued a report entitled "TENNESSEE VALLEY AUTHORITY, Debt Reduction Efforts and Potential Stranded Costs." In this report GAO said that, although TVA has made progress in reducing its level of debt and in recovering the cost of deferred assets and although its financial condition has improved, in light of its levels of debt and deferred assets, TVA's financial flexibility to respond to financial and competitive challenges is less than that of its likely competitors, and as a result TVA could have stranded costs if Congress enacts legislation that requires TVA to compete with other electricity providers. TVA disagrees with this report. TVA continues to believe

that it has certain cost advantages that would be beneficial in a restructured market. Its power prices are currently in the lowest quartile of the nation's prices, and its total power prices are average for the Southeast, a low-cost region. TVA will continue to develop plans and strategies designed to position TVA for competitive success in a restructured industry. Nevertheless, we cannot predict the outcome of any future electricity restructuring or its timing.

Business Strategy

Strategic Objectives

TVA's strategic objectives for competing in the energy market of the future encompass excellence in operating performance, economic leadership, and sensitivity to our stakeholders' needs. Critical success factors have been evaluated and targets established to reach our goals. TVA strives to:

Improve life in the Tennessee Valley through integrated management of the river system and environmental stewardship by balancing competing demands and optimization of the river system, and manage the environmental and safety impacts TVA's operations have on employees and the region;

Meet customers' needs with affordable, reliable electric power by continuing to improve power reliability to meet customer requirements, providing flexible contracts, competitive pricing of products and services and achieve excellence in stakeholder relations and communications processes;

Demonstrate leadership in sustainable economic development in the Valley by promoting development through targeted growth initiatives, and develop workforce capabilities required to be the supplier and employer of choice;

Continue the trend of debt reduction (begun in 1997) by generating more electricity for less dollars and by investing prudently;

Reduce TVA's delivered cost of power relative to the market by achieving excellence in asset optimization and production processes; and

Strengthen working relationships with all of TVA's stakeholders by shaping the culture to model TVA's values and achieve excellence in the customer value and relationship processes.

Key Indicators and Objectives

<u>Measure</u>	<u>Strategic Objective</u>	<u>Indicator</u>	<u>2002</u>	<u>2001</u>
Customer	Meet customers' needs with affordable, reliable electric power	Customer-connection-point interruptions (interruptions per connection point)	1.03	1.17
	Demonstrate leadership in sustainable economic development in the Valley	Jobs added or retained in the Valley	48,248	47,808
Operations	Meet customers' needs with affordable, reliable electric power	Watershed water quality (number of watersheds rated good to fair out of a maximum of 611)	512	496
Financial	Reduce TVA's delivered cost of power relative to the market	Delivered Cost of Power (cents/kWh)	4.07	4.05
People	Strengthen working relationship with all of TVA's stakeholders	All injury rate (per 100 employees)	1.97	2.32

Environmental Matters

TVA's activities are subject to various federal, state and local environmental statutes and regulations. Major areas of regulation affecting TVA's activities include air pollution control, water pollution control and management and disposal of solid and hazardous wastes.

TVA has incurred and continues to incur substantial capital expenditures and operating expenses in order to comply with environmental requirements. Because these requirements change frequently, the total amount of such costs in the future is not now determinable. It is anticipated that environmental requirements will become more stringent and that compliance costs will increase, perhaps by substantial amounts.

Clean Air Developments

Under the Clean Air Act, EPA has promulgated national ambient air quality standards for certain air pollutants, including sulfur dioxide ("SO₂"), particulate matter and ozone. Coal-fired generating units such as TVA's are considered major sources of pollutants that impact these standards, and TVA has implemented strategies to reduce its emissions in order to comply with these air quality standards.

Title IV of the Clean Air Act Amendments of 1990 ("CAAA") requires coal-fired generation units to reduce their SO₂ and nitrogen oxide emissions ("NO_x") in two phases in order to control acid rain. Compliance with these requirements has resulted in substantial expenditures for the reduction of emissions at TVA's coal-fired generating plants. Through 2002, TVA had invested approximately \$1 billion in capital improvements for acid rain compliance. TVA estimates it will spend an additional \$85 million between 2003 and 2006 to complete switches to lower sulfur coals for acid rain compliance purposes.

TVA's strategy for complying with the CAAA has included the use of flue gas desulfurization systems, or scrubbers, at two fossil units in addition to existing scrubbers on four other units, and the use of lower-sulfur coal at other fossil units to reduce SO₂ emissions. TVA has completed these scrubbers and is on schedule to complete the changeover to lower-sulfur coal.

NO_x reductions were required under the CAAA for 58 of TVA's 59 coal-fired units. The only TVA unit for which NO_x reductions are not required under the CAAA is the Atmospheric Fluidized Bed Unit 10 at TVA's Shawnee Fossil Plant. The NO_x reductions for the other 58 units were achieved through the installation of low-NO_x burners and/or overfire air at 40 units and boiler optimization at the remaining 18 units. In 1996, TVA selected an early election option for four of these 58 units, which allows the four units at John Sevier Steam Plant to be limited to Phase I NO_x levels through 2007. In 2008, these four units will have to meet lower Phase II NO_x levels. For the remaining 54 units, TVA has elected to average NO_x emissions to meet a 54-unit NO_x Averaging Plan. This option enables TVA to optimize the cost of NO_x reduction while fully complying with the CAAA Title IV NO_x requirements. In addition to its Title IV projects, TVA is in the process of installing selective catalytic reduction systems ("SCRs") or other NO_x control technologies on at least 25 of its coal-fired units. This follows up on a commitment TVA has made to further reduce NO_x emissions throughout its system. Installation of these SCRs will also comply with the EPA's State Implementation Plan NO_x Reduction rule issued in 1998. Depending on future generation requirements, additional NO_x controls may be required.

In TVA's continuing efforts to improve air quality in the Tennessee Valley and to comply with the Clean Air Act, TVA plans to design, build and operate five more scrubbers to further reduce SO₂ emissions from 12 of its coal-fired units. Although design of these scrubbers is scheduled to start in 2003, substantial construction activities are not expected to begin until TVA completes its SCR installation program in 2005. Completion of the five scrubbers is expected by 2011.

The EPA has finalized new, more stringent National Ambient Air Quality Standards for particulate matter standards and ozone and a rule designed to reduce regional haze. Each of these rule-makings has been the subject of litigation and the EPA is in the process of developing implementation strategies for the ambient standards and readdressing several provisions of the regional haze rule. These actions may require TVA to make additional reductions of SO₂ emissions beyond those currently planned. TVA anticipates that compliance with the new regulations will be required after 2010. The EPA has also determined that mercury

emissions from coal-fired plants should be reduced and is developing both a rule to reduce mercury and legislative packages that put mercury reductions in a multipollutant plan. Depending on the severity of the mercury reductions, TVA could incur additional substantial capital costs for control of mercury.

On February 14, 2002, the Bush Administration announced its “Clear Skies Initiative,” which outlines legislative requirements for the phased reduction of SO₂, NO_x, and mercury emissions from utilities during the period from 2008 to 2018. In July of 2002, legislation known as the Clear Skies Act was introduced in Congress. A number of bills have been introduced in Congress that would result in significant decreases in emissions of NO_x, SO₂ and mercury, as well as carbon dioxide. The timing and content of such legislation remains highly uncertain.

Expenditures related to clean air projects during 2002 and 2001 were approximately \$400 million and \$200 million, respectively. The cost of the SCR strategy, including 2001 and 2002 expenditures, is now estimated to be \$1.3 billion, and the cost of the planned installation of five scrubbers is estimated to be \$1.3 billion. The total cost of future compliance with NO_x, SO₂, mercury and particulate matter requirements, however, cannot reasonably be determined at this time because of the uncertainties surrounding emerging EPA regulations, resultant compliance strategies, potential for the development of new emissions control technologies, court litigation, and future amendments to the Clean Air Act. However, total future costs through 2020 could exceed \$3 billion, exclusive of the costs of the planned SCRs and scrubbers. These future controls will also apply towards any enforcement liability (see “Legal Proceedings”).

The EPA has instituted judicial and administrative actions against a number of utilities in the eastern U.S., including TVA, alleging that they have modified their coal-fired units without complying with new source review (“NSR”) requirements. TVA contends that the EPA’s enforcement action is based on a new interpretation of an old rule and that TVA has routinely maintained its power plants to ensure efficient, reliable power generation while complying with all requirements. The EPA issued TVA an administrative order directing TVA to put new source controls on 14 of its coal-fired units and to evaluate whether more controls should be installed on other units. TVA has challenged the validity of this order, and the Eleventh Circuit Court of Appeals has stayed the order pending its review. The outcome of this litigation and the EPA proceedings is uncertain (see “Legal Proceedings”).

The Bush administration has reviewed the energy implications of the EPA’s new NSR interpretation and concluded that there is evidence that NSR impedes utilities from increasing the efficiency and performance of existing fossil-fuel generation. TVA has determined that if the EPA’s new interpretation becomes law, TVA could lose about 11 percent of the energy capabilities of its coal-fired system within three years through permit limits on use of its units. On November 22, 2002, EPA announced changes to its NSR program intended to address aspects of the program that have deterred companies from implementing projects that would enhance energy efficiency and decrease air pollution. These changes are not anticipated to affect TVA’s commitments to emissions control projects discussed above or the NSR litigation.

See “Legal Proceedings” for a discussion of Clean Air Act legal proceedings, including those involving NSR.

Hazardous Substances

The release and cleanup of hazardous substances are regulated under the Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”). In a manner similar to many other industries and power systems, TVA has generated or used hazardous substances over the years. TVA is aware of hazardous-substance releases at eight offsite areas for which it may have some liability. TVA’s potential liabilities for its share of cleanup costs at these sites are uncertain but are not expected to have significant impact on TVA’s financial position or results of operations.

Water Quality

Under the Clean Water Act (“CWA”), every point source which discharges pollutants into waters of the United States must obtain a National Pollutant Discharge Elimination System (“NPDES”) permit specifying the allowable quantity and characteristics of the pollutants discharged. All of TVA’s various point

sources operate under NPDES permits, including all of its major generating units. Compliance with NPDES requirements has necessitated substantial expenditures and may require additional expenditures in the future as NPDES permits come up for renewal and applicable requirements become more stringent.

The CWA allows the permitting authority to establish thermal limits less stringent than the water quality criteria if the discharger can demonstrate that the alternate limit will assure protection and propagation of a balanced, indigenous aquatic population. TVA has now been issued alternate limits at several of its facilities, and it is meeting these limits. Periodic monitoring of fish and other aquatic life is required to substantiate that the standard is still being met. The CWA also requires that the design, capacity, location and construction of cooling water intake structures reflect the best technology available for minimizing adverse environmental impacts. In December 2001, the EPA issued a national rule for implementing this statutory requirement at new intakes — a rule which will require that future intakes meet specified criteria. EPA is currently engaged in rulemaking to address existing facilities — a rule which, in its proposed form, will establish national performance standards for minimizing impact to aquatic life. The new rule should reduce environmental impact uncertainty and long-term monitoring requirements. The rulemaking for existing facilities, scheduled to be issued in August 2003 but likely to be delayed until February 2004, may require additional short-term monitoring at some existing TVA facilities, and may require some additional control or operational measures if control costs are not significantly greater than the environmental benefits to be derived from their use. The need for and cost of such potential changes is uncertain, but the requirements for facilities on reservoirs and large rivers where most TVA facilities occur are less stringent than for facilities on oceans, estuaries, tidal rivers, the Great Lakes and smaller rivers.

Solid and Hazardous Waste Management

Under the Resource Conservation and Recovery Act (“RCRA”), the storage, transportation and disposal of hazardous wastes are regulated by EPA and the states. RCRA also allows EPA and the states to regulate solid wastes, and the states have EPA authorized programs for this. TVA has detailed procedures in place designed to ensure compliance with all applicable requirements for the management of hazardous wastes. Additionally, TVA has instituted an approved supplier list for hazardous waste disposal contractors under which such contractors’ financial status, compliance history and physical facilities and operations are reviewed before they are allowed to treat or dispose of any of the hazardous wastes generated by TVA facilities. TVA does not itself operate any hazardous waste disposal or treatment facilities but does operate a permitted hazardous waste storage facility in Muscle Shoals, Alabama. TVA maintains solid waste disposal permits for the solid waste disposal areas (e.g., fly ash, scrubber sludge, demolition materials and asbestos) it operates at some of its plant sites. TVA’s costs in this area have not been substantial, but applicable requirements change frequently and are expected to become more stringent.

Miscellaneous

Polychlorinated biphenyls (“PCBs”) have been widely used as insulating fluids in electric equipment such as transformers and capacitors. Use of this equipment and the cleanup of released PCBs are regulated by EPA under the Toxic Substances Control Act. The TVA power system uses thousands of pieces of equipment that contain some level of PCBs. These pieces of equipment, when maintained properly, may continue to be operated under EPA’s PCB regulations for the remainder of their useful lives. However, both international and domestic pressures are increasing to eliminate all use of PCBs. TVA has been phasing out much of this equipment as a matter of policy. The cost of phasing out the remainder of this equipment cannot be accurately determined at this time, but is expected to be at least \$23 million. TVA has detailed procedures in place to continue operational compliance with EPA’s PCB regulations and has not incurred substantial costs in this area.

There is public concern about whether there are adverse health effects from exposure to electric and magnetic fields (“EMF”). There are many sources of EMF, including electric transmission lines. Certain research, including a report by a National Academy of Sciences organization, has not found conclusive evidence that EMF causes adverse health effects. Other research, such as a report by the National Institute of Environmental Health Sciences, has found limited evidence that certain types of exposure to EMF are

carcinogenic. Research in this area continues. Substantial costs could be incurred by electric systems, including TVA, if EMF levels from transmission lines have to be reduced, but this appears unlikely at this time.

Nuclear Power Program

Overview

TVA has five operating nuclear units, three deferred nuclear units and one inoperative nuclear unit that is scheduled to be returned to service in 2007. Selected features of each of these units are described in the chart below.

Nuclear Unit	Status	Installed Capacity (MW)	Net Capacity Factor for FY 2002	Date of Expiration of Operating License	Date of Expiration of Construction License
Sequoyah Unit 1	Operating	1,221	90.2	2020	—
Sequoyah Unit 2	Operating	1,221	87.6	2021	—
Browns Ferry Unit 2	Operating	1,190	94.0	2014	—
Browns Ferry Unit 3	Operating	1,190	94.6	2016	—
Watts Bar Unit 1	Operating	1,270	89.8	2035	—
Watts Bar Unit 2	Deferred	—	—	—	2010
Bellefonte Unit 1	Deferred	—	—	—	(1)
Bellefonte Unit 2	Deferred	—	—	—	2004
Browns Ferry Unit 1	Inoperative	—	—	2013	—

- (1) Bellefonte Unit 1's construction license was due to expire on October 1, 2001, and Bellefonte Unit 2's is due to expire on October 1, 2004. On July 11, 2001, TVA asked the Nuclear Regulatory Commission ("NRC") to extend the construction license for Bellefonte Unit 1 until October 1, 2011 and for Bellefonte Unit 2 until October 1, 2014. While the NRC considers TVA's request, Bellefonte Unit 1's construction license is automatically extended on a day-by-day basis. Previously, Watts Bar Unit 2's construction license was similarly extended on a day-by-day basis while the NRC considered TVA's request to extend its construction license until 2010. At this time, TVA is aware of no issue that would result in the NRC's not granting TVA's request to extend the Bellefonte construction licenses.

Status of Certain Nuclear Units

Browns Ferry Unit 1 was taken offline in 1985 for modifications and improvements. The undepreciated cost of Browns Ferry Unit 1 of \$46 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period. Reflecting the recent interest in the competitive cost of nuclear generation, the Board requested in September 2001 a technical study regarding the feasibility of recovering and restarting Browns Ferry Unit 1. In March 2002, TVA's nuclear staff reported to the Board the results of a detailed cost and planning study, which concluded that TVA can return Browns Ferry Unit 1 to service safely and economically. In May 2002, the Board of Directors initiated activities for the return of Browns Ferry Unit 1 to service in order to meet long-term energy needs in the Tennessee Valley. It is anticipated the Browns Ferry Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately \$1.8 billion and will take five years to complete. When Unit 1 returns to service, it is expected additional generation will help lower the average cost of power and provide additional cash flow for accelerated debt reduction.

TVA has three units in deferred status. In 1988, TVA suspended construction activities on Watts Bar Unit 2, and the unit is currently in lay-up. Bellefonte Unit 1 and Unit 2 were deferred in 1988 and 1985, respectively. Estimated 2003 expenditures for the three deferred units are limited to lay-up, maintenance and ensuring that options for the use of the units remain viable.

