Tennessee Valley Authority

(Wholly Owned Corporate Agency and Instrumentality of the United States of America)

Quarterly Report

For the quarterly period ended March 31, 2005

Tennessee Valley Authority

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For the quarterly period ended March 31, 2005

This document contains the unaudited Quarterly Report of TVA for the quarterly period ended March 31, 2005 (this "Quarterly Report"). TVA is not required to register securities under the Securities Act of 1933 and is currently not required 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 Quarterly Report with the SEC. Due to legislation enacted in December 2004, beginning with its 2006 annual report, TVA will file annual reports, quarterly reports, and current reports with the SEC under the Securities Exchange Act of 1934. Several portions of this Quarterly Report contain forward-looking statements, and reference is made to page one regarding such statements. This Quarterly Report should be read in conjunction with the 2004 Information Statement dated November 24, 2004, as may be amended from time to time (the "2004 Information Statement").

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FORWARD-LOOKING STATEMENTS

This Quarterly Report 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.

Examples of forward-looking statements include, but are not limited to, strategic objectives; estimates of costs for disposing of certain tangible long-lived assets; expectations about the adequacy of TVA’s nuclear decommissioning fund; the impact of new accounting pronouncements and interpretations, including Interpretation No. 46, “*Consolidation of Variable Interest Entities*,” which was amended by Financial Accounting Standards Board Interpretation No. 46R, and Statement of Financial Accounting Standards No. 151, “*Inventory Costs—an amendment of ARB No. 43, Chapter 4;*” TVA’s plans to continue using short-term debt to meet current obligations; and the anticipated cost and schedule of returning Browns Ferry Unit 1 to service.

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; damage to power production or transmission facilities due to accidental events or terrorist activity; 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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF INCOME (unaudited)
(in millions)

	Three months ended March 31		Six months ended March 31	
	2005	2004	2005	2004
Operating revenues				
Sales of electricity				
Municipalities and cooperatives	$ 1,561	$ 1,610	$ 3,086	$ 3,131
Industries directly served	236	215	451	413
Federal agencies and other	32	30	105	67
Other revenue	10	24	31	45
Total operating revenues	1,839	1,879	3,673	3,656
Operating expenses				
Fuel and purchased power	598	518	1,075	948
Operating and maintenance	584	570	1,166	1,128
Depreciation, amortization, and accretion	290	277	575	552
Tax-equivalents	90	84	181	168
Loss on project cancellation (note 1)	–	–	–	35
Total operating expenses	1,562	1,449	2,997	2,831
Operating income	277	430	676	825
Other income, net	6	8	11	15
Unrealized gain on derivative contracts, net	8	6	12	5
Interest expense				
Interest on debt	338	345	677	693
Amortization of debt discount, issue, and reacquisition costs, net	5	6	10	13
Allowance for funds used during construction	(28)	(25)	(54)	(47)
Net interest expense	315	326	633	659
Net (loss) income	$ (24)	$ 118	$ 66	$ 186

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

TENNESSEE VALLEY AUTHORITY
BALANCE SHEETS (unaudited)
(in millions)

ASSETS	March 31 2005	September 30 2004
Current assets		
Cash and cash equivalents	$ 757	$ 519
Short-term investments	133	335
Accounts receivable, net	932	1,034
Inventories at average cost and other		
Fuel	191	193
Other, net	322	305
Total current assets	2,335	2,386
Property, plant, and equipment		
Completed plant	34,876	34,786
Less accumulated depreciation	(13,955)	(13,424)
Net completed plant	20,921	21,362
Construction in progress	2,414	1,923
Nuclear fuel and capital leases	566	504
Total property, plant, and equipment	23,901	23,789
Deferred nuclear generating units	3,910	3,909
Investment funds	800	744
Deferred charges and other assets		
Loans and other long-term receivables	92	144
Reacquisition costs	269	277
Other deferred charges	1,427	974
Regulatory assets (note 1)	2,029	2,057
Total deferred charges and other assets	3,817	3,452
Total assets	$ 34,763	$ 34,280
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	$ 783	$ 761
Accrued liabilities	237	284
Accrued interest	417	402
Current portion of lease/leaseback obligations	34	35
Current portion of energy prepayment obligations	106	105
Short-term debt	2,028	1,924
Current maturities of long-term debt	2,000	2,000
Total current liabilities	5,605	5,511
Other liabilities		
Deferred liabilities	3,294	2,893
Asset retirement obligations	1,807	1,782
Lease/leaseback obligations	1,120	1,143
Energy prepayment obligations	1,297	1,350
Total other liabilities	7,518	7,168
Long-term debt		
Public bonds	19,175	19,326
Unamortized discount and other adjustments	57	11
Total long-term debt	19,232	19,337
Total liabilities	32,355	32,016
Commitments and contingencies (note 6)		
Proprietary capital		
Appropriation investment	4,793	4,803
Retained earnings of power program	1,226	1,162
Accumulated net expense of nonpower programs	(3,655)	(3,649)
Accumulated other comprehensive income (loss) (note 2)	44	(52)
Total proprietary capital	2,408	2,264
Total liabilities and proprietary capital	$ 34,763	$ 34,280

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS (unaudited)
(in millions)

	Three months ended March 31		Six months ended March 31	
	2005	2004	2005	2004
Cash flows from operating activities				
Net (loss) income	$ (24)	$ 118	$ 66	$ 186
Items not requiring (providing) cash				
Depreciation, amortization, and accretion	318	269	639	562
Allowance for funds used during construction	(28)	(25)	(54)	(47)
Nuclear fuel amortization	31	30	65	61
Loss on project cancellation	–	–	–	35
Other, net	46	21	99	57
Changes in current assets and liabilities				
Short-term investments, net	316	101	202	101
Accounts receivable, net	64	32	102	68
Inventories and other	(12)	(15)	(31)	(8)
Accounts payable and accrued liabilities	193	93	(41)	(120)
Accrued interest	107	112	14	32
Proceeds from energy prepayments	–	–	–	1,504
Refueling outage costs	(43)	(28)	(71)	(81)
Other	(14)	(11)	(33)	(18)
Net cash provided by operating activities	954	697	957	2,332
Cash flows from investing activities				
Construction expenditures	(293)	(415)	(622)	(803)
Allowance for funds used during construction	28	25	54	47
Nuclear fuel expenditures	(34)	(52)	(118)	(53)
Investments	1	(1)	1	(1)
Loans and other receivables				
Advances	(11)	16	(6)	10
Repayments	9	(15)	7	(11)
Proceeds from sale of loans	–	–	55	–
Other, net	2	2	–	–
Net cash (used in) investing activities	(298)	(440)	(629)	(811)
Cash flows from financing activities				
Long-term debt				
Issues	24	664	24	757
Redemptions and repurchases	(174)	(80)	(177)	(495)
Short-term issues (redemptions), net	39	(626)	104	(1,810)
Bond premium received	–	97	–	97
Payments on combustion turbine financing	(14)	(17)	(17)	(20)
Payments on equipment financing	(6)	(29)	(6)	(29)
Proceeds from other financing	–	–	1	–
Financing costs, net	(2)	(3)	(2)	(4)
Payments to U.S. Treasury	(8)	(9)	(17)	(19)
Net cash (used in) financing activities	(141)	(3)	(90)	(1,523)
Net change in cash and cash equivalents	515	254	238	(2)
Cash and cash equivalents at beginning of period	242	277	519	533
Cash and cash equivalents at end of period	$ 757	$ 531	$ 757	$ 531

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL (unaudited)
(in millions)

	Appropriation Investment	Retained Earnings - Power Program	Accumulated Net Expense of Nonpower Programs	Accumulated Other Comprehensive Income (Loss)	Total	Comprehensive Income (Loss)
Balance at December 31, 2003	$ 4,818	$ 849	$ (3,641)	$ (59)	$ 1,967	$ –
Net income (loss)	–	121	(3)	–	118	118
Return on appropriation investment	–	(4)	–	–	(4)	–
Other comprehensive (loss) (note 2)	–	–	–	(4)	(4)	(4)
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at March 31, 2004	$ 4,813	$ 966	$ (3,644)	$ (63)	$ 2,072	$ 114
Balance at December 31, 2004	$ 4,798	$ 1,251	$ (3,652)	$ 14	$ 2,411	$ –
Net (loss)	–	(21)	(3)	–	(24)	(24)
Return on appropriation investment	–	(4)	–	–	(4)	–
Other comprehensive income (note 2)	–	–	–	30	30	30
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at March 31, 2005	$ 4,793	$ 1,226	$ (3,655)	$ 44	$ 2,408	$ 6

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL (unaudited)
(in millions)

	Appropriation Investment	Retained Earnings - Power Program	Accumulated Net Expense of Nonpower Programs	Accumulated Other Comprehensive Income (Loss)	Total	Comprehensive Income
Balance at September 30, 2003	$ 4,823	$ 783	$ (3,638)	$ (74)	$ 1,894	$ –
Net income (loss)	–	192	(6)	–	186	186
Return on appropriation investment	–	(9)	–	–	(9)	–
Other comprehensive income (note 2)	–	–	–	11	11	11
Return of appropriation investment	(10)	–	–	–	(10)	–
Balance at March 31, 2004	$ 4,813	$ 966	$ (3,644)	$ (63)	$ 2,072	$ 197
Balance at September 30, 2004	$ 4,803	$ 1,162	$ (3,649)	$ (52)	$ 2,264	$ –
Net income (loss)	–	72	(6)	–	66	66
Return on appropriation investment	–	(8)	–	–	(8)	–
Other comprehensive income (note 2)	–	–	–	96	96	96
Return of appropriation investment	(10)	–	–	–	(10)	–
Balance at March 31, 2005	$ 4,793	$ 1,226	$ (3,655)	$ 44	$ 2,408	$ 162

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

NOTES TO FINANCIAL STATEMENTS (unaudited)
Dollars in millions except where noted

1. Summary of Significant Accounting Policies

Organization
TVA is a wholly owned corporate agency and instrumentality of the United States and was established by Congress by the Tennessee Valley Authority Act of 1933, as amended, 16 U.S.C. §§ 831-831ee (2000 and Supp. II 2002) (the "TVA Act"). TVA is charged with 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, such as proceeds from the issuance of debt. Although TVA no longer receives congressional appropriations for either its power or nonpower programs, it 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 was provided by congressional appropriations. These programs are now funded largely with power funds. Certain nonpower activities are also funded with various revenues and user fees. Prior to 2004, TVA presented information separately on its power program and nonpower programs in its financial statements.

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 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 generally accepted accounting principles 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 year ended September 30, 2004, and the notes thereto, which are contained in the 2004 Information Statement.

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 and the timing of planned maintenance and refueling outages of electric generating units, the results of operations for interim periods are not necessarily indicative of amounts expected for the entire year.

In preparing financial statements that conform to 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.

As discussed in Note 1—*Project Cancellation*, in the first quarter of 2004 TVA recorded a project cancellation loss of $36 million which included an estimated $1 million in contingency costs related to the Regenesys project cancellation. In April 2004, Regenesys Technologies Limited ("RTL") reimbursed TVA for early termination on the contract in the amount of $15 million. In the fourth quarter of 2004, TVA determined that the $1 million contingency liability no longer existed and reduced the loss on project cancellation previously recorded from $21 million to $20 million.

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
Dollars in millions except where noted

Fiscal Year

TVA's fiscal year ends September 30. Unless otherwise indicated, years (2005, 2004, etc.) refer to TVA's fiscal years.

