



Tennessee Valley Authority

£200,000,000

5.35% Global Power Bonds

1998 Series H Due June 7, 2021

Issue Price: 99.649%

The Tennessee Valley Authority ("TVA") is issuing £200,000,000 aggregate principal amount of its 5.35% Global Power Bonds 1998 Series H Due June 7, 2021 (the "Bonds"). The Bonds will bear interest from December 2, 1998, payable semi-annually in arrear on each December 7 and June 7, commencing June 7, 1999.

The Bonds will not be subject to redemption prior to maturity. The Bonds will be issued in minimum denominations of £1,000 and integral multiples thereof.

The Bonds will be represented by one or more global securities (collectively, the "Global Bond") in fully registered form, which will be deposited with a custodian for The Depository Trust Company ("DTC") and registered in the name of a nominee of DTC for the accounts of its participants (including the DTC participant that holds for the benefit of each of Morgan Guaranty Trust Company of New York, Brussels office, as operator of the Euroclear System ("Euroclear"), and Cedelbank, société anonyme ("Cedelbank")). Beneficial interests in the Bonds will be shown on, and transfers thereof will be effected only through, records maintained by DTC and its direct and indirect participants. Investors electing to hold beneficial interests in the Bonds through financial institutions other than DTC will hold indirect interests in the Global Bond. Except in limited circumstances, definitive Bonds will not be issued in exchange for beneficial interests in the Global Bond. See "Description of Bonds" — "Definitive Bonds" and "Clearance and Settlement".

Purchasers of beneficial interests in the Bonds are required to pay for the Bonds in immediately available British pound sterling funds. The Manager (as defined herein) is prepared to arrange for the conversions of U.S. dollars into British pounds sterling to enable investors in the United States to make such payment. See "Currency Conversions and Foreign Exchange Risks".

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

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

TVA is a wholly owned corporate agency and instrumentality of the United States of America. Principal and interest will be payable solely from TVA's Net Power Proceeds (as defined herein).

The Bonds shall be governed by and construed in accordance with the laws of the State of New York, to the extent such law is not inconsistent with U.S. federal law.

THE BONDS WILL NOT BE OBLIGATIONS OF, NOR WILL PAYMENT OF THE PRINCIPAL THEREOF OR THE INTEREST THEREON BE GUARANTEED BY, THE UNITED STATES OF AMERICA. THE BONDS ARE NOT REQUIRED TO BE REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933. ACCORDINGLY, NO REGISTRATION STATEMENT HAS BEEN FILED WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION. TVA IS NOT SUBJECT TO THE PERIODIC REPORTING REQUIREMENTS OF THE U.S. SECURITIES EXCHANGE ACT OF 1934.

The Bonds will be purchased solely by J.P. Morgan Securities Ltd. at a purchase price of 99.199% of the principal amount thereof (£198,398,000 in the aggregate), plus accrued interest, if any, from December 2, 1998 to the date of delivery. The Bonds will be offered to the public initially at an offering price of 99.649% of the principal amount thereof (£199,298,000 in the aggregate), plus accrued interest, if any, from December 2, 1998 to the date of delivery.

The Bonds are offered by the Manager subject to prior sale, withdrawal, cancellation or modification of the offer without notice, to delivery to and acceptance by the Manager and to certain further conditions. It is expected that delivery of the Bonds will be made on or about December 2, 1998, against payment therefor in immediately available British pound sterling funds.

J.P. Morgan Securities Ltd.

G L O B A L I M P A C T

TVA is recognized around the world as an expert in power production, flood control, river navigation, and environmental quality. Many international visitors come to TVA each year to study its river operations and power program. TVA has hosted representatives from countries such as Australia, Brazil, Sri Lanka, China, Estonia, France, Germany, India, Japan, Malaysia, Poland, Russia, Sweden, and Tanzania.



Southeastern Region Served by the Tennessee Valley Authority



Countries around the globe have come to depend on TVA's knowledge and experience in the utility industry and in resource management. For example:

- The Republic of Georgia is receiving assistance from TVA in analyzing its energy needs. Georgia's Energy Department is a sister utility to TVA as part of a program funded by the United States Agency for International Development.
- The People's Republic of China is using TVA's expertise in developing the Yellow and Yalong rivers for flood control, hydroelectric power, industrial development, and farming. In fact, China is using TVA as a model.
- TVA has been involved in the study phases of river development programs in Lesotho, South Africa, the Nile in Sudan, Lake Titicaca located between Bolivia and Peru, and Zimbabwe.