In December 1994, TVA determined that it will not, by itself, complete Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 as nuclear units. TVA's integrated resources planning process identified as a viable option

the conversion of the Bellefonte facility to a combined-cycle plant utilizing natural gas or gasified coal. In 1997 an independent team of technical and financial experts completed a feasibility study to evaluate options for the conversion of the Bellefonte Nuclear Plant to a fossil-fired plant. The feasibility study indicated that one of the most economic fossil conversion strategies would be to complete Bellefonte as a natural gas fired combined-cycle plant. TVA also issued an Environmental Impact Statement (“EIS”) assessing the environmental impacts of various fossil conversion options. The EIS identified the natural gas fired combined-cycle plant alternative as the preferred option. Bellefonte remains in a deferred status; however, TVA is re-examining its nuclear and nonnuclear options for Bellefonte.

While future decisions on TVA’s deferred units will ultimately impact the method of cost recovery, the TVA Board determined as of the end of 2001 that the values of some of its existing assets were not appropriate in a competitive marketplace. Certain nuclear assets, portions of Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 in its entirety, were identified as assets for which the estimated future values were less than recorded book values. Consequently, for 2001 TVA revalued these assets downward by \$2,220 million and recognized an impairment loss. The Board will establish rate adjustments and operating policies to ensure full recovery of the remaining cost of the Bellefonte units and compliance with the requirements of the TVA Act (see “Business” — “Rates and Customers” and note 1 — *Impairment of Assets*).

Spent Nuclear Fuel

TVA has entered into a contract with DOE for the disposal of spent nuclear fuel. Payments are based on TVA’s nuclear generation and charged to expense. The provisions of the contract called for DOE to begin accepting spent nuclear fuel from utilities on January 31, 1998, the date provided by the Nuclear Waste Policy Act of 1982. However, as of September 30, 2002, DOE has accepted no spent fuel. As a result of this failure, in April 2001 TVA filed a breach of contract lawsuit against the United States in the Court of Federal Claims. TVA’s spent nuclear fuel storage facilities will be sufficient to provide storage space for spent fuel generated in TVA’s system through 2004 for its Sequoyah Nuclear Plant, 2005 for its Browns Ferry Nuclear Plant, and 2018 for its Watts Bar Nuclear Plant. TVA plans to extend storage capability through life-of-plant if necessary, by using dry storage casks in independent spent-fuel storage installations located at the Browns Ferry and Sequoyah Nuclear Plants. Such spent fuel arrangements require Nuclear Regulatory Commission (“NRC”) approval. However, such arrangements have been approved by the NRC at other facilities throughout the United States.

Low-Level Radioactive Waste

Low-level radioactive waste resulting from the normal operation of nuclear units includes such materials as disposable protective clothing, mops and filters. Disposal costs for low-level radioactive waste have increased significantly in recent years. Pursuant to the Low-Level Radioactive Waste Policy Act, each state is responsible for disposal of low-level radioactive waste generated in that state. States may form regional compacts to jointly fulfill their disposal responsibilities. The states of Tennessee and Alabama (where TVA’s nuclear plants are located) have joined with other southeastern states to form the Southeast Compact Commission for Low-Level Radioactive Waste Management. This commission regulates the siting of new disposal facilities and the disposal of low-level waste within the southeastern states.

Until July 1995, the low-level waste generators located in the southeastern states were required to dispose of their radwaste at the Barnwell, South Carolina, disposal facility. South Carolina is no longer a member of the interstate compact serving the southeastern states and is now a member of the Atlantic Interstate Low-Level Radioactive Waste Compact. Recently, South Carolina announced volume caps that cannot be exceeded due to the acceptance of waste from states that are not members of the Atlantic Interstate Low-Level Radioactive Waste Compact. After June 2009, no waste will be accepted from such states, which include Tennessee and Alabama.

After reviewing its storage and disposal options for low-level radwaste management, TVA, in 1999, began storage of the type of low-level radwaste that had previously been sent to Barnwell at the storage facilities on two of TVA’s plant sites. These facilities are sized to handle the anticipated storage needs for the foreseeable

life of TVA's operating plants. TVA continues to send some dry radioactive waste to the Envirocare of Utah disposal facility in Clive, Utah, when economic conditions permit, and may send dry radioactive waste to the Chem-Nuclear Systems, L.L.C., disposal facility in Barnwell, South Carolina.

Nuclear Insurance

As of September 30, 2002, negotiation on the renewal of the Price-Anderson Act were still ongoing in Congress. While certain provisions of the Price-Anderson Act expired on August 1, 2002, the existing indemnification and limitation of liability plan continues to apply to TVA's nuclear plants. Under the Price-Anderson Act, the limit of liability from an accident at an NRC-licensed reactor is approximately \$9.3 billion (\$88 million for each of the NRC-licensed reactors in the United States), composed of primary and secondary layers of financial protection. This amount is periodically adjusted for inflation. For further information about this nuclear liability insurance and its deferred premium (see note 9 — *Contingencies — Nuclear Insurance*). In accordance with industry practice, TVA maintains certain liability insurance coverage for workers at its nuclear sites.

NRC regulations require nuclear power plant licensees to obtain \$1.06 billion onsite property damage insurance coverage, and TVA has acquired \$2.06 billion of such coverage per nuclear site, with a \$2.5 million deductible. Some of the nuclear property insurance may require the payment of retrospective premiums of up to approximately \$57 million in the event that losses by another insured party or TVA exceed available funds. In accordance with NRC regulations, the proceeds of nuclear property insurance are first used to ensure that the reactor is in safe and stable condition and that it can be maintained in a condition that prevents significant risk to the public. Next, the proceeds are used for decontamination or, if necessary, decommissioning the reactor. Any excess proceeds insure against casualties to property.

Operating License Extensions

The TVA Board of Directors also authorized the nuclear staff to ask the NCR for a 20-year extension of the operating licenses for all three reactors at the Browns Ferry Plant. Current expiration dates for the Browns Ferry units are:

Browns Ferry Unit 1	2013
Browns Ferry Unit 2	2014
Browns Ferry Unit 3	2016

The original 40-year term on licenses per the Atomic Energy Act and the NRC regulations was based on economic and antitrust considerations — not on limitations of technology.

Tritium Production Approved

In September 2002, the NRC issued an amendment to the Watts Bar Nuclear Plant operating license, allowing TVA to irradiate tritium-producing burnable absorber rods at the plant for use by the U.S. Department of Defense. TVA's license amendment permits it to install up to 2,304 of the rods into the Watts Bar reactor and irradiate them for one fuel cycle, which lasts about 18 months. TVA will then remove the irradiated rods for shipment to DOE's tritium-extraction facility at the Savannah River Site near Aiken, South Carolina. TVA expects to begin tritium production at Watts Bar in the fall of 2003. Also in September 2002, the NRC issued an amendment to the Sequoyah Nuclear Plant operating license allowing TVA to produce tritium at the plant. TVA will recover costs associated with the tritium production program, and TVA retains the right to operate the reactors for their primary mission of producing electricity.

Combustion Turbine Installations/Plant Cancellation

TVA installed eight 85 MW natural-gas combustion turbines in time for the summer 2001 peak demands for power at its new Lagoon Creek site in West Tennessee. TVA also installed eight additional 85 MW natural-gas combustion turbines in 2002, four units at the existing Lagoon Creek site and four at TVA's

Kemper County, Mississippi site. This brings the total number of TVA combustion turbines to 72 units — 24 of which were put on the ground in three years.

TVA recently decided not to proceed with its plans to build a gas-fired, combined-cycle plant that would have provided 510 MWs of power initially scheduled to begin operation in 2003. Current power projections indicate that in the near-term, ample power from generation sources within the TVA service area should be available to meet TVA's near-term power needs at competitive prices. Accumulated costs associated with the project total approximately \$154 million, which was recognized as a loss on plant cancellation.

Stewardship Responsibilities

TVA's responsibilities for managing public resources began with its creation in 1933. Today, these resource management activities help sustain the interconnected tributaries and main stem of the Tennessee River, the nation's fifth-largest river system. These resources are managed to accomplish the multiple objectives of flood control, navigation, electric power production, recreation and environmental protection. Funding for these programs has historically included federal appropriations, power revenues and nonpower revenues such as user fees.

Prior to 2000, congressional appropriations provided most of the funding for TVA's nonpower programs. TVA has obtained additional funds from revenues and user fees from the nonpower programs. In 1997, Congress enacted appropriations legislation that anticipated no further appropriations for the nonpower programs and required TVA, in the absence of appropriations, to fund certain nonpower programs constituting essential stewardship activities from various sources, which may include power revenues. Because Congress has not provided appropriations for TVA's nonpower programs since 1999, TVA primarily is using power funds (along with user fees, other forms of nonpower revenues and nonpower fund balances unused in prior years) for its essential stewardship activities in compliance with the 1997 appropriations legislation. In 1999, the last year TVA received appropriated funds, it spent a total of approximately \$75 million on essential stewardship activities, \$30 million of which amount was power funds. In 2000 and 2001, TVA spent a total of approximately \$70 million on essential stewardship activities each year. TVA expenditures on essential stewardship activities increased to \$83 million on these activities in 2002, reflecting increased expenditures associated with the Reservoir Operations Study and asset maintenance initiatives (see "Certain Provisions of the Tennessee Valley Authority Act and Related Legislation" — "Other Legislation" and note 10).

Labor Agreements and Compensation

On September 30, 2002, TVA had 13,444 employees, of which 5,274 were represented by unions. Neither the federal labor relations laws covering most private sector employees nor those covering most federal agencies are applicable to TVA. However, the Board has a long-standing policy of acknowledging and dealing with recognized representatives of its employees, which policy is reflected in long-term agreements to recognize the unions (or their successors) that represent TVA employees. Federal law prohibits TVA employees from engaging in strikes against TVA.

Salaries of regular TVA employees are limited by a federal pay cap (Executive Level IV, currently \$134,000). The federal pay cap makes it a challenge for TVA to recruit and retain top management talent. In response, TVA has developed and implemented supplementary compensation arrangements to reduce the impact of the pay cap and to enhance TVA's ability to attract and retain the caliber of executive talent required to manage one of the largest power systems in the country. Compensation is established considering compensation for similar positions in the relevant labor market and performance toward predefined TVA and business unit goals, both annual and long-term. TVA believes the implementation of these arrangements is within its legal authority. In the past, the General Accounting Office ("GAO") has expressed the opinion that some of TVA's compensation arrangements are not within TVA's legal authority. However, GAO has no authority to issue binding legal opinions on this matter or to stop any TVA payments. Congress has been aware of TVA's supplemental compensation arrangements and has not taken any action that would undermine TVA's position that the arrangements are within its legal authority.

In October 1995, the President issued an Executive Order requiring government corporations, including TVA, to submit information to OMB on bonuses paid to its senior executives. TVA submits information on these bonuses annually to OMB and also publicly disseminates this information. OMB approval of TVA's bonuses is not required.

Forward-Looking Information

This Statement contains forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions, assumptions or otherwise relating to future events or performance may be forward-looking.

In certain cases, forward-looking statements can be identified by the use of the words such as "may," "will," "should," "expect," "anticipate," "believe," "intend," "project," "plan," "predict," "assume," "estimate," "objective," "possible," "potential" or other similar expressions.

Some examples of forward-looking statements include statements regarding TVA's projections of future power and energy requirements; future costs related to environmental compliance; impacts of potential legislation on TVA and the likelihood of enactment of such legislation; strategic objectives; anticipated availability of nuclear waste storage facilities; projections of nuclear decommissioning costs; and impacts of pending litigation and various administrative orders which have been or may be issued.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations and administrative orders, especially those related to the restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA's generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; changes in accounting standards; and unforeseeable events. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA's business or cause results to differ materially from those contained in any forward-looking statement.

TVA undertakes no obligation to update any forward-looking statement to reflect developments that occur after the statement is made.

QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Governance

TVA does not engage in wholesale trading operations for the purposes of speculation. Rather, when necessary in order to supplement generation to meet its native load, TVA will engage in some aspects of physical trading. Further, TVA employs commodity-based instruments which include forwards and option contracts to manage risks associated with the market fluctuations in the price and transportation costs of certain commodities and fuels including, but not limited to, coal, natural gas and electricity.

The Board has established a Risk Management Committee, which is charged with governance and risk oversight for TVA. These functions include but are not limited to: review and direction of risk management strategy, review and monitoring risk indicators, review and approval of counterparty exposure limits, review of new instruments for Board approval, oversight of models and assumptions used to model risk, and controls regarding the use of hedging instruments. In addition, there are policies and procedures established to provide direction for daily operations.

TVA is exposed to market risks, including changes in interest rates, foreign currency exchange rates in association with TVA bonds, volatility of energy related commodities (electricity, natural gas, coal), equity market prices and losses in the event of counterparties' nonperformance. To manage the volatility attributed

to these exposures, TVA has entered into various nontrading derivative transactions, principally an interest rate swap agreement, foreign currency swap contracts, electricity contracts, coal contracts and natural gas contracts. Additionally, to manage environmental volatility, TVA has obtained options related to SO₂ allowances (see note 5 — *Commodity Contracts*). The exposure to losses in the event of the counterparties' nonperformance has been mitigated through controls to determine the creditworthiness of counterparties before transactions take place.

Value at Risk

The market risk exposure is measured through TVA's Value at Risk ("VaR") calculation. VaR is a single summary statistic of possible portfolio losses due to normal market movements for a given confidence level over a selected period of time. TVA measures VaR on a daily basis. TVA's VaR exposure for the electricity and natural gas commodities in which TVA has market positions, assuming each a 10-day holding period and a 1-day holding period, is as follows:

Electricity

Electricity Value at Risk Associated with Energy Trading Contracts and Related Energy Derivative Contracts for the Year Ended September 30, 2002

	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2002	\$ 2.42
Average for the period	\$ 7.17
High	\$24.39
Low	\$ 1.06
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2002	\$ 0.99
Average for the period	\$ 2.92
High	\$ 9.95
Low	\$ 0.43

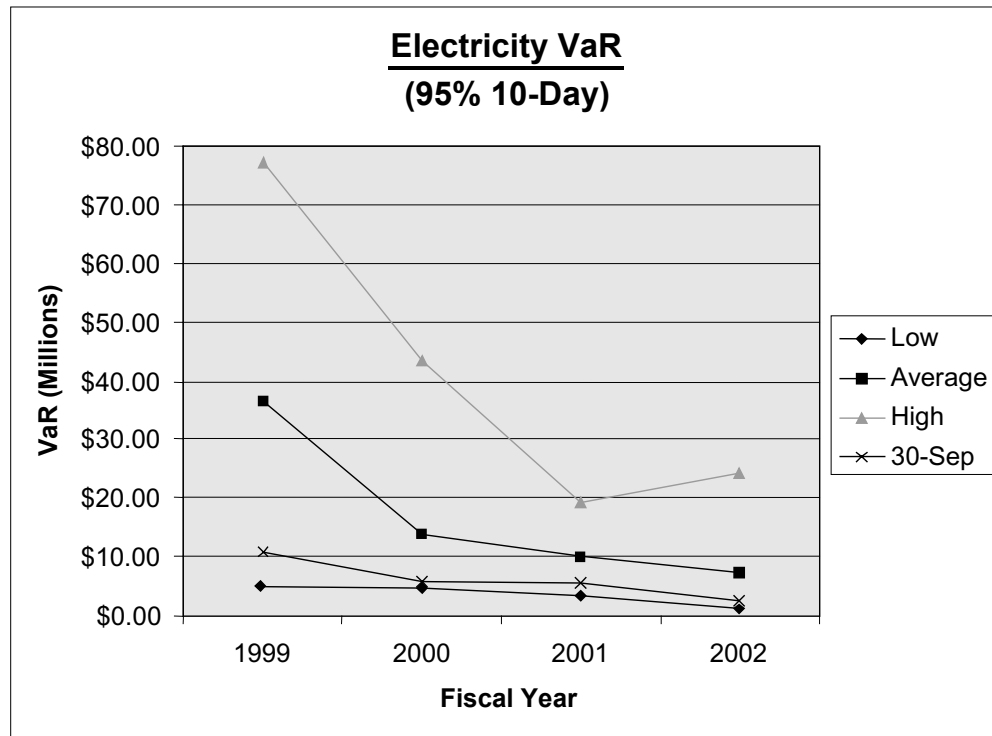
Notes

The VaR calculations are for the TVA 5x16 electricity portfolio for 2002. The calculations are for the rolling forward 12-month portfolio. The VaR method used is the parametric variance/covariance method accepted as an industry standard.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily Mark-to-Market (MTM) profit and loss fluctuations for 3-month, 6-month and 12-month periods. The chi-square values for all periods are within the selected significance level indicating a valid VaR calculation.

