Tennessee Valley Authority

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

Quarterly Report

For the quarterly period ended June 30, 2004

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Tennessee Valley Authority

Quarterly Report

For the quarterly period ended June 30, 2004

This document contains the unaudited Quarterly Report of TVA's Power Program and All Programs for the quarterly period ended June 30, 2004 (this "Quarterly Report"). TVA is not required to register securities under the Securities Act of 1933 or to make periodic reports to the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934. Accordingly, TVA does not intend to file this report with the SEC. In addition, several portions of this Quarterly Report contain forward-looking statements, and reference is made to page one regarding such statements. This report should be read in conjunction with the 2003 Information Statement dated as of February 4, 2004 (as may be amended from time to time, the "2003 Information Statement").

TABLE OF CONTENTS Page

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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 words such as “may,” “will,” “should,” “expect,” “anticipate,” “believe,” “intend,” “project,” “plan,” “predict,” “assume,” “estimate,” “objective,” “possible,” “potential,” or other similar expressions.

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

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

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

FINANCIAL INFORMATION

STATEMENTS OF INCOME–POWER PROGRAM (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Operating revenues				
Sales of electricity				
Municipalities and cooperatives	$ 1,568	$ 1,396	$ 4,699	$ 4,368
Industries directly served	227	194	640	597
Federal agencies and other	30	27	97	86
Other revenue	32	13	77	53
Total operating revenues	1,857	1,630	5,513	5,104
Operating expenses				
Fuel and purchased power	561	472	1,509	1,426
Operating and maintenance	556	492	1,684	1,465
Depreciation and accretion	277	265	823	792
Tax-equivalents	84	80	252	243
(Gain) loss on project cancellation, net (see note 1)	(15)	–	21	–
Total operating expenses	1,463	1,309	4,289	3,926
Operating income	394	321	1,224	1,178
Unrealized gain (loss) on derivative contracts, net	29	(4)	33	(6)
Other income, net	8	7	24	20
Interest expense				
Interest, net	347	347	1,040	1,047
Amortization of debt discount, issue, and reacquisition costs, net	6	7	19	21
Allowance for funds used during construction	(27)	(22)	(74)	(55)
Net interest expense	326	332	985	1,013
Income before cumulative effects of accounting changes	105	(8)	296	179
Cumulative effect of change in accounting for unbilled revenue	–	–	–	412
Cumulative effect of change in accounting for asset retirement obligations	–	–	–	(195)
Net income (loss)	$ 105	$ (8)	$ 296	$ 396

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

BALANCE SHEETS—POWER PROGRAM AND ALL PROGRAMS (unaudited)
(in millions)

	Power Program		All Programs	
ASSETS	**June 30 2004**	**September 30 2003**	**June 30 2004**	**September 30 2003**
Current assets				
Cash and cash equivalents	$ 422	$ 532	$ 423	$ 533
Accounts receivable, net	990	994	990	994
Inventories at average cost and other				
Fuel	211	219	211	219
Other, net	311	308	311	308
Total current assets	1,934	2,053	1,935	2,054
Property, plant, and equipment				
Completed plant	33,367	32,626	34,378	33,637
Less accumulated depreciation	(12,908)	(12,251)	(13,233)	(12,568)
Net completed plant	20,459	20,375	21,145	21,069
Construction in progress	1,824	1,619	1,824	1,619
Deferred nuclear generating units	4,113	4,110	4,113	4,110
Nuclear fuel and capital leases	511	530	511	530
Total property, plant, and equipment	26,907	26,634	27,593	27,328
Investment funds	905	905	905	905
Deferred charges and other assets				
Loans and other long-term receivables	178	168	201	191
Debt issue and reacquisition costs	283	241	283	241
Other deferred charges	868	531	868	531
Regulatory assets	1,804	1,861	1,804	1,861
Total deferred charges and other assets	3,133	2,801	3,156	2,824
Total assets	$ 32,879	$ 32,393	$ 33,589	$ 33,111
LIABILITIES AND PROPRIETARY CAPITAL				
Current liabilities				
Accounts payable	$ 705	$ 776	$ 706	$ 777
Accrued liabilities	199	232	199	232
Current portion of lease/leaseback obligations	37	68	37	68
Current portion of energy prepayment obligations	106	5	106	5
Accrued interest	315	404	315	404
Short-term debt	906	2,080	906	2,080
Current maturities of long-term debt	3,000	2,336	3,000	2,336
Total current liabilities	5,268	5,901	5,269	5,902
Other liabilities				
Deferred liabilities	2,347	2,177	2,347	2,177
Asset retirement obligations	1,758	1,725	1,758	1,725
Lease/leaseback obligations	1,146	1,170	1,146	1,170
Energy prepayment obligations (see note 1)	1,376	42	1,376	42
Total other liabilities	6,627	5,114	6,627	5,114
Long-term debt				
Public bonds	19,405	20,459	19,405	20,459
Unamortized discount and other adjustments	63	(258)	63	(258)
Total long-term debt	19,468	20,201	19,468	20,201
Total liabilities	31,363	31,216	31,364	31,217
Commitments and contingencies (see note 6)				
Proprietary capital				
Appropriation investment	453	468	4,808	4,823
Retained earnings	1,065	783	1,065	783
Accumulated other comprehensive loss	(2)	(74)	(2)	(74)
Accumulated net expense of nonpower programs	–	–	(3,646)	(3,638)
Total proprietary capital	1,516	1,177	2,225	1,894
Total liabilities and proprietary capital	$ 32,879	$ 32,393	$ 33,589	$ 33,111

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

STATEMENTS OF CASH FLOWS—POWER PROGRAM (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	**2003**	**2004**	**2003**
Cash flows from operating activities				
Net power income (loss)	$ 105	$ (8)	$ 296	$ 396
Items not requiring (providing) cash				
Depreciation, amortization, and accretion	359	283	915	844
Allowance for funds used during construction	(27)	(22)	(74)	(55)
Nuclear fuel amortization	36	30	97	94
Cumulative effect of accounting changes	–	–	–	(217)
(Gain) loss on project cancellation (see note 1)	(15)	–	21	–
Other, net	(6)	26	52	59
Changes in current assets and liabilities				
Accounts receivable, net	(64)	(16)	4	167
Inventories and other	3	(33)	(5)	(59)
Accounts payable and accrued liabilities	(9)	100	(127)	(3)
Accrued interest	(116)	(113)	(84)	(108)
Proceeds from energy prepayments	–	–	1,504	47
Refueling outage costs	(2)	(23)	(83)	(60)
Other	9	(1)	(12)	(14)
Net cash provided by operating activities	273	223	2,504	1,091
Cash flows from investing activities				
Construction expenditures	(351)	(431)	(1,153)	(1,213)
Proceeds from project cancellation settlement (see note 1)	15	–	15	–
Allowance for funds used during construction	27	22	74	55
Nuclear fuel	(35)	(66)	(88)	(174)
Investments	2	(6)	103	136
Other, net	–	–	(3)	–
Net cash (used in) investing activities	(342)	(481)	(1,052)	(1,196)
Cash flows from financing activities				
Long-term debt				
Issues	15	865	772	1,163
Redemptions and repurchases	(674)	(146)	(1,169)	(528)
Short-term borrowings (redemptions), net	635	(757)	(1,175)	(980)
Proceeds from combustion turbine financing	–	162	–	325
Proceeds from call monetization	–	–	–	175
Payments on combustion turbine financing	(7)	(12)	(27)	(45)
Payments on equipment financing	–	–	(29)	–
Financing costs, net	1	(6)	94	(13)
Payments to U.S. Treasury	(9)	(11)	(28)	(31)
Net cash (used in) provided by financing activities	(39)	95	(1,562)	66
Net change in cash and cash equivalents	(108)	(163)	(110)	(39)
Cash and cash equivalents at beginning of period	530	521	532	397
Cash and cash equivalents at end of period	$ 422	$ 358	$ 422	$ 358