Accounts Receivable

Accounts receivable primarily consist of amounts due from power sales. The table below summarizes the types and amounts of receivables:

	At March 31 2005	At September 30 2004
Power receivables billed	$ 270	$ 288
Power receivables unbilled	638	713
Total power receivables	908	1,001
Other receivables	31	41
Allowance for uncollectible accounts	(7)	(8)
Net accounts receivable	$ 932	$ 1,034

Cost-Based Regulation

Regulatory assets represent costs capitalized under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 71, "*Accounting for the Effects of Certain Types of Regulation.*" TVA's regulatory assets are shown as REGULATORY ASSETS, REACQUISITION COSTS, and DEFERRED NUCLEAR GENERATING UNITS on the Balance Sheets. TVA's regulatory assets consist of the following:

	At March 31 2005	At September 30 2004
Decommissioning costs	$ 725	$ 755
Changes in fair value of derivative contracts	61	59
Adjustment to accrue minimum pension liability		
TVA Retirement System	1,235	1,235
Supplemental executive retirement plan	8	8
Subtotal	2,029	2,057
Reacquisition costs	269	277
Deferred nuclear generating units	3,910	3,909
Total	$ 6,208	$ 6,243

Regulatory liabilities accounted for under provisions of SFAS No. 71 consist of unrealized gains related to mark-to-market valuations of coal contracts. The balances of TVA's regulatory liabilities at March 31, 2005, and September 30, 2004, were $753 million and $478 million, respectively, and are included in DEFERRED LIABILITIES on the Balance Sheets.

Although Bellefonte Nuclear Plant ("Bellefonte") remains in a deferred status, TVA continues to evaluate recovery options for the deferred nuclear generating units. The Board believes that the deferred nuclear generating units associated with the Bellefonte site have value to TVA and plans to develop a specific plan during 2005 to recover Bellefonte site costs upon receiving TVA management's recommendation.

Asset Retirement Obligations

In accordance with the provisions of SFAS No. 143, "*Accounting for Asset Retirement Obligations*," TVA recognizes legal obligations associated with the future retirement of certain tangible long-lived assets. TVA only records estimates of such disposal costs at the time the legal obligation arises or costs are actually incurred.

The following table summarizes for each asset retirement obligation ("ARO") category the revised asset cost, the ARO liability as of September 30, 2004, and March 31, 2005, the fair market value of any assets legally restricted for purposes of settling the obligations, and the estimated future liability at the projected time of retirement.

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
Dollars in millions except where noted

ARO Category	Revised Asset Cost	September 30 2004 Obligation	March 31 2005 Obligation	Fair Market Value of Assets	Estimated Future Liability
Nuclear Plants	$ 451	$ 1,555	$ 1,573	$ 778	$ 10,002
Coal-Fired Plants	19	225	232	N/A	1,021
Gas/Oil Turbine Plants	1	2	2	N/A	45
Total	$ 471	$ 1,782	$ 1,807	$ 778	$ 11,068

During the first quarter of 2005, there was a change in the estimated closure date related to the Bellefonte diesel generators. The original estimate assumed asset retirement in 2029 and a six year waiting period before closure work would begin in 2035. The new estimate assumes that closure work will begin at the date the assets cease to operate in 2029. This change in estimate resulted in a decrease in the total future liability of nearly $1 million, and an increase in the current net present value of the ARO asset and liability of less than $0.1 million.

In March 2005, TVA made revisions to the amount and timing of certain cash flow estimates related to its nuclear plant AROs. The revisions in cost were based on new engineering studies performed in accordance with requirements of the Nuclear Regulatory Commission ("NRC"). The effect of the changes in estimates produced obligations that were less than the amounts originally recorded on an accreted basis. Accordingly, TVA made adjustments in the recorded amounts to properly reflect such revised balances. The adjustments resulted in an aggregate decrease of $25 million in the ARO, a $7 million reduction in the asset base, a $3 million reduction in accumulated depreciation, and a decrease of $21 million in the originally recorded regulatory asset. The result of the changes described does not impact net income for the three and six month periods ended March 31, 2005.

Energy Prepayment Obligations

During October 2002, TVA introduced the Discounted Energy Units ("DEU") program. Under this program, TVA customers may purchase DEU, generally in $1 million increments, which entitle them to a $0.025/kilowatt-hour discount on a specified quantity of firm load over a period of years (five, ten, 15, or 20) for each kilowatt-hour of electricity in the prepaid block. The remainder of the price of the kilowatt-hours of electricity delivered is due upon billing.

As of March 31, 2005, TVA had entered into sales agreements for 54.5 DEU totalling $54.5 million of which $7.25 million is for the 2004 program. Total credits applied to power billings on a cumulative basis through March 31, 2005, total nearly $12 million. Of this amount, nearly $3 million was recognized as revenue during 2005.

In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment will be applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was $1.5 billion. Total prepayment credits applied to power billings on a cumulative basis through March 31, 2005, exceed $140 million. Of this amount, $50 million was recognized as revenue during 2005. This amount was based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

TVA is reporting the March 31, 2005, and September 30, 2004, energy prepayment obligations of $1,403 million and $1,455 million, respectively, to deliver power under these programs as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the March 31, 2005 and September 30, 2004 Balance Sheets.

There have been no energy prepayment transactions during 2005.

Blended Low Enriched Uranium Program

On December 5, 2004, TVA received the first fuel assembly under the Blended Low Enriched Uranium ("BLEU") fuel program for loading into its Browns Ferry Nuclear Plant Unit 2. The unit ended its most recent refueling outage in April 2005, at which time the costs of the BLEU fuel assemblies began being amortized to nuclear fuel expense.

The BLEU fuel program is implemented, in part, through agreements with counterparties. One is an interagency agreement with the Department of Energy ("DOE") to provide raw nuclear fuel materials to be processed into usable fuel for TVA nuclear reactors, and the others are contracts with third-party nuclear fuel processors under which the nuclear fuel processors, either by themselves or through subcontractors (collectively "Third Party Fuel Processors"), acquire land, construct facilities, and process the raw materials from DOE into usable fuel for TVA nuclear reactors.

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
Dollars in millions except where noted

Under the terms of the interagency agreement, DOE agrees to supply off-specification, highly enriched uranium materials to the appropriate Third Party Fuel Processors for processing into usable fuel for TVA. In exchange, DOE will participate to a certain degree in the savings generated by TVA's use of this blended nuclear fuel product. As of March 31, 2005, TVA projects that the DOE's share of savings generated by TVA's use of this blended nuclear fuel product will result in future payments to DOE of $185 million. TVA anticipates these future payments will begin in 2010, and TVA will accrue the obligation related to these estimated future payments on a per reload basis as the BLEU fuel assemblies are loaded into TVA's nuclear fuel reactors.

The Third Party Fuel Processors own the conversion and processing facilities and will retain title to all land, property, plant, and equipment used in the BLEU fuel program. There is no provision for TVA to own or otherwise take title to the facilities, materials, or equipment now or at any time in the future.

However, in accordance with the requirements of EITF No. 01-08, "*Determining Whether an Arrangement Contains a Lease*," and SFAS No. 13, "*Accounting for Leases,*" TVA recognized a capital lease asset and corresponding lease obligation related to amounts paid or payable to a Third Party Fuel Processor. Accounting recognition of the capital lease asset and obligation was brought about due to a contract modification to the pre-existing fuel fabrication contract, which occurred during the second quarter of 2004.

During the quarter ended March 2005, TVA recorded a capital lease asset of $60 million comprised of $23 million in pre-recharacterization contract payments and $37 million in post-recharacterization contract payments either paid or payable. Also during the quarter, TVA recorded an initial capital lease obligation of $37 million which has been reduced by $16 million in post-recharacterization principal payments leaving an unpaid capital lease obligation of $21 million at the end of March 2005. Additionally, TVA has recognized asset amortization expense of $6 million and interest expense of $1 million related to the capital lease obligation during the quarter ended March 31, 2005.

Sale of Loans

On December 2, 2004, TVA sold a portfolio of 51 power distributor loans receivable. The portfolio was sold for $55 million without recourse and contained loans with maturities ranging from less than one year to over 34 years. The principal amount due on the loans at the time of the sale was $57 million. The $2 million loss is reported in OTHER INCOME, NET on the Income Statement for the six months ended March 31, 2005.

Reduction in Workforce

During 2004, organizations within TVA performed program and staffing reviews to identify surplus staffing. For the areas identified, TVA provided the opportunity for certain qualifying employees to apply for voluntary resignations beginning in February 2004. In conjunction with the voluntary reduction process, TVA also instituted an involuntary reduction in force ("RIF") for certain employees. As of March 31, 2005, there were 717 employees impacted by the combined RIF actions, including 17 during the first quarter of 2005 and ten in the second quarter of 2005. TVA has recognized total expense in the amount of $38 million for termination costs incurred through March 31, 2005, of which $1 million is for the first quarter of 2005 and $1 million is for the second quarter of 2005. Payout of benefits occurs as employees retire from TVA, and substantially all affected employees will have retired by the end of 2005.

Termination Costs Liability Activity

	Three months ended March 31		Six months ended March 31	
	2005	**2004**	**2005**	**2004**
Termination costs liability at beginning of period	$ 10	$ –	$ 14	$ –
Liabilities incurred	1	23	2	23
Actual costs paid	(3)	(3)	(8)	(3)
Termination costs liability at end of period	$ 8	$ 20	$ 8	$ 20

Project Cancellation

In December 2003, TVA was notified that RTL would not proceed with manufacturing of the fuel cells to be installed in the partially completed Regenesys energy storage plant in Columbus, Mississippi. TVA had invested approximately $35 million in the Regenesys project and, accordingly, recognized a $35 million loss during the first quarter of 2004. Subsequently, RTL reimbursed TVA for early termination on the contract in the amount of $15 million in April 2004 resulting in a net project loss of $20 million for 2004.

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
Dollars in millions except where noted

Other
Certain reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation.

Impact of New Accounting Pronouncements and Interpretations
Variable Interest Entities. In January 2003, the Financial Accounting Standards Board ("FASB") published FASB Interpretation No. 46 ("FIN 46"), "*Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*," which was later revised by FIN No. 46(R) ("FIN 46R") in December 2003. The interpretation explains how to identify a variable interest entity ("VIE") and how an enterprise assesses its interests in a VIE to decide whether to consolidate that entity. It also clarifies the application of Accounting Research Bulletin ("ARB") No. 51, "*Consolidated Financial Statements*," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The interpretation applies to nonpublic enterprises, and it becomes effective for TVA beginning October 1, 2005, for VIEs created on or before December 31, 2003, and immediately for VIEs created after December 31, 2003.

TVA has not identified any material VIEs created, or interests in VIEs obtained, after December 31, 2003, which require consolidation or disclosure under FIN 46R. TVA continues to assess the existence of any interests in VIEs created on or prior to December 31, 2003, which may or may not be material to its results of operations or financial position.

In March 2005, the FASB released FASB Staff Position ("FSP") FIN 46(R)-5, "*Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities*," which is applicable to both nonpublic and public reporting enterprises. This FSP addresses transactions in which a reporting enterprise has an interest in, or other involvement with, a VIE or potential VIE that is not considered a variable interest, and the reporting enterprise's related party (a non-VIE) has a variable interest in the same entity. This FSP must be applied in accordance with the FIN 46R effective date and transition. At this time, TVA is in the process of evaluating the requirements of this interpretation and does not yet know the impact of its implementation, which may or may not be material to TVA's results of operations or financial position.

Pension and Other Postretirement Benefit Disclosures. In December 2003, the FASB issued SFAS No. 132 (revised), "*Employers' Disclosures about Pensions and Other Postretirement Benefits*," which improves financial statement disclosures for defined benefit plans and replaces existing FASB disclosure requirements for pensions. The guidance is effective for fiscal years ending after December 15, 2003, and for quarters beginning after December 15, 2003. TVA adopted this standard for the quarter beginning January 1, 2004, by making the required disclosures (see note 5).