That is to say, that given a 95 percent confidence level at September 30, 2002, there is a 2.5 percent probability TVA's electricity portfolio could lose as much as \$2.42 million over the next 10 days. The average VaR for the entire year for the 10-day holding period would be a loss of \$7.17 million. Further, given a 99 percent confidence level at September 30, 2002, there is a 0.5 percent probability that TVA's electricity portfolio could lose as much as \$0.99 million over the next day. The average VaR for the entire year for the 1-day holding period would be a loss of \$2.92 million.

The historical performance of TVA's VaR calculation is represented in the following graph:



As indicated by the chart, TVA's electricity market risk exposure has been reduced since 1999 when VaR was first measured. This reduction was primarily due to four factors: lower forward market prices as of September 30, 2002; TVA's new peaking generation coming on line; lower market price volatility in recent years; and less dependence on the energy spot market for energy balancing requirements.

Natural Gas

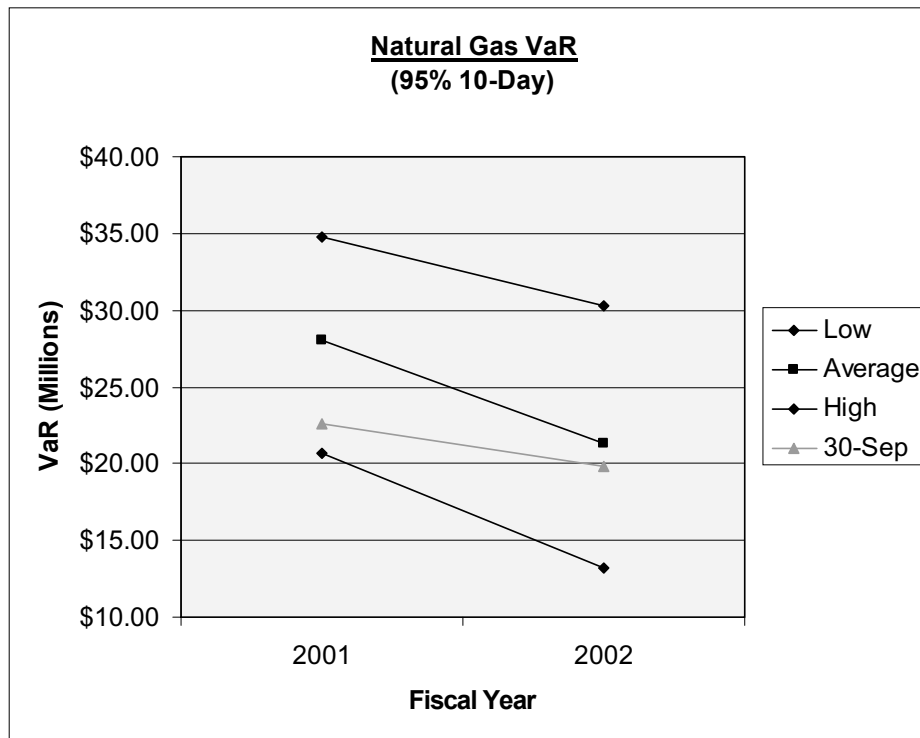
**Natural Gas Value at Risk
Associated with Energy Trading Contracts and Related Energy Derivative Contracts
for the Year Ended September 30, 2002**

	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2002	\$19.79
Average for the period	\$21.35
High	\$30.31
Low	\$13.18
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2002	\$ 8.08
Average for the period	\$ 8.71
High	\$12.36
Low	\$ 5.37

Notes

The VaR calculations are for the TVA natural gas portfolio for 2002. The calculations are for the rolling forward 12-month portfolio. The VaR method used is the parametric variance/covariance method accepted as an industry standard.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily MTM profit and loss fluctuations for 3-month, 6-month and 12-month periods. The chi-square values for all periods are within the selected significance level indicating a valid VaR calculation.



TVA has tracked natural gas VaR exposure since 2001. The graphs above indicate TVA's lower market risk exposure to natural gas since initially tracking this measure in 2001. This reduction was primarily due to lower gas prices and TVA's 2002 gas hedges, which reduced exposure to market price fluctuations.

Coal

TVA's contracts with coal suppliers have specified rates and volumetric flexibility which limit TVA's exposure to market risk. Given TVA's contract mix, TVA is approximately 81 percent hedged to coal market risk exposure. Because of issues concerning coal's lack of fungibility and market transparency, TVA does not currently maintain a VaR calculation.

Other TVA Commodity Transactions

TVA currently holds SO₂ options for future years. SO₂ emission credits will be used for TVA's fossil fleet and are not subject to market trading activities. The number of options from outside sources held is not material and the estimated VaR for future years is less than \$1 million. The market risk is not material as of September 30, 2002.

TVA purchases fuel oil as a substitute fuel source for TVA's gas turbine fleet. TVA's hedge against market risk for fuel oil is use of natural gas and is captured in the natural gas VaR. The TVA fossil fuels group monitors the spread between fuel oil and natural gas for hedging purposes. During 2002, natural gas had a significant advantage over fuel oil. Therefore, TVA's fuel oil position was not materially affected by market risk.

TVA has no merchant capacity assets or transactions which expose TVA to market risk. TVA does have long-term transactions, the energy supplied under which will serve native load requirements (see note 9 — *Commitments — Power Purchase Obligations*). The market risk associated with the structure of these transactions is captured in the VaR estimates above.

Mark-to-Market Valuation

Sensitivity analyses are performed on a daily and weekly basis to determine the market price impact to the energy portfolio when the market price moves beyond TVA's projections.

TVA also monitors the MTM fair value of energy assets in future years. MTM accounting reports contracts at their "fair value," the value a willing third party would pay for the particular contract at the time a valuation is made. These transactions include, but are not limited to, native systems load contracts, energy forwards, energy options or other energy derivative instruments for unit specific generation units. Due to the public service nature of its business, TVA historically values its resource positions for the year ahead.

When available, quoted market prices are used to record a contract's fair value. However, market values for energy trading contracts may not be readily determinable because the duration of the contracts exceeds the liquid activity in a particular market. If no active trading market exists for a commodity, holders of these contracts must calculate fair value using pricing models based on contracts with similar terms and risks. As of September 30, 2002, TVA's forward position on a MTM basis for all energy assets for all hours are as follows:

<u>Source of Fair Value</u> (in millions)	<u>2003</u>
Owned Assets	—
Actively Quoted	—
Prices provided by external sources	\$ 3,901
Modeled	—
Total	<u>\$ 3,901</u>
Average tenor of portfolio	1 year

Note that prices quoted by external sources reflect independent broker quotations and publicly posted prices on electronic media such as IntercontinentalExchange.

Based on September 30, 2002 closing prices, the MTM value of TVA's energy portfolio for calendar 2003 is \$3.9 billion as shown in the chart above. The fair value calculation determines a profit or loss for each source of fair value, e.g. load, based on market prices. For example, instead of using accrual accounting to calculate load revenue, the MTM calculation compares the load revenue from selling the generation to customers to the load revenue from selling the generation into the market. The difference is the Mark-to-Market value. Since TVA is almost completely hedged, only a small portion of power is bought and sold in the market so the market price has little impact on TVA margins.

Hedging Activities

With respect to hedging activities, TVA risk management policies provide for the use of derivative financial instruments to manage financial exposures but prohibit the use of these instruments for speculative or trading purposes. Prior to October 1, 2000, TVA accounted for hedging activities using the deferral method, and gains and losses were recognized in the financial statements when the related hedged transaction occurred. During 2001, TVA adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. Derivative contracts to which TVA is a party that are covered by these standards include various purchase power option contracts, certain fuel supply and power purchase agreements, and certain currency and interest rate swap agreements.

**Cash Flow Hedges Included in Accumulated
Other Comprehensive Loss on the Balance Sheet
September 30, 2002
(in millions)**

	<u>Accumulated Other Comprehensive Loss</u>	<u>Portion Expected to Be Reclassified to Earnings During the Next 12 Months</u>	<u>Maximum Term</u>
Interest Rate	\$ (19)	—	5 years
Foreign Currency	<u>(131)</u>	—	29 years
Total	<u><u>\$(150)</u></u>		

In summary, based on TVA's overall market risk exposure position and risk controls, management does not anticipate a materially adverse effect on TVA's financial position or results of operations as a result of market fluctuations and market risk.

Credit Risk

Credit risk is the exposure to economic loss that would occur as a result of a counterparty's nonperformance of its contractual obligations.

The majority of TVA's credit risk is limited to trade accounts receivable from delivered power sales to municipal and cooperative distributors, all located in the seven-state Tennessee Valley region. To a lesser extent, TVA is exposed to credit risk from industries and federal agencies directly served and from exchange power arrangements with a small number of investor-owned regional utilities related to either delivered power or the replacement of open positions of longer-term purchased power or fuel agreements.

Where exposed to credit risk, TVA analyzes the counterparty's financial condition prior to entering into an agreement, establishes credit limits, monitors the appropriateness of those limits on an ongoing basis and employs credit mitigation measures, such as collateral or prepayment arrangements and master purchase and sale agreements to mitigate credit risk.

The table below summarizes TVA's counterparty credit risk exposure as of September 30, 2002:

Counterparty Credit Risk Exposure
(in millions)

Trade Accounts Receivable:

Municipalities & Cooperative Distributors	
Investment Grade	\$392
Internally Rated — Investment Grade	130
Noninvestment Grade	0
Industries & Federal Agencies Directly Served	
Investment Grade	26
Noninvestment Grade	46
Internally Rated — Investment Grade	18
Internally Rated — Noninvestment Grade	6
Exchange Power Arrangements	
Investment Grade	4
Noninvestment Grade	1
Internally Rated — Investment Grade	0
Internally Rated — Noninvestment Grade	<u>1</u>
Subtotal	624
Other Accounts Receivable:	
Miscellaneous Accounts	44
Provision for Uncollectible Accounts	<u>(13)</u>
Subtotal	<u>31</u>
Total	<u><u>\$655</u></u>

TVA has concentrations of accounts receivable from four municipal customers that represented 32 percent of total accounts receivable as of September 30, 2002.

Rating Triggers

As of September 30, 2002, TVA was a party to three swap contracts and five power purchase agreements that contained rating triggers. TVA's primary triggers in its power purchase agreements are based on the Edison Electric Institute ("EEI") standard contract agreement. Under most of the rating triggers, the amount of collateral that TVA will have to post under certain circumstances will increase if TVA's rated bonds are downgraded. The requirement to post collateral under any of these contracts, if triggered, would not have a material effect on TVA's financial condition.

Interest Rate and Foreign Currency Risk

TVA manages its daily cash needs through issuance of Discount Notes and other short-term borrowings. These borrowings expose TVA to fluctuations in short-term interest rates. TVA is not exposed to changes in interest rates on most of its long-term debt until such debt matures and may be refinanced at the then-applicable rates. An interest rate swap is used to hedge TVA's exposure related to its inflation-indexed accreting principal bonds, and currency swap contracts are used as hedges for foreign currency denominated debt issues (see note 5 — *Foreign Currency and Interest Rate Swaps*). Based on TVA's overall interest rate exposure at September 30, 2002, including derivative and other interest rate sensitive instruments, a near-term one percentage point change in interest rates would not have had a material impact on TVA's financial position or results of operations.

Equity Price Risk

See “Management’s Discussion and Analysis of Financial Condition and Result of Operations” — “Critical Accounting Policies” — “*Nuclear Decommissioning Costs*,” note 1 — *Decommissioning Costs* and note 9 — *Contingencies* — *Decommissioning Costs*.

Forward Contracts

TVA enters into electricity forward contracts for the sole purpose of limiting or otherwise hedging its economic risks directly associated with meeting its power supply obligations in the Tennessee Valley region. During 2002, TVA supplied approximately 6 percent of system requirements with power purchased under electricity forward contracts. These contracts qualify for normal purchase and normal sale accounting under SFAS No. 133, as interpreted by DIG Issue C15 (see “Management’s Discussion and Analysis of Financial Condition and Result of Operations” — “Critical Accounting Policies” — “*Normal Purchases and Normal Sales Special Exemption*”). At September 30, 2002, management does not anticipate a materially adverse effect on TVA’s financial position or results of operations as a result of market fluctuations.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

STATEMENTS OF INCOME — POWER PROGRAM For the Years Ended September 30 (in millions)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Operating revenues			
Sales of electricity			
Municipalities and cooperatives	\$5,856	\$ 5,908	\$5,676
Industries directly served	732	659	626
Federal agencies and other	159	330	361
Other revenue	<u>88</u>	<u>102</u>	<u>99</u>
Total operating revenues	6,835	6,999	6,762
Operating expenses			
Fuel and purchased power	1,925	1,989	1,962
Operating and maintenance	1,840	1,660	1,443
Depreciation and amortization	1,027	1,312	1,185
Tax-equivalents	328	315	308
Accelerated amortization (<i>note 1</i>)	<u>66</u>	<u>230</u>	<u>121</u>
Total operating expenses	<u>5,186</u>	<u>5,506</u>	<u>5,019</u>
Operating income	1,649	1,493	1,743
Other income, net	<u>7</u>	<u>248</u>	<u>17</u>
Income before interest expense and losses on plant cancellation and impairment of assets	1,656	1,741	1,760
Interest expense			
Interest on debt	1,468	1,601	1,695
Amortization of debt discount, issue, and reacquisition costs, net	22	87	94
Allowance for funds used during construction	<u>(61)</u>	<u>(55)</u>	<u>(53)</u>
Net interest expense	<u>1,429</u>	<u>1,633</u>	<u>1,736</u>
Income before losses on plant cancellation and impairment of assets	227	108	24
Loss on impairment of assets/plant cancellation (<i>notes 1 and 2</i>)	<u>(154)</u>	<u>(3,419)</u>	<u>—</u>
Net income (loss)	<u>\$ 73</u>	<u>\$(3,311)</u>	<u>\$ 24</u>

The accompanying notes are an integral part of these financial statements.