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

STATEMENTS OF CASH FLOWS—ALL PROGRAMS (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	**2003**	**2004**	**2003**
Cash flows from operating activities				
Net power income (loss)	$ 105	$ (8)	$ 296	$ 396
Net expense of nonpower programs	(2)	(4)	(8)	(9)
Items not requiring (providing) cash				
Depreciation, amortization, and accretion	361	286	923	852
Allowance for funds used during construction	(27)	(22)	(74)	(55)
Nuclear fuel amortization	36	30	97	94
Cumulative effect of accounting changes	–	–	–	(217)
(Gain) loss on project cancellation (see note 1)	(15)	–	21	–
Other, net	(7)	26	51	59
Changes in current assets and liabilities				
Accounts receivable, net	(64)	(16)	4	167
Inventories and other	3	(33)	(5)	(59)
Accounts payable and accrued liabilities	(8)	100	(126)	(3)
Accrued interest	(116)	(113)	(84)	(108)
Proceeds from energy prepayments	–	–	1,504	47
Refueling outage costs	(2)	(23)	(83)	(60)
Other	8	(1)	(13)	(14)
Net cash provided by operating activities	272	222	2,503	1,090
Cash flows from investing activities				
Construction expenditures	(351)	(431)	(1,153)	(1,213)
Proceeds from project cancellation settlement (see note 1)	15	–	15	–
Allowance for funds used during construction	27	22	74	55
Nuclear fuel	(35)	(66)	(88)	(174)
Investments	2	(5)	103	136
Other, net	1	–	(2)	–
Net cash (used in) investing activities	(341)	(480)	(1,051)	(1,196)
Cash flows from financing activities				
Long-term debt				
Issues	15	865	772	1,163
Redemptions and repurchases	(674)	(146)	(1,169)	(528)
Short-term borrowings (redemptions), net	635	(757)	(1,175)	(980)
Proceeds from combustion turbine financing	–	162	–	325
Proceeds from call monetization	–	–	–	175
Payments on combustion turbine financing	(7)	(12)	(27)	(45)
Payments on equipment financing	–	–	(29)	–
Financing costs, net	1	(6)	94	(13)
Payments to U.S. Treasury	(9)	(11)	(28)	(31)
Net cash (used in) provided by financing activities	(39)	95	(1,562)	66
Net change in cash and cash equivalents	(108)	(163)	(110)	(40)
Cash and cash equivalents at beginning of period	531	523	533	400
Cash and cash equivalents at end of period	$ 423	$ 360	$ 423	$ 360

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

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

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Retained earnings reinvested at beginning of period	$ 965	$ 743	$ 783	$ 349
Net income (loss)	105	(8)	296	396
Return on appropriation investment	(5)	(6)	(14)	(16)
Retained earnings reinvested at end of period	1,065	729	1,065	729
Accumulated other comprehensive loss at beginning of period	(63)	(231)	(74)	(150)
Other comprehensive income (loss)	61	79	72	(2)
Accumulated other comprehensive loss at end of period	(2)	(152)	(2)	(152)
Appropriation investment at beginning of period	458	478	468	488
Return of appropriation investment	(5)	(5)	(15)	(15)
Appropriation investment at end of period	453	473	453	473
Proprietary capital at end of period	$ 1,516	$ 1,050	$ 1,516	$ 1,050

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

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL—NONPOWER PROGRAMS (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Proprietary capital at beginning of period	$ 711	$ 724	$ 717	$ 729
Net expense	(2)	(4)	(8)	(9)
Proprietary capital at end of period	$ 709	$ 720	$ 709	$ 720

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

STATEMENTS OF COMPREHENSIVE INCOME—POWER PROGRAM (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Net power income (loss)	$ 105	$ (8)	$ 296	$ 396
Other comprehensive income (loss)	61	79	72	(2)
Comprehensive income	$ 166	$ 71	$ 368	$ 394

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

STATEMENTS OF NET EXPENSE AND COMPREHENSIVE LOSS—NONPOWER PROGRAMS (unaudited)
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Water and land stewardship	$ (2)	$ (4)	$ (8)	$ (9)
Net expense and comprehensive loss	$ (2)	$ (4)	$ (8)	$ (9)

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

NOTES TO FINANCIAL STATEMENTS (unaudited)

1. Summary of Significant Accounting Policies

Organization

TVA is a wholly owned corporate agency and instrumentality of the United States. It was established by Congress in 1933 by the TVA Act with the objective of developing the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense by providing: (1) an ample supply of power within the region, (2) navigable channels and flood control for the Tennessee River System, and (3) agricultural and industrial development and improved forestry in the region. TVA carries out these regional and national responsibilities in a service area that includes most of Tennessee, northern Alabama, northeastern Mississippi, southwestern Kentucky, and small portions of Georgia, 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. Since 1999, Congress has provided no appropriations for TVA's nonpower programs. In compliance with the Energy and Water Development Appropriations Act enacted in October 1997, TVA is and will continue funding its essential stewardship activities with funds from its power program (and other available funds) to the extent that Congress does not make appropriations for these activities.

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.

Basis of Presentation

TVA prepares its interim financial statements in conformity with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. As a result, they should be read in conjunction with the audited financial statements for the year ended September 30, 2003, and the notes thereto.

The amounts included in the interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary to fairly present TVA's financial position and results of operations for the interim periods. Due to seasonal weather variations and the timing of planned maintenance and refueling outages of electric generating units and other factors, 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 reported amounts of revenues and expenses. Actual results could differ from those estimates.

Fiscal Year

TVA's fiscal year ends September 30. Unless otherwise indicated, years (2004, 2003, etc.) refer to TVA's fiscal years.

Accounts Receivable

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

	At June 30 2004	At September 30 2003
	(in millions)	
Power receivables billed	$ 226	$ 304
Power receivables unbilled	733	655
Total power receivables	959	959
Other receivables	39	43
Allowance for uncollectible accounts	(8)	(8)
Net accounts receivable	$ 990	$ 994

Regulatory Assets

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 consist of certain charges related to the closure and removal of nuclear generating units, mark-to-market valuation adjustments of certain derivative contracts, and an adjustment related to minimum pension liability. TVA's regulatory assets consist of the following:

	At June 30 2004	At September 30 2003
	(in millions)	
Decommissioning costs	$ 719	$ 783
Changes in fair value of derivative contracts	57	50
Adjustment to accrue minimum pension liability	1,028	1,028
Total	$ 1,804	$ 1,861

In addition, TVA has approximately $4.1 billion of deferred nuclear plant costs.

Energy Prepayment Obligations

During October 2002, TVA introduced an energy prepayment program called the Discounted Energy Units ("DEU") program. Annually for years 2003 to 2007, TVA customers may purchase DEU generally in $1 million increments, which entitles them to a $0.025/kWh discount on a specified quantity of firm power over a period of years (5, 10, 15, or 20) for each kilowatt-hour in the prepaid block. The remainder of the price of the kilowatt-hours delivered to the customer is due upon billing. This program allows customers to use the DEU to reduce their overall costs and provides a higher return for available cash. TVA does not anticipate selling additional DEUs during the remainder of 2004.

As of June 30, 2004, TVA had entered into sales agreements for 47.25 DEU totaling $47.25 million for the 2003 program and sales agreements of 7.25 DEU totaling $7.25 million for the 2004 program. TVA is accounting for the prepayment proceeds as unearned revenue and reported the obligations to deliver power as Energy prepayment obligations and Current portion of energy prepayment obligations on the June 30, 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers, based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of June 30, 2004, nearly $8 million has been applied against power billings on a cumulative basis during the life of the program, of which $4.1 million was recognized as revenue during 2004.

During 2004, TVA and its largest customer, Memphis Light, Gas & Water ("MLGW"), entered into an energy prepayment agreement under which MLGW prepaid TVA $1.5 billion for the costs of electricity to be delivered by TVA to MLGW over a period of 180 months. In exchange for this prepayment, MLGW receives a credit on its monthly bills during this period. The City of Memphis issued bonds with net proceeds of $1.5 billion, which were used to fund this prepay arrangement. The principal and interest on the bonds are payable from MLGW's pledged revenues. The bonds are not obligations of TVA and are not secured by any TVA revenues or property. TVA received the $1.5 billion prepayment in December 2003, accounted for the prepayment as unearned revenue, and is reporting the obligation to deliver power as Energy prepayment obligations and Current portion of energy prepayment obligations on the June 30, 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. For the nine months ended June 30, 2004, over $65 million was recognized as revenue related to this energy prepayment transaction.

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. In February 2004, TVA made revisions to the amount and timing of certain cash flow estimates related to its nuclear asset retirement obligations. The revisions in cost were based on new engineering studies performed in accordance with requirements of the Nuclear Regulatory Commission. 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 based on the latest cost estimates. The adjustments resulted in an aggregate decrease of $40 million in the asset retirement obligation, a $12 million reduction in the asset base, a $5 million reduction in accumulated depreciation, and a decrease of $33 million in the originally recorded regulatory asset, which TVA created in accordance with SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. Therefore, the result of the changes described did not impact net income for three and nine month periods ended June 30, 2004.