Medicare Prescription Drug, Improvement and Modernization Act of 2003. In May 2004, the FASB issued FSP Financial Accounting Standard ("FAS") 106-2, "*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*." This FSP provides accounting guidance for employers that sponsor defined benefit postretirement health care plans that provide prescription drug benefits, and requires those employers to provide certain disclosures regarding the effect of the federal subsidy provided by this act. TVA has elected to continue its study of the particulars contained in the accounting guidance and, accordingly, has not determined either the existence of a subsidy or an estimate of the value of any such subsidy at this time. TVA adopted the disclosure requirements for nonpublic entities of the FSP for interim reporting periods beginning after January 1, 2004, and subsequently transitioned to the disclosure requirements for public entities for the reporting periods ended September 30, 2004, and thereafter. It is likely that during 2005, TVA will not only make a determination of the propriety and amount of any such subsidy but also the manner in which it will account for such a subsidy, should it exist.

Inventory Costs. In November 2004, the FASB issued SFAS No. 151, "*Inventory Costs—an amendment of ARB No. 43, Chapter 4.*" This statement amends the guidance in ARB No. 43, Chapter 4, "*Inventory Pricing*," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The statement requires that those items be recognized as current-period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This statement will become effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted. The adoption of SFAS No. 151 is not expected to have a material impact on TVA's results of operations or financial condition.

Exchanges of Nonmonetary Assets. In December 2004, the FASB published SFAS No. 153, "*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*," which eliminates the exception to fair value for

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
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exchanges of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance—that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. This statement is intended to produce financial reporting that more faithfully represents the economics of the transactions. This guidance is effective for fiscal periods beginning after June 15, 2005, and will be applied prospectively. The adoption of SFAS No. 153 is not expected to have a material impact on TVA's results of operations or financial condition.

Conditional Asset Retirement Obligations. In March 2005, the FASB issued FIN No. 47, "*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*." This interpretation clarifies that the term conditional asset retirement obligation ("conditional ARO") as used in SFAS No. 143, "*Accounting for Asset Retirement Obligations*," refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional ARO if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional ARO should be recognized when incurred. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an ARO. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. TVA is evaluating the potential implications of this interpretation on its AROs, which may or may not be material to its financial position or results of operations.

2. Proprietary Capital

Accumulated Other Comprehensive Income

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 non-owner sources. The gains (losses) for the three months and six months ended March 31, 2005, and 2004, are due to unrealized gains (losses) related to mark-to-market valuation adjustments for certain derivative instruments that qualify for cash flow hedge accounting treatment.

Total Other Comprehensive Income (Loss) Activity

	Three months ended March 31		Six months ended March 31	
	2005	**2004**	**2005**	**2004**
Accumulated other comprehensive income (loss) at beginning of period	$ 14	$ (59)	$ (52)	$ (74)
Changes in fair value of interest rate swaps	26	(12)	91	4
Changes in fair value of foreign currency swaps	4	7	5	6
Changes in fair value of emission allowance call options	–	1	–	1
Accumulated other comprehensive income (loss) at end of period	$ 44	$ (63)	$ 44	$ (63)

3. 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 adopted on October 6, 1960, as amended on September 28, 1976, October 17, 1989, and March 25, 1992. Power Bonds in each series must be further authorized by supplemental resolution.

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Dollars in millions except where noted

The table below summarizes TVA's debt securities activity for the period from October 1, 2004, to March 31, 2005.

Activity from October 1, 2004 to March 31, 2005

Redemptions/Maturities:	Date	Amount	Interest Rate
electronotes®	First Quarter 2005	$ 3	3.50% to 6.50%
electronotes®	Second Quarter 2005	75	3.20% to 6.13%
2000E QUINTS	March 18, 2005	100	7.75%
Issues:			
electronotes®	Second Quarter 2005	$ 25	5.00%

In March 2005, TVA provided notice that on April 15, 2005, it would redeem at par all of its 2001 6.50 percent electronotes® due April 15, 2021, with a par amount of $63 million, and all of its 2002 6.25 percent electronotes® due April 15, 2017, with a par amount of $34 million (see note 9).

4. Risk Management Activities and Derivative Transactions

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

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

Mark-to-Market Values of Derivative Transactions

	Asset (Liability)	
	At March 31 2005	**At September 30 2004**
Interest rate swaps:		
Inflation bond issue	$ 9	$ 2
$476 million notional	(134)	(140)
Currency swaps:		
Deutschemark (DM1.5 billion)	36	(62)
Sterling (GBP200 million)	42	13
Sterling (GBP250 million)	114	79
Sterling (GBP150 million)	48	32
Swaption:		
$1 billion notional	(256)	(225)
Emission allowance call options	–	6
Coal contracts	753	478
Purchase power contracts	(61)	(59)

5. Benefit Plans

TVA sponsors a noncontributory defined benefit pension plan for substantially all of its employees. In addition, TVA sponsors a substantially contributory postretirement plan for health care and other benefits for retirees of TVA that meet certain eligibility requirements and who elect participation at the time of retirement.

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The following table provides the components of net periodic benefit cost for the plans:

	Pension Benefits for the Three Months Ended March 31		Other Benefits for the Three Months Ended March 31		Pension Benefits for the Six Months Ended March 31		Other Benefits for the Six Months Ended March 31	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**	**2005**	**2004**
Service Cost	$ 31	$ 28	$ 1	$ 2	$ 62	$ 56	$ 3	$ 3
Interest Cost	110	101	7	4	219	203	13	9
Expected return on plan assets	(115)	(116)	–	–	(229)	(232)	–	–
Amortization of prior service costs	9	9	2	2	18	18	3	3
Amortization of losses	32	22	3	–	65	44	5	–
Cost of special events	–	–	–	1	–	–	–	3
Net periodic benefit	$ 67	$ 44	$ 13	$ 9	$ 135	$ 89	$ 24	$ 18

TVA's Board approved $53 million in pension contributions for 2005. During the six months ended March 31, 2005, TVA has made approximately $27 million in contributions and plans to contribute another $26 million by the end of the year. TVA does not separately set aside assets to fund other benefit costs, but rather funds such costs on an as-paid basis. TVA provided approximately $9 million during the six months ended March 31, 2005, to fund other benefits cost.

6. Commitments and Contingencies

The estimated future commitments for TVA as of March 31, 2005, are as follows:

	2005*	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Debt	$ 4,028	$ 2,621	$ 961	$ 91	$ 2,031	$ 13,471	$ 23,203
Leases	40	79	75	67	64	103	428
Lease/leasebacks	36	84	85	89	84	1,300	1,678
Power purchase obligations	86	166	156	130	135	3,595	4,268
Other obligations	376	406	200	163	53	63	1,261
Fuel purchase obligations	520	465	241	237	181	643	2,287
Pension contribution	26	–	–	–	–	–	26
Total	$ 5,112	$ 3,821	$ 1,718	$ 777	$ 2,548	$ 19,175	$ 33,151

* Period April 1 – September 30, 2005

During the quarter ended March 2005, TVA recorded a capital lease asset of $60 million comprised of $23 million in pre-recharacterization contract payments and $37 million in post-recharacterization contract payments either paid or payable. Also during the quarter, TVA recorded an initial capital lease obligation of $37 million which has been reduced by $16 million in post-recharacterization principal payments leaving an unpaid capital lease obligation of $21 million at the end of March 2005. See note 1–*Blended Low Enriched Uranium Program*.

In addition to the cash requirements above, TVA has contractual obligations related to energy prepayments (see note 1—*Energy Prepayment Obligations*).

	2005*	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Energy prepayment obligations	$ 53	$ 106	$ 106	$ 106	$ 105	$ 927	$ 1,403

* Period April 1 – September 30, 2005

7. Legal Proceedings

The National Parks Conservation Association ("NPCA") and the Sierra Club filed cases in two federal district courts in 2001 alleging that TVA modified its Bull Run Fossil Plant ("Bull Run") and Colbert Fossil Plant Unit 5 ("Colbert Unit 5")

NOTES TO FINANCIAL STATEMENTS (unaudited) Continued
Dollars in millions except where noted

without complying with the new source review ("NSR") requirements of the Clean Air Act ("CAA"). In March 2005, the district court granted TVA's motion to dismiss the lawsuit in the Bull Run case, and the plaintiffs have moved for reconsideration of the decision. In the Colbert Unit 5 case, a final pretrial scheduling conference is set for November 30, 2005, and the liability trial would likely begin four to eight weeks thereafter. In similar lawsuits filed by EPA and others against other utility companies, the rulings by the respective courts differ widely.

The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert Fossil Plant between July 1, 1997, and June 30, 2002. The groups sought a court order that could require TVA to incur substantial costs, in addition to the costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately $250 million. On September 14, 2004, the court found that TVA had not violated the CAA, and the complaint was dismissed in its entirety. The plaintiffs have appealed the district court's decision to the Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit"), which has set oral argument for the week of August 15, 2005.

On July 25, 2003, TVA received a notice of intent to sue from Our Children's Earth Foundation ("OCE"). OCE contends that TVA violated the NSR requirements of the CAA by undertaking major modifications of TVA's Allen Unit 3, Bull Run, Cumberland Units 1 and 2, Kingston Units 6 and 8, John Sevier Unit 3, Paradise Units 1, 2, and 3, Shawnee Units 1 and 4, Colbert Unit 5, and Widows Creek Unit 5 without installing additional pollution control equipment. OCE also contends the CAA new source performance standards at Colbert Unit 5 and the operations at TVA's Johnsonville Fossil Plant have not met the applicable opacity requirements. This notice does not specify a monetary amount of TVA's claimed liability. OCE's allegations about Bull Run and Colbert Unit 5 are already the subject of litigation in federal district courts initiated by the NPCA and the Sierra Club. In 2004, OCE obtained the district court's permission to join as a plaintiff in the Bull Run NSR suit. It made a similar request in the Colbert Unit 5 NSR suit which the court denied as untimely.

The Sierra Club gave notice in a September 26, 2002, letter that it intends to sue TVA for violating CAA 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 four years ago in federal court in Knoxville, Tennessee. TVA ultimately prevailed in that lawsuit. The Sierra Club has not yet filed suit.

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. The lawsuit sought, among other things, compensatory damages in excess of $45 million, plus interest. TVA and Bowater settled the lawsuit by entering into revised and extended power supply arrangements at the two plants. The settlement agreement does not require TVA to pay Bowater for the damages sought. On March 8, 2005, the court dismissed this case with prejudice.

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in federal court in Alabama alleging that TVA overcharged for ESP during the summer of 1998. The lawsuit was filed as a class action on behalf of industrial customers who participated 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 some costs that were added to TVA's incremental cost. The complaint seeks over $100 million in damages on behalf of Birmingham Steel and the other class members. In September 2002, the district court decertified the class and then dismissed Birmingham Steel's individual claim without prejudice on a jurisdictional issue. The class lawyers appealed the ruling on class decertification, and in December 2003, the Eleventh Circuit reversed that ruling and sent the case back to the district court to allow the class lawyers a reasonable time to find a new class representative. The district court allowed the substitution of Johns Manville Corporation to represent the class.

In July 2004, two lawsuits were filed against TVA in federal court in New York City alleging that global warming is a public nuisance and that carbon dioxide ("CO_2") emissions from TVA's fossil-fired electric generating facilities should be ordered abated because they contribute to causing the nuisance. The first case was filed by the States of California, Connecticut, Iowa, New Jersey, New York, Rhode Island, Vermont, and Wisconsin and the City of New York against TVA, American Electric Power, Inc., American Electric Power Service Corporation, Southern Company, Xcel Energy, Inc., and Cinergy Corporation. The second case, which also alleges private nuisance, was filed against the same defendants by Open Space Institute, Inc., Open Space Conservancy, Inc., and the Audubon Society of New Hampshire. There are no CAA requirements limiting CO_2 emissions, and, accordingly, the suits do not involve allega-

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tions of regulatory noncompliance. The theory of the cases is that global warming constitutes a nuisance and defendants' CO_2 emissions are contributing to the nuisance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO_2 emissions and then reduce these emissions by a specified percentage each year for at least a decade. The defendants filed motions to dismiss, and briefing on the motions has been completed. TVA is awaiting decisions on the pending motions.