BALANCE SHEETS
At September 30 (in millions)

	<u>Power Program</u>		<u>All Programs</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
ASSETS				
Current assets				
Cash and cash equivalents	\$ 397	\$ 339	\$ 400	\$ 343
Accounts receivable	655	720	655	720
Inventories at average cost and other				
Fuel	173	170	173	170
Other	305	272	305	272
Total current assets	1,530	1,501	1,533	1,505
Property, plant, and equipment				
Completed plant	31,207	30,467	32,219	31,485
Less accumulated depreciation	(11,162)	(10,344)	(11,469)	(10,647)
Net completed plant	20,045	20,123	20,750	20,838
Construction in progress	1,040	923	1,040	923
Deferred nuclear generating units	4,113	4,110	4,113	4,110
Nuclear fuel and capital leases	481	487	481	487
Total property, plant, and equipment	25,679	25,643	26,384	26,358
Investment funds	659	725	659	725
Deferred charges and other assets				
Loans and other long-term receivables	138	124	161	149
Debt issue and reacquisition costs	193	140	193	140
Other deferred charges	1,959	1,566	1,959	1,566
Total deferred charges and other assets	2,290	1,830	2,313	1,855
Total assets	<u>\$ 30,158</u>	<u>\$ 29,699</u>	<u>\$ 30,889</u>	<u>\$ 30,443</u>
LIABILITIES AND PROPRIETARY CAPITAL				
Current liabilities				
Accounts payable	\$ 700	\$ 710	\$ 702	\$ 715
Accrued liabilities	220	235	220	235
Accrued interest	397	389	397	389
Short-term debt	3,492	3,016	3,492	3,016
Current maturities of long-term debt	—	1,984	—	1,984
Total current liabilities	4,809	6,334	4,811	6,339
Other liabilities	3,304	2,806	3,304	2,806
Long-term debt				
Public bonds	21,763	20,375	21,763	20,375
Unamortized discount and other adjustments	(405)	(524)	(405)	(524)
Total long-term debt	21,358	19,851	21,358	19,851
Commitments and Contingencies (note 9)				
Proprietary capital				
Appropriation investment	488	508	4,843	4,863
Retained earnings	349	306	349	306
Accumulated other comprehensive loss	(150)	(106)	(150)	(106)
Accumulated net expense of nonpower programs	—	—	(3,626)	(3,616)
Total proprietary capital	687	708	1,416	1,447
Total liabilities and proprietary capital	<u>\$ 30,158</u>	<u>\$ 29,699</u>	<u>\$ 30,889</u>	<u>\$ 30,443</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CASH FLOWS
For the Years Ended September 30 (in millions)

	Power Program			All Programs		
	2002	2001	2000	2002	2001	2000
Cash flows from operating activities						
Net power income (loss)	\$ 73	\$(3,311)	\$ 24	\$ 73	\$(3,311)	\$ 24
Net expense of nonpower programs	—	—	—	(10)	(32)	(28)
Items not requiring (providing) cash						
Depreciation and amortization	1,084	1,471	1,289	1,093	1,482	1,299
Accelerated amortization	66	230	121	66	230	121
Allowance for funds used during						
construction	(61)	(55)	(53)	(61)	(55)	(53)
Nuclear fuel amortization	142	158	177	142	158	177
Loss on impairment of assets/plant						
cancellation	154	3,419	—	154	3,419	—
Other, net	(16)	(45)	25	(16)	(33)	25
Changes in current assets and liabilities						
Accounts receivable	66	(42)	42	66	(42)	42
Inventories and other	(49)	(60)	19	(49)	(60)	19
Accounts payable and accrued liabilities ..	(3)	234	61	(5)	226	42
Accrued interest	7	(49)	(26)	7	(49)	(26)
Other	(116)	(36)	(95)	(116)	(36)	(95)
Net cash provided by operating activities	1,347	1,914	1,584	1,344	1,897	1,547
Cash flows from investing activities						
Construction expenditures	(1,231)	(1,015)	(867)	(1,230)	(1,015)	(867)
Allowance for funds used during						
construction	61	55	53	61	55	53
Nuclear fuel	(146)	(94)	(184)	(146)	(94)	(184)
Other, net	(30)	(137)	(37)	(29)	(129)	(38)
Net cash used in investing activities	(1,346)	(1,191)	(1,035)	(1,344)	(1,183)	(1,036)
Cash flows from financing activities						
Long-term debt						
Issues	2,120	2,708	2,250	2,120	2,708	2,250
Redemptions and repurchases	(2,720)	(5,069)	(2,944)	(2,720)	(5,069)	(2,944)
Short-term borrowings, net	476	1,742	292	476	1,742	292
Proceeds from combustion turbine leasing,						
net	289	(29)	300	289	(29)	300
Financing costs, net	(58)	(29)	(148)	(58)	(29)	(148)
Other, net	—	—	—	—	—	(6)
Payments to U.S. Treasury	(50)	(55)	(54)	(50)	(55)	(54)
Net cash provided by/(used in) financing						
activities	57	(732)	(304)	57	(732)	(310)
Net change in cash and cash equivalents	58	(9)	245	57	(18)	201
Cash and cash equivalents at beginning of						
period	339	348	103	343	361	160
Cash and cash equivalents at end of period ...	\$ 397	\$ 339	\$ 348	\$ 400	\$ 343	\$ 361

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL — POWER PROGRAM
For the Years Ended September 30 (in millions)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Retained earnings reinvested at beginning of period	\$ 306	\$ 3,652	\$3,662
Net income (loss)	73	(3,311)	24
Return on appropriation investment	<u>(30)</u>	<u>(35)</u>	<u>(34)</u>
Retained earnings reinvested at end of period	349	306	3,652
Accumulated other comprehensive loss	(150)	(106)	—
Appropriation investment at beginning of period	508	528	548
Return of appropriation investment	<u>(20)</u>	<u>(20)</u>	<u>(20)</u>
Appropriation investment at end of period	488	508	528
Proprietary capital at end of period	<u>\$ 687</u>	<u>\$ 708</u>	<u>\$4,180</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL — NONPOWER PROGRAMS
For the Years Ended September 30 (in millions)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Proprietary capital at beginning of period	\$739	\$771	\$860
Net expense	(10)	(32)	(28)
Transfers to other federal agencies (<i>note 10</i>)	—	—	(56)
Other, net	<u>—</u>	<u>—</u>	<u>(5)</u>
Proprietary capital at end of period	<u>\$729</u>	<u>\$739</u>	<u>\$771</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF COMPREHENSIVE INCOME (LOSS) — POWER PROGRAM
For the Years Ended September 30 (in millions)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net power income (loss)	\$ 73	\$(3,311)	\$24
Accumulated other comprehensive loss	<u>(150)</u>	<u>(106)</u>	<u>—</u>
Comprehensive (loss) income	<u>\$ (77)</u>	<u>\$(3,417)</u>	<u>\$24</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF NET EXPENSE AND COMPREHENSIVE INCOME (LOSS) — NONPOWER PROGRAMS
For the Years Ended September 30 (in millions)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Water and Land Stewardship	\$(10)	\$(32)	\$(26)
Economic Development	<u>—</u>	<u>—</u>	<u>(2)</u>
Net expense and comprehensive loss (<i>note 10</i>)	<u>\$(10)</u>	<u>\$(32)</u>	<u>\$(28)</u>

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

General

TVA is a wholly owned corporate agency and instrumentality of the United States. It was established by the TVA Act with the objective of developing the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense by providing: (1) an ample supply of power within the region, (2) navigable channels and flood control for the Tennessee River System, and (3) agricultural and industrial development and improved forestry in the region. TVA carries out these regional and national responsibilities in a service area that centers on Tennessee and includes parts of Alabama, Georgia, Kentucky, Mississippi, North Carolina and Virginia.

TVA's operations have historically been divided into two types of activities, the power program and the nonpower programs. Substantially all TVA revenues and assets are attributable to the power program. The power program has historically been separate and distinct from the nonpower programs and is required to be self-supporting from power revenues and proceeds from power program financings. The power program receives no congressional appropriations and is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Until 2000, most of the funding for TVA's nonpower programs had been provided by congressional appropriations. These programs are now funded largely with power funds. Certain nonpower activities are also funded by various revenues and user fees. See note 10 for a discussion related to future funding of TVA's nonpower programs.

Power rates are established by the TVA Board of Directors as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; payments to states and counties in lieu of taxes; and debt service on outstanding indebtedness. Rates set by the Board are not subject to review or approval by any state or federal regulatory body. In a future restructured electric power industry, it is possible, however, that the ability of the Board to set TVA's rates as specified in the TVA Act could be adversely affected by legislative changes or by competitive pressures.

Five municipal customers, which accounted for an aggregate 27 percent of total power sales for 2002, purchase power from TVA under long-term contracts that require 5 to 10 years' notice to terminate.

TVA prepares its financial statements in conformity with generally accepted accounting principles accepted in the United States of America applied on a consistent basis and, in some cases, TVA's financial statements reflect amounts based on the best estimates and judgment of management.

Fiscal Year

Unless otherwise indicated, years (2002, 2001, etc.) refer to TVA's fiscal years ended September 30.

Cost-based Regulation

As a regulated entity, TVA is subject to the provisions of Statement of Financial Standards ("SFAS") No. 71, *Accounting for the Effects of Certain Types of Regulation*. Accordingly, TVA records certain assets and liabilities resulting from the effects of the ratemaking process that would not be recorded under generally accepted accounting principles for nonregulated entities. Currently, the electric utility industry is predominantly regulated on a basis designed to recover the cost of providing electric power to its customers. If cost-based regulation were to be discontinued in the industry for any reason, profits could be reduced and utilities might be required to reduce their asset balances to reflect a market basis less than cost. Discontinuance of cost-based regulation would also require affected utilities to write-off their associated regulatory assets (see note 9 — *Contingencies — Cost-based Regulation*).

Revenue

Revenues from power sales are recorded as power is delivered to customers. TVA accrues estimated unbilled revenues for power sales provided to customers for the period of time from the end of the billing cycle to month's end (see note 12).

Off-system sales are presented in the accompanying Statements of Income — Power Program as a component of Sales of electricity — Federal agencies and other.

Cash and Cash Equivalents

Cash and cash equivalents include the cash available in commercial bank accounts and U.S. Treasury accounts, as well as short-term securities held for the primary purpose of general liquidity. Such securities mature within three months from the date of acquisition.

Inventories

Coal, oil, limestone, tire-derived fuel inventories and materials and supplies inventories are valued using an average unit cost. A new average cost is computed after each transaction and issues are priced at the latest moving weighted average unit cost.

Inventories of natural gas (at the Egan storage facility) are relatively minor. Inventory is valued at the weighted average cost of gas, which is recalculated monthly.

Property, Plant and Equipment, and Depreciation

Additions to plant are recorded at cost, which includes direct and indirect costs and an allowance for funds used during construction. The cost of current repairs and minor replacements is charged to operating expense. Nuclear fuel is valued at the lower of cost or market using the average cost method for raw materials and the specific identification method for nuclear fuel in reactor. Amortization of nuclear fuel is calculated on a units-of-production basis and is included in fuel expense. The TVA Act requires TVA's Board of Directors to allocate the cost of completed multipurpose projects between the power and nonpower programs, subject to the approval of the President of the United States. The original cost of property retired, together with removal costs less salvage value, is charged to accumulated depreciation. Depreciation is generally computed on a straight-line basis over the estimated service lives of the various classes of assets. Depreciation expense expressed as a percentage of the average annual depreciable completed plant was 3.33 percent for 2002, 3.28 percent for 2001 and 3.27 percent for 2000. Depreciation rates (percent) by asset class are as follows:

<u>Asset Class</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Nuclear	3.34	3.32	3.30
Coal-fired	3.53	3.52	3.53
Hydro	1.79	1.79	1.77
Combustion Turbine	4.30	4.21	3.55
Transmission	2.56	2.43	2.44
Other	6.31	5.67	6.12

Decommissioning Costs

TVA recognizes as incurred all obligations related to closure and removal of its nuclear units. Earnings from decommissioning investments, amortization of the decommissioning regulatory asset and interest expense on the decommissioning liability are deferred (see note 9 — *Contingencies — Decommissioning Costs*). TVA is currently evaluating the nature and scope of its decommissioning policy as it relates to all electric plant. The evaluation will be used to determine the need for recognition of additional asset retirement obligations as described in the recently issued SFAS No. 143, *Accounting for Obligations Associated with Retirement of Long-Lived Assets*. SFAS No. 143 will be effective for TVA in 2003.

Allowance for Funds Used during Construction

TVA capitalizes an allowance for funds used during construction. The allowance is applicable to construction in progress, excluding deferred nuclear generating units.

Other Deferred Charges

Other deferred charges primarily include regulatory assets capitalized under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*.

Regulatory Assets. At September 30, 2002 and 2001, other deferred charges included total unamortized regulatory assets of \$1,452 million and \$439 million, respectively, which for both years represent certain charges related to the closure and removal of nuclear units (see note 1 — *Decommissioning Costs*). The 2002 balance also includes certain costs associated with TVA's September 30, 2002 minimum pension liability, as the Board has determined that such costs will be recovered through future revenues in compliance with the TVA Act. At September 30, 2000, the unamortized balance of regulatory assets of \$372 million consisted of \$228 million, representing a transition obligation for certain postemployment benefits, and \$144 million, representing certain charges related to the closure and removal of nuclear units (see note 1 — *Decommissioning Costs*). The \$228 million transition obligation for certain postemployment benefits was fully amortized during 2001.

	<u>At September 30</u>	
	<u>2002</u>	<u>2001</u>
(in millions)		
Decommissioning costs	\$ 556	\$439
Adjustment to accrue minimum pension liability	896	—
	<u>\$1,452</u>	<u>\$439</u>

Accelerated Amortization. Annual provisions for amortization of deferred charges are adjusted as necessary in order to achieve certain earnings levels. Such earnings levels are set forth in resolutions adopted annually by the TVA Board of Directors in connection with the rate review process. The targeted earnings levels are based on the requirements of the TVA Act and the Basic TVA Power Bond Resolution (see note 6 — *Borrowing Authority*). Such adjustments may result in either contraction or extension of the estimated amortization periods. The amortization of such assets is principally computed on a straight-line basis, over periods ranging from 3 to 15 years. As a result of surplus earnings levels in 2002, 2001 and 2000, TVA accelerated amortization of certain regulatory assets by \$66 million, \$230 million and \$121 million, respectively.

Nuclear Fuel

TVA's investment in the fuel used in the Sequoyah, Watts Bar and Browns Ferry units is being amortized and accounted for as a component of fuel expense.

Nuclear Refueling Outage Costs. Nuclear refueling outage maintenance costs are deferred and amortized on a straight-line basis over the estimated period until the next refueling outage. The amounts of deferred outage costs at September 30, 2002, 2001 and 2000 were \$85 million, \$57 million and \$73 million, respectively.

Investment Funds

Investment funds consist primarily of trust funds designated to fund nuclear decommissioning requirements and debt securities held-to-maturity (see note 9 — *Contingencies — Decommissioning Costs*). Decommissioning funds are invested in portfolios of securities generally designed to earn returns in line with overall equity market performance. These investments are classified according to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (see note 7 — *Investment Funds*).

Debt Issue and Reacquisition Costs

Debt issue and reacquisition expenses, call premiums and other related costs are deferred and amortized (accreted) on a pooled straight-line basis over the weighted average life of TVA's debt portfolio. The unamortized balances of such debt issue and reacquisition costs at September 30, 2002 and 2001 were \$193 million and \$140 million, respectively.

TVA has incurred premiums related to certain advanced refundings and also received and paid premiums in connection with the monetization of certain call provisions. In accordance with regulatory practices, TVA defers and amortizes such premiums on a pooled straight-line basis over the weighted average life of its public debt portfolio. In 2001, TVA charged the remaining deferred cost of \$789 million against earnings (see note 1 — *Impairment of Assets*).

Tax Equivalents

The TVA Act requires TVA to make payments to states and local governments where the power operations of the corporation are conducted and in which TVA has acquired properties previously subject to state and local taxation. The amount is 5 percent of gross receipts from the prior year's sale of power, excluding sales to other federal agencies and off-system sales with other utilities, with a provision for minimum payments under certain circumstances.

Plant Cancellation

Due to changes in the market forecast, TVA elected during 2002 not to complete a gas-fired combined-cycle plant that would have provided 510 MW of power in 2004. Accumulated costs of the project totaled approximately \$154 million, which TVA recognized as a loss on plant cancellation.

Impairment of Assets

During 2001, TVA identified certain assets for which the estimated future cash flows provided through future rates were likely to be less than recorded book values. Accordingly, TVA reduced the carrying amount of these assets by a total of \$3,419 million, of which \$2,220 million was attributable to deferred nuclear generating units, \$789 million was attributable to deferred debt refinancing costs, and \$410 million was attributable to plant held for future use. The ultimate disposition of these assets is unaffected by the asset value reductions (see note 1 — *Debt Issue and Reacquisition Costs*, and notes 2 and 3) in accordance with SFAS No. 71. This nonrecurring charge will have no effect on TVA's statutory obligation to set rates at levels necessary to produce revenues sufficient to pay the service on its debt and other expenses specified in the TVA Act.

Insurance

TVA is primarily self-insured for property loss, workers' compensation, general liability, and automotive liability. TVA is also self-insured for health-care claims for eligible active and retired employees not covered by Medicare. Consulting actuaries assist TVA in determining certain liabilities for self-insured claims. TVA maintains nuclear liability insurance and nuclear property, decommissioning and decontamination insurance with an outside party (see note 9 — *Contingencies — Nuclear Insurance*).

Impact of New Accounting Standards

Effective October 1, 2000, TVA adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, which requires that certain derivative instruments be recorded on the balance sheet as either an asset or a liability measured at fair value. Changes in the fair value of derivatives are recognized in either net income or other comprehensive income, depending on the designated purpose of the derivative. For 2002 and 2001, accumulated other comprehensive loss includes mark-to-market swap valuation adjustments of \$150 million and \$106 million, respectively.

In June 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, which requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. At the present time, TVA is unable to determine whether the implementation of this standard will be material to its results of operations or financial position.

In October 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which replaces SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. The statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. It also developed one accounting model for long-lived assets to be disposed of by sale, based on the framework established in SFAS No. 121, and addressed significant implementation issues. SFAS No. 144 requires that those long-lived assets be measured at the lower of the carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and, generally, are to be applied prospectively. At the present time, TVA is unable to determine whether the implementation of this standard will be material to its results of operations or financial position.