The following table summarizes for each asset retirement obligation ("ARO") category the original asset cost, the ARO liability as of September 30, 2003, and June 30, 2004, the fair market value of any assets legally restricted for purposes of settling the obligations, and the estimated future liability at the time of closure.

ARO Category	Original Asset Cost	September 30, 2003 Obligation	June 30, 2004 Obligation	Fair Market Value of Assets	Estimated Future Liability
(in millions)					
Nuclear plants	$ 470	$ 1,510	$ 1,535	$ 734	$ 10,212
Coal fired plants	19	214	222	NA	1,021
Gas/Oil turbine plants	1	1	1	NA	42
Total	$ 490	$ 1,725	$ 1,758	$ 734	$ 11,275

TVA's total ARO liability increased $33 million during the first nine months of 2004 due to accretion expense of $73 million offset by the $40 million revision to the nuclear ARO described above. The nuclear accretion expense of $64 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $9 million, related to coal-fired and gas/oil plants, was expensed during 2004.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") published Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was revised by Interpretation No. 46R ("46R") in December 2003. This interpretation explains how to identify variable interest entities ("VIEs") 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 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 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 its results of operations or financial position.

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 the nonpublic disclosure requirements of this standard for the quarter beginning January 1, 2004 (see note 5).

In May 2004, the FASB issued Staff Position ("FSP") 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 will adopt the nonpublic disclosure requirements of the FSP for reporting periods beginning after June 30, 2004. Accordingly, TVA is in the process of evaluating the requirements of the FSP but does not expect the impact of the implementation of FAS 106-2 to have a material effect on its results of operations or financial position.

Project Cancellation

In December 2003, TVA was notified that Regenesys Technologies Limited ("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 $36 million in the Regenesys project and, accordingly, TVA recognized a $36 million noncash loss on the cancellation of the Regenesys project in the second quarter of 2004. On April 30, 2004, RTL reimbursed TVA for early termination of the contract in the amount of $15 million, which reduced the net loss to $21 million on the cancellation of the Regenesys project.

Reduction in Workforce

Organizations within TVA are performing program and staffing reviews to identify surplus staffing situations. In areas where surplus staffing exists, TVA has asked for employees to apply for voluntary resignations beginning in February 2004. To the extent there are not enough volunteers, TVA is conducting an involuntary Reduction in Force ("RIF"). TVA expects the majority of voluntary resignations and involuntary RIFs to occur in 2004. It is anticipated that between 600 to 800 people will be affected by the change in staffing levels. Implementation of the change in staffing levels is estimated to cost between $27 million and $36 million in termination benefits. TVA has recognized expense in the amount of $29 million for estimated termination benefits incurred as of June 30, 2004.

Changes in the associated liability are as follows:

(in millions)	Three months ended June 30	Nine months ended June 30
Termination benefit liability at beginning of period	$ 20	$ –
Additional liability incurred	7	29
Actual severance benefits paid	(12)	(14)
Estimated medical benefits paid	(1)	(1)
Termination benefit liability at end of period	$ 14	$ 14

Other

Certain reclassifications have been made to the 2003 financial statements to conform to the 2004 presentation.

2. Proprietary Capital

Accumulated Other Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, requires the disclosure of comprehensive income (loss) to reflect changes in capital that result from transactions and economic events from nonowner sources. The losses for the nine months ended June 30, 2004, are due to mark-to-market valuation adjustments for certain derivative instruments.

Total Other Comprehensive Income (Loss) Activity—Power Program
(in millions)

	Three months ended June 30		Nine months ended June 30	
	2004	2003	2004	2003
Accumulated other comprehensive loss at beginning of period	$ (63)	$ (231)	$ (74)	$ (150)
Changes in fair value of interest rate swap	(2)	(8)	2	2
Changes in fair value of foreign currency swaps	60	87	66	(4)
Changes in fair value of emission allowance call options	3	–	4	–
Accumulated other comprehensive loss at end of period	$ (2)	$ (152)	$ (2)	$ (152)

3. Debt Securities

TVA issues power bonds, notes, and other evidences of indebtedness pursuant to Section 15d of the TVA Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution, as amended. Power bonds in each series must be further authorized by a supplemental resolution.

TVA's power bonds, notes, and other evidences of indebtedness are not obligations of the United States of America, and the United States of America does not guarantee the payment of the principal of, or interest on, any of TVA's power bonds, notes, or other evidences of indebtedness.

From October 1, 2003, to June 30, 2004, TVA issued $222 million of electronotes® with an average interest rate of 4.78 percent and also reopened its 2002 Series A power bonds (due May 23, 2012) for an additional $550 million principal amount at an effective interest rate of 4.22 percent. During this period, one issue of power bonds totaling $400 million with an interest rate of 5.00 percent matured. In addition, two power bonds of $25 million each, one with an interest rate of 7.50 percent and one with an interest rate of 7.65 percent, were redeemed. TVA also redeemed $118 million of electronotes® carrying an average interest rate of 4.95 percent as well as two issues of power bonds of $476 million and $10 million carrying interest rates of 6.88 percent and 4.75 percent, respectively. On May 3, 2004, investors put $115 million of the 1999 Series A PARRS issue back to TVA. On May 1, 2004, the interest rate on the remaining outstanding bonds of that issue reset from 6.50 percent to 5.62 percent. TVA also issued discount notes of nearly $10 billion while redeeming $11 billion of discount notes. The average interest rate on the discount notes issued was 0.99 percent.

The table below summarizes TVA's debt securities activity for the period from October 1, 2003, to June 30, 2004.

Activity from October 1, 2003 to June 30, 2004
(in millions)

Redemptions/Maturities:	Date	Principal Amount	Interest Rate
electronotes®	First Quarter 2004	$ 15	5.70%
	Second Quarter 2004	30	5.50%
	Third Quarter 2004	73*	3.50%-6.00%
1998 Series I	December 18, 2003	400	5.00%
2000C QUINTS	February 18, 2004	25	7.50%
2000D QUINTS	February 18, 2004	25	7.65%
1993 Series F	April 10, 2004	476	6.88%
1999 Series A	May 3, 2004	115	6.50%
2003 Series C	May 14, 2004	10	4.75%
		$ 1,169	
Issues:			
electronotes®	First Quarter 2004	$ 93	4.50%-5.63%
	Second Quarter 2004	114	3.20%-5.13%
	Third Quarter 2004	15	5.38%
2002 Series A (reopening)	March 4, 2004	550	4.22%
		$ 772	

* Includes $1 million of survivor options.

In the fourth quarter of 2003, TVA monetized the call option on a public bond issue by entering into a swaption transaction (see "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "*Liquidity and Capital Resources*" — "*Monetization of Call Options*" in Part II of the 2003 Information Statement). In February 2004, the counterparty to the swaption transaction exercised its option to enter into a swap with TVA, effective April 10, 2004, requiring TVA to make fixed rate payments to the counterparty of 6.875 percent and the counterparty to make floating payments to TVA based on London Interbank Offered Rate ("LIBOR"). These payments are based on a notional principal amount of $476 million, and the parties began making these payments on June 15, 2004.

TVA does not anticipate needing additional funds from its electronotes® program during the remainder of 2004. Accordingly, TVA suspended its electronotes® program for the remainder of 2004 following the electronotes® issuance that closed on April 15, 2004.

On August 5, 2004, TVA notified bondholders that on September 4, 2004, it will redeem all of its 2001 6.25 percent electronotes® due June 15, 2016 with a par amount of $22 million and all of its 2001 6.25 percent electronotes® due July 15, 2016 with a par amount of $58 million.

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 an interest rate swap agreement, foreign currency swap contracts, option and swaption contracts, and futures contracts.

