# 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

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*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.*

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**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 | 21 | 22 | 40 | 38 |
| 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 | 81 | 81 | 163 | 163 |
| Total operating expenses | 1,381 | 1,240 | 2,634 | 2,401 |
| **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 | (18) | (16) | (33) | (30) |
| Net interest expense | 335 | 357 | 681 | 717 |
| **Income (loss) before cumulative effects of accounting changes** | 90 | (89) | 187 | (86) |
| Cumulative effect of accounting for unbilled revenue | – | – | 412 | – |
| Cumulative effect of accounting for asset retirement obligations | – | – | (178) | – |
| **Net income (loss)** | $ 90 | $ (89) | $ 421 | $ (86) |

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** | $ 31,581 | $ 30,158 |
| **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** | $ 31,581 | $ 30,158 |

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** | $ 521 | $ 11 | $ 521 | $ 11 |

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 2003 | Three months ended March 31 2002 | Six months ended March 31 2003 | Six months ended March 31 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 2003 | Three months ended March 31 2002 | Six months ended March 31 2003 | Six months ended March 31 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 | $ 884 | $ 655 |

Change in Accounting for Unbilled Revenue

Effective during the first quarter of 2003, 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 mark-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 |
| | $ 1,834 | $ 1,452 |

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 | $ 479 | $ 1,652 | $ 1,607 | $ 1,564 | $ 518 | $ 11,400 |

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 | $ (39) | $ (52) |

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 | $ (231) |

## 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) | – |
| | $ (404) | $ (327) |

## 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 | 747 | 1,078 | 654 | 430 | 322 | 518 | 3,749 |
| Total | $ 4,143 | $ 3,654 | $ 2,903 | $ 3,297 | $ 1,577 | $ 17,655 | $ 33,229 |

*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 | 844 | 1,337 | 2,250 | 2,648 |
| Total sales of electricity | 41,828 | 39,755 | 81,361 | 75,829 |

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 | | |
|---|---|---|---|
| | 2003 | 2002 | Percent Change |
| | (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 | 21 | 22 | -4.5% |
| Total operating revenues | $ 1,803 | $ 1,653 | 9.1% |

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 | 40 | 38 | 5.3% |
| Total operating revenues | $ 3,496 | $ 3,174 | 10.1% |

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 swaption 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 | $ (2,947) | $ (3,279) |
| Discount notes <90 days | $ 3,269 | $ 3,492 |

**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 | $ 4,143 | $ 3,654 | $ 2,903 | $ 3,297 | $ 1,577 | $17,655 | $33,229 |

*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.

<u>Nuclear Generating Plants.</u> 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.

<u>Coal-Fired Generating Plants.</u> 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.

<u>Gas/Oil Turbine Generating Plants.</u> 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.

<u>Ash/Waste Ponds.</u> 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 | $ 3,826 |

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, A*ccounting 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 | $ (231) |

## 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% |
| | | $ 381 | |
| Issues: | | | |
| electronotes® | First Quarter 2003 | $ 156 | 4.600% - 5.050% |
| | Second Quarter 2003 | 142 | 3.050% - 5.000% |
| | | $ 298 | |

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 million 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 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 obligations 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

Glenn L. McCullough, Jr.
Chairman

Skila Harris
Director

Bill Baxter
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

David N. Smith

Chief Financial Officer and Executive Vice President of Financial Services

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