The purpose of Emerging Issues Task Force (“EITF”) Issue 02-3, *Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, is to codify and reconcile the Task Force consensus on previously issued EITF Issues No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, and No. 00-17, *Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10*, and EITF Abstracts, Topic No. D-105, *Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10*. These EITF Issues and Abstracts address various aspects of the accounting for contracts involved in energy trading and risk management activities. At a special October 25, 2002 meeting, the Task Force reached a consensus to rescind EITF Issue No. 98-10, the impact of which is to preclude mark-to-market accounting for all energy trading contracts not within the scope of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Task Force also reached consensus that gains and losses on derivative instruments within the scope of SFAS No. 133 should be shown net in the income statement if the derivative instruments are held for trading purposes. The consensus reached effectively supercede the consensus reached on this Issue at the June 19-20, 2002 EITF meeting. The consensus regarding the rescission of Issue 98-10 is applicable for fiscal periods beginning after December 15, 2002. Energy trading contracts not within the scope of SFAS No. 133 purchased after October 25, 2002, but prior to the implementation of the consensus are not permitted to apply mark-to-market accounting. The adoption of EITF Issue 02-3 will have no impact on TVA’s current operations.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the related amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Other

Certain reclassifications have been made to the 2001 financial statements to conform to the 2002 presentation.

2. Nuclear Power Program

The nuclear power program at September 30, 2002, consists of nine units — five operating, three deferred and one inoperative — at four locations, with investments in property, plant and equipment as follows and in the status indicated:

	<u>Operating Units</u>	<u>Installed Capacity (Megawatts)</u>	<u>Completed Plant, Net</u> (Dollars in millions)	<u>Construction in Progress</u>	<u>Deferred</u>	<u>Fuel Investment</u>
Browns Ferry	2	2,380	\$ 2,607	\$ 58	\$ —	\$175
Sequoyah	2	2,442	1,769	115	—	86
Watts Bar	1	1,270	5,907	8	—	51
Bellefonte	—	—	—	—	4,113	—
Raw Materials	—	—	—	—	—	7
Total	<u>5</u>	<u>6,092</u>	<u>\$10,283</u>	<u>\$181</u>	<u>\$4,113</u>	<u>\$319</u>

* Browns Ferry Unit 1, an inoperative unit, is discussed below.

Browns Ferry Unit 1 was taken off-line in 1985 for modifications and improvements and will continue to remain in an inoperative status until recovered. In May 2002, the TVA Board of Directors initiated activities for the return of Unit 1 to service in order to meet long-term power requirements. The decision was made upon completion of the Detailed Scoping, Estimating and Planning project and the Final Supplemental Environmental Impact Statement, which demonstrate that Unit 1 can be returned to safe operation in a controlled manner and that operating the unit will have no significant, adverse impacts on the environment. TVA has determined that restarting Unit 1 is the best alternative currently available among the mix of generation options. It is anticipated the Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately \$1.8 billion and will take five years to complete. It is anticipated that when Unit 1 returns to service, additional generation will help lower the average cost of power and provide additional cash flow for accelerated debt reduction. The undepreciated cost of Unit 1 of \$46 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period.

TVA has three units in deferred status. In 1988, TVA suspended construction activities on Watts Bar Unit 2, and the unit is currently in lay-up. Bellefonte Units 1 and 2 were deferred in 1988 and 1985, respectively. Estimated 2003 expenditures for the three deferred units are limited to lay-up, maintenance and ensuring that options remain viable.

While future decisions on TVA's deferred units will ultimately impact the method of cost recovery, the TVA Board determined as of the end of 2001 that the value of some of its existing assets was not appropriate in the competitive marketplace. Certain assets, Bellefonte Units 1 and 2 and Watts Bar Unit 2, were identified as assets where the estimated future values were less than recorded book values. Consequently, in 2001 TVA revalued these assets downward by \$2,220 million and recognized an impairment loss. The Board will establish rate adjustments and operating policies to ensure full recovery of the remaining cost of the Bellefonte units and compliance with the requirements of the TVA Act (see note 1 — *Impairment of Assets*).

3. Completed Plant — Power Program

Completed plant of the power program consisted of the following at September 30 after a downward revaluation adjustment during 2001 of \$410 million to plant held for future use (see note 1 — *Impairment of Assets*):

	2002			2001		
	Cost	Accumulated Depreciation	Net	Cost	Accumulated Depreciation	Net
(in millions)						
Coal-fired	\$ 8,579	\$ 4,117	\$ 4,462	\$ 8,324	\$ 3,877	\$ 4,447
Combustion turbine	1,151	292	859	837	251	586
Nuclear	14,778	4,495	10,283	14,747	4,025	10,722
Transmission	3,847	1,284	2,563	3,672	1,211	2,461
Hydro	1,665	570	1,095	1,623	556	1,067
Other	1,187	404	783	1,264	424	840
Total	<u>\$31,207</u>	<u>\$11,162</u>	<u>\$20,045</u>	<u>\$30,467</u>	<u>\$10,344</u>	<u>\$20,123</u>

4. Proprietary Capital

Appropriation Investment — Power Program

The TVA Act requires TVA to make annual payments to the U.S. Treasury from net power proceeds as a return on the appropriations investment in the power system and as a repayment of that investment. The payments required by the TVA Act may be deferred under certain circumstances for not more than two years. TVA paid \$20 million each year for 2002, 2001 and 2000 as a repayment of the appropriation investment. In addition, TVA paid the U.S. Treasury \$30 million in 2002, \$35 million in 2001 and \$34 million in 2000 as a return on the appropriation investment. The return is based on the appropriation investment as of the beginning of the year and on the computed average interest rate payable by the U.S. Treasury on its total marketable public obligations as of the same date (5.82 percent, 6.63 percent, and 6.34 percent at September 30, 2001, 2000, and 1999, respectively). Cumulative repayments and return on investment paid by TVA to the U.S. Treasury exceed \$3.4 billion, on the government's appropriation investment of \$1.4 billion, approximately \$955 million of which TVA has repaid.

Accumulated Other Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, requires the disclosure of comprehensive income to reflect changes in capital that result from transactions and economic events from nonowner sources. The amounts included in other comprehensive loss were \$150 million for 2002, \$106 million for 2001, and \$0 for 2000. The \$150 million loss in 2002 and the \$106 million loss for 2001 are due to market valuation adjustments for certain derivative instruments (see note 1 — *Impact of New Accounting Standards* and note 5).

Total Other Comprehensive Income (Loss) Activity

(in millions)

Accumulated other comprehensive income, September 30, 2000	\$ 0
Interest rate swap	5
Foreign currency swaps	26
Electricity purchase options	20
Cumulative effect of adoption of SFAS No. 133 at October 1, 2000	51
Changes in fair value:	
Interest rate swap	(34)
Foreign currency swaps	(103)
Electricity purchase options	(20)
Accumulated other comprehensive loss, September 30, 2001	(106)
Changes in fair value:	
Interest rate swap	10
Foreign currency swaps	(54)
Accumulated other comprehensive loss, September 30, 2002	<u>\$ (150)</u>

5. Risk Management Activities and Derivative Transactions

TVA has established a Risk Management Committee, which is charged with the responsibility of reviewing and approving controls and procedures for TVA-wide risk management activities, including the oversight of models and assumptions used to measure risk, the review of counterparty exposure limits and the establishment of formal procedures regarding the use of financial hedging instruments.

TVA is exposed to market risks, including changes in interest rates, foreign currency exchange rates and volatility of certain commodity and equity market prices. To manage the volatility attributable to these exposures, TVA has entered into various nontrading derivative transactions, principally an interest rate swap agreement, foreign currency swap contracts and option contracts.

TVA is exposed to losses in the event of counterparties' nonperformance and accordingly has established controls to determine the creditworthiness of counterparties in order to mitigate exposure to credit risk.

With respect to hedging activities, TVA risk management policies provide for the use of derivative financial instruments to manage financial exposures but prohibit the use of these instruments for speculative or trading purposes. Prior to October 1, 2000, TVA accounted for hedging activities using the deferral method, and gains and losses were recognized in the financial statements when the related hedged transaction occurred. During 2001, TVA adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. See further discussion related to TVA's adoption of SFAS No. 133 at note 1 — *Impact of New Accounting Standards*.

In accordance with SFAS No. 133, certain interest rate and foreign currency swap contracts were marked-to-market and resulted in losses of \$44 million for 2002 and \$106 million for 2001. Since such contracts represent cash flow hedges of certain commodity and debt transactions, the losses have been recognized in accumulated other comprehensive loss. Because of the highly effective nature of its hedging transactions, TVA was not required to recognize losses in the Statements of Income. If any loss/(gain) were to be incurred as a result of the early termination of an interest rate swap contract, any resulting charge/(income) would be amortized over the remaining life of the associated bond as a component of interest expense.

Commodity Contracts

TVA enters into contracts that hedge cash flow exposures to market fluctuations in the price and delivery of certain commodities. TVA expects to take or make delivery, as appropriate, under these forward contracts. Accordingly, these contracts qualify for normal purchase and normal sale accounting under SFAS No. 133,

as interpreted by the Derivative Implementation Group (“DIG”). DIG Issue C15 describes the criteria that must be met in order for such contracts to qualify for the use of normal purchase and normal sale accounting.

Gains and losses on cash flow hedges are deferred in other comprehensive income and recognized as adjustments to the carrying amount of the items hedged. Deferral of the gains and losses continues until the items hedged are recognized in income. Gains and losses on derivatives not qualifying for hedge accounting are deferred in accordance with SFAS No. 71.

Foreign Currency and Interest Rate Swaps

During 1996, TVA entered into a currency swap contract as a hedge for a foreign currency denominated debt transaction. TVA issued DM1.5 billion of bonds and entered into a currency swap to hedge fluctuations in the DM exchange rate. TVA also entered into currency swap contracts during 2001 and 1999 as hedges for sterling-denominated debt transactions in which TVA issued £250 million and £200 million of bonds, respectively. Any gains or losses on the debt instruments due to the foreign currency transactions are offset by losses or gains on the swap contracts. At September 30, 2002 and 2001, the currency transactions resulted in net translation gains of \$220 million and \$322 million, respectively, which are included in the account “unamortized discount and other adjustments.” However, the net translation gains were offset by corresponding losses on the swap contracts, which are recorded as a deferred liability. Additionally, in 1997 TVA issued \$300 million of inflation-indexed accreting principal bonds. The 10-year bonds have a fixed coupon rate that is paid on the inflation-adjusted principal amount. TVA hedged its inflation exposure under the securities through a receive-floating, pay-fixed interest rate swap agreement.

Mark-to-Market of TVA Derivatives at September 30

(in millions)	<u>2002 Balance Asset/(Liability)</u>	<u>2001 Balance</u>	<u>2002 Notional</u>	<u>Year of Expiration</u>
Interest Rate Swap	\$ 22	\$ 8	USD300 million	2007
Currency Swaps:				
Deutschemark	(328)	(358)	DM1.5 billion	2006
Sterling	(35)	(40)	GBP200 million	2021
Sterling	13	—	GBP250 million	2032
Coal Contracts — Volume Options	1	275	118 million tons	2007

6. Debt

Borrowing Authority

The TVA Act authorizes TVA to issue bonds, notes, and other evidences of indebtedness up to a total of \$30 billion outstanding at any one time. TVA must meet certain financial tests that are contained in the TVA Act and the Basic TVA Power Bond Resolution. Debt service on these obligations, which is payable solely from TVA’s net power proceeds, has precedence over the payment to the U.S. Treasury (see note 4 — *Appropriation Investment — Power Program*).

Short-Term Debt

The weighted average rates applicable to TVA short-term debt outstanding in the public market as of September 30, 2002, 2001 and 2000, were 1.74 percent, 2.90 percent and 6.53 percent, respectively. During 2002, 2001 and 2000, the maximum outstanding balances of short-term borrowings held by the public were (in millions) \$3,497, \$3,459 and \$3,943, respectively. For these same years the average amounts (and weighted average interest rates) of short-term borrowings were approximately (in millions) \$2,290 (1.95 percent), \$1,994 (4.90 percent) and \$2,628 (5.94 percent), respectively.

Put and Call Options

Bond issues of \$4.5 billion held by the public are redeemable in whole or in part, at TVA's option, on call dates ranging from the present to July 2020 and at call prices ranging from 100 percent to 106 percent of the principal amount. Additionally, TVA has bond issues of \$3.2 billion held by the public that are redeemable in whole or in part at the option of the respective bondholders, as follows: one bond issue totaling \$936 million, which matures in 2012, is redeemable in 2004 by the bondholders; a second issue totaling \$121 million, which matures in April 2036, is redeemable in 2006 at the option of the bondholders; a third issue totaling \$1.5 billion, which matures in April 2036, is redeemable in 2006 at the option of the bondholders; and a fourth bond issue totaling \$600 million which matures December 2016, is redeemable in 2007 by the bondholders. Each of these issues is reported in the debt schedule with maturity dates corresponding to the earliest redemption dates. Thirty-six additional issues totaling \$1.3 billion, with maturity dates ranging from 2005 to 2030, include a provision for a right of redemption upon the death of a beneficial owner in certain specified circumstances.

Additionally, TVA has two issues of Puttable Automatic Rate Reset Securities ("PARRS") outstanding. After a fixed period of five years, the coupon rate on the PARRS may be reset downward under certain market conditions. Investors have the option to redeem the bonds at par if and when the interest rate is reset. One PARRS issue totals \$575 million, matures in June 2028 and has its first potential reset date in June 2003. The second issue of PARRS totals \$525 million, matures in May 2029 and has its first potential reset date in May 2004.

Debt Outstanding

Debt outstanding at September 30, 2002 and 2001 consisted of the following:

	<u>2002</u>	<u>2001</u>
	(in millions)	
Short-term debt		
Discount notes (net of discount)	\$ 3,492	\$ 3,016
Current maturities of long-term debt — 5.00% to 7.14%	<u>—</u>	<u>1,984</u>
Total short-term debt	3,492	5,000
Long-term debt		
Maturing in 2004 — 4.75% to 6.79%	2,336	1,400
Maturing in 2005 — 6.375% to 7.15%	2,065	2,065
Maturing in 2006 — 5.25% to 7.125%	2,621	2,670
Maturing in 2007 — 3.50% to 6.643%	1,051	336
Maturing in 2008 through 2045 — 4.375% to 8.25%	<u>13,690</u>	<u>13,904</u>
Total long-term debt	<u>21,763</u> (1)	<u>20,375</u> (1)
Total indebtedness	<u>\$25,255</u>	<u>\$25,375</u>

(1) Excludes net translation gains from currency transactions of \$220 million and \$322 million at September 30, 2002 and 2001, respectively, which are included in the account "unamortized discount and other adjustments."

Interest and Capital Costs

During 2002, 2001 and 2000 cash paid for interest on outstanding indebtedness (net of amount capitalized) was \$1,414 million, \$1,471 million and \$1,669 million, respectively. In addition to paying interest on outstanding indebtedness, TVA is required by the TVA Act to make annual payments to the U.S. Treasury. The annual Treasury payments represent a repayment of the government's appropriation investment, along with a return on the appropriation investment (see note 4 — *Appropriation Investment — Power Program*).

7. Fair Value of Financial Instruments

TVA uses the methods and assumptions described below to estimate the fair value of each significant class of financial instrument. The fair market value of the financial instruments held at September 30, 2002, may not be representative of the actual gains or losses that will be recorded when these instruments mature or if they are called or presented for early redemption.

The estimated values of TVA's financial instruments at September 30 are as follows:

	<u>2002 Carrying Amount</u>	<u>2002 Fair Amount</u>	<u>2001 Carrying Amount</u>	<u>2001 Fair Amount</u>
(in millions)				
Cash and cash equivalents	\$ 400	\$ 400	\$ 343	\$ 343
Investment funds	659	659	725	725
Loans and other long-term receivables	161	161	149	149
Short-term debt, net of discount	3,492	3,492	3,016	3,016
Long-term debt, net of discount	21,358	23,767	19,851	23,139
Other financing obligations	559	559	271	271

Cash and Cash Equivalents and Short-Term Debt

Because of the short-term maturity of these instruments, the carrying amount approximates fair value.

Investment Funds

Information on investments by major type at September 30 are as follows:

	<u>2002</u>	<u>2001</u>
(in millions)		
Equity securities held as trading	\$503	\$600
Debt securities held-to-maturity	149	119
Joint ventures	<u>7</u>	<u>6</u>
	<u>\$659</u>	<u>\$725</u>

These investments were primarily classified as trading securities and held-to-maturity securities. Gains and losses on trading securities are recognized in current earnings and subsequently reclassified to a regulatory asset account in accordance with TVA's decommissioning accounting policy. The fund had unrealized losses of \$97 million in 2002, unrealized losses of \$233 million in 2001 and unrealized gains of \$109 million in 2000. Held-to-maturity securities, purchased during September, approximate market value and are accounted for at amortized cost.

Loans and Other Long-Term Receivables

Fair values for these homogeneous categories of loans and receivables are estimated by determining the present value of future cash flows using a discounted rate equal to lending rates for similar loans made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amount approximates fair value.