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

Mark-to-Market Values of Derivative Transactions
(in millions)

	Asset (Liability)	
	At June 30 2004	At September 30 2003
Interest rate swaps:		
Inflation bond issue	$ 52	$ 42
$476 million bond issue (see note 3)	(89)	–
Currency swaps:		
Deutschemark (DM1.5 billion)	(55)	(149)
Sterling (GBP200 million)	23	(9)
Sterling (GBP250 million)	89	44
Sterling (GBP150 million)	39	11
Swaptions:		
Call provision on $1 billion bond issue	(164)	(207)
Call provision on $476 million bond issue	–	(111)
Debt-embedded calls:		
Call provision on $1 billion bond issue	129	169
Call provision on $476 million bond issue	–	91
Emission allowance call options	3	–
Coal contracts	304	45
Power purchase contracts	(57)	(50)
Natural gas futures contracts	–	–

The natural gas futures contracts are part of a financial trading pilot program which extends through August 31, 2005. Trading under this pilot program commenced on May 26, 2004, and trades are being executed routinely. At June 30, 2004, TVA's derivative financial instruments under this pilot program consisted solely of short-term natural gas futures contracts having a maturity of two months or less and a total volume of 540,000 mmBtu of natural gas. These derivative contracts do not qualify for hedge accounting under SFAS No. 133. Since the commencement of trading on May 26, 2004, TVA recognized unrealized losses of $145,000 and realized losses of $61,000 which were included in purchased power expense on the income statement for the periods ended June 30, 2004.

5. Benefit Plans

During the second quarter of 2004, TVA adopted SFAS No.132 (revised), *Employers' Disclosures about Pensions and Other Postretirement Benefits*. The statement requires entities with defined benefit plans to provide more details about benefit plans on an annual basis as well as selected information on a quarterly basis.

TVA's net periodic pension, postretirement, and postemployment benefit costs are determined using assumptions as of the beginning of each year. Effective for the September 30, 2003 measurement date and calculation of the pension and postretirement funded status, the discount rate utilized in the valuation of the obligations was 6.0 percent. The cost of living rate was 2.3 percent to reflect current market and demographic conditions. TVA maintained its assumption related to mortality based on results of an experience study performed during the prior year which underlies the continued use of the 1983 mortality tables.

The TVA Board approved a contribution of $22.5 million to the pension plan for 2004. As of June 30, 2004, a payment of $11.25 million has been made with the balance to be paid in September 2004 (see note 6).

6. Debt, Commitments, and Contingencies

The debt maturities and estimated cash requirements for TVA as of June 30, 2004, are as follows:

(in millions)	2004*	2005	2006	2007	2008	Thereafter	Total
Debt	$ 1,906	$ 2,000	$ 2,621	$ 956	$ 91	$ 15,737	$ 23,311
Leases	14	54	50	45	39	94	296
Lease/leaseback obligations	24	84	85	85	89	1,386	1,753
Power purchase obligations	40	151	151	138	115	2,634	3,229
Other purchase commitments	791	633	459	265	96	108	2,352
Fuel purchase obligations	368	1,130	908	597	411	856	4,270
Pension contribution	11	–	–	–	–	–	11
Total	$ 3,154	$ 4,052	$ 4,274	$ 2,086	$ 841	$ 20,815	$ 35,222

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

(in millions)	2004*	2005	2006	2007	2008	Thereafter	Total
Energy prepayment obligations	$ 27	$ 105	$ 106	$ 106	$ 105	$ 1,033	$ 1,482

* Period July 1 – September 30, 2004

7. Legal Proceedings

In the fall of 1999, the Environmental Protection Agency ("EPA") commenced judicial or administrative actions against a number of utilities in the eastern United States, including TVA, alleging that they modified their coal-fired units without complying with the Clean Air Act's ("CAA") new source review ("NSR") requirements. EPA issued an administrative order directing TVA to put new source controls on 14 of its coal-fired units and evaluate whether more controls should be installed on other units. TVA challenged the validity of this order, and on June 24, 2003, the U.S. Court of Appeals for the Eleventh Circuit ("Eleventh Circuit") issued its decision in the case. Although the Eleventh Circuit did not rule on the merits of the case, the court held that the procedure used by EPA against TVA was unconstitutional because it allowed EPA to decide that a regulated party like TVA has violated the law and is liable for severe penalties without ever allowing the regulated party to present evidence on whether the law was in fact violated. On May 3, 2004, the United States Supreme Court denied EPA's petition for review, refusing to review the Eleventh Circuit's decision that EPA's procedure for imposing administrative compliance orders was unconstitutional.

The National Parks Conservation Association ("NPCA") and the Sierra Club filed cases in two federal district courts in 2001 alleging similar violations to those in EPA's administrative order at TVA's Bull Run Fossil Plant and Colbert Fossil Plant Unit 5. These cases had been stayed pending the Supreme Court's decision, but in light of the Supreme Court's action, the stays have been lifted. (See "*Legal Proceedings*" in the 2003 Information Statement.)

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

- The federal judge presiding over the suit brought by the Alabama Environmental Council and Sierra Club alleging that TVA violated CAA opacity limits at its Colbert Fossil Plant between July 1, 1997, and June 30, 2002, has reassigned the case to a new judge. No trial is currently scheduled in this case, and it is unlikely that the trial will be scheduled before the spring of 2005. (See "*Legal Proceedings*" in the 2003 Information Statement.)

- On July 25, 2003, TVA received a notice of intent to sue from Our Children's Earth Foundation ("OCE"). OCE alleges 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. OCE also alleges 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 allege a specific amount of damages. 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. OCE stated in its notice that they intend to file suit anytime after 60 days from the date of their letter, but they have not done so to date.

- 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 date of the notice. The alleged opacity violations substantially overlap those that were challenged in a lawsuit previously filed by the NPCA in federal court in Knoxville, Tennessee. TVA ultimately prevailed in the previous lawsuit.

On December 28, 2001, Bowater Incorporated and Bowater Newsprint South, Inc. (together, "Bowater") filed a lawsuit against TVA in federal court in Knoxville, Tennessee, challenging TVA's charges for Economy Surplus Power ("ESP") and Testing and Restart Power ("TRP") for two Bowater plants. In its complaint, Bowater alleges that in violation of the contract provision which states that TVA will charge ESP and TRP customers based on TVA's actual hourly incremental cost of providing ESP (1) TVA included certain alleged non-incremental costs in the prices for ESP and TRP and (2) when calculating such prices TVA used the cost of providing the most expensive 100 megawatts of ESP sold during a given hour instead of the average cost in that hour of serving the entire ESP load. The complaint also alleges that TVA has been unjustly enriched as a result of these overcharges. The lawsuit seeks, among other things, compensatory damages in excess of $39 million and interest of more than $15 million. The case is set for trial in January 2005.

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the federal district court in Birmingham, 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 class lawyers have identified two new proposed class representatives, and the district court has allowed the substitution of these two class representatives while allowing TVA to challenge their adequacy to serve as class representatives and other class action issues after a period of discovery. TVA is opposing the designation of these class members as class representatives, and the district judge set the matter for briefing in September 2004. The district judge subsequently transferred the case to a new judge, and it is uncertain whether the existing schedule will remain in place.

On March 18, 2004, North Carolina filed a petition with the EPA under the interstate air pollution provision of the CAA, section 126, seeking a finding that the sulfur dioxide and nitrogen oxide emissions from large fossil-fueled electric generating units in 13 states, including all of TVA's fossil-fueled units in Tennessee, Alabama, and Kentucky, are contributing to North Carolina's nonattainment of EPA's national ambient air quality standards for fine particulate and ozone. EPA acts on section 126 petitions through rulemaking, and TVA plans to participate in the rulemaking. If, as a result of the rulemaking, EPA makes a finding that identified sources are significantly contributing to North Carolina's inability to meet these standards, EPA could establish revised permit limits for these sources. Alternatively, EPA could conclude that its January 2004 proposed Interstate Air Quality rule will resolve any impermissible pollutant transport.

In April 2004, a lawsuit was filed against TVA and 22 electric cooperatives (which provide power to members/consumers across many counties in Tennessee) in federal district court in Nashville, Tennessee. The plaintiffs are Tennessee residents and customers of some of the cooperatives and are seeking class action status on behalf of all similarly situated customers. The plaintiffs allege a number of violations of federal and state law, including the antitrust laws and the Tennessee Consumer Protection Act. They claim that (1) TVA and the cooperatives have unreasonably restrained trade and have created and maintained artificially high power rates, (2) the cooperatives are required by Tennessee law to issue patronage refunds or reduce rates and have failed to do so, and (3) the cooperatives have breached the fiduciary duty owed to the plaintiffs by mismanaging assets, using the assets in an improper manner, and entering into contracts with TVA which precluded them from issuing patronage refunds or reducing rates as required by law. The plaintiffs have asked the court to issue an injunction barring TVA and the cooperatives from engaging in unfair competition practices and to award the plaintiffs actual and treble damages (based on the alleged violation of antitrust statutes), restitution, rescission, or any other appropriate remedy pursuant to the Tennessee Consumer Protection Act. TVA has moved for summary judgment. In July 2004, the plaintiffs filed an amended complaint adding an inverse condemnation claim and a due process claim.