On November 10, 2004, North Carolina sent the EPA a Notice of Intent to Sue TVA for violations of the CAA (the "Notice"), which allows North Carolina to file a lawsuit in federal court 60 days after November 15, the date TVA received the Notice. North Carolina alleges that TVA violated the NSR requirements of the CAA (among other state and federal regulations) by modifying nine fossil plants located in Alabama, Kentucky, and Tennessee, without having these modifications reviewed by the EPA or the states to determine if new emission controls or technologies needed to be put in place. North Carolina asserts that these actions have contributed to the degradation of air quality in North Carolina. Although the 60-day period has expired, North Carolina has not yet filed suit.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of some of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory period. As to the plaintiffs' allegations of federal law violations, the court found that Congress had specifically authorized TVA to set the rates charged by distributors via its contracts. In the face of such express Congressional authorization, the plaintiffs' federal law claims failed as a matter of law and were dismissed with prejudice, precluding them from being brought again. The plaintiffs have moved for reconsideration of the dismissal, and the court has not ruled on that motion.

8. Stewardship Responsibilities

During the first six months of 2005, 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 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 approximately $36 million and $46 million on essential stewardship activities during each of the first six months of 2005 and 2004, respectively, and recognized depreciation expense on nonpower assets of $5 million in each six month period.

9. Subsequent Events

Debt Securities
On April 15, 2005, TVA redeemed at par all of its 2001 6.50 percent electronotes® due April 15, 2021, with a par amount of $63 million, and all of its 2002 6.25 percent electronotes® due April 15, 2017, with a par amount of $34 million.

In April 2005, TVA issued $50 million of electronotes® with an interest rate of 5.00 percent which mature in 2015.

In April 2005, TVA monetized the call provisions on two electronotes® issues ($42 million total par value) by entering into swaption agreements with a third party in exchange for $5 million. The swaptions will be recorded in Other Liabilities and will be marked to market, with changes in the market value recognized currently in earnings. See note 6 in the 2004 Information Statement.

TVA determined on May 4, 2005, that the interest rate on the TVA 1998 Series D Putable Automatic Rate Reset Securities ("PARRS") will be reset from 5.95 percent to 5.49 percent on June 1, 2005. The bonds will begin to accrue interest at the new rate on June 1, 2005. The rate may be reset again under certain circumstances on June 1, 2006,

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and annually thereafter, until maturity. In conjunction with the pending reset, approximately $86 million of the $552 million of 1998 Series D PARRS outstanding were submitted for redemption by bondholders. The bonds mature on June 1, 2028.

In May 2005, TVA issued $14 million of electronotes® with an interest rate of 5.13 percent which mature in 2025.

Sale of Building
TVA and the party with the option to purchase the East Tower of the Knoxville Office Complex agreed to extend the option period for 60 days so that the option now expires July 23, 2005.

Revolving Credit Facility Agreement
On May 26, 2005, TVA and a national bank entered into a revolving credit facility agreement with an initial term of 180 days. The facility provides TVA with an unsecured revolving line of credit of up to $2.5 billion.

Transmission System
On October 1, 2004, East Kentucky Power Cooperative ("EKPC") filed an application with the Federal Energy Regulatory Commission ("FERC") ostensibly seeking an order requiring EKPC to be interconnected with TVA's transmission system. If this interconnection is granted, EKPC would be able to use TVA's transmission system to provide power to Warren Rural Electric Cooperative Corporation ("WRECC") when WRECC's contract with TVA terminates in April 2008. TVA submitted a response to FERC stating that if FERC grants the requested relief, the actual effect would be to require TVA to provide free transmission service across TVA's transmission system in violation of the Anti-Cherrypicking Provision of the Federal Power Act. On April 13, 2005, FERC issued a proposed order granting EKPC's application. A settlement judge will be appointed who will attempt to facilitate the negotiation of the terms and conditions under which the interconnection would be granted. The proposed order is not a final order and therefore is not appealable at this time. After the settlement process, with recommendations from the settlement judge, FERC will issue a final order. After the order becomes final, TVA can request rehearing and ultimately appeal to the Court of Appeals.

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

Dollars in million except where noted

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 2004 Information Statement.

Overview

Although the transition to a deregulated market has slowed, TVA continues to prepare for potential changes in the market that could affect TVA, its stakeholders, and the way TVA fulfills its obligations. TVA's financial health in the future will depend on what changes may come and how well it is able to adapt to those changes. TVA continues to evaluate and focus on four strategic areas outlined in the Strategic Plan adopted in 2004:

- Developing new, more highly differentiated prices, services, and contract terms that more closely tie the cost and the risk of the product to its terms and pricing;
- Addressing the range of issues related to wholesale market design and transmission pricing, including how TVA will interface with the markets that are expected to surround it, as well as how TVA will price transmission services within its service area when distributors can choose other suppliers;
- Retiring total financing obligations and driving to higher interest-coverage ratios in order to provide the financial flexibility needed to tolerate the higher levels of revenue and cost volatility associated with a more competitive market; and
- Maintaining and operating its generation and transmission assets so that it can continue to fulfill its supply obligations in a safe and reliable manner.

For a more in-depth discussion of TVA's business strategy and economic factors, see "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" in TVA's 2004 Information Statement.

Results of Operations

Net loss for the second quarter of 2005 was $24 million compared to net income of $118 million for the same period of 2004. Significant items contributing to the $142 million change in net income for the three months ended March 31, 2005, as compared to March 31, 2004, include:

- A $49 million decrease in revenues from municipalities and cooperatives due to lower average rates related to a shift in product and customer mix, lower rates for variable priced products, and milder weather;
- A $14 million decrease in other revenue due to a reduction in nonutility services and wheeling activity;
- A $46 million increase in fuel expense attributable primarily to higher coal prices;
- A $34 million increase in purchased power expense due to increased economy power purchases and higher market prices for off-system power;
- An $18 million charge to operating and maintenance expense ("O&M") for the year-to-date accrual for expected performance awards; and
- A $26 million increase in pension expense (a component of O&M) due primarily to increased interest cost coupled with increased amortization of actuarial loss.

These items were partially offset by:

- A $21 million increase in revenues from directly served industries due in large part to increased power demand reflecting favorable economic conditions; and
- A $11 million decrease in net interest expense, due in large part to a lower average outstanding balance of long-term debt.

Net income through the first two quarters of 2005 was $66 million compared to $186 million for the same period of 2004. Significant items contributing to the $120 million decrease in net income for the six months ended March 31, 2005, as compared to March 31, 2004, include:

- A $45 million decrease in revenues from municipalities and cooperatives due to lower average rates related to a shift in product and customer mix, lower rates for variable priced products, and milder weather;

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
Dollars in millions except where noted

- An $87 million increase in fuel expense due to a two percent increase in production (primarily in the first quarter of 2005) coupled with higher coal prices;
- A $40 million increase in purchased power expense primarily related to increased economy power purchases and higher market prices for off-system power;
- A $48 million increase in pension expense due primarily to increased interest cost coupled with increased amortization of actuarial loss;
- An $18 million charge to O&M for the year-to-date accrual for expected performance awards;
- A $17 million increase in depreciation expense attributable to capital projects placed in service; and
- A $6 million increase in amortization expense related to the amortization of the capital lease recognized for the Blended Low Enriched Uranium Program (see note—*Blended Low Enriched Uranium Program*).

These items were partially offset by:

- A $38 million increase in sales to federal agencies and other primarily due to greater off-system sales as a result of increased generation available for sale (primarily in the first quarter of 2005) and favorable market conditions;
- A $38 million increase in revenues from directly served industries due in large part to increased power demand reflecting favorable economic conditions;
- A one-time loss of $35 million recognized in the first quarter of 2004 due to the cancellation of the Regenesys project (see note 1—*Project Cancellation*); and
- A $26 million decrease in net interest expense due primarily to a lower average outstanding balance of long-term debt.

<u>Operating Revenues</u>
A detailed table of operating revenue for the three and six month periods ended March 31, 2005, and 2004 is as follows:

	Three months ended March 31			Six months ended March 31		
	2005	**2004**	**Percent Change**	**2005**	**2004**	**Percent Change**
Operating revenues						
Sales of electricity						
Municipalities and cooperatives	$ 1,561	$ 1,610	(3.0%)	$ 3,086	$ 3,131	(1.4%)
Industries directly served	236	215	9.8%	451	413	9.2%
Federal agencies and other	32	30	6.7%	105	67	56.7%
Other revenue	10	24	(58.3%)	31	45	(31.1%)
Total operating revenues	$ 1,839	$ 1,879	(2.1%)	$ 3,673	$ 3,656	0.5%

Significant items contributing to the $40 million decrease in operating revenues for the three months ended March 31, 2005, as compared to March 31, 2004, include:

- A $49 million decrease in revenues from municipalities and cooperatives due to lower average rates related to a shift in product and customer mix, lower rates for variable priced products, and milder weather; and
- A $14 million decrease in other revenue due to a reduction in nonutility services and wheeling activity.

These items were partially offset by a $21 million increase in sales to industries directly served primarily due to increased power demand reflecting favorable economic conditions.

Significant items contributing to the $17 million increase in operating revenues for the six months ended March 31, 2005, as compared to March 31, 2004, include:

- A $36 million increase in off-system sales due to increased generation available for sale (primarily in the first quarter of 2005) and favorable market conditions; and

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
Dollars in millions except where noted

- A $38 million increase in sales to industries directly served, primarily due to increased power demand reflecting favorable economic conditions.

These items were partially offset by:

- A $45 million decrease in revenues from municipalities and cooperatives due to lower average rates related to a shift in product and customer mix, lower rates for variable priced products, and milder weather; and
- A $14 million decrease in other revenue due to a reduction in nonutility services and wheeling activity.

A detailed table of electricity sales for the three and six month periods ended March 31, 2005, and 2004 is as follows:

	Three months ended March 31			Six months ended March 31		
	2005	2004	Percent Change	2005	2004	Percent Change
	(millions of kWh)			(millions of kWh)		
Sales of electricity						
Municipalities and cooperatives	32,651	33,205	(1.7%)	64,136	63,992	0.2%
Industries directly served	8,373	7,969	5.1%	16,615	15,656	6.1%
Federal agencies and other	661	716	(7.7%)	2,466	1,698	45.2%
Total sales	41,685	41,890	(0.5%)	83,217	81,346	2.3%

Significant items contributing to the 205 million kilowatt-hour decrease in electricity sales for the three months ended March 31, 2005, as compared to March 31, 2004, include:

- A 554 million kilowatt-hour, or two percent, decrease in sales to municipalities and cooperatives reflecting milder weather; offset by
- A 404 million kilowatt-hour, or five percent, increase in sales to industries directly served due in large part to increased power demand reflecting favorable economic conditions.

Significant items contributing to the 1,871 million kilowatt-hour increase in electricity sales for the six months ended March 31, 2005, as compared to March 31, 2004, include:

- A 744 million kilowatt-hour, or 80 percent, increase in off-system electricity sales due to increased generation available for sale (primarily in the first quarter of 2005) and favorable market conditions; and
- A 959 million kilowatt-hour, or six percent, increase in sales to industries directly served due in large part to increased power demand reflecting favorable economic conditions.