Long-Term Debt

Fair value of long-term debt traded in the public market is determined by multiplying the par value of the bonds by the market price nearest the balance sheet date. At September 30, 2002, the carrying amount of long-term debt was \$21,358 million compared with a fair value of \$23,767 million, and at September 30, 2001, the carrying amount of long-term debt was \$19,851 million compared with a fair value of \$23,139 million.

Other Financing Obligations

In 2002 and 2000, TVA received approximately \$320 million and \$300 million, respectively, in proceeds by entering into lease-leaseback transactions for 16 new peaking combustion turbine units. Due to the nature of the transactions, the carrying amounts of the obligations and fair market values are equal. At September 30, 2002 and 2001, the total balances of the obligations were \$559 million and \$271 million, respectively.

Due to TVA's continuing involvement in the operation and maintenance of the units and its control over the distribution of power produced by the facilities during the leaseback term, TVA accounted for the respective lease proceeds of \$320 million and \$300 million as financing obligations as required in accordance with SFAS No. 66, *Accounting for Sales of Real Estate*, and SFAS No. 98, *Accounting for Leases*. Accordingly, the outstanding financing obligations of \$559 million in 2002 and \$271 million in 2001 are included in Current Liabilities (\$16 million and \$6 million, respectively) and Other Liabilities (\$543 million and \$265 million, respectively) in TVA's 2002 and 2001 year-end Balance Sheets.

8. Benefit Plans

Pension Plan

TVA has a defined benefit plan for most full-time employees that provides two benefit structures: the Original Benefit Structure and the Cash Balance Benefit Structure. The plan is controlled and administered by a legal entity separate from TVA, the TVA Retirement System ("TVARS"), which is governed by its own independent board of directors. The plan assets are primarily stocks and bonds. TVA contributes to the plan such amounts as are agreed upon by the TVA and TVARS boards of directors. No TVA contribution is legally required when the plan's assets are sufficient to meet its accrued liabilities, as determined by an independent outside actuary.

The pension benefit for a member participating in the Original Benefit Structure is based on the member's years of creditable service, average base pay for the highest three consecutive years, and the pension rate for the member's age and years of service, less a Social Security offset.

The pension benefit for a member participating in the Cash Balance Benefit Structure is based on credits accumulated in the member's account and the member's age. A member's account receives credits each pay period equal to 6.0 percent of his or her straight-time earnings. The account also increases at an interest rate equal to the change in the Consumer Price Index ("CPI") plus 3.0 percent, with the provision that the rate may not be less than 6.0 percent nor more than 10.0 percent. The actual changes in the CPI for 2002 and 2001 were 3.1 percent and 3.2 percent, which resulted in interest rates of 6.1 percent and 6.2 percent, respectively.

TVARS also maintains a defined contribution plan, a 401(k) plan, to which TVA makes matching contributions of 25 cents on the dollar (up to 1.5 percent of pay) for members participating in the Original Benefit Structure and of 75 cents on the dollar (up to 4.5 percent of pay) for members participating in the Cash Balance Benefit Structure.

Net pension income is determined using assumptions as of the beginning of each year. Funded status is determined using assumptions as of the end of each year. The valuations performed at the end of 2001 were based on actuarial assumptions that were consistent for all of TVA's benefit plans. For 2002, TVA recognized pension income of about \$40 million, postretirement benefit expense of \$19 million, and workers compensation expense of approximately \$64 million.

Effective with the September 30, 2002 measurement date for funded status, the discount rate was reduced from 7.50 percent to 7.05 percent and the cost of living rate was reduced from 3.0 percent to 2.3 percent to reflect current market and demographic conditions. Additionally, TVA modified its assumption related to mortality based on results of an experience study performed during the year and converted from 1994 to 1983 mortality tables. As a result of these changes, the September 30, 2002 projected benefit obligation decreased by nearly \$128 million for the year. The changes in assumptions had no effect on pension income for 2002, 2001 or 2000 but will reduce pension expense for 2003 by approximately \$37 million.

The assumptions utilized to measure net pension income and the projected benefit obligations are as follows:

	2002	2001	2000
Discount rate	7.05	7.5	8.0
Cost of living rate	2.3	3.0	3.0
Expected long-term rate of return	9.0	9.0	10.0
Average increase in compensation	3-8%	3-8%	3-8%

During 2000, plan amendments were effected that enhanced certain pension benefits, resulting in approximately \$250 million in additional pension-plan benefit obligations.

Other Postretirement Benefits

TVA sponsors an unfunded postretirement plan that provides for nonvested contributions toward the cost of certain retirees' medical coverage. This plan formerly covered all retirees participating in the TVA medical plan, and TVA's contributions were a flat dollar amount based on the participants' ages and years of service and certain payments toward the plan costs. This plan now operates on a much more limited basis, covering only certain retirees and surviving dependents who do not qualify for TVARS benefits.

During 2000, these postretirement benefits were enhanced to help covered retirees offset the cost of medical coverage, resulting in approximately \$16 million in additional postretirement benefit obligations.

The annual assumed cost trend for covered benefits was 8.5 percent in 2002, decreasing by one-half percent per year to a level of 5.0 percent in 2009 and thereafter. For 2001 and 2000, annual trend rates of 8.5 percent and 9.0 percent, respectively, were assumed. The effect of the change in assumptions of the cost basis was not significant. Increasing/ (reducing) the assumed health-care cost trend rates by 1 percent would increase/ (reduce) the accumulated postretirement benefit obligation ("APBO") as of September 30, 2002, by \$33 million/ (\$33 million) and the aggregated service and interest cost components of net periodic postretirement benefit cost for 2002 by \$2 million/ (\$2 million).

The weighted average discount rate used in determining the APBO was 7.05 percent for 2002, 7.5 percent for 2001 and 8.0 percent for 2000. Any net unrecognized gain or loss resulting from experience different from that assumed or from changes in assumptions, and exceeding 10 percent of the APBO, is amortized over the average remaining service period of active plan participants.

The assumptions utilized to measure other post-retirement benefits are as follows:

	2002	2001	2000
Discount rate	7.05	7.5	8.0
Health-care trend rate	8.5	8.5	9.0
Cost of living rate	2.3	3.0	3.0
Assumed ultimate trend rate	5.0	5.0	5.0
Assumed ultimate trend rate to be reached in year	2009	2008	2008

Other Postemployment Benefits

Other postemployment benefits include workers' compensation provided to former or inactive employees and their beneficiaries and covered dependents for the period after employment but before retirement. Adoption of SFAS No. 112, *Employers' Accounting for Postemployment Benefits*, in 1995 changed TVA's method of accounting from recognizing costs as benefits are paid to accruing the expected costs of providing these benefits. In connection with the adoption of SFAS No. 112 and related approval by its Board of Directors, TVA recorded the transition obligation as a regulatory asset. The regulatory asset was being amortized over approximately 15 years, whereby the annual expense approximated the expense that would have been recorded on an as-paid basis. In 2000, TVA accelerated amortization of the regulatory asset approximately \$80 million, and in 2001 it accelerated the amortization by \$194 million to complete the write-

off of the regulatory asset. This acceleration was in accordance with TVA's accounting policy as previously described (see note 1 — *Other Deferred Charges — Accelerated Amortization*).

The components of pension expense and other postretirement benefits expense for the years ended September 30 were:

(in millions)	Pension Benefits		Other Postretirement Benefits	
	2002	2001	2002	2001
Change in benefit obligation				
Benefit obligation at beginning of year	\$ 5,958	\$ 5,461	\$ 221	\$ 133
Service cost	87	79	4	2
Interest cost	434	424	16	10
Plan participants' contributions	36	28	51	43
Amendments, including special events	—	—	199	—
Actuarial (gain)/loss	(289)	268	4	93
Net transfers (to)/from variable fund/401(k) plan	9	9	—	—
Expenses paid	(4)	(4)	—	—
Benefits paid	(330)	(307)	(64)	(60)
Benefit obligation at end of year	\$ 5,901	\$ 5,958	\$ 431	\$ 221
Change in plan assets				
Fair value of plan assets at beginning of year	\$ 5,878	\$ 7,312	\$ —	\$ —
Adjustments	(5)	(1)	—	—
Actual return on plan assets	(496)	(1,159)	—	—
Plan participants' contributions	35	28	51	43
Net transfers (to)/from variable fund/401(k) plan	9	9	—	—
Employer contribution	—	—	14	17
Expenses paid	(4)	(4)	—	—
Benefits paid	(330)	(307)	(65)	(60)
Fair value of plan assets at end of year	\$ 5,087	\$ 5,878	\$ —	\$ —
Funded status	\$ (814)	\$ (80)	\$(431)	\$(221)
Unrecognized net actuarial loss	1,229	418	63	62
Unrecognized prior service cost	419	456	161	(43)
Prepaid (accrued) benefit cost	\$ 834	\$ 794	\$(207)	\$(202)
Amount recognized in statement of financial position				
Prepaid benefit cost	\$ —	\$ 794	\$ —	\$ —
Accrued benefit liability	(481)	—	(207)	(202)
Intangible asset	419	—	—	—
Regulatory asset	896	—	—	—
Net amount recognized	\$ 834	\$ 794	\$(207)	\$(202)

(in millions)	Pension Benefits			Other Postretirement Benefits		
	2002	2001	2000	2002	2001	2000
Components of net periodic benefit cost						
Service cost	\$ 87	\$ 78	\$ 76	\$ 4	\$ 2	\$ 5
Interest cost	434	424	367	16	10	11
Expected return on plan assets	(597)	(599)	(602)	N/A	N/A	N/A
Amortization of prior service cost	36	36	24	(4)	(4)	(6)
Amortization of transition obligation	—	—	—	—	—	—
Recognized net actuarial (gain)/loss	—	(39)	(19)	3	(2)	—
Net periodic benefit (income)	(40)	(100)	(154)	19	6	10
Special events	—	—	—	—	—	—
Total benefit (income)	<u>\$ (40)</u>	<u>\$ (100)</u>	<u>\$ (154)</u>	<u>\$ 19</u>	<u>\$ 6</u>	<u>\$ 10</u>

9. Commitments and Contingencies

Commitments

Leases/Leasebacks. Certain property, plant and equipment are leased under agreements with terms ranging from 1 to 30 years. Many of the agreements include purchase options or renewal options that cover substantially all the economic lives of the properties. Obligations under capital lease agreements in effect at September 30, 2002, total \$36 million annually through 2007, and an aggregate of \$121 million thereafter, for a total commitment of \$301 million. Of this amount, \$138 million represents the cost of financing. Obligations under non-cancelable lease agreements in effect at September 30, 2002 total \$4 million for each of 2003 and 2004 and \$3 million for each of 2005-2007. There are no non-cancelable operating lease agreements in effect after that period. TVA also has cancelable lease agreements in effect at September 30, 2002 which total \$2 million for 2003, \$3 million for each of 2004 and 2005, \$2 million for 2006 and \$1 million for each of 2007-2013. Because of the nature of these cancelable lease agreements, they are not included in the commitment table below.

Obligations under combustion turbine lease/leaseback transactions in effect at September 30, 2002, total \$44 million annually for 2003 and 2004, \$46 million for 2005, and \$44 million for 2006 and 2007 and an aggregate of \$640 million thereafter, for a total commitment of \$862 million. Of this amount, \$301 million represents the cost of financing.

Other Obligations. TVA has approximately \$1.7 billion in long-term commitments consisting primarily of construction of generating and emission control assets. Terms of the contracts extend into 2008.

Fuel Purchase Obligations. TVA has approximately \$2.7 billion in long-term fuel purchase commitments, with terms up to seven years, for the purchase and transportation of coal and approximately \$1.1 billion in long-term commitments, with terms of up to 10 years, for the purchase of enriched uranium and fabrication of nuclear fuel assemblies.

Power Purchase Obligations. TVA has an agreement for the purchase of power from a 440-megawatt, lignite-fired electric generating plant that requires TVA to purchase the plant's output for a 30-year period which began in April 2002. Pricing of the contract includes fixed and variable components with estimated power purchases approximating \$3 billion for the remainder of the contract term. TVA also entered into long-term power supply agreements with a generator for supply from a facility that has a current generating capacity of 500 megawatts. These commitments extend through May 2007 with a future obligation for demand charges in the amount of \$136 million. Agreements are in place with respect to five other projects. These five contracts are for durations of 2 to 12 years, the earliest of which began in 2000. Payments for the remainder of the terms of these five contracts are estimated to be approximately \$38 million. Costs under these contracts are included in Fuel and purchased power and expensed as incurred.

Under the Public Utility Regulatory Policies Act of 1978, TVA is obligated to purchase power from qualifying facilities. In 2002, a new facility qualified under this program, and as a result TVA could be required to take up to 800 MW of power during certain on-peak hours from the facility.

The estimated commitments for TVA as of September 30, 2002 are as follows:

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
<i>(in millions)</i>							
Leases	\$ 40	\$ 40	\$ 39	\$ 39	\$ 39	\$ 121	\$ 318
Lease/leaseback transactions	44	44	46	44	44	640	862
Power purchase obligations	137	113	136	136	124	2,390	3,036
Other obligations	441	379	330	293	215	—	1,658
Fuel purchase obligations	1,515	999	641	178	99	374	3,806

Tritium Production Approved. In September 2002, the Nuclear Regulatory Commission (“NRC”) issued an amendment to the Watts Bar Nuclear Plant operating license, allowing TVA to irradiate tritium-producing burnable absorber rods at the plant for use by the U.S. Department of Defense. TVA’s license amendment permits it to install up to 2,304 of the rods into the Watts Bar reactor and irradiate them for one fuel cycle, which lasts about 18 months. TVA will then remove the irradiated rods for shipment to DOE’s tritium-extraction facility at the Savannah River Site near Aiken, South Carolina. TVA expects to begin tritium production at Watts Bar in the fall of 2003. Also in September 2002, the NRC issued an amendment to the Sequoyah Nuclear Plant operating license allowing TVA to produce tritium at the plant. TVA will recover costs associated with the tritium production program, and TVA retains the right to operate the reactors for their primary mission of producing electricity.

Contingencies

Nuclear Insurance. The Price-Anderson Act sets forth an indemnification and limitation of liability plan for the U.S. nuclear industry. All NRC licensees, including TVA, maintain nuclear liability insurance in the amount of \$200 million for each plant with an operating license. The second level of financial protection required is the industry’s retrospective assessment plan, using deferred premium charges. The maximum amount of the deferred premium for each nuclear incident is approximately \$88 million per reactor, but not more than \$10 million per reactor may be charged in any one year for each incident. TVA could be required to pay a maximum of \$528 million per nuclear incident on the basis of its six licensed units, but it would have to pay no more than \$60 million per incident in any one year.

TVA carries property and decontamination insurance of \$2.06 billion at each licensed nuclear plant for the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums of up to a maximum of approximately \$57 million.

Clean Air Developments. Title IV of the Clean Air Act Amendments (“CAAA”) of 1990 requires coal-fired generation units to reduce their sulfur dioxide (“SO₂”) and nitrogen oxide (“NO_x”) emissions in two phases in order to control acid rain. Compliance with these requirements has resulted in substantial expenditures for the reduction of emissions at TVA’s coal-fired generating plants. Through 2002, TVA has invested approximately \$1 billion in capital improvements for acid rain compliance. TVA estimates it will spend an additional \$85 million from 2003 to 2006 to complete switches to lower sulfur coals for acid rain compliance purposes.

TVA’s strategy for complying with the CAAA has included the use of flue gas desulfurization systems, or scrubbers, on two fossil units in addition to existing scrubbers on four other units, and the use of lower-sulfur coal at other fossil units to reduce SO₂ emissions. TVA has completed these scrubbers and is on schedule to complete the changeover to lower-sulfur coal.

NO_x reductions were required for 58 of TVA’s 59 coal-fired units. The only TVA unit for which NO_x reductions are not required under the CAAA is the Atmospheric Fluidized Bed Unit 10 at TVA’s Shawnee Fossil Plant. The NO_x reductions for the other 58 units were achieved through the installation of low-

nitrogen-oxide burners and/or overfire air at 40 units and boiler optimization on the remaining 18 TVA units. In 1996, TVA selected an early election option for 4 of these 58 units, which allows the 4 units at John Sevier Fossil Plant to be limited to Phase I NO_x levels through 2007. In 2008, these 4 units will have to meet lower Phase 2 NO_x levels. For the remaining 54 units, TVA has elected to average NO_x emissions to meet a 54 unit NO_x Averaging Plan. This option enables TVA to optimize the cost of NO_x reductions while fully complying with the CAAA Title IV NO_x requirements. In addition to its Title IV projects, TVA is in the process of installing selective catalytic reduction systems (“SCRs”) or other NO_x control technology on at least 25 of its coal-fired units. SCRs are state-of-the-art NO_x pollution technology. This follows up on a commitment TVA made to further reduce NO_x emissions on its system. Installation of these SCRs will also comply with the State Implementation Plan NO_x Reduction rule issued by EPA in 1998. Depending on future generation requirements, additional NO_x controls may be required.