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

8. Stewardship Responsibilities

During the first nine months of 2004, TVA continued to conduct certain nonpower programs including managing navigable river channels, providing flood control, and overseeing certain recreation facilities. TVA's responsibilities under these nonpower programs 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 from various sources, including power funds, in the event that there were insufficient appropriations or other available funds to pay for such activities in any year. Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. TVA primarily is using power revenues (along with user fees and other forms of nonpower revenues) to continue to fund these stewardship activities. TVA spent a total of $57 million of power revenues on essential stewardship activities during the first nine months of 2004.

9. Subsequent Events

Legal

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 allegations 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.

TVA's answer is not yet due, and TVA has not yet answered the complaints.

Regulatory

On July 9, 2004, the EPA published a final rule in the Federal Register that established performance standards for certain existing power producing facilities that are designed to withdraw 50 million gallons or more of water per day from rivers, streams, lakes, oceans, or other waters, and use 25 percent or more of this withdrawn water exclusively for cooling purposes. The rule implements Section 316(b) of the Clean Water Act which requires that the location, design, construction, and capacity of cooling water intake structures reflect best technology available for minimizing adverse environmental impact. The regulations will be implemented through the National Pollutant Discharge Elimination System permit process. The regulations have been challenged in federal court by a group of states and environmental groups claiming that they do not go far enough in protecting aquatic animals from the entrainment and impingement impacts resulting from the use of intake structures. The cost of complying with the regulations published on July 9, 2004, is not expected to be significant. However, the outcome of the litigation could affect the ultimate content of the regulations, and the ultimate cost of the regulations on TVA will not be known until the litigation is finally resolved.

Debt Securities

On August 5, 2004, TVA notified bondholders that on September 4, 2004, it will redeem all of its 2001 6.25 percent electronotes® due June 15, 2016 with a par amount of $22 million and all of its 2001 6.25 percent electronotes® due July 15, 2016 with a par amount of $58 million.

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

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

Results of Operations
Net income for the third quarter was $105 million, an increase of $113 million compared with the third quarter of 2003. The increase relates to higher operating income of $73 million, higher nonoperating income of $34 million, and lower net interest expense of $6 million.

Year-to-date net income was $296 million compared to $396 million for the same period last year, a decrease of $100 million primarily related to two noncash accounting changes implemented during the first quarter of 2003. Excluding the two accounting changes, TVA had income of $296 million for the nine months ended June 30, 2004, an increase of $117 million from the same period last year. The increase reflects higher operating income of $46 million, higher nonoperating income of $43 million, and lower net interest expense of $28 million.

Operating Revenues. Total sales of electricity increased 3.1 billion kilowatt-hours, or about eight percent, for the quarter ended June 30, 2004, over the same period of 2003. The increase was primarily weather related with two all time May peak demands occurring during 2004. Heating degree days increased 51 percent and cooling degree days increased 49 percent during the third quarter of 2004 as compared to the prior year. The increase in total sales for the nine month period ended June 30, 2004, over the same period of 2003 was 3.8 billion kilowatt-hours, or about three percent, and was also weather related. Cooling degree days increased 38 percent, partially offset by a decrease in heating degree days of six percent in comparison with the prior year.

A detailed table of electricity sales for the three and nine month periods ended June 30, 2004 and 2003, is as follows:

	Three months ended June 30		Nine months ended June 30	
(millions of kWh)	2004	2003	2004	2003
Sales of electricity				
Municipalities and cooperatives	32,509	30,219	96,501	94,154
Industries directly served	7,539	6,786	23,195	21,962
Federal agencies and other	673	649	2,371	2,118
Total sales of electricity	40,721	37,654	122,067	118,234

A detailed table of operating revenues for the three and nine month periods ended June 30, 2004 and 2003, is as follows:

	Three months ended June 30			Nine months ended June 30		
(millions of dollars)	2004	2003	Percent Change	2004	2003	Percent Change
Operating revenues						
Sales of electricity						
Municipalities and cooperatives	$ 1,568	$ 1,396	12.3%	$ 4,699	$ 4,368	7.6%
Industries directly served	227	194	17.0%	640	597	7.2%
Federal agencies and other	30	27	11.1%	97	86	12.8%
Other revenue	32	13	146.2%	77	53	45.3%
Total operating revenues	$ 1,857	$ 1,630	13.9%	$ 5,513	$ 5,104	8.0%

On August 27, 2003, the TVA Board of Directors ("Board") approved rate actions to fund certain clean-air improvements for the next ten years and to help retain manufacturing jobs in the Tennessee Valley. The Board approved an overall 6.1 percent increase in electric rates. The Board also approved a change in the rate structure to more equitably distribute TVA's costs to serve various customer groups and to make manufacturing rates more competitive with neighboring utilities.

Effective with the October 2003 wholesale billing months, these rate actions were implemented. The rate actions resulted in a 7.4 percent increase in wholesale rates for resale to residential and non-manufacturing loads and a two percent decrease in wholesale rates for resale to large manufacturers. Corresponding changes and adjustments were approved for distributor resale rates and for TVA's rates to directly served customers.

The increase in total operating revenues for the three and nine month periods ended June 30, 2004, over the same periods in 2003, of $227 million and $409 million, respectively, resulted primarily from the increase in TVA's electric rates discussed above and the increased sale of electricity. The increase in revenues from industries directly served for the three and nine month periods ended June 30, 2004, over the same periods last year of $33 million and $43 million, respectively, is due to higher sales to industrial customers resulting from improved economic conditions and business activity for certain industrial customers.

Fuel and Purchased Power. Fuel and purchased power expense was $561 million for the quarter ended June 30, 2004, compared with $472 million for the quarter ended June 30, 2003, an increase of $89 million, or 19 percent. Fuel costs increased $50 million, or 14 percent, due to lower hydro generation and a corresponding increase in coal generation during the third quarter. Purchased power costs increased $39 million, or 34 percent, due mainly to increased purchases of off-system power to meet a higher weather-related level of demand.

Fuel and purchased power expense was $1,509 million for the nine month period ended June 30, 2004, compared with $1,426 million in the same period last year, an increase of $83 million, or six percent. Fuel costs increased $52 million due to lower hydro generation of 12 percent which resulted in a greater reliance on coal generation, up six percent from the prior year. Purchased power costs increased $31 million due to increased purchases of off system power resulting from warmer than normal temperatures in comparison with the prior year.

Operating and Maintenance Expenses. Operating and maintenance ("O&M") costs increased $64 million, or 13 percent, from $492 million to $556 million for the quarters ended June 30, 2003, and 2004, respectively. This increase was primarily due to increased outage costs of $29 million related to more planned outages in comparison with the prior year, increased project costs of $8 million, and increased other O&M costs of $33 million, partially offset by lower base O&M costs of $6 million. Other O&M costs increased primarily due to higher employee benefit costs of $7 million, increased pension expense of $25 million resulting from actuarial decreases in asset returns and a change in related discount rates, and recognition of termination benefit expense of $7 million not present in the prior year (see *Strategic Plan Implementation* and note 1 — *Reduction in Workforce*).

O&M expenses increased $219 million, or 15 percent, from $1,465 million to $1,684 million for the nine month periods ending June 30, 2003, and 2004, respectively. The increase was primarily due to increased outage costs of $59 million related to more planned outages in comparison with the prior year, increased project costs of $17 million, and increased other O&M costs of $150 million, partially offset by lower base O&M costs of $11 million. Other O&M costs increased primarily due to higher employee benefit costs of $24 million, increased pension expense of $76 million resulting from actuarial decreases in asset returns and a change in related discount rates, increased lease/leaseback costs of $15 million, and recognition of termination benefit expense of $29 million not present in the prior year.

Depreciation and Accretion. Depreciation and accretion increased from $265 million to $277 million for the quarters ended June 30, 2003, and 2004, respectively. Depreciation and accretion increased for the nine months ending June 30, 2004, from $792 million in the prior year to $823 million in 2004. The increase in depreciation and accretion for both periods resulted from increased capital projects placed in service during 2004.