Operating Expenses

A detailed table of operating expenses for the three and six month periods ended March 31, 2005, and 2004 is as follows:

	Three months ended March 31			Six months ended March 31		
	2005	2004	Percent Change	2005	2004	Percent Change
Operating expenses						
Fuel and purchased power	$ 598	$ 518	15.4%	$ 1,075	$ 948	13.4%
Operating and maintenance	584	570	2.5%	1,166	1,128	3.4%
Depreciation, amortization, and accretion	290	277	4.7%	575	552	4.2%
Tax-equivalents	90	84	7.1%	181	168	7.7%
Loss on project cancellation	–	–		–	35	(100.0%)
Total operating expenses	$ 1,562	$ 1,449	7.8%	$ 2,997	$ 2,831	5.9%

Significant items contributing to the $113 million increase in total operating expenses for the three months ended March 31, 2005, as compared to March 31, 2004, include:

- A $46 million increase in fuel expense attributable primarily to higher coal prices;
- A $34 million increase in purchased power expense which can be attributed to increased economy power purchases and higher market prices for off-system power;
- A $26 million increase in pension expense due primarily to increased interest cost coupled with an increased amortization of actuarial loss;
- An $18 million charge to O&M for the year-to-date accrual for expected performance awards;
- A $7 million increase in depreciation expense attributable to capital projects placed in service; and
- A $6 million increase in amortization expense related to the amortization of the capital lease recognized for the Blended Low Enriched Uranium Program (see note—*Blended Low Enriched Uranium Program*).

These items were partially offset by a $21 million reduction in severance expense due to recognition of termination benefits.

Significant items contributing to the $166 million increase in total operating expenses for the six months ended March 31, 2005, as compared to March 31, 2004, include:

- An $87 million increase in fuel expense attributable to higher coal prices and increased generation at coal fired plants (primarily in the first quarter of 2005);
- A $40 million increase in purchased power expense which can be attributable primarily to higher market prices for off-system power;
- A $48 million increase in pension expense due primarily to increased interest cost coupled with increased amortization of actuarial loss;
- An $18 million charge to O&M for the year-to-date accrual for expected performance awards;
- A $17 million increase in depreciation expense attributable to capital projects placed in service; and
- A $6 million increase in amortization expense related to the amortization of the capital lease recognized for the Blended Low Enriched Uranium Program (see note—*Blended Low Enriched Uranium Program*).

These items were partially offset by a one-time loss of $35 million recognized in the first quarter of 2004 due to the cancellation of the Regenesys project (see note 1—*Project Cancellation*).

Other Income, Net
Net other income was $2 million lower for the three months ended March 31, 2005, as compared to the same period in 2004 due to a decrease in non-electric business activity.

Items contributing to the $4 million decrease in net other income for the six months ended March 31, 2005, as compared to March 31, 2004, include a $2 million loss on the sale of distributor loan program receivables (see note 1—*Sale of Loans*) and a decrease in non-electric business activity.

Unrealized Gain on Derivative Contracts, Net
Significant items contributing to the $8 million unrealized net gain on derivative contracts for the three months ended March 31, 2005, include a $30 million unrealized gain related to the mark-to-market valuation adjustment of an embedded call option contract, partially offset by a $19 million loss recognized on the mark-to-market valuation of a swaption contract.

Significant items contributing to the $12 million unrealized net gain on derivative contracts for the six months ended March 31, 2005, include:

- A $5 million unrealized net gain related to the mark-to-market valuation adjustment of an interest rate swap contract; and
- A $43 million unrealized net gain related to the mark-to-market valuation adjustment of an embedded call option contract.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
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These gains were partially offset by:

- A $6 million unrealized net loss related to the mark-to-market valuation of SO_2 emissions allowance call options; and
- A $31 million unrealized net loss related to the mark-to-market valuation of a swaption contract.

Interest Expense

A detailed table of interest expense for the three and six month periods ended March 31, 2005, and 2004 is as follows:

	Three months ended March 31			Six months ended March 31		
	2005	2004	Percent Change	2005	2004	Percent Change
Interest expense						
Interest on debt	$ 338	$ 345	(2.0%)	$ 677	$ 693	(2.3%)
Amortization of debt discount, issue, and reacquisition costs, net	5	6	(16.7%)	10	13	(23.1%)
Allowance for funds used during construction	(28)	(25)	12.0%	(54)	(47)	14.9%
Net interest expense	$ 315	$ 326	(3.4%)	$ 633	$ 659	(3.9%)

Significant items contributing to the $11 million decrease in interest expense for the three months ended March 31, 2005, as compared to March 31, 2004, include:

- A reduction of approximately $1,516 million in the average balance of long-term debt outstanding; and
- A $3 million increase in Allowance for Funds Used During Construction ("AFUDC") due to a higher level of construction work-in-progress in 2005.

These items were partially offset by:

- An increase in the average long-term interest rate on TVA's outstanding long-term debt from 6.15 percent to 6.30 percent; and
- An increase of approximately $948 million in the average balance of short-term debt outstanding coupled with an increase in average short-term interest rates from 0.96 percent to 2.37 percent.

Significant items contributing to the $26 million decrease in interest expense for the six months ended March 31, 2005, as compared to March 31, 2004, include:

- A reduction of approximately $1,676 million in the average balance of long-term debt outstanding; and
- A $7 million increase in AFUDC due to a higher level of construction work-in-progress in 2005.

These items were partially offset by:

- An increase in the average long-term interest rate on TVA's outstanding long-term debt from 6.13 percent to 6.31 percent; and
- An increase of approximately $628 million in the average balance of short-term debt outstanding coupled with an increase in average short-term interest rates from 0.99 percent to 2.14 percent.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
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Material Changes in Liquidity and Capital Resources

Comparative Cash Flow Analysis
Net cash provided by operating activities increased $257 million, from $697 million to $954 million for the three month periods ending March 31, 2004, and 2005, respectively. The increase is due to a $345 million increase in cash provided by working capital components, which is discussed below, and:

- A decline in cash outlays for interest of $7 million, primarily due to a reduction in the average balance of long-term debt outstanding; and
- A decrease in cash outlays for O&M of $49 million due to the reduction in workforce, decreased cash outlays for O&M base costs, and decreased cash outlays for O&M outage costs; offset by
- An increase of $15 million in expenditures for nuclear refueling outages due to the number and timing of outages; and
- An increase in cash paid for fuel and purchased power of $79 million due to higher coal prices, increased economy power purchases, and higher market prices for purchased power.

Cash provided by working capital components increased $345 million for the three month period ending March 31, 2005, as compared to the same period of the prior year. This increase resulted from:

- A larger liquidation of short-term investments which generated cash of $215 million;
- A larger decrease in accounts receivable of $32 million resulting from lower operating revenues; and
- A larger increase in accounts payable and accrued liabilities of $100 million due primarily to a counterparty that posted collateral with TVA under the provisions of a swap agreement. The balance of collateral held by TVA at March 31, 2005, was $124 million and was recorded in accounts payable. The larger increase in accounts payable and accrued liabilities is also due to the $18 million accrual made for expected performance awards. These factors were offset by a $22 million reduction in termination benefits and certain payments for rebate accruals of $15 million; offset by
- A smaller increase in accrued interest of $5 million due to a lower level of long-term debt outstanding.

Net cash provided by operating activities decreased $1,375 million, from $2,332 million to $957 million for the six month periods ending March 31, 2004, and 2005, respectively. This decrease resulted from:

- Proceeds of $1.5 billion received in 2004 for energy prepayments not present in the current year; and
- An increase in cash paid for fuel and purchased power of $124 million due to higher coal prices and higher market prices for purchased power.

These items were partially offset by an increase in cash provided by working capital components, which is discussed below, as well as:

- A decline in cash outlays for interest of $16 million, primarily due to a reduction in the average balance of long-term debt outstanding;
- A decrease of $10 million in expenditures for nuclear refueling outages due to the number and timing of outages; and
- A decrease in cash outlays for O&M costs of $76 million due to the reduction in workforce, decreased cash outlays for O&M base costs, and decreased cash outlays for O&M outage costs.

Cash provided by working capital components increased $173 million, from $73 million for the six month periods ending March 31, 2004, to $246 million in the current year. This increase resulted from:

- A larger liquidation of short-term investments which generated cash of $101 million; and
- A smaller decrease in accounts payable and accrued liabilities of $79 million due primarily to a counterparty that posted collateral with TVA under the provisions of a swap agreement. The balance of collateral held by TVA at March 31, 2005, was $124 million, and was recorded in accounts payable. The smaller decrease in accounts payable and accrued liabilities is also due to the accrual of $18 million for expected performance

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
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awards. These factors were offset by a $21 million reduction in termination benefits, certain payments for rebate accruals of $18 million, and accruals made in 2004 and paid in 2005; offset by

- A smaller increase in accrued interest of $18 million due to a lower level of long-term debt outstanding; and
- A larger increase in inventories and other assets of $23 million primarily due to the purchase of emission allowances and an increase in certain contract prepayments related to the Browns Ferry Unit 1 restart project.

Cash used in investing activities decreased $142 million, from $440 million to $298 million for the three month periods ending March 31, 2004, and 2005, respectively, primarily due to:

- A decrease in expenditures for capital projects of $122 million, primarily due to decreases in clean air expenditures, and decreased fossil, hydro, and transmission expenditures; and
- A decrease in the fabrication of nuclear fuel of $18 million. For the three month periods ending March 31, 2005, two nuclear plants had scheduled refueling outages in comparison with the prior year that had one plant down for refueling.

Cash used in investing activities decreased $182 million, from $811 million to $629 million for the six month periods ending March 31, 2004, and 2005, respectively, primarily due to:

- A decrease in expenditures for capital projects of $181 million, primarily due to decreases in clean air expenditures offset by increases in expenditures for the Browns Ferry Unit 1 restart; and
- Proceeds received from the sale of certain power distributor loans receivable of $55 million (see note 1); offset by:
- An increase in the fabrication of nuclear fuel of $65 million in preparation for the upcoming reloads during 2005. For the six-month period ending March 31, 2004, two nuclear plants completed refueling outages. In 2005, preparation for three refueling outages is scheduled.

Net cash used in financing activities increased $138 million, from $3 million to $141 million for the three months ended March 31, 2004, and 2005, respectively. The change is related primarily to:

- An increase of $94 million in redemptions of long-term debt;
- A decrease of $640 million in long-term debt issues; and
- Bond reopening proceeds of $97 million in the prior year; offset by
- Net short-term debt issues of $39 million for the three months ended March 31, 2005, compared to net short-term debt redemptions of $626 million in the prior year.

Net cash used in financing activities decreased $1,433 million, from $1,523 million to $90 million for the six months ended March 31, 2004, and 2005, respectively. The change is related primarily to:

- A decrease of $318 million in redemptions of long-term debt; and
- Net short-term debt issues of $104 million for the six months ended March 31, 2005, compared to net short-term debt redemptions of $1,810 million in the prior year due primarily to $1,500 million in proceeds received from energy prepayments in the first quarter of 2004; offset by:
- A decrease of $733 million in long-term debt issues; and
- Bond reopening proceeds of $97 million in the prior year.

Working Capital

At March 31, 2005, TVA had negative working capital of $3,270 million, largely attributable to current maturities of long-term debt of $2,000 million and short-term indebtedness of $2,028 million. 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 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.

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	March 31 2005	September 30 2004
Current assets	$ 2,335	$ 2,386
Current liabilities	(5,605)	(5,511)
Working capital	$ (3,270)	$ (3,125)
Discount notes <90 days	$ 2,028	$ 1,924
Current maturities of long-term debt	2,000	2,000
Total short-term debt	$ 4,028	$ 3,924

Financing Activities

Capital Resources. From October 1, 2004, to March 31, 2005, TVA redeemed at par $78 million of electronotes® carrying an average interest rate of 6.01 percent and redeemed at par the 2000E QUINTS with $100 million par amount and an interest rate of 7.75 percent. TVA issued $25 million of electronotes® with an interest rate of 5.00 percent during this period.

On April 15, 2005, TVA redeemed at par all of its 2001 6.50 percent electronotes® due April 15, 2021, with a par amount of $63 million, and also redeemed at par all of its 2002 6.25 percent electronotes® due April 15, 2017, with a par amount of $34 million.

In April 2005, TVA monetized the call provisions of two electronotes® issues ($42 million total par value) by entering into swaption agreements with a third party in exchange for $5 million. The swaptions will be recorded in Other Liabilities on the balance sheet and will be marked to market, with changes in the market value recognized currently in earnings. See note 6 in the 2004 Information Statement.