In TVA’s continuing efforts to improve air quality in the Tennessee Valley and to comply with the Clean Air Act, TVA plans to design, build and operate five more scrubbers to further reduce SO₂ emissions from 12 of its coal-fired units. Although design of these scrubbers is scheduled to start in 2003, substantial construction activities are not expected to begin until TVA completes its SCR installation program in 2005. Completion of the five scrubbers is expected by 2011.

The Environmental Protection Agency (“EPA”) has finalized new, more stringent National Ambient Air Quality Standards for particulate matter and ozone and a rule designed to reduce regional haze. Each of these rule-makings has undergone litigation and the EPA is in the process of developing implementation strategies for the ambient standards and readdressing several provisions of the regional haze rule. These actions may require TVA to make additional reductions of SO₂ emissions beyond those currently planned. TVA anticipates that compliance with the new regulations will be required after 2010. The EPA has also determined that mercury emissions from coal-fired plants should be reduced, and is developing both a rule to reduce mercury and legislative packages that put mercury reductions in a multipollutant plan. Depending on the severity of the mercury reductions required by EPA, TVA could incur additional substantial capital costs for control of mercury.

On February 14, 2002, the Bush administration announced its “Clear Skies Initiative,” which outlines legislative requirements for the phased reduction of SO₂, NO_x and mercury emissions from utilities during the period from 2008 to 2018. In July of 2002, legislation known as the Clear Skies Act was introduced in Congress. A number of bills have been introduced in Congress that would result in significant decreases in emissions of NO_x, SO₂ and mercury, as well as carbon dioxide. The timing and content of such legislation remains highly uncertain.

Expenditures related to the Clean Air projects during 2002 and 2001 were approximately \$400 million and \$200 million, respectively. The cost of the SCR strategy, including the 2001 and 2002 expenditures, is now estimated to be \$1.3 billion, and the cost of the planned installation of five scrubbers is estimated to be \$1.3 billion. The total cost of future compliance with NO_x, SO₂, mercury and particulate matter requirements, however, cannot reasonably be determined at this time because of the uncertainties surrounding emerging EPA regulations, resultant compliance strategies, potential for the development of new emission control technologies, court litigation, and future amendments to the Clean Air Act. However, total costs through 2020 could exceed \$3 billion, exclusive of the costs of the planned SCRs and scrubbers. These future controls will also apply to any enforcement liability.

The EPA has instituted judicial and administrative actions against a number of utilities in the eastern U.S., including TVA, alleging that they have modified their coal-fired units without complying with new source review (“NSR”) requirements. TVA contends EPA’s enforcement action is based on a new interpretation of an old rule and that TVA has routinely maintained its power plants to ensure efficient, reliable power generation while complying with all requirements. EPA issued TVA an administrative order directing TVA to put new source controls on 14 of its coal-fired units and to evaluate whether more controls should be installed on other units. TVA has challenged the validity of this order, and the Eleventh Circuit Court of Appeals has stayed the order pending its review. The outcome of this litigation and the EPA proceedings is uncertain.

It is not possible to predict with certainty what impact implementation of EPA's order will have on TVA if TVA's challenge is unsuccessful. If EPA substantially prevails, TVA could be required to incur capital costs in excess of \$3 billion by 2010 to 2012. Any additional controls that TVA could be required to install on units as a result of this matter would, however, also be sufficient to comply with reduction requirements that are planned or anticipated under the other air quality programs for that same time period, which are discussed above. Thus, because of the other environmental program requirements, TVA would, in any event, probably incur a substantial portion of the costs that might result from the EPA enforcement action, although the schedule for the installation of the controls could be somewhat accelerated by the EPA action. TVA fully supports the need to further reduce emissions from coal-fired plants and seeks a resolution that will not put TVA customers and the region at a disadvantage.

The Bush administration has reviewed the energy implications of the EPA's new NSR interpretation and concluded that there is evidence that NSR impedes utilities from increasing the efficiency and performance of existing fossil-fuel generation. TVA has determined that if the EPA's new interpretation becomes law, TVA could lose about 11 percent of the energy capabilities of its coal-fired system within three years through permit limits on use of its units. On November 22, 2002, EPA announced changes to its NSR program intended to address aspects of the program that have deterred companies from implementing projects that would enhance energy efficiency and decrease air pollution. These changes are not anticipated to affect TVA's commitments to emissions control projects discussed above or the NSR litigation.

The National Parks Conservation Association ("NPCA") and the Sierra Club filed cases in federal district courts raising the same NSR allegations at TVA's Bull Run Fossil Plant and Colbert Fossil Plant Unit 5 as were raised in the EPA proceedings. Both cases have been stayed pending a decision from the Eleventh Circuit.

Environmental groups are taking legal action against TVA, as well as against other utilities across the country, for allegedly violating opacity limits applicable to coal-fired plants.

- The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated Clean Air Act opacity limits applicable to Colbert Fossil Plant between July 1, 1997 and June 30, 2002. The groups seek a court order requiring TVA to bring Colbert Fossil Plant into continuous compliance with the opacity limits, which would require TVA to incur substantial costs in addition to the costs TVA is already planning to incur for environmental controls, and to pay civil penalties of up to approximately \$250 million. TVA filed its answer to the lawsuit in November 2002.
- The Sierra Club gave notice in a September 26, 2002, letter that it intends to sue TVA for violating Clean Air Act opacity limits applicable to the John Sevier and Kingston Fossil Plants. The notice claims that TVA violated opacity standards at the two plants from July 1, 1997, to the present. The alleged opacity violations substantially overlap those that were challenged in a lawsuit filed by the National Parks Conservation Association two years ago in federal court in Knoxville, Tennessee. TVA ultimately prevailed in that lawsuit.

Hazardous Substances. The release and cleanup of hazardous substances are regulated under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). In a manner similar to many other industries and power systems, TVA has generated or used hazardous substances over the years. TVA is aware of hazardous-substance releases at eight off-site areas for which it may have some liability. Under CERCLA, the release and cleanup of hazardous substances are regulated. Liability under CERCLA is generally viewed as joint and several; however, TVA's share of cleanup costs under CERCLA is not expected to have a significant impact on TVA's financial position or results of operations.

Pending Litigation. EPA has issued TVA an administrative order directing TVA to put new source controls on 14 of its units and to evaluate whether more controls should be installed on other units. TVA has challenged the validity of this order. It is not possible to predict with certainty what impact implementation of EPA's order would have on TVA if TVA's challenge is unsuccessful. If EPA substantially prevails, TVA

could be required to incur significant capital costs in order to implement EPA's order (see *Clean Air Developments* for a discussion of this litigation and other Clean Air Act legal proceedings).

On December 28, 2001, Bowater Incorporated and Bowater Newsprint South, Inc. (together, "Bowater") filed a lawsuit against TVA in federal court in Knoxville challenging TVA's charges for Economy Surplus Power ("ESP") and Testing and Restart Power ("TRP") for two Bowater plants. In its complaint, Bowater alleges that in violation of the contract provision which states that TVA will charge ESP and TRP customers based on TVA's actual hourly incremental cost of providing ESP (1) TVA included certain alleged nonincremental costs in the prices for ESP and TRP and (2) when calculating such prices TVA used the cost of providing the most expensive 100 megawatts of ESP sold during a given hour instead of the average cost in that hour of serving the entire ESP load. The complaint also alleges that TVA has been unjustly enriched as a result of these overcharges. The lawsuit seeks, among other things, compensatory damages in excess of \$25 million and interest of more than \$10 million. TVA believes that it will prevail in this lawsuit based on the information presently available.

TVA is a party to various other civil lawsuits and claims that have arisen in the ordinary course of its business. Although the outcome of these other civil lawsuits and claims cannot be predicted with any certainty, TVA believes that their ultimate outcome should not have a material adverse effect on TVA's financial position or results of operations.

Decommissioning Costs. Provision for decommissioning costs of nuclear generating units is based on the estimated cost to dismantle and decontaminate the facilities to meet NRC criteria for license termination. Effective for 1998, TVA changed its method of accounting for nuclear decommissioning costs and related liabilities in order to comply with certain tentative conclusions as reached by the FASB in its project for closure and removal of long-lived assets, as well as certain rate-setting actions.

TVA recognizes as incurred all obligations related to closure and removal of its nuclear units. The liability for closure is measured as the present value of the estimated cash flows required to satisfy the related obligation and discounted at a determined risk-free rate of interest. The charge to recognize the obligation is effected by adjusting the corresponding regulatory asset. Earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset and interest expense on the decommissioning liability are deferred in accordance with SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. At September 30, 2002, the present value of the estimated future decommissioning cost of \$891 million was included in other liabilities, and the unamortized regulatory asset of \$556 million was included in deferred charges. The decommissioning cost estimates are based on prompt dismantlement and removal of the plant from service. The actual decommissioning costs may vary from the estimates because of changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology and changes in the cost of labor, materials and equipment.

TVA maintains a decommissioning trust fund to provide funding for the decommissioning of nuclear power plants. As of September 30, 2002, the decommissioning trust fund assets totaled approximately \$500 million and were invested in securities selected to achieve a return in line with overall equity market performance. TVA may find it necessary to provide additional decommissioning funding over the next several years if performance of the investment portfolio does not improve over recent years' performance. The need for additional funding could be eliminated if operating license extensions for Browns Ferry Units 1, 2 and 3 are granted by the NRC. TVA plans to submit its application for Browns Ferry license extensions at the end of 2003. NRC has typically taken two years to review such applications, and several nuclear utilities have already received operating license extensions.

Cost-based Regulation. Regulatory assets for TVA total approximately \$1,452 million at September 30, 2002, along with approximately \$4.1 billion of deferred nuclear plant costs. Management cannot predict the potential impact, if any, of the change in the regulatory environment on TVA's future financial position and results of operations. (See note 1 — *Regulatory Assets*.)

10. Stewardship Responsibilities

During 2002, TVA continued to conduct certain nonpower programs, including managing navigable river channels, providing flood control and overseeing certain recreation facilities. TVA's responsibilities include general stewardship of land, water and wildlife resources.

Historically, nonpower programs were primarily funded with federal appropriations. Certain nonpower program activities have also been funded with user fees and outside services revenues. In October 1997, Congress passed legislation that directed TVA to fund essential stewardship activities related to its management of the Tennessee River system and TVA properties with power funds in the event that there were insufficient appropriations or other available funds to pay for such activities in any year.

Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. Consequently, during 2000, 2001 and 2002, TVA paid \$71 million, \$72 million and \$83 million, respectively, for essential stewardship activities primarily with power revenues. In addition, administrative jurisdiction over Land Between The Lakes was transferred to the Secretary of Agriculture effective October 1, 1999. As part of the transfer, TVA also assumed responsibility for certain transition expenses associated with the transfer. To date, TVA has paid \$7.3 million of transition expenses with an estimated remaining liability of \$2 million at September 30, 2002. TVA retains responsibility for management of the remaining nonpower assets and settlement of nonpower obligations.

As of September 30, 2000, TVA had transferred \$56 million of property and equipment to the U.S. Forest Service. After this transfer, the completed plant of the nonpower programs consists of multipurpose dams and other plant. At September 30, 2002, the net completed plant balances for multipurpose dams and other plant were \$665 million and \$40 million, respectively. At September 30, 2001, the net completed plant balances for multipurpose dams and other plant were \$673 million and \$43 million, respectively.

11. Unaudited Quarterly Financial Information

A summary of the quarterly results of operations for the years 2002 and 2001 follows. The information has been prepared by TVA's management and is unaudited. It should be read in conjunction with the audited financial statements appearing herein. Results for interim periods may fluctuate as a result of weather conditions, changes in rates and other factors.

(in millions)	2002				
	First	Second	Third	Fourth	Total
Operating revenues	\$1,521	\$1,653	\$1,678	\$ 1,983	\$6,835
Income from operations	360	413	412	464	1,649
Income before loss on impairment of assets/plant cancellation	3	61	59	104	227
Net income (loss)	3	(89)	51	108	73
(in millions)	2001				
	First	Second	Third	Fourth	Total
Operating revenues	\$1,715	\$1,758	\$1,627	\$ 1,899	\$ 6,999
Income from operations	469	303	371	350	1,493
Income before loss on impairment of assets/plant cancellation	47	122	(25)	(36)	108
Net income (loss)	47	122	(25)	(3,455)	(3,311)

12. Subsequent Events

Effective during the first quarter of 2003, the TVA Board of Directors approved a change in the methodology for estimating unbilled revenue from electricity sales. The change was from a method using cumulative generation to a method using generation for the current billing period only as a basis for calculating

the unbilled energy. The impact of this change resulted in an increase in accounts receivable of \$411 million. A corresponding gain from the cumulative effect of the change is being deferred pending disposition.

TVA has received notice from one distributor which terminates its power contract with TVA in October 2007. A second distributor has also given a notice which seeks to so terminate its power contract conditioned upon the availability of transmission service from TVA. During 2001, sales to these two distributors generated approximately one percent of TVA's total revenues. Once a power contract is terminated, the terminating distributor would have neither the obligation nor the right to take power or obtain transmission from TVA, absent the negotiation of new arrangements.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors of the Tennessee Valley Authority

In our opinion, the accompanying balance sheets (power program and all programs) and the related statements of income (power program), changes in proprietary capital (power program and nonpower programs), comprehensive income (power program), net expense and comprehensive income (nonpower programs), and cash flows (power program and all programs) present fairly, in all material respects, the financial position of the power program and all programs of the Tennessee Valley Authority at September 30, 2002 and 2001, and the results of its operations of the power program and nonpower programs and its cash flows of the power program and all programs for each of the three years in the period ended September 30, 2002, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Tennessee Valley Authority's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 19, 2002, on our consideration of the Tennessee Valley Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations for the year ended September 30, 2002. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

PricewaterhouseCoopers LLP

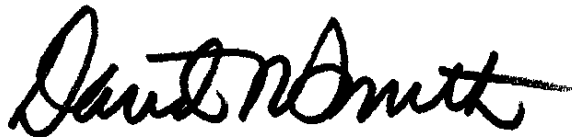
PricewaterhouseCoopers LLP
Knoxville, Tennessee
December 19, 2002

REPORT OF MANAGEMENT

Management is responsible for the preparation, integrity, and objectivity of the financial statements of the Tennessee Valley Authority as well as all other information contained in the Information Statement. The financial statements have been prepared in conformity with generally accepted accounting principles applied on a consistent basis and, in some cases, reflect amounts based on the best estimates and judgments of management, giving due consideration to materiality. Financial information contained in the Information Statement is consistent with that in the financial statements.

The Tennessee Valley Authority maintains an adequate system of internal controls to provide reasonable assurance that transactions are executed in accordance with management's authorization, that financial statements are prepared in accordance with generally accepted accounting principles, and that the assets of the corporation are properly safeguarded. The system of internal controls is documented, evaluated, and tested on a continuing bases. No internal control system can provide absolute assurance that errors and irregularities will not occur due to the inherent limitations of the effectiveness of internal controls; however, management strives to maintain a balance, recognizing that the cost of such a system should not exceed the benefits derived. No material internal control weaknesses have been reported to management.

PricewaterhouseCoopers LLP was engaged to audit the financial statements of the Tennessee Valley Authority and issue reports thereon. Its audits were conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States. Such standards require a review of internal controls and an examination of selected transactions and other procedures sufficient to provide reasonable assurance that the financial statements neither are misleading nor contain material errors. The Report of Independent Accountants does not limit the responsibility of management for information contained in the financial statements and elsewhere in the Information Statement.

A handwritten signature in black ink, reading "David N. Smith". The signature is fluid and cursive, with the first name "David" and last name "Smith" clearly legible.

David N. Smith
Chief Financial Officer and
Executive Vice President of Financial Services

REPORT OF INSPECTOR GENERAL

To The Board of Directors of the Tennessee Valley Authority

The Tennessee Valley Authority contracted with the independent certified public accounting firm of PricewaterhouseCoopers LLP (“PricewaterhouseCoopers”) to audit the balance sheets (power program and all programs) as of September 30, 2002 and 2001 and the related statements of income (power program), changes in proprietary capital (power program and nonpower programs), comprehensive income (power program), net expense and comprehensive income (nonpower programs), and cash flows (power program and all programs) for each of the three years in the period ended September 30, 2002. The contract required the audit be done in accordance with generally accepted government auditing standards.