(Gain) Loss on Project Cancellation. In December 2003, TVA was notified that Regenesys Technologies Limited ("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 $36 million in the Regenesys project and, accordingly, TVA recognized a $36 million loss on the cancellation of the Regenesys project in the second quarter of 2004. On April 30, 2004, RTL reimbursed TVA for early termination of the contract in the amount of $15 million, which reduced the net loss to $21 million on the cancellation of the Regenesys project (see note 1 — *Project Cancellation*).

Unrealized Gain (Loss) on Derivative Contracts. The unrealized gain on derivative contracts of $29 million was an increase of $33 million for the three months ending June 30, 2004, in comparison with the prior year. The increase was primarily related to mark-to-market adjustments on swaption and swap contracts. Unrealized gain on derivative contracts increased for the nine months ending June 30, 2004, from a $6 million loss in the prior year to a $33 million gain in 2004 also from mark-to-market adjustments on swaption and swap contracts (see note 4).

Interest Expense. Net interest expense was $326 million for the quarter ended June 30, 2004, compared with $332 million in 2003. This reduction reflects a lower level of total outstanding debt during the third quarter of 2004. Total outstanding indebtedness, excluding discounts and premiums, as of June 30, 2004, was $23.3 billion with a blended average interest rate for the quarter of 6.09 percent (of long-term and short-term debt); as of June 30, 2003, total outstanding indebtedness, excluding discounts and premiums, was $24.9 billion with a blended average interest rate for the quarter of 5.66 percent (of long-term and short-term debt). The average long-term and short-term interest rates for the quarter ended June 30, 2004, were 6.18 percent and 1.37 percent, respectively, compared with 6.26 percent and 1.21 percent for the same quarter of 2003.

Net interest expense declined $28 million for the nine months ended June 30, 2004, from $1,013 million in 2003 to $985 million in 2004. This reduction reflects lower average interest rates and a lower level of total outstanding debt during the first nine months of 2004. The blended average interest rate on debt was 6.05 percent for the first nine months of 2004 compared with 5.82 percent for the same period of 2003. The average long-term and short-term interest rates for the nine months ended June 30, 2004, were 6.22 percent and 1.00 percent, respectively, as compared with 6.45 percent and 1.34 percent in the prior year.

Cumulative Effects of Accounting Changes. The net gain of $217 million from accounting changes during the first quarter of 2003 resulted from a gain related to a change in accounting for unbilled revenues of $412 million, partially offset by a charge related to a change in accounting for asset retirement obligations of $195 million.

Material Changes in Liquidity and Capital Resources

Comparative Cash Flow Analysis - Power Program

Net cash provided by operating activities increased $50 million from $223 million to $273 million for the three month periods ending June 30, 2003, and 2004, respectively. The increase reflects higher operating revenues of $227 million driven primarily by the 2004 rate increase. Other items providing cash were $9 million compared to the other items using cash of $1 million in the same quarter last year, and deferred nuclear refueling outage costs decreased $21 million due to the number and timing of outages. Other changes included decreased cash outlays for O&M costs of $44 million offset by increased cash paid for purchased power of $82 million. Cash required by working capital components increased $124 million, from $62 million in 2003 to $186 million in 2004. This increase resulted from a decrease in accounts payable and accrued liabilities of $9 million compared to an increase in accounts payable and accrued liabilities of $100 million in the third quarter of 2003, a larger decrease in accrued interest of $3 million, and a larger increase in accounts receivable of $48 million, partially offset by a decrease in inventories and other of $3 million compared to an increase in inventories and other of $33 million in the same period last year.

Net cash provided by operating activities increased $1,413 million from $1,091 million to $2,504 million for the nine month periods ending June 30, 2003, and 2004, respectively. The increase primarily reflects $1.5 billion in proceeds received from MLGW for energy prepayments and higher operating revenues of $409 million. Cash outlays for interest declined $7 million, deferred nuclear refueling outage costs increased $23 million due to the number and timing of outages, and other items requiring cash decreased $2 million. Other changes included increased cash outlays for O&M costs of $65 million and increased cash paid for purchased power of $82 million. Cash required for working capital components was $212 million for the first nine months of 2004 compared with $3 million in the first nine months of 2003. This change resulted from a smaller decrease in accounts receivable of $163 million and a larger decrease in accounts payable and accrued liabilities of $124 million, partially offset by a smaller increase in inventories and other of $54 million and a smaller decrease in accrued interest of $24 million.

Cash used in investing activities decreased $139 million for the three months ended June 30, 2004, primarily due to decreased expenditures for capital projects of $80 million, a decrease in nuclear fuel expenditures of $31 million due to timing of enrichment services performed, and proceeds from the Regenesys project cancellation settlement of $15 million.

Cash used in investing activities decreased $144 million for the nine month period ending June 30, 2004, compared to the prior year. The decrease is primarily due to lower construction expenditures of $60 million, a decrease in nuclear fuel expenditures of $86 million, an increase in allowance for funds used during construction of $19 million, and proceeds from the Regenesys project cancellation settlement of $15 million partially offset by a decrease in investment proceeds of $33 million. Four nuclear plants completed refueling outages between June 2003 and June 2004 with one unit reflected in 2003 and three units reflected in 2004. The current year reflects certain nuclear fuel inventory that built up during the prior year in preparation for the reloads. Both factors contributed to the overall decrease in nuclear fuel expenditures.

Net cash used in financing activities was $39 million for the three months ended June 30, 2004, compared with net cash provided by financing activities of $95 million for the same period of 2003. Long-term debt issues decreased $850 million and redemptions of long-term debt increased $528 million. Net redemptions of short term debt totaled $757 million in the prior year compared to net issues of $635 million in the current year. There were no proceeds received from combustion turbine financing in the three months ended June 30 in the current year compared to $162 million received for the same period in the prior year.
Net cash used in financing activities was $1,562 million for the nine month period ended June 30, 2004, compared

with net cash provided by financing activities of $66 million for the same period of 2003. This change is primarily related to the use of the $1.5 billion in proceeds received from energy prepayments to reduce debt during 2004. Long-term debt issues decreased $391 million and redemptions of long-term debt increased $641 million. Net redemptions of short-term debt increased $195 million compared to the prior year. There were no proceeds received from combustion turbine financing or call monetizations in the nine months ended June 30 of the current year compared to $325 million and $175 million, respectively, received in the same period of the prior year.

Comparative Cash Flow Analysis-All Programs

The Statements of Cash Flows-All Programs are substantially the same as the Statements of Cash Flows-Power Program and should be viewed in conjunction with the Comparative Cash Flow Analysis-Power Program and the Statements of Cash Flows-Power Program.

Working Capital

At June 30, 2004, TVA had negative working capital of $3,334 million, largely attributable to current maturities of long-term debt of $3,000 million and short-term indebtedness of $906 million. The table below summarizes the components of working capital. TVA's cash management policy is 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 and interest coverage levels are met.

	Power Program		All Programs	
(in millions)	June 30 2004	September 30 2003	June 30 2004	September 30 2003
Current assets	$ 1,934	$ 2,053	$ 1,935	$ 2,054
Current liabilities	(5,268)	(5,901)	(5,269)	(5,902)
Working capital	$ (3,334)	$ (3,848)	$ (3,334)	$ (3,848)
Discount notes <90 days	$ 906	$ 2,080	$ 906	$ 2,080
Current maturities of long-term debt	3,000	2,336	3,000	2,336
Total short-term debt	$ 3,906	$ 4,416	$ 3,906	$ 4,416

Financing Activities

Capital Resources

From October 1, 2003 to June 30, 2004, TVA issued $222 million of electronotes® with an average interest rate of 4.78 percent and also reopened its 2002 Series A bonds due May 23, 2012 for an additional $550 million principal amount at an effective interest rate of 4.22 percent. During this period, one issue of power bonds totaling $400 million with an interest rate of 5.00 percent matured. In addition, two power bonds of $25 million each, one with an interest rate of 7.50 percent and one with an interest rate of 7.65 percent, were redeemed. TVA also redeemed $118 million of electronotes® carrying an average interest rate of 4.95 percent as well as two issues of power bonds of $476 million and $10 million carrying interest rates of 6.88 and 4.75 percent, respectively. On May 3, 2004, investors put $115 million of the 1999 Series A PARRS issue back to TVA. On May 1, 2004, the interest rate on the remaining outstanding bonds of that issue reset from 6.50 percent to 5.62 percent. TVA also issued discount notes of nearly $10 billion while redeeming $11 billion of discount notes. The average interest rate on the discount notes issued was 0.99 percent.