In April 2005, TVA issued $50 million of electronotes® with an interest rate of 5.00 percent which mature in 2015.

TVA determined on May 4, 2005, that the interest rate on the TVA 1998 Series D Putable Automatic Rate Reset Securities ("PARRS") will be reset from 5.95 percent to 5.49 percent on June 1, 2005. The bonds will begin to accrue interest at the new rate on June 1, 2005. The rate may be reset again under certain circumstances on June 1, 2006, and annually thereafter, until maturity. In conjunction with the pending reset, approximately $86 million of the $552 million of 1998 Series D PARRS outstanding were submitted for redemption by bondholders. The bonds mature on June 1, 2028.

In May 2005, TVA issued $14 million of electronotes® with an interest rate of 5.13 percent which mature in 2025.

On May 26, 2005, TVA and a national bank entered into a revolving credit facility agreement with an initial term of 180 days. The facility provides TVA with an unsecured revolving line of credit of up to $2.5 billion.

Sale of Loans. On December 2, 2004, TVA sold a portfolio of 51 power distributor loans receivable. The portfolio was sold for $55 million without recourse and contained loans with maturities ranging from less than one year to over 34 years. The principal amount due on the loans at the time of the sale was $57 million. The $2 million loss is reported in Other Income, Net on the Income Statement for the six months ended March 31, 2005.

Energy Prepayment Obligations. During October 2002, TVA introduced the Discounted Energy Units ("DEU") program. Under this program, TVA customers may purchase DEU generally in $1 million increments, which entitle them to a $0.025/kilowatt-hour discount on a specified quantity of firm load over a period of years (five, ten, 15, or 20) for each kilowatt-hour of electricity in the prepaid block. The remainder of the price of the kilowatt-hours of electricity delivered is due upon billing.

As of March 31, 2005, TVA had entered into sales agreements for 54.5 DEU totalling $54.5 million of which $7.25 million is for the 2004 program. Total credits applied to power billings on a cumulative basis through March 31, 2005, total nearly $12 million. Of this amount, nearly $3 million was recognized as revenue during 2005.

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In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment will be applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was $1.5 billion. Total prepayment credits applied to power billings on a cumulative basis through March 31, 2005, exceed $140 million. Of this amount, $50 million was recognized as revenue during 2005. This amount was based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

TVA is reporting the March 31, 2005, and September 30, 2004, obligations of $1,403 million and $1,455 million, respectively, to deliver power under these energy prepayment programs as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the March 31, 2005 and September 30, 2004 Balance Sheets.

There have been no energy prepayment transactions during 2005.

Cash Requirements and Contractual Obligations. The estimated future cash requirements and contractual obligations for TVA as of March 31, 2005, are as follows:

	2005*	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Debt	$ 4,028	$ 2,621	$ 961	$ 91	$ 2,031	$ 13,471	$ 23,203
Leases	40	79	75	67	64	103	428
Lease/leasebacks	36	84	85	89	84	1,300	1,678
Power purchase obligations	86	166	156	130	135	3,595	4,268
Other obligations	376	406	200	163	53	63	1,261
Fuel purchase obligations	520	465	241	237	181	643	2,287
Pension contribution	26	–	–	–	–	–	26
Total	$ 5,112	$ 3,821	$ 1,718	$ 777	$ 2,548	$ 19,175	$ 33,151

* Period April 1 – September 30, 2005

During the quarter ended March 2005, TVA recorded a capital lease asset of $60 million comprised of $23 million in pre-recharacterization contract payments and $37 million in post-recharacterization contract payments either paid or payable related to the blended low enriched uranium program (see *Other — Blended Low Enriched Uranium Program*). Also during the quarter, TVA recorded an initial capital lease obligation of $37 million which has been reduced by $16 million in post-recharacterization principal payments leaving an unpaid capital lease obligation of $21 million at the end of March 2005.

In addition to the cash requirements above, TVA has the following contractual obligations related to energy prepayments (see note 1—*Energy Prepayment Obligations*).

	2005*	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Energy prepayment obligations	$ 53	$ 106	$ 106	$ 106	$ 105	$ 927	$ 1,403

* Period April 1 – September 30, 2005

As of March 31, 2005, TVA's decommissioning trust funds totaled approximately $778 million, which is less than the present value of the estimated future decommissioning costs calculated in accordance with the Nuclear Regulatory Commission ("NRC") requirements. In March 2005, TVA submitted its biennial letter to the NRC on the funding status of the TVA Nuclear Decommissioning Trust versus its liabilities. In addition, on October 30, 2003, TVA sent a letter to the NRC establishing a method to provide funding assurance on an ongoing basis. This method essentially establishes a projection of necessary funds at the end of each year based upon current decommissioning cost estimates and assumptions regarding escalation and rate of earnings. Each year TVA reviews the performance of the trust fund. If funds at the end of the calendar year are below an established threshold of 95 percent of projected value, TVA will make contributions to the trust fund or provide other methods of funding assurance to ensure adequate funding. At the end of 2004, the total trust fund balance provided sufficient funding assurance to meet the updated threshold levels calculated in accordance with the October 2003 letter.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
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Impact of New Accounting Pronouncements and Interpretations

Variable Interest Entities
In January 2003, the FASB published FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*," which was later revised by FASB Interpretation ("FIN") No. 46(R) ("FIN 46R") in December 2003. The interpretation explains how to identify a variable interest entity ("VIE") and how an enterprise assesses its interests in a VIE to decide whether to consolidate that entity. It also clarifies the application of Accounting Research Bulletin ("ARB") No. 51, "*Consolidated Financial Statements*," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The interpretation applies to nonpublic enterprises, and it becomes effective for TVA beginning October 1, 2005, for VIEs created on or before December 31, 2003, and immediately for VIEs created after December 31, 2003.

TVA has not identified any material VIEs created, or interests in VIEs obtained, after December 31, 2003, which require consolidation or disclosure under FIN 46R. TVA continues to assess the existence of any interests in VIEs created on or prior to December 31, 2003, which may or may not be material to its results of operations or financial position.

In March 2005, the FASB released FASB Staff Position ("FSP") FIN 46(R)-5, "*Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities*," which is applicable to both nonpublic and public reporting enterprises. This FSP addresses transactions in which a reporting enterprise has an interest in, or other involvement with, a VIE or potential VIE that is not considered a variable interest, and the reporting enterprise's related party (a non-VIE) has a variable interest in the same entity. This FSP must be applied in accordance with the FIN 46 effective date and transition. At this time, TVA is in the process of evaluating the requirements of this interpretation and does not yet know the impact of its implementation, which may or may not be material to TVA's results of operations or financial position.

Pension and Other Postretirement Benefit Disclosures
In December 2003, the FASB issued SFAS No. 132 (revised), "*Employers' Disclosures about Pensions and Other Postretirement Benefits*," which improves financial statement disclosures for defined benefit plans and replaces existing FASB disclosure requirements for pensions. The guidance is effective for fiscal years ending after December 15, 2003, and for quarters beginning after December 15, 2003. TVA adopted this standard for the quarter beginning January 1, 2004, by making the required disclosures (see note 5).

Medicare Prescription Drug, Improvement and Modernization Act of 2003
In May 2004, the FASB issued Financial Accounting Standard ("FAS") FSP 106-2, "*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*." This FSP provides accounting guidance for employers that sponsor defined benefit postretirement health care plans that provide prescription drug benefits, and requires those employers to provide certain disclosures regarding the effect of the federal subsidy provided by this act. TVA has elected to continue its study of the particulars contained in the accounting guidance and, accordingly, has not determined either the existence of a subsidy or an estimate of the value of any such subsidy at this time. TVA adopted the disclosure requirements of the FSP for nonpublic entities for interim reporting periods beginning after January 1, 2004, and subsequently transitioned to the disclosure requirements for public entities for the reporting periods ended September 30, 2004, and thereafter. It is likely that during 2005, TVA will not only make a determination of the propriety and amount of any such subsidy but also the manner in which it will account for such a subsidy, should it exist.

Inventory Costs
In November 2004, the FASB issued SFAS No. 151, "*Inventory Costs—an amendment of ARB No. 43, Chapter 4.*" This statement amends the guidance in ARB No. 43, Chapter 4, "*Inventory Pricing*," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The statement requires that those items be recognized as current-period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This statement will become effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted. The adoption of SFAS No. 151 is not expected to have a material impact on TVA's results of operations or financial condition.

Exchanges of Nonmonetary Assets
In December 2004, the FASB published SFAS No. 153, "*Exchanges of Nonmonetary Assets—an amendment of APB*

Opinion No. 29," which eliminates the exception to fair value for exchanges of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance—that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. This statement is intended to produce financial reporting that more faithfully represents the economics of the transactions. This guidance is effective for fiscal periods beginning after June 15, 2005, and will be applied prospectively. The adoption of SFAS No. 153 is not expected to have a material impact on TVA's results of operations or financial condition.

Conditional Asset Retirement Obligations

In March 2005, the FASB issued FIN No. 47, "*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*." This interpretation clarifies that the term conditional asset retirement obligation ("conditional ARO") as used in SFAS No. 143, "*Accounting for Asset Retirement Obligations*," refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional ARO if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional ARO should be recognized when incurred. This Interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an ARO. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. TVA is evaluating the potential implications of this interpretation on its AROs, which may or may not be material to its financial position or results of operations.

Risk Factors and Forward-Looking Statements

Weather Risk

TVA is subject to short-term variability in weather, including both temperature variations and drought conditions affecting hydroelectric generation. Over periods of one year or longer, however, the financial risks associated with weather are modest, for reasons including averaging of effects over a large service territory, averaging of effects over different times of the year as TVA is a "double-peaking utility," and nominal changes in hydroelectric availability during high-value periods.

Operational Risk

Due to the robustness of the transmission system, the financial risks associated with the operation of the system are modest over periods of one year or more. However, the increasing need for coordination with surrounding regional transmission organizations introduces new costs that are difficult to quantify at this point.

Annual financial targets can be noticeably influenced by the unforeseen interruption of key generating facilities during peak seasons. The likelihood of such interruptions increases with an aging generation fleet.

Rate Setting

In a future restructured electric power industry, it is possible 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.

Risk of Loss of Customers

The 1959 amendments to the TVA Act provide that, subject to certain minor exceptions, neither TVA nor its distributors may be a source of power supply outside TVA's defined service area. This statutory provision is referred to as the "Fence" because it bounds TVA's sales activities, essentially limiting TVA to power sales within a defined service territory that includes most of Tennessee and parts of six other states: Kentucky, Mississippi, Alabama, Georgia, North Carolina, and Virginia.

While the Fence essentially confines TVA to this defined service territory, the "anti-cherrypicking provision" provides that the Federal Energy Regulatory Commission cannot order TVA to deliver power from an outside source to a customer if the power would be consumed within the TVA service territory. Thus, TVA cannot be ordered to provide access to its transmission lines for the purpose of delivering power to wholesale customers within the Valley.

The "anti-cherrypicking provision" minimizes the financial exposure of TVA to loss of distributor customers due to their limited access to transmission resources. However, due to the uncertainties in rulings related to the nation's transmission systems, TVA's financial exposure to customer losses may increase in the future. See note 9, *Subsequent Events—Transmission System*.

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Termination Notices
In January 2005, TVA received notice from the Princeton Electric Plant Board ("PEPB") terminating its power contract with TVA effective January 2010. PEPB is a municipal distributor in Princeton, Kentucky. In 2004, less than 0.1 percent of TVA's total operating revenues came from sales to PEPB.