Under the Inspector General Act, the Office of the Inspector General (“OIG”) is responsible for taking appropriate steps to assure that any work performed by nonfederal auditors, including PricewaterhouseCoopers, complies with generally accepted government auditing standards. The Chief Financial Officers Act also places responsibilities on the OIG regarding TVA’s annual financial statement audit. In keeping with our statutory responsibilities, we reviewed PricewaterhouseCoopers’ reports and related audit documentation, interviewed their representatives, and performed such other procedures as we deemed appropriate in the circumstances to provide reasonable assurance that the audit was performed in accordance with generally accepted government auditing standards.

The objective of our review was not intended to enable us to express, and we do not express, an opinion on the Tennessee Valley Authority’s financial statements or on management’s conclusions about the effectiveness of its system of internal control. PricewaterhouseCoopers is responsible for the auditor’s reports dated December 19, 2002, and the conclusions expressed in the reports. However, our review disclosed no instances where PricewaterhouseCoopers did not comply, in all material respects, with generally accepted government auditing standards. Our review was performed in accordance with generally accepted government auditing standards.

A handwritten signature in black ink that reads "Ben R. Wagner". The signature is fluid and cursive, with the first name "Ben" and last name "Wagner" clearly legible.

Ben R. Wagner
Assistant Inspector General (Audits)
December 30, 2002

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

During 2002, there were no changes in or disagreements with TVA's independent auditors on accounting matters of financial disclosure.

PART III

DIRECTORS AND EXECUTIVE OFFICERS

TVA is administered by a board of directors composed of three persons appointed by the President and confirmed by the Senate. TVA's management structure includes a Management Committee which works with the Board to determine TVA's strategic mission and future direction, as well as an Executive Committee which provides management oversight and ensures that policies of the Board are carried out. The Board and selected officers, their ages, their years of employment with TVA and principal occupations for recent years are as follows:

	<u>Age</u>	<u>Year Appointed</u>	<u>Year Term Expires</u>
Directors			
Glenn L. McCullough, Jr. Chairman	48	1999	2005
Skila Harris Director	52	1999	2008
William W. Baxter Director	49	2001	2011

Mr. McCullough was appointed to the Board in November 1999, and previously served as the mayor of Tupelo, Mississippi, beginning in 1997. Prior to his election as mayor of Tupelo, he was the director of the Mississippi office of the Appalachian Regional Commission. Chairman McCullough also worked in the family business, McCullough Steel Products, for 12 years.

Ms. Harris was appointed to the Board in November 1999. Prior to her current position, she served at DOE as Executive Director of the Secretary of Energy Advisory Board. From 1993 until 1997, she was a Special Assistant to Vice President Gore and Mrs. Gore's Chief of Staff. She came to the White House from Steiner-Liff Iron and Metal Company in Nashville, Tennessee, where she was Vice President for Development and Compliance. Ms. Harris served as a project manager at the U.S. Synthetic Fuels Corporation, and she was with DOE during the Carter Administration. She has also held positions with management and engineering consulting firms specializing in energy-related work.

Mr. Baxter was appointed to the Board in November 2001. Prior to joining the Board, Mr. Baxter was Chairman and Chief Executive Officer of Holston Gases Inc. of Knoxville, Tennessee. Before joining Holston Gases Inc. in 1981, Mr. Baxter was an attorney with Garrett, Coffee, McGee & Baxter in Knoxville. From December 1997 through December 2000, Mr. Baxter was Commissioner of the Department of Economic and Community Development for the State of Tennessee.

	<u>Age</u>	<u>Year Commenced Employment</u>
Executive Officers		
Oswald J. Zeringue* President and Chief Operating Officer	57	1989
John A. Scalice Chief Nuclear Officer & Executive Vice President, TVA Nuclear	55	1989

	<u>Age</u>	<u>Year Commenced Employment</u>
David N. Smith* Chief Financial Officer & Executive Vice President, Financial Services	58	1995
Maureen H. Dunn* Executive Vice President and General Counsel	53	1978
John E. Long, Jr.* Executive Vice President, Human Resources	50	1980
Mark O. Medford* Executive Vice President, Customer Service and Marketing	56	1989
Ellen Robinson* Executive Vice President, Communications and Government Relations	48	2001
D. LeAnne Stribley* Executive Vice President, Administration	48	1995
John Bradley* Senior Vice President, Economic Development	42	2002
Theresa A. Flaim* Senior Vice President, Strategic Planning and Analysis	53	2002

** Member of Management Committee*

Mr. Zeringue was named President and Chief Operating Officer in April 1998. Prior to his current position, he served as Chief Nuclear Officer & Executive Vice President (1997-1998), as Senior Vice President, Nuclear Operations (1993-1997), as Browns Ferry Site Vice President (1989-1993) and as Plant Manager of Palo Verde Nuclear Station, Arizona Public Service Company (1987-1989).

Mr. Scalice was named Chief Nuclear Officer & Executive Vice President, TVA Nuclear in June 1998. Prior to his current position, he served as Acting Chief Nuclear Officer (beginning April 1998), as Senior Vice President of Nuclear Operations (1997-1998), as Watts Bar Site Vice President (1993-1997), as Plant Manager of Browns Ferry Nuclear Plant (1991-1993), as Plant Manager of Watts Bar Nuclear Plant (1989-1991) and as Plant Manager of Shoreham Nuclear Power Station, Long Island Lighting Company (1989).

Mr. Smith was named Chief Financial Officer in January 1995 and additionally was named Executive Vice President, Financial Services, in October 1996. Prior to his current position, he served as Executive Director of Odyssey Financial (1993-1994), as Vice President of Finance of LTV Corporation (1991-1993) and as Assistant Treasurer and Director of Corporate Finance of LTV Corporation (1986-1991).

Ms. Dunn joined TVA as an attorney in May 1978, assumed the position of Assistant General Counsel in September 1986, and assumed the position of Executive Vice President and General Counsel in January 2001.

Mr. Long was named Executive Vice President of Human Resources in October 2000. Prior to his current position, he served as a management appointee to the TVA Retirement System Board since 1992. Mr. Long joined TVA in 1980 as a Personnel Officer in the Engineering Division.

Mr. Medford was named Executive Vice President of Customer Service and Marketing in December 1996. He joined TVA as Vice President and Nuclear Technical Director in 1989. Mr. Medford directs staffs that manage customer accounts, product development and pricing, marketing and economic development. He has more than 26 years of public and private utility experience and he is responsible for relations between TVA and its customers. Before joining TVA, Mr. Medford was manager of nuclear regulatory affairs at Southern California Edison.

Ms. Robinson was named Executive Vice President of Communications and Government Relations in June 2001. She served as senior vice president of communications and government affairs at CNH Global NV in Racine, Wisconsin and before that as vice president of communications and government affairs at Case

Corporation. Ms. Robinson joined Case from Burson-Marsteller in New York, where she was a vice president and a head of the business-to-business marketing unit.

Ms. Stribley was named Executive Vice President of Administration in December 2000. She joined TVA as Vice President of Finance in 1995 and assumed additional responsibilities as Controller in 1997. Before joining TVA, Ms. Stribley was vice president of finance and chief financial officer at Travel Resources Management Group, Inc. Additionally, Ms. Stribley was director of corporate finance at Ohio-based LTV Corporation from 1987 to 1994, and between 1981 to 1987 she worked as assistant treasurer for the Western Company of North America, an offshore-drilling and oil-services corporation.

Mr. Bradley was named Senior Vice President of Economic Development in August 2002. He is responsible for recruitment and retention of capital investment and job creation, business development, technical services and community development. Mr. Bradley served as senior vice president for economic development for the Memphis Regional Chamber of Commerce from 1996 to 2002, and he worked in Memphis Light, Gas & Water's economic development department from 1980 to 1996.

Ms. Flaim was named as Senior Vice President of Strategic Planning and Analysis in June 2002. She is responsible for developing strategies related to the ongoing competitive restructuring of the electric-utility industry. She served for nine years as vice president of strategic planning for Niagara Mohawk. Ms. Flaim worked at the Solar Energy Research Institute and the Los Alamos National Laboratory.

CONTROLS AND PROCEDURES

TVA's management, including the Chief Financial Officer, and the members of the Board of Directors have conducted an evaluation of the effectiveness of TVA's disclosure controls and procedures during November and December 2002. Based on that evaluation, members of the Board of Directors and the Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information necessary and appropriate for this Statement has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the members of the Board of Directors and Chief Financial Officer completed their evaluation.

In 2002, TVA, along with its external auditors, identified no deficiencies in the design and operation of its internal control procedures that were reportable control weaknesses.

PART IV

STATISTICAL & FINANCIAL SUMMARIES

STATISTICAL & FINANCIAL SUMMARIES **For the years ended September 30**

	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
Sales (millions of kWh) (a)											
Municipalities and cooperatives.....	128,600	129,760	125,991	122,880	123,330	114,771	117,035	110,245	108,073	105,566	98,505
Industries directly served.....	26,478	23,306	22,204	22,885	18,514	17,359	16,599	16,684	15,792	16,196	16,576
Federal agencies and other.....	5,013	8,355	11,376	10,190	21,293	27,198	19,964	12,356	13,599	10,952	8,970
Total sales.....	160,091	161,421	159,571	155,955	163,137	159,328	153,598	139,285	137,464	132,714	124,051
Operating revenues (millions of dollars) (a)											
Electric											
Municipalities and cooperatives.....	\$ 5,856	\$ 5,908	\$ 5,676	\$ 5,510	\$ 5,554	\$ 4,811	\$ 4,980	\$ 4,654	\$ 4,582	\$ 4,479	\$ 4,266
Industries directly served.....	732	659	626	642	523	464	452	460	472	472	472
Federal agencies and other.....	159	330	361	357	556	561	430	277	441	414	342
Other.....	88	102	99	86	96	98	89	82	71	71	71
Total revenues.....	\$ 6,835	\$ 6,999	\$ 6,762	\$ 6,595	\$ 6,729	\$ 5,934	\$ 5,951	\$ 5,473	\$ 5,546	\$ 5,436	\$ 5,151
Electric revenue per kWh (cents) (b).....	4.21	4.27	4.18	4.17	4.07	3.66	3.82	3.87	3.87	3.92	3.97
Winter net dependable generating capacity (megawatts)											
Hydro (c).....	5,660	5,677	5,492	5,492	5,491	5,384	5,298	5,225	5,242	4,885(d)	4,885(d)
Fossil (e).....	15,463	15,050	15,049	15,049	15,003	15,014	15,012	15,032	15,032	15,088	15,088
Nuclear units in service.....	5,751	5,715	5,729	5,729	5,625	5,625	5,545	5,342	5,342	5,365	5,361
Combustion turbine.....	4,643	3,923	2,232	2,232	2,384	2,394	2,268	2,232	2,264	2,284	2,284
Total capacity.....	31,517	30,365	28,502	28,502	28,498	28,417	28,123	25,831	25,880	25,622	25,618
System peak load (megawatts) — summer.....	29,052	27,368	29,344	28,295	27,253	26,661	25,376	25,496	23,398	23,878	21,980
System peak load (megawatts) — winter.....	26,290	27,163	25,940	26,388	23,204	26,670	25,995	24,676	24,723	21,666	21,974
Percent gross generation by fuel source											
Fossil.....	63%	64%	63%	63%	62%	61%	65%	71%	72%	77%	69%
Hydro.....	6%	6%	6%	7%	10%	11%	11%	12%	14%	13%	14%
Nuclear.....	30%	29%	31%	30%	28%	28%	24%	17%	10%	10%	17%
Combustion turbine.....	1%	1%	NM	NM	NM	NM	NM	NM	NM	NM	NM
Fuel cost per kWh (cents)											
Fossil.....	1.39	1.32	1.27	1.28	1.25	1.23	1.23	1.26	1.34	1.27	1.33
Combustion turbine.....	4.65	6.07	6.22	3.94	4.01	5.22	4.54	3.61	5.45	5.09	8.26
Nuclear (f).....	0.41	0.44	0.49	0.51	0.71	0.58	0.56	0.61	1.10	1.09	1.10
Aggregate fuel cost per kWh net thermal generation.....	1.11	1.08	1.05	1.05	1.10	1.04	1.06	1.14	1.31	1.25	1.29
Fuel data											
Net thermal generation (millions of kWh).....	141,272	146,806	143,224	137,169	139,727	135,736	131,898	118,097	110,643	109,968	105,577
Billion Btu.....	1,458,367	1,505,304	1,470,452	1,403,110	1,426,151	1,381,837	1,338,157	1,197,295	1,120,868	1,105,395	1,069,725
Fuel expense (millions of dollars).....	1,564	1,588	1,504	1,434	1,538	1,406	1,395	1,348	1,450	1,375	1,360
Cost per million Btu (cents).....	107.25	105.47	102.29	102.21	107.81	101.73	104.22	112.61	129.40	124.42	127.16
Net heat rate.....	10,323	10,255	10,267	10,229	10,207	10,180	10,145	10,138	10,131	10,052	10,132

(a) Sales and revenues have been adjusted to include sales to other utilities.

(b) Excludes settlement payment from Department of Energy of \$160 million for the years 1992-1994.

(c) Includes 405 megawatts of capacity from the Corps of Engineers projects on the Cumberland River System.

(d) Reflects expiration of TAPOCO exchange agreement in 1990 — renewed in 1994.

(e) Includes 440 megawatts of capacity from power purchase agreement under which TVA has contracted with Choctaw Generation, L.P., for power from a lignite-fired generation plant in Chester, Mississippi.

(f) TVA changed its method of expensing the interest component of nuclear fuel expense in 1995.

Independent Accountants

The financial statements of TVA at September 30, 2002 and 2001, and for each of the three fiscal years in the period ended September 30, 2002, appended hereto as part of this Statement, have been audited by PricewaterhouseCoopers LLP, independent accountants, as stated in their report, dated December 19, 2002, which report is also appended hereto.

* * * * *

Any statements in this Statement involving matters of opinion, regardless of whether expressly so identified, are opinions only and not factual representations. This Statement is not a contract with the purchaser of any Power Bonds, Discount Notes or Other Indebtedness.

This Statement has been approved by duly authorized officers of the Tennessee Valley Authority.

Tennessee Valley Authority

By: /s/ DAVID N. SMITH

David N. Smith
*Chief Financial Officer &
Executive Vice President,
Financial Services*

/s/ RANDY TRUSLEY

Randy Trusley
Vice President and Controller

CERTIFICATIONS

Glenn L. McCullough, Jr., Skila Harris and Bill Baxter, individually certify that:

1. I have reviewed this Information Statement of the Tennessee Valley Authority:
2. Based on my knowledge, the information in this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement;
3. Based on my knowledge, the financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Information Statement;
4. I and the other certifiers are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:
 - a) designed such disclosure controls and procedures to ensure that the financial statements and other financial information relating to the Tennessee Valley Authority are made known to us by others particularly during the period in which this Information Statement is being prepared;
 - b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures as of a date within 90 days prior to the date of this Information Statement (the "Evaluation Date"); and
 - c) presented in this Information Statement our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. I and the other certifiers have disclosed, based on our most recent evaluation, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Tennessee Valley Authority's ability to record, process, summarize and report financial data and have identified for the Tennessee Valley Authority's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal controls; and
6. I and the other certifiers have indicated in this Information Statement whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: January 13, 2003



Glenn L. McCullough, Jr.
Chairman



Skila Harris
Director



Bill Baxter
Director

PRINCIPAL EXECUTIVE OFFICE OF TVA

**400 W. Summit Hill Drive
Knoxville, TN 37902
U.S.A.**

FISCAL AGENT

**U.S. Federal Reserve Banks
c/o Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045
U.S.A.**

**U.S. TAX AND
LEGAL ADVISORS TO TVA
Orrick, Herrington & Sutcliffe LLP
666 Fifth Avenue
New York, NY 10103
U.S.A.**

**LEGAL COUNSEL FOR TVA
Maureen H. Dunn
Executive Vice President and
General Counsel
Tennessee Valley Authority
400 W. Summit Hill Drive
Knoxville, TN 37902
U.S.A.**

U.S. LEGAL ADVISORS TO THE MANAGERS

**Sullivan & Cromwell LLP
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006
U.S.A.**

**LISTING AGENT AND SPECIAL
AGENT**

**Kredietbank S.A. Luxembourgeoise
43 Boulevard Royal L-2955
Luxembourg
R.C. Luxembourg B6395**

**AUDITORS TO TVA
PricewaterhouseCoopers LLP
2030 Falling Water Road
Suite 280
Knoxville, TN 37922
U.S.A.**