TVA does not anticipate needing additional funds from its electronotes® program during the remainder of 2004. Accordingly, TVA suspended its electronotes® program for the remainder of 2004 following the electronotes® issuance that closed on April 15, 2004.

Energy Prepayment Obligations

During October 2002, TVA introduced an energy prepayment program called the Discounted Energy Units ("DEU") program. Annually for fiscal years 2003 to 2007, TVA customers may purchase DEU generally in $1 million increments, which entitles them to a $0.025/kWh discount on a specified quantity of firm power over a period of years (5, 10, 15, or 20) for each kilowatt-hour in the prepaid block. The remainder of the price of the kilowatt-hours delivered to the customer is due upon billing. This program allows customers to use the DEU to reduce their overall costs and provides a higher return for available cash. TVA does not anticipate selling additional DEUs during the remainder of 2004.

As of June 30, 2004, TVA had entered into sales agreements for 47.25 DEU totaling $47.25 million for the 2003 program and sales agreements of 7.25 DEU totaling $7.25 million for the 2004 program. TVA is accounting for the prepayment proceeds as unearned revenue and reported the obligations to deliver power as Energy prepayment obligations and Current portion of energy prepayment obligations on the June 30, 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers, based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of June 30, 2004, nearly $8 million has been applied against power billings on a cumulative basis during the life of the program, of which $4.1 million was recognized as revenue during 2004.

During 2004, TVA and its largest customer, Memphis, Light, Gas & Water ("MLGW"), entered into an energy prepayment agreement under which MLGW prepaid TVA $1.5 billion for the costs of electricity to be delivered by TVA to MLGW over a period of 180 months. In exchange for this prepayment, MLGW receives a credit on its monthly bills during this period. The City of Memphis issued bonds with net proceeds of $1.5 billion which were used to fund this prepay arrangement. The principal and interest on the bonds are payable from MLGW's pledged revenues. The bonds are not obligations of TVA and are not secured by any TVA revenues or property. TVA received the $1.5 billion prepayment in December 2003, accounted for the prepayment as unearned revenue, and is reporting the obligation to deliver power as Energy prepayment obligations and Current portion of energy prepayment obligations on the June 30, 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. For the nine months ended June 30, 2004, over $65 million was recognized as revenue related to this energy prepayment transaction.

Cash Requirements and Contractual Obligations
TVA's debt maturities and estimated cash commitments as of June 30, 2004, are as follows:

(in millions)	2004*	2005	2006	2007	2008	Thereafter	Total
Debt	$ 1,906	$ 2,000	$ 2,621	$ 956	$ 91	$ 15,737	$ 23,311
Leases	14	54	50	45	39	94	296
Lease/leaseback obligations	24	84	85	85	89	1,386	1,753
Power purchase obligations	40	151	151	138	115	2,634	3,229
Other purchase commitments	791	633	459	265	96	108	2,352
Fuel purchase obligations	368	1,130	908	597	411	856	4,270
Pension contribution	11	–	–	–	–	–	11
Total	$ 3,154	$ 4,052	$ 4,274	$ 2,086	$ 841	$ 20,815	$ 35,222

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

(in millions)	2004*	2005	2006	2007	2008	Thereafter	Total
Energy prepayment obligations	$ 27	$ 105	$ 106	$ 106	$ 105	$ 1,033	$ 1,482

* Period July 1 – September 30, 2004

As of June 30, 2004, the nuclear decommissioning trust funds totaled approximately $734 million. The present value of the estimated future decommissioning costs calculated in accordance with Nuclear Regulatory Commission ("NRC") requirements was $986 million. In October 2003, TVA submitted a supplemental decommissioning funding status report to the NRC. The report contained a yearly schedule of projected nuclear decommissioning trust fund balances which provides assurance that adequate funds will be available to decommission the nuclear plants when necessary. (Estimates of fund adequacy are based on current regulatory assumptions.) TVA will make contributions to the decommissioning trust fund or provide other methods of funding assurance if necessary to match its schedule of projected decommissioning fund balances. TVA's decommissioning fund met the 2003 funding target of approximately $606 million.

Strategic Plan Implementation
To ensure safe, reliable operations and to prepare for a more competitive electricity market, TVA has implemented a strategic planning process that analyzes how the new market may function, what competitive pressures TVA will face, and how TVA must prepare now for success in the future. More specifically, the process focuses on what TVA needs to do in order to preserve TVA's core mission to provide low-cost power, promote economic prosperity in the Valley, and enhance environmental stewardship, and to remain financially viable in a competitive market.

As part of its strategic plan, TVA is striving to enhance its financial flexibility by reducing debt and other fixed costs. TVA expects a substantial portion of the necessary budget reductions to come from (1) reductions in capital projects, with resulting reductions in spending for materials and contractors, (2) reductions in contractors supporting ongoing work, and (3) a methodical review of all TVA programs and functions, including staffing levels. To this end, organizations within TVA are performing program and staffing reviews to identify surplus staffing situations. In areas where surplus staffing exists, TVA asked for employees to apply for voluntary resignations beginning in February 2004. To the extent there are not enough volunteers, TVA is conducting an involuntary Reduction in Force (“RIF”). TVA expects the majority of voluntary resignations and involuntary RIFs to occur in 2004. It is anticipated that between 600 to 800 people will be affected by the change in staffing levels. Implementation of the change in staffing levels is estimated to cost between $27 million and $36 million in termination benefits. TVA has recognized expense in the amount of $29 million for estimated termination benefits incurred as of June 30, 2004.

The plan also recommends a reduction in financing obligations of $3 billion to $5 billion over the next ten to 12 years but notes that targets for reductions in financing obligations will be updated annually depending on TVA's priorities and changing market conditions.

Reservoir Operations Study
On May 19, 2004, the Board approved a new reservoir operations policy, based on the completed Reservoir Operations Study (“ROS”). The ROS consists of a comprehensive overview of how TVA operates 35 of the 49 dams and reservoirs under TVA control, and included input from state and local agencies and the public. The new policy will increase recreational opportunities on the reservoir system while maintaining TVA power production, navigation, and flood control capabilities. TVA will work with state and federal agencies to monitor the effects of the new policy on the watershed. It is expected that the implementation of the new policy will have the effect of slightly increasing power generation costs and annual operating costs and will require a minor capital investment.

New Accounting Pronouncements
In January 2003, the Financial Accounting Standards Board (“FASB”) published Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was revised by Interpretation No. 46R (“46R”) in December 2003. This interpretation explains how to identify variable interest entities (“VIEs”) 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 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 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.

In December 2003, the FASB issued SFAS No. 132 (revised), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which is designed to improve 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 the nonpublic disclosure requirements of this standard for the quarter beginning January 1, 2004 (see note 5).

In May 2004, the FASB issued Staff Position ("FSP") 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 will adopt the nonpublic disclosure requirements of the FSP for reporting periods beginning after June 30, 2004. Accordingly, TVA is in the process of evaluating the requirements of the FSP but does not expect the impact of the implementation of FAS 106-2 to have a material effect on its results of operations or financial position.

QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

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 and accordingly has established controls to determine the creditworthiness of counterparties in order to mitigate exposure to credit risk.

Weather Risk
Regarding weather risk, TVA is subject to short-term variability in weather, including both temperature variations and drought conditions affecting hydro-electric 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 year (which is particularly helpful to TVA since it is a “double-peaking utility”), and nominal changes in hydroelectric availability during high-value periods.

Operational Risk
Due to the size and diversity of the TVA generation fleet and the redundancy and robustness of the transmission system, the financial risks associated with the operation of the system are modest over periods of one year or longer.

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 "fences" TVA in, 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. (See "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "*TVA and Competition*" in Part II of the 2003 Information Statement.)

While the Fence confines TVA to this service area, the so-called "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 Fence. Thus, TVA cannot be ordered to provide access to its transmission lines for the purpose of delivering power to wholesale customers within the TVA service area.

The "anti-cherrypicking provision" minimizes the financial exposure of TVA to loss of distributor customers due to their limited access to transmission resources.