Since October 2002, eight distributors including PEPB have given notice that terminates their power contracts with TVA, but, as discussed below, two of these notices have since been withdrawn and deemed to be of no force and effect. Five of the six distributors whose notices are still in effect are located in Kentucky, where neighboring power suppliers enjoy significant competitive advantages. These five distributors are PEPB, Warren Rural Electric Cooperative Corporation, Monticello Electric Plant Board, Glasgow Electric Plant Board, and Paducah Power System. The sixth distributor, Duck River Electric Membership Corporation, is located in Tennessee.

Two other distributors gave TVA notice terminating their power contracts—Meriwether Lewis Electric Cooperative ("MLEC") and Bowling Green Municipal Utilities ("BGMU"). In 2004, the MLEC notice was withdrawn and deemed to be of no force and effect by the mutual agreement of MLEC and TVA. In March 2005, the BGMU notice was also withdrawn and deemed to be of no force and effect by the mutual agreement of BGMU and TVA. With its notice of contract cancellation withdrawn, BGMU will receive full TVA support and services under the five-year rolling contract that was in effect before notice to terminate the contract was submitted in October 2002. In 2004, BGMU purchased $43 million in electricity from TVA, which accounted for 0.6 percent of TVA's operating revenues.

The table below lists the distributors (other than MLEC and BGMU) that have given notice that terminates their power contracts with TVA, the date that their power contracts with TVA terminate, the amount of revenues that TVA generated by selling power to these distributors in 2004, and the percentage of TVA's total 2004 operating revenues represented by these revenues.

Distributor	Date of Termination of Power Contract	Sales to Distributor in 2004	Percentage of Operating Revenues in 2004
Warren Rural Electric Cooperative Corporation	April 2008	$ 80	1.1%
Duck River Electric Membership Corporation	August 2008	80	1.1%
Monticello Electric Plant Board	November 2008	5	0.1%
Glasgow Electric Plant Board	December 2008	18	0.2%
Paducah Power System	December 2009	32	0.4%
Princeton Electric Plant Board	January 2010	5	0.1%
Total		$ 220	3.0%

Long-Term Contracts
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 with respect to contract term and other matters, such as purchasing a portion of their power requirements from suppliers other than TVA. Representatives of TVA and distributors have been meeting to discuss various potential long-term contract structures that could provide more certainty to both TVA and distributors. While these discussions have not yet resulted in any agreed upon structure, TVA and the distributors plan to continue with the process.

Compliance with Environmental Regulations
TVA has incurred, and continues to incur, significant capital, operating, and other cost associated with compliance with environmental regulations. These costs could be even more significant in the future as a result of changes in legislation and other factors.

TVA continues to consider better ways to reduce emissions in light of evolving emission reduction requirements. These efforts have led TVA to consider making some changes to its clean air compliance strategy including accelerating switches to lower sulfur coals at some plants, and incorporating the selective non-catalytic reduction ("SNCR") technology into TVA's current nitrogen oxide ("NOx") emission reduction strategy. As TVA moves forward to comply with increasingly stringent NOx and sulfur dioxide ("SO_2") emission reduction requirements, TVA also plans to make use of minimal amounts of purchased emission allowances.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – Continued
Dollars in millions except where noted

In March 2005, the Environmental Protection Agency finalized two major rules for electric utilities, the Clean Air Interstate Rule ("CAIR"), which took effect on May 12, 2005, and a rule dealing with mercury. Together these rules place cap and trade requirements on utility emissions of SO_2, NOx, and mercury, tracking closely the Administration's Clear Skies legislation. Under these cap and trade programs, emissions of pollutants are capped, and each state is authorized to distribute a specific number of emission allowances to sources within the state. Affected sources must limit their emissions to the allowances they hold at the end of reporting periods, but allowances can be transferred among sources throughout the affected region.

The mercury rule is being challenged in court by several states alleging that it does not do enough to control mercury emissions from fossil-fired plants, and it is possible that CAIR will also be challenged in court. Accordingly, it may be several years before the full impact of the rules on TVA will be known. It is certain, however, that the rules will significantly increase TVA's air compliance costs, possibly adding in excess of $4 billion to currently planned expenditures and commitments over the next ten to 15 years.

When fully implemented, the rules are expected to reduce emissions of SO_2 and NOx by over 70 percent and over 60 percent, respectively, from 2003 levels in 28 eastern states and the District of Columbia and to reduce utility emission of mercury by approximately 70 percent.

Forward-Looking Statements

This Quarterly Report 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.

Examples of forward-looking statements include, but are not limited to, strategic objectives; estimates of costs for disposing of certain tangible long-lived assets; expectations about the adequacy of TVA's nuclear decommissioning fund; the impact of new accounting pronouncements and interpretations, including Interpretation No. 46, "*Consolidation of Variable Interest Entities*," which was amended by FASB Interpretation No. 46R, and SFAS No. 151, "*Inventory Costs—an amendment of ARB No. 43, Chapter 4;*" TVA's plans to continue using short-term debt to meet current obligations; and the anticipated cost and schedule of returning Browns Ferry Unit 1 to service.

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; damage to power production or transmission facilities due to accidental events or terrorist activity; 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.

Legislative Activity

In April 2005, the House passed an energy bill that among other things would (1) authorize the Federal Energy Regulatory Commission ("FERC") to review TVA's transmission rates and terms and conditions of service to determine whether they are comparable to those TVA imposes on itself and whether they are unduly discriminatory, and (2) authorize FERC to order refunds if the rates charged by TVA and other nonjurisdictional entities on wholesale electricity transactions for a term of 31 days or less are not just and reasonable. In addition, the House bill contains some

unclear language that might be interpreted as inadvertently repealing the Anti-Cherrypicking Provision. However, TVA and the Tennessee Valley Public Power Association have agreed to compromise amendatory language that addresses TVA's concern about the previous language, which seems likely to be included in the Senate's own energy bill and any final version of this legislation. The Senate and House have not reached agreement in past sessions. It is not clear that energy legislation will be enacted during this session of Congress and, if Congress does take action, it is unclear how the final version may affect TVA.

The Chairman of the Senate Energy and Natural Resources Committee has prepared a Chairman's mark of a Senate energy bill. With respect to TVA, the Chairman's mark is substantially similar to the energy bill passed by the House. Unlike the House energy bill, the Chairman's mark, however, contains language making it clear that the Anti-Cherrypicking Amendment is not inadvertently repealed but instead remains in full force and effect.

Other

<u>Blended Low Enriched Uranium Program</u>
On December 5, 2004, TVA received the first fuel assembly under the Blended Low Enriched Uranium ("BLEU") fuel program for loading into its Browns Ferry Nuclear Plant Unit 2. The unit ended its most recent refueling outage in April 2005, at which time the costs of the BLEU fuel assemblies began being amortized to nuclear fuel expense.

The BLEU fuel program is implemented, in part, through agreements with counterparties. One is an interagency agreement with the Department of Energy ("DOE") to provide raw nuclear fuel materials to be processed into usable fuel for TVA nuclear reactors, and the others are contracts with third-party nuclear fuel processors under which the nuclear fuel processors, either by themselves or through subcontractors (collectively "Third Party Fuel Processors"), acquire land, construct facilities, and process the raw materials from DOE into usable fuel for TVA nuclear reactors.

Under the terms of the interagency agreement, DOE agrees to supply off-specification, highly enriched uranium materials to the appropriate Third Party Fuel Processors for processing into usable fuel for TVA. In exchange, DOE will participate to a certain degree in the savings generated by TVA's use of this blended nuclear fuel product. As of March 31, 2005, TVA projects that the DOE's share of savings generated by TVA's use of this blended nuclear fuel product will result in future payments to DOE estimated to be $185 million. TVA anticipates these future payments will begin in 2010, and TVA will accrue the obligation related to these estimated future payments on a per reload basis as the BLEU fuel assemblies are loaded into TVA's nuclear fuel reactors.

The Third Party Fuel Processors own the conversion and processing facilities and will retain title to all land, property, plant, and equipment used in the BLEU fuel program. There is no provision for TVA to own or otherwise take title to the facilities, materials, or equipment now or at any time in the future.

However, in accordance with the requirements of EITF No. 01-08, "*Determining Whether an Arrangement Contains a Lease*," and SFAS No. 13, "*Accounting for Leases,*" TVA recognized a capital lease asset and corresponding lease obligation related to amounts paid or payable to a Third Party Fuel Processor. Accounting recognition of the capital lease asset and obligation was brought about due to a contract modification to the pre-existing fuel fabrication contract, which occurred during the second quarter of 2004.

During the quarter ended March 2005, TVA recorded a capital lease asset of $60 million comprised of $23 million in pre-recharacterization contract payments and $37 million in post-recharacterization contract payments either paid or payable. Also during the quarter, TVA recorded an initial capital lease obligation of $37 million which has been reduced by $16 million in post-recharacterization principal payments leaving an unpaid capital lease obligation of $21 million at the end of March 2005. Additionally, TVA has recognized asset amortization expense of $6 million and interest expense of $1 million related to the capital lease obligation during the quarter ended March 31, 2005.

<u>Guarantee</u>
TVA has entered into a contract which required it to secure its payment obligations with a letter of credit. The letter of credit was issued by a commercial institution in the amount of $1.2 million on March 7, 2003. The letter of credit will expire on June 30, 2005, but may be renewed if the project associated with the letter is not complete. As of March 31, 2005, TVA's liability associated with this project was less than $0.4 million. The project is scheduled to be completed in May 2005, and TVA does not expect the letter of credit to be drawn upon.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Dollars in millions except where noted

Through the normal course of its business, TVA is exposed to various market risks, including changes in interest rates, foreign currency exchange rates, and certain commodity and equity market prices. TVA is also exposed to losses in the event of counterparties' nonperformance under certain contractual arrangements. Accordingly, TVA has established controls necessary to mitigate exposure to these various risks.

Mark-to-Market Valuation

TVA monitors the mark-to-market ("MTM") value, or fair value, of energy assets for the upcoming year. MTM analysis values assets at the price a willing third party would pay for a particular asset. The MTM calculation determines a profit or loss for each asset (e.g., load revenue) based on market prices. These analyses include, but are not limited to, native system load contracts, energy forwards, energy options, and other energy derivative instruments for unit specific generation units. When available, quoted market prices are used to value an energy asset. However, market values for energy assets may not be readily available because the duration of the contracts exceeds the liquid activity in a particular market. If no active trading market exists, the fair value of the energy asset is based on pricing models of assets with similar terms and risks. As of March 31, 2005, the MTM value of TVA's electricity portfolio for the next 12 months is $3.7 billion.

Derivatives

TVA has entered into various derivative transactions to manage its risk exposures. 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 trading purposes. TVA accounts for these derivative instruments in accordance with the provisions of 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—an amendment of FASB Statement No. 133*," and SFAS No. 149, "*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*."

Derivative contracts utilized by TVA include currency and interest rate swap agreements, swaption agreements, and option and futures contracts for various commodities. 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. These swap transactions qualify for cash flow hedge accounting treatment under SFAS No. 133. Consequently, the effective portions of gains and losses related to these types of contracts are deferred and reported in Accumulated Other Comprehensive Income (Loss) with corresponding adjustments to the derivatives' book values until the contracts actually settle. The ineffective portions of the derivatives' changes in fair value are recognized immediately in the determination of earnings.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on the Balance Sheets at March 31, 2005, and September 30, 2004, include the following:

	Accumulated Other Comprehensive Income (Loss)	
	March 31, 2005	**September 30, 2004**
Interest rate swap	$ 3	$ (50)
Foreign currency swaps	41	(2)
Total	$ 44	$ (52)

Other derivative contracts include various purchased power option contracts, coal contracts, natural gas futures contracts, swaption agreements, and an interest rate swap. Certain of these contracts qualify and are accounted for as fair value hedges under SFAS Nos. 133 and 138 with changes in market values deferred and recognized as regulatory assets and/or liabilities in accordance with SFAS No. 71, "*Accounting for the Effects of Certain Types of Regulation*." Such treatment reflects TVA's ability and intent to account for these derivative instruments on a settlement basis for rate-making purposes. The ineffective portions of the derivatives' changes in fair value are recognized immediately in the determination of earnings.