These are just a few of the reasons why TVA has an international reputation for teamwork, innovation, and dependability.



U.S. Ambassador to the People's Republic of China Jim Sasser (left) greets TVA Chairman Craven Crowell at a reception at the U.S. Embassy in Beijing in conjunction with Tennessee Valley Authority's and the State of Tennessee's international conference on economic development and energy.

PROVIDING POWER IN THE PUBLIC INTEREST

TVA is poised to be a major player in what is predicted to be a new, highly competitive electric utility



market. With one of the largest generating and transmission

systems in the United States,

TVA's power operations form a vital part of the nation's energy

infrastructure.



TVA provides reliable, universal access to electricity at competitive prices and provides stewardship of the lands and waters of the Tennessee River Valley. TVA power enriches lives, promotes economic growth, and improves the overall quality of life in the Tennessee Valley.



TVA's power system is entirely self-funded and not supported by any U.S. federal tax dollars. The power system is running better today than at any time in the past decade. TVA has made substantial improvements to its nuclear program over the last decade, restarting four nuclear units, completing and starting a fifth and bringing its total nuclear generation to over 40 billion kWh in fiscal 1997. TVA's fossil and hydro plants increased their productivity by about 20 percent systemwide between fiscal 1994 and 1997. TVA carries out other programs mandated by the U.S. Congress, such as eco-

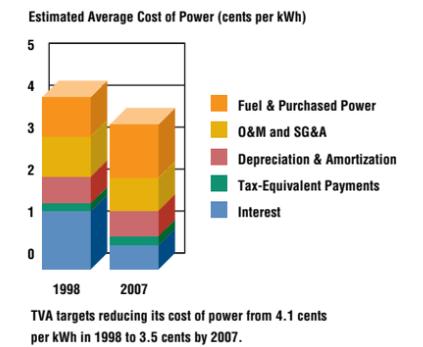
nomie development, flood control, navigation and natural resource development on the Tennessee River.

TVA unveiled an ambitious 10-year Business Plan in July 1997 that is designed to strengthen it financially, position the electric power operations to meet the competitive challenges of a restructured marketplace, promote economic development and provide power to its customers at the lowest feasible rates. This plan sets a focused course for TVA to reduce its debt by half by 2007 and lower its average cost of power to 3.5 cents per kilowatt hour.

The 10-year Business Plan is designed to accomplish long-term objectives that would enable TVA to be competitive in the coming restructured marketplace by:

- Reducing the cost of power as needed to meet the lower market prices anticipated in a more competitive market.
- Altering TVA's cost structure from a high fixed-to-variable cost relationship to a more flexible structure better suited to a volatile, competitive market.
- Strengthening customer allegiance and satisfaction by developing opportunities for mutual support and partnerships.

TVA is committed to serving the public good—through economic development, reliable service, environmental stewardship and universal access. TVA, as a government owned power entity, is an advocate for the public interest in electricity generation, transmission and distribution as the electric utility industry is restructured.



J.P. MORGAN SECURITIES LTD. MAY ENGAGE IN TRANSACTIONS THAT STABILIZE, MAINTAIN, OR OTHERWISE AFFECT THE PRICE OF THE BONDS. SPECIFICALLY, J.P. MORGAN SECURITIES LTD. MAY OVERALLOT IN CONNECTION WITH THE OFFERING, AND MAY BID FOR, AND PURCHASE, BONDS IN THE OPEN MARKET AND MAY IMPOSE PENALTY BIDS. SUCH TRANSACTIONS MAY BE EFFECTED ON THE LUXEMBOURG STOCK EXCHANGE AND/OR THE NEW YORK STOCK EXCHANGE, IN AN OVER-THE-COUNTER MARKET OR OTHERWISE.

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

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

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

This Offering Circular should be read in conjunction with TVA's current Information Statement, dated February 27, 1998 (the "current Information Statement"), which is attached hereto and incorporated herein. Any statement contained in the current Information Statement shall be deemed to be modified or superseded for all purposes of the current Information Statement and this Offering Circular to the extent that a statement contained in this Offering Circular modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified, to constitute a part of the current Information Statement. The 1998 Financial Statements contained in this Offering Circular, including the notes thereto (the "1998 Financial Statements"), and the Management's Discussion and Analysis section of this Offering Circular (together with the 1998 Financial Statements, the "Dated Information") are current only as of September 30, 1998. Any statement contained in the Dated Information shall be deemed to be modified or superseded for all purposes of the Dated Information and this Offering Circular to the extent that a statement contained in any section of this Offering Circular outside of the Dated Information modifies or supersedes such statement in the Dated Information. Any statement so modified or superseded shall not be deemed, except as so modified, to constitute a part of this Offering Circular. Additional copies of this Offering Circular and of the current Information Statement may be obtained (free of charge) upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902, Attention: Vice President and Treasurer, or by calling (423) 632-3366 in the United States. Copies may also be obtained (free of charge) from Kredietbank S.A. Luxembourgeoise (the "Special Agent" or "Listing Agent"), 43 Boulevard Royal L-2955, Luxembourg, R.C. Luxembourg B6395. The then current Information Statement and other information concerning TVA may be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

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

In this Offering Circular and the current Information Statement, references to "U.S. dollars", "U.S.\$", "dollars" and "\$" are to United States dollars, and references to "£" and "GBP" are to British pounds sterling.

Forward-Looking Statements

This Offering Circular and the current Information Statement contain forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions or assumptions or otherwise relating to future events or performance may be forward-looking. Some examples include statements regarding TVA's projections of future power and energy requirements, future costs related to environmental compliance, targets for TVA's future competitive position and the potential effect of the Year 2000 issue on TVA's operations. Although TVA believes that these statements are accurate, TVA does not guarantee their accuracy. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. Such factors include, among other things, new laws and regulations, especially those related to the deregulation of electric utilities, the status of TVA as a government agency and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial environment; performance of TVA's generating facilities; fuel prices; the demand for electricity; weather conditions; changes in accounting standards; the efficacy of TVA's Year 2000 remediation efforts and the efforts of those entities with which it interfaces; and unforeseeable adverse events.

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Summary of Offering

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

Issuer	TVA is a wholly owned corporate agency and instrumentality of the United States of America established by the Tennessee Valley Authority Act of 1933, as amended.
Securities Offered	£200,000,000 aggregate principal amount of 5.35% Global Power Bonds 1998 Series H Due June 7, 2021 (the "Bonds")
Interest	The Bonds will bear interest from December 2, 1998, at the annual rate set forth on the cover page hereof, payable semi-annually in arrear on each December 7 and June 7, commencing June 7, 1999.
Redemption	The Bonds will not be subject to redemption prior to maturity.
Global Agent	The Chase Manhattan Bank
GBP Paying Agent	The Chase Manhattan Bank (London branch)
Listings	Application has been made to list the Bonds on the Luxembourg Stock Exchange and the New York Stock Exchange.
Use of Proceeds	The net proceeds received by TVA from the sale of the Bonds will be used to retire existing debt.
Source of Payment	The interest and principal on the Bonds are payable solely from Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" in the current Information Statement.
Form and Denomination of Bonds	The Bonds will be represented by the Global Bond, which will not be exchangeable for definitive Bonds, except in the limited circumstances described herein. The Global Bond is issued in registered form in the name of Cede & Co. ("Cede"), as nominee of DTC. Beneficial interests in Bonds will be represented through accounts of financial institutions acting on behalf of beneficial owners as direct and indirect participants in DTC, including Euroclear and Cedelbank. Investors may elect to hold interests in the Bonds through DTC or through either Euroclear or Cedelbank, if they are participants in such systems, or indirectly through organizations that are participants in such systems. Beneficial interests in the Bonds will be maintained and transferred in minimum denominations of £1,000 and integral multiples thereof. See "Description of Bonds" — "Form and Denominations" and "Clearance and Settlement".
Clearance and Settlement	Beneficial interests in the Bonds may be held in accounts with institutions that are direct or indirect DTC participants, including Euroclear and Cedelbank. Initial settlement for the Bonds will be made in immediately available British pound sterling funds. However, the Manager is prepared to arrange for the conversion of U.S. dollars into British pounds sterling to enable investors in the United States to make such payment. Secondary market sales of the Bonds for settlement within each clearing system will be settled in accordance with the rules and procedures established by the relevant system. Sales to be settled within Euroclear or Cedelbank and between Euroclear and Cedelbank will normally settle on a three business day basis unless parties specify a different period (which may be as short as two business days). Sales to be settled within DTC will be settled using the procedures applicable to U.S. corporate debt obligations in DTC's Same-Day Funds Settlement System in same-day funds, if payment is effected in U.S. dollars, or free of payment, if payment is not effected in U.S. dollars. In such case, separate payment arrangements outside DTC

are required to be made between the DTC participants. Secondary market sales between a DTC participant and a Euroclear or Cedelbank participant will settle in accordance with the usual rules and operating procedures established by DTC, Euroclear and Cedelbank. See “Clearance and Settlement” and “Currency Conversions and Foreign Exchange Risks”.

Legality of Investment in the

United States

Each person or entity is advised to consult with its own counsel with respect to the legality of investment in the Bonds. The following generally describes the legality of investment in the United States in TVA Power Bonds. Power Bonds are:

- acceptable as security for all fiduciary, trust, and public funds, the investment or deposit of which shall be under the authority or control of any officer or agency of the United States of America;
- among those obligations which U.S. national banks may deal in, underwrite and purchase for their own accounts in an amount up to 10% of unimpaired capital and surplus;
- eligible as collateral for advances by U.S. Federal Reserve Banks to member banks;
- legal investments for U.S. federal savings associations and U.S. federal savings banks to the extent specified in applicable regulations;
- eligible as collateral for advances by U.S. Federal Home Loan Banks to members for which Power Bonds are legal investments; and
- legal investments for U.S. federal credit unions.

See “Legality of Investment in the United States”.

No Acceleration Rights

The Bonds will not contain any provisions permitting the Holders to accelerate the maturity thereof on the occurrence of any default or other event.

Taxation

United States federal income tax generally will not be withheld from payments on Bonds that are beneficially owned by non-U.S. beneficial owners (as defined under “United States Tax Matters”), provided that an appropriate United States Internal Revenue Service Form W-8 (or successor form) is provided. See “United States Tax Matters”. The Bonds are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA will have no obligation to pay additional interest or other amounts in respect of any such tax that may be imposed on payments on the Bonds as a result of a change in law or otherwise, including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form.

For further discussion of United States tax consequences with respect to the purchase, ownership or disposition of the Bonds, see “United States Tax Matters”.

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Tennessee Valley Authority

The Tennessee Valley Authority is one of the largest power producers in the United States of America, having produced over 155 billion kilowatt-hours (“kWh”) of electricity in fiscal 1998. The TVA system supplies electric power to a region containing nearly eight million people located in parts of Tennessee, Kentucky, Mississippi, Alabama, Georgia, North Carolina and Virginia.

TVA is a wholly owned corporate agency and instrumentality of the United States of America established pursuant to the Tennessee Valley Authority Act of 1933, as amended (the “Act”), primarily to develop and manage the resources of the Tennessee Valley region. The programs at TVA consist of power and nonpower programs. The Act requires TVA’s electric system operations to be self-supporting from power system revenues, which were about U.S.\$6.7 billion in fiscal 1998. Congress does not appropriate funds to TVA for its power program. The Act authorizes TVA to issue Evidences of Indebtedness (as defined in “Description of Bonds”), the proceeds of which TVA may only use to finance its power program. TVA’s nonpower activities include responsibilities associated with operation of the Tennessee River System, land management, economic development and the environment. Congress provided U.S.\$70 million for TVA’s nonpower programs in fiscal 1998. Appropriations legislation enacted in October 1997 anticipates no further appropriations to TVA in fiscal years following 1998. Nonetheless, Congress appropriated U.S.\$50 million for TVA’s nonpower programs in fiscal 1999. See “Recent Developments” — “Other Matters” in this Offering Circular and “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Recent Legislation” in the current Information Statement.

For over six decades, TVA has been associated with bringing prosperity to a significant region of the United States. Its dams have averted an estimated U.S.\$4 billion in flood damage; its power program has brought electricity to a large undeveloped area of the country; and its economic development program has contributed to a vast increase in the number of jobs in the Tennessee Valley.

Electric power industry restructuring is changing the way TVA and utilities across the nation generate, transmit and distribute electricity. TVA is positioning itself to successfully compete in a restructured marketplace by sustaining excellent operational performance and achieving greater financial flexibility. For 1997, TVA ranked as the third lowest-cost producer among the nation’s largest 25 generating utilities according to information published in the October 1998 issue of *Electric Light & Power* magazine. Building on its operational soundness, TVA implemented its Ten-Year Business Plan in October 1997 to reduce its total delivered cost of power consistent with the forecast future market price of power and adopt a more flexible cost structure suitable for an increasingly volatile marketplace. See “Competition” in the current Information Statement.

TVA is an advocate for the public’s interest in universal access, customer service and reliability, economic development and environmental protection. TVA will continue to work actively with Congress to ensure that these standards are upheld through the development of an equitable, effective framework for success in a restructured marketplace.

Use of Proceeds

TVA will use the net proceeds from the sale of the Bonds of £198,398,000 (before deducting expenses estimated to be £150,000) to retire existing debt.

Recent Developments

Financial Results

The following information should be read in conjunction with the audited financial statements and notes thereto (the “1998 Financial Statements”) presented on pages C-20 through C-36 herein.

Liquidity and Capital Resources

In October 1998, TVA issued in the public market U.S.\$250 million in Power Bonds (due 2001) to retire existing debt. In November 1998, TVA issued in the public market U.S.\$2,000 million in Global Power Bonds (due 2008) to retire existing debt.

Other Matters

In the spring of 1998, TVA's Allen Fossil Plant team received the Rochester Institute of Technology/*USA Today* Quality Cup award in the government category for their work in reducing the cost of compliance with environmental rules requiring coal plants to emit less sulfur dioxide. The team's work resulted in (1) a drop in sulfur dioxide emissions from 80,000 tons annually to 26,000 tons annually, (2) an 80 percent drop in losses from shutdowns of Allen Fossil Plant in fiscal 1997 and (3) U.S.\$3 million in savings during fiscal 1997 from switching to low-sulfur coal. The team's plan is being adopted by TVA at other fossil fuel plants.

On April 24, 1998, the TVA Board consolidated TVA's power production, transmission and resource stewardship functions as part of TVA's continuing actions to prepare for success in the restructured utility industry. The TVA Board named Ike Zeringue, previously TVA's Chief Nuclear Officer, to head the functions as President and Chief Operating Officer. John Scalice, formerly TVA's Senior Vice President of Nuclear Operations, served as TVA's acting Chief Nuclear Officer until June 1998, at which time he was named Chief Nuclear Officer & Executive Vice President. TVA believes that consolidating these functions will allow TVA to serve the Tennessee Valley and the nation better in a competitive market. The TVA Board also consolidated TVA's financial functions under the Chief Financial Officer, David N. Smith.

In July 1998, the TVA Board named Claude C. Cross, a veteran of the nuclear Navy and a former senior-level executive with the Institute of Nuclear Power Operations, as its Nuclear Advisor. The Nuclear Advisor provides advice and consultation to the Board about nuclear operations, as needed. In August 1998, Joseph W. Dickey, Executive Vice President, Fossil and Hydro Power Group, resigned. After Dickey's resignation, Joseph R. Bynum, previously Vice President of Fossil Operations, became the Acting Executive Vice President, Fossil and Hydro Power Group.

On March 6, 1998, the U.S. General Accounting Office (the "GAO") released a report discussing federal power marketing administrations. Although this report was not focused on TVA, an appendix to the report repeats comments regarding TVA's competitive position that the GAO initially made in reports released in August 1995 and September 1997. For a discussion of these two reports, see "Competition" in the current Information Statement.

On March 31, 1998, the GAO released a report entitled "Tennessee Valley Authority: Information on Nonpower Programs". The report, which was requested by U.S. Senators Fred Thompson and Bill Frist of Tennessee, analyzes TVA's various nonpower activities and compares them to those performed by four investor-owned utilities ("IOUs") around the country. The GAO report concludes that (1) the selected IOUs do not have nonpower roles and responsibilities that are as comprehensive in nature as TVA's; (2) activities such as flood control and navigation tend to be viewed by TVA, the selected IOUs and other officials as the responsibility of the federal government; (3) TVA's land management responsibilities, especially with regard to the Land Between The Lakes, exceed the selected IOUs' land management activities; and (4) the selected IOUs have some programs, such as ones for dam safety, that are similar to nonpower programs operated by TVA.

In August 1998, the GAO began a study of the TVA Ten-Year Business Plan at the request of two members of the U.S. Congress. Included within the study are the review of the assumptions that underlie the plan, measurement and estimating methodologies, and specific TVA plans for implementation.

On March 25, 1998, the Clinton administration proposed a Comprehensive Electricity Competition Plan (the "Competition Plan"), which addresses various aspects of national retail competition in the electric power industry, including extension of the general regulatory authority of the U.S. Federal Energy Regulatory Commission ("FERC") to cover transmission service by cooperatives and all government-owned electric systems, including TVA. In addition, the Competition Plan notes that the Clinton administration is considering issues relating to the role that the TVA power system should play in the electric power industry after nationwide competition has begun. The Competition Plan further notes that the administration expects the recommendations of the Tennessee Valley Electric System Advisory Committee (the "Advisory Committee") regarding TVA to provide the administration with a broad framework for bringing competition to TVA and restructuring its operations. The Advisory Committee is a subcommittee of the U.S. Secretary of Energy's Advisory Board and includes representatives of TVA, TVA employees, TVA customers, TVA Watch, power marketers and various interest groups in the Tennessee Valley.

Shortly after the release of the Competition Plan, the Advisory Committee released its recommendations regarding TVA. The Advisory Committee members agreed, among other things, that (1) TVA should be subject to FERC transmission jurisdiction comparable to that imposed on other transmitting utilities; (2) TVA should, to some extent, be subject to federal antitrust laws; (3) distributors or their customers should pay some type of excise tax in place of taxes on gross receipts or “in lieu of tax” payments by producers; (4) TVA should relinquish its role of regulating retail power sales; (5) the anti-cherry picking provision and the fence (as both terms are defined in the “Competition” section of the current Information Statement) should be removed concurrently with the implementation of retail competition; (6) TVA should remain primarily a wholesaler of electricity; and (7) any stranded costs resulting from mandated competition should be borne by the customers of TVA or its distributors for whom TVA incurred the costs, subject to review by FERC or another federal authority. The Advisory Committee members did not agree on numerous other issues such as (1) the conditions under which TVA should become subject to FERC transmission jurisdiction; (2) TVA’s ability to set its wholesale rates; (3) the extent to which TVA should be subject to federal antitrust laws, labor laws, and income tax; (4) the identity of the entity or entities responsible for regulating retail rates; (5) the nature of TVA’s mission; (6) the authority of TVA to build new generation capacity; (7) the extent to which the anti-cherry picking provision and the fence should be removed if retail competition is delayed; (8) the terms of TVA’s wholesale power contracts; (9) the extent to which TVA should be able to serve retail customers; and (10) certain other issues regarding the status and powers of TVA.

A June 23, 1998, draft bill prepared by the U.S. House Commerce Committee staff for Representatives Largent and Paxon has many provisions that parallel those to which members of the Advisory Committee agreed in principal. Nevertheless, the Largent draft differs significantly in several respects by providing that (1) sales of power outside the fence could be made only under limited conditions; (2) new generating resources greater than 50 megawatts could be acquired by TVA only if the customers for whose benefit the resources are acquired contractually or financially commit to paying the full cost of the resources; (3) significant transmission investments would require FERC approval; (4) the recovery of stranded costs would be based on FERC’s lost-revenue methodology rather than on the competitive-rate methodology, on which the TVA Ten-Year Business Plan is premised; and (5) FERC would be provided broad additional authority to issue regulations and orders related to the management and operation of the TVA power system. Although Congress has not enacted retail choice legislation during 1998, TVA expects that retail electric competition bills will continue to be introduced in the next session of Congress and will receive considerable attention. See “Competition” in the current Information Statement.

In October 1998, Congress appropriated U.S.\$50 million for TVA’s nonpower programs for fiscal 1999. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Recent Legislation” in the current Information Statement. Additionally, Congress enacted legislation permitting TVA to repurchase all of its outstanding U.S.\$3.2 billion Power Bonds issued to the Federal Financing Bank (the “FFB”) by paying the principal amount of such bonds plus accrued interest to the date of repurchase without making any further payment. The legislation requires TVA to apply a certain portion of the interest savings from the repurchase of its FFB Power Bonds to debt reduction. Pursuant