In 2003, TVA received notices from four distributors of TVA power to terminate their power contracts. The notice from Bowling Green Municipal Utilities terminates its power contract with TVA in October 2007, the notice from Warren Rural Electrical Cooperative Corporation ("WRECC") terminates its power contract with TVA in April 2008, and the notice from Duck River EMC terminates its power contract with TVA in August 2008. The notice from Meriwether Lewis Electrical Cooperative ("MLEC"), which TVA received in October 2003, was rescinded in March 2004, and as a result of this action, TVA remains MLEC's sole provider of wholesale power. On May 25, 2004, the WRECC Board of Directors voted to become a full member of East Kentucky Power Cooperative ("EKPC") and receive its full power requirement from EKPC when WRECC's current contract with TVA expires.

In 2004, TVA also received notice from Monticello Electric Plant Board that terminates its power contract with TVA in November 2008 and notice from Glasgow Electric Plant Board that terminates its power contract with TVA in December 2008.

In 2003, sales to the distributors who have given notice to terminate their power contracts with TVA were $205 million and represented approximately 3.0 percent of TVA's total electricity sales.

Derivatives
To manage the volatility attributable to its various risk exposures, TVA has entered into various nontrading derivative transactions. 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*, 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. These currency and interest rate swap agreements 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 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.

Other derivative contracts include various purchased power option contracts, coal and natural gas contracts, certain swaption agreements, purchased options related to emission allowances, and future contracts (see note 4). Hedges entered into in conjunction with these contracts qualify for fair value hedge accounting 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.

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 allows 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 the 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 June 30, 2004, TVA's derivative financial instruments under this pilot program consisted solely of short-term natural gas futures contracts having a maturity of two months or less and a total volume of 540,000 mmBtu of natural gas. These derivative contracts do not qualify for hedge accounting under SFAS No. 133. Since the commencement of trading on May 26, 2004, TVA recognized unrealized losses of $145,000 and realized losses of $61,000 which were included in purchased power expense for the quarter ended June 30, 2004.

CONTROLS AND PROCEDURES

TVA's management, including the Chief Financial Officer ("CFO") 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 CFO concluded that the disclosure controls and procedures are effective in providing reasonable assurance that all material information necessary and appropriate for disclosure in this Quarterly Report has been made known to them in a timely fashion. TVA's disclosure controls and procedures are effective in providing reasonable assurance that information to be disclosed in TVA's reports is accumulated and communicated to management, including the members of the Board and the CFO, as appropriate, to allow timely decisions regarding disclosure. There have been no changes in internal control over financial reporting during the quarter ended June 30, 2004, 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 above 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

At the May 19, 2004, Board Meeting, the Board:

> Approved and directed staff to begin implementing the preferred alternative identified in the final environmental impact study for Reservoir Operation Study. See "*Management Discussion and Analysis of Financial Condition and Results of Operations*" — "*Reservoir Operations Study.*"
>
> Delegated authority to the Executive Vice President, Fossil Power Group, to enter into a contract with Norfolk Southern Railway Company for transportation of coal to John Sevier Fossil Plant. The term of the contract is three years, and the estimated total cost of the contract is $51.2 million.

As of March 25, 2004, the Board approved entering into a contract with the United States Enrichment Corporation for uranium enrichment services and enriched uranium for TVA's Browns Ferry Nuclear Plant. The total cost of the contract is estimated to be $65 million.

As of April 1, 2004, the Board approved a contract supplement for management and craft labor for the planning and execution of modification and supplemental maintenance work at TVA's fossil and hydro plants, as well as other TVA controlled facilities, and the completion of multiple Selective Catalytic Reduction projects at TVA assigned fossil plants. This supplement increases the contract cost by $182 million, for a total contract cost of $973.6 million.

ADDITIONAL INFORMATION

Management

On August 2, 2004, Kenneth Breeden joined TVA to prepare to fill the position of Executive Vice President, Customer Service and Marketing. Mr. Breeden will replace Mark Medford who has announced plans to retire later this year. Mr. Breeden has 20 years of utility industry experience, having served in officer positions at both TXU Corp. in Dallas, Texas, and Entergy Services Inc. in Little Rock, Arkansas. He holds a B.S. in Business Administration and an MBA from Wichita State University.

Karl Singer assumed the position of Chief Nuclear Officer and Executive Vice President, TVA Nuclear, on June 1, 2004. He replaces John Scalice who previously announced his retirement in February 2004.

Legislation

On February 12, 2004, Senate Energy and Natural Resources Committee Chairman, Pete V. Domenici, R-NM, introduced a new "slimmed down" national energy policy bill, S. 2095 ("S. 2095"). Although "slimmed down," S. 2095 contains the same provisions with respect to TVA that were included in the energy bill that came out of the Conference Committee, but did not become law, in the last session of Congress.

Among other things, S. 2095 would (1) convert TVA's Board of Directors into a part-time Board of nine members serving sequenced five-year terms and create a new position of Chief Executive Officer to manage TVA's day-to-day operations, (2) 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 (3) 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, S. 2095 contains some unclear language that might be interpreted as inadvertently repealing the "anti-cherrypicking provision." However, TVA does not believe that this provision of S. 2095 was included with the intention of repealing the "anti-cherrypicking provision."

During the summer of 2004, the House of Representatives passed an energy bill identical to the one that was reported out of Conference Committee and approved by the House last year. A number of controversial issues have prevented the Senate and House from reaching agreement on common language for an energy bill. Although key members of Congress have pledged to work together to resolve the differences on the energy bill, it is unclear whether there will be energy legislation this year and, if so, how it would affect TVA.

Operations

<u>Peak Demand</u>

The TVA power system met its highest-ever power demand on July 13, 2004, with a record 29,878 megawatts. All of the available generating units at TVA's coal, nuclear, hydro, combustion-turbine and pumped-storage plants, along with

TVA's renewable-energy portfolio and transmission system, performed extremely well to meet this record power demand.

Widows Creek Fossil Plant
Widows Creek Fossil Plant Unit 8 is currently operating within applicable opacity limits. TVA has installed necessary modifications to the scrubber hardware to further reduce opacity. As previously reported, the unit was not meeting applicable opacity limits immediately after installation of a major scrubber modification on December 20, 2003.

Browns Ferry Unit 1
In May 2002, the TVA 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. 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 June 30, 2004, TVA had incurred approximately $723 million of costs (including AFUDC of $34 million) on the Browns Ferry Unit 1 restart project, the planned amount for this period. The restart project was about 49 percent complete at that date.

Regulatory Actions
License Renewal Application
TVA submitted its license renewal application for Browns Ferry Nuclear Plant on December 31, 2003. The NRC has set a 28-month schedule to review the submittal. The NRC staff's goal is to complete a review in 22 months if there is no hearing and 30 months if a hearing is held. The NRC said the longer schedule was necessary due to "the complexity and uniqueness of the application" since it involves Browns Ferry Unit 1, which has been shut down for 19 years. Since no one petitioned to intervene, the license renewal proceeding is uncontested.

Other
Participation in PJM Interconnection Energy Market
Effective July 7, 2004, TVA joined the PJM Interconnection Energy Market, the world's largest competitive wholesale electricity market. This arrangement will not result in any changes in how the TVA transmission system is operated or controlled and will be consistent with the statutory constraints on where TVA power may be sold.

TVA Nuclear
In July 2004, TVA began its Dry Cask Storage Program at Sequoyah Nuclear Plant, which involves transferring spent nuclear fuel to casks which are then placed on a pad within the protected area of the facility. The first dry cask was loaded and placed on the storage pad on July 13, 2004. This will provide additional storage for spent nuclear fuel and help reduce the impact of the Department of Energy's failure to accept spent nuclear fuel, which it agreed to do via a contract with TVA executed on June 28, 1983.

Green Power
In December 2002, TVA entered into a 20-year Power Purchase Agreement with Invenergy TN LLC to purchase energy from a 27 megawatt wind-powered generating facility. The wind-turbine generating units are expected to be completed by the end of 2004, and it is expected that TVA will begin taking power from this facility in fiscal year 2005.

CERTIFICATIONS OF THE MEMBERS OF THE TVA BOARD OF DIRECTORS

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

1. I have reviewed the Tennessee Valley Authority Quarterly Report (“Report”) for the quarterly period ended June 30, 2004;

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 unaudited financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;

4. 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 June 30, 2004, 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: August 11, 2004

Glenn L. McCullough, Jr. Chairman	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 June 30, 2004;

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 unaudited financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;

4. 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 June 30, 2004, 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: August 12, 2004

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

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