Credit Risk

TVA's credit risk has not changed materially from that reported in the 2004 Information Statement. However, as a result of certain credit terms included in a swap contract, one swap counterparty has posted collateral with TVA. The balance of collateral held by TVA at March 31, 2005, was $124 million, which is recorded in Cash and Short-Term Investments, Net. The offsetting liability is recorded in Accounts Payable.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK – Continued
Dollars in millions except where noted

Emission Allowances
In October 2004, the Board expanded the existing delegation, which allows TVA to enter into agreements for the sale, purchase, and loan of SO_2 emission allowances, to include NOx emission allowances. This provides TVA the same ability to transact in the new and evolving NOx emissions allowance market as the SO_2 emissions allowance market.

Financial Trading Pilot Program
A financial trading pilot program to reduce TVA's economic risk exposure associated with TVA's physical electricity generation, purchases, and sales was approved by the Board on September 11, 2003. The program enables TVA to trade certain futures contracts and options on futures contracts for the purpose of managing risks associated with the cost of natural gas and fuel oil for TVA's power generation operations and risks under power purchase or sale arrangements where the energy price varies based upon a fuel index. Trading of authorized futures contracts and options on futures contracts is limited solely to those transactions that hedge or otherwise limit economic risks directly associated with TVA's fuel requirements for power generation or with the aforementioned type of power purchase or sale arrangement. Transactions are limited to trading of NYMEX futures contracts and options on futures contracts related to natural gas and fuel oil. Trading is not authorized for speculative purposes. The pilot program extends through August 31, 2005. Trading under this pilot program commenced on May 26, 2004, and trades are being executed routinely. TVA monitors the program's status on a daily basis by tracking the program's financial positions and Value at Risk.

At March 31, 2005, TVA had 89 derivative contracts outstanding under this pilot program. The pilot program enabled TVA to effectively hedge the price risk associated with a portion of its natural gas and power purchases. TVA recognized unrealized gains of approximately $0.9 million which were included as a reduction of purchased power expense for the period ended March 31, 2005. The same period also produced realized losses of about $0.2 million which were charged to purchased power expense. The losses on the positions were less than one percent of the total natural gas expense for the period.

Financial Trading Pilot Activity

	Three months ended March 31, 2005		Six months ended March 31, 2005	
	Notional Amount (in mmBtu)	Contract Value	Notional Amount (in mmBtu)	Contract Value
Futures contracts				
Financial positions at beginning of period, net	550,000	$ 3.7	–	$ `–
Purchased	170,000	1.0	770,000	5.0
Sold	(340,000)	(2.3)	(390,000)	(2.6)
Net positions–long	380,000	2.4	380,000	2.4
Option contracts				
Financial positions at beginning of period, net	450,000	–	–	–
Calls purchased	100,000	0.1	250,000	0.2
Puts sold	200,000	(0.1)	500,000	(0.2)
Positions closed or expired	(240,000)	–	(240,000)	–
Net positions–long	510,000	–	510,000	–
Holding gains (losses)				
Unrealized (losses) at beginning of period, net	–	(0.3)	–	–
Unrealized gain for the period	–	1.2	–	0.9
Unrealized gains at end of period, net	–	0.9	–	0.9
Financial positions at end of period, net	890,000	$ 3.3	890,000	$ 3.3

CONTROLS AND PROCEDURES

TVA's management, including the Chief Financial Officer and the members of the Board, have conducted an evaluation of the effectiveness of TVA's disclosure controls and procedures as of the end of the period covered by 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 providing reasonable assurance that all material information necessary and appropriate in this Quarterly Report has been accumulated and communicated to them to allow timely decisions regarding disclosure.

During the fourth quarter of 2004, management identified a significant deficiency related to TVA's end use billing arrangements with wholesale power customers. Under these arrangements, TVA relies on the customers to calculate major components of their own power bills. Without some assurance of the adequacy of customer internal controls, TVA cannot be reasonably satisfied that internal control deficiencies within the customer control environments do not exist. TVA has developed and is communicating a plan to obtain annual Statement on Auditing Standards ("SAS") 70 internal control reports on 18 specific control objectives from customers and their third party billing processors. The first SAS 70 reports will be due to TVA on October 1, 2006.

Also during the fourth quarter of 2004, TVA management identified a significant deficiency related to the mark-to-market valuation of coal contracts that contain volumetric optionality. Although key controls have been designed to facilitate the complete and accurate capture and processing of coal contract activities, many control activities are not standardized. As such, the reliability and effectiveness of these control processes are dependent on interpretation and execution by different coal contract administrators. In addition, certain coal contract activities are not adequately documented and have not been supported by formal training or communication of controls. To improve controls in this area, TVA reviewed all new contracts and supplements and changes made to the valuation model during the quarter ended March 31, 2005. TVA is also implementing plans to address this internal control deficiency which include standardized guidelines and procedures, formal training, communications of controls, and proper segregation of duties.

There have been no changes in internal control over financial reporting during the quarter ended March 31, 2005, that have materially affected, or are reasonably likely to materially affect, TVA's internal control over financial reporting. TVA management believes that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company can be detected. TVA's controls and procedures can only provide reasonable, not absolute, assurance that the objectives will be met.

It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

OTHER INFORMATION

BOARD ACTIONS

As of March 16, 2005, the individual Board members sequentially approved, with Director Baxter not voting, the proposed Joint Reliability Coordination Agreement among TVA, the Midwest Independent Transmission System, and PJM Interconnection, LLC (collectively, "Parties"), providing for the coordination of operations, planning, and congestion management protocols among the Parties to insure continued reliable operations of their interconnection transmission systems.

As of May 9, 2005, the individual Board members sequentially approved a delegation for TVA to enter into one or more credit facilities with one or more financial institutions in a total amount not to exceed $5 billion at any time, and to borrow under such credit facility(ies) from time-to-time amounts not to exceed $1 billion outstanding at any time without the need for further Board approval.

ADDITIONAL INFORMATION

Customers
In March 2005, the notice of contract termination that Bowling Green Municipal Utilities ("BGMU") gave TVA in October 2002 was withdrawn and deemed to be of no force and effect by the mutual agreement of BGMU and TVA. In fiscal year 2004, BGMU purchased $43 million in electricity from TVA, which accounted for 0.6 percent of TVA's total operating revenues.

Management
On March 3, 2005, Tom Kilgore became the President & Chief Operating Officer ("COO") of TVA, succeeding Ike Zeringue, who had previously announced his retirement from TVA on January 25, 2005. Mr. Kilgore reports directly to the Board and serves on TVA's Management Committee with responsibility for overall management of TVA's power production, transmission, power trading, and resource-management programs.

On May 2, 2005, the Board announced the realignment of TVA's senior management team. In addition, effective May 2, 2005, all of TVA's Management Committee members will report to President & COO Tom Kilgore during this transition period.

Chairman Glenn L. McCullough's term on the Board expired on May 18, 2005. Mr. McCullough was appointed to the Board in November 1999. Since no one has been selected to replace him on the Board, the TVA Board will consist of two full-time members, Director Skila Harris and Director William W. Baxter.

On December 8, 2004, President Bush signed H.R. 4818, an "omnibus" appropriations bill for fiscal year 2005, which provided, among other things, for the Board to be restructured from a three member full-time board of directors to a nine member part-time board of directors. The new structure will go into effect once the Board has a quorum of five members. Until that time, the existing structure will continue with Directors Harris and Baxter constituting the Board. See "*Management's Discussion and Analysis of Financial Condition and Results of Operations*"—"*Subsequent Events*" in Part II in the 2004 Information Statement.

Operations
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 (excluding AFUDC). Unit 1 is expected to return to service in 2007, and the additional generating capacity is expected to lower the average cost of power and provide additional cash flow. As of March 31, 2005, TVA had incurred approximately $1.1 billion of costs (including AFUDC of $70 million) on the Browns Ferry Unit 1 restart project, the planned amount for this period. The restart project was about 59 percent complete at that date and on schedule for completion.

Tritium
In February 2005, TVA's Watts Bar Nuclear Plant completed the first cycle during which TVA irradiated tritium producing burnable absorber rods for DOE. During the cycle, more tritium was released into the reactor's water system than anticipated. Even at the higher amount, the tritium in the reactor's water did not exceed NRC limits. TVA informed the NRC and is working with DOE to solve the problem. Tritium is an isotope of hydrogen that enhances the explosive force of nuclear weapons.

Transmission Agreements

On April 22, 2005, TVA, the Midwest Independent Transmission System Operator Inc. (“Midwest ISO”) and PJM Interconnection signed a Joint Reliability Coordination Agreement that will provide for cooperation in the management and operation of the electric transmission grid over a major portion of the eastern United States. The three parties will coordinate planning and congestion management to ensure reliability and market liquidity in the Eastern Interconnection – the wholesale electric transmission grid that serves much of the area from the Atlantic coast to the Rockies. The scope of the area includes 306,000 megawatts of generating capacity, 164,000 miles of transmission lines, and more than 68 million customers/end users.

Environmental

The Clean Air Interstate Rule (“CAIR”) became effective as of May 12, 2005, with its publication in the Federal Register. CAIR calls for reductions of about 70 percent in SO_2 emissions and of about 60 percent in NOx emissions in 28 eastern states and the District of Columbia beginning in 2015. The rule creates an emissions allowance trading program for states to use to control these pollutants from coal-fired power plants.

Bellefonte and NuStart

In May 2005, NuStart Energy Development LLC (“NuStart”), a consortium of 11 companies, including TVA, announced six sites as potential locations for a new advanced nuclear reactor. TVA’s Bellefonte Nuclear Plant site is one of the six locations. NuStart will further review these six sites and choose two of them for use in the NRC’s combined construction and operating license process. NuStart is not expected to select the final two sites until later in 2005. Neither NuStart nor TVA has made a commitment to build an advanced reactor at this time.

Other

In April 2005, the National Academy of Sciences released a declassified version of a report that concluded that terrorist attacks at spent fuel storage pools at nuclear power plants could release large quantities of radioactive material into the environment. The report urged the NRC to require the nuclear industry to take measures to mitigate risks, including reconfiguring the fuel assemblies in the pools, installing water spray systems, and moving additional spent fuel from pools into dry storage casks. In a letter dated March 14, 2005, from NRC Chairman Nils Diaz to Senator Domenici, Chairman Diaz stated that although the NRC is seriously considering the report’s recommendations, the NRC believes that spent fuel storage systems are safe and secure and that the storage of spent fuel in both spent fuel pools and in dry storage casks provides reasonable assurance that the environment and public health and safety will be adequately protected. TVA stores spent nuclear fuel in pools of water at Watts Bar, Sequoyah, and Browns Ferry Nuclear Plants and also stores spent nuclear fuel in dry cask storage facilities at Sequoyah Nuclear Plant. These pools and dry cask storage facilities are located within the protected area of TVA’s nuclear plants and meet all NRC regulatory requirements.

CERTIFICATIONS OF THE MEMBERS OF THE TVA BOARD OF DIRECTORS

Skila Harris and Bill Baxter individually certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended March 31, 2005;

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 periods covered by this Report;

3. Based on my knowledge, the 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. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Report is being prepared;

b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and

c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended March 31, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and

5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; 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 control over financial reporting.

Date: May 31, 2005

Skila Harris
Director

Bill Baxter
Director

CERTIFICATION OF THE CHIEF FINANCIAL OFFICER

I, Michael E. Rescoe, certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended March 31, 2005;

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 periods covered by this Report;

3. Based on my knowledge, the 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. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Report is being prepared;

b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and

c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended March 31, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and

5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; 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 control over financial reporting.

Date: May 31, 2005

Michael E. Rescoe
Chief Financial Officer
and Executive Vice President of Financial Services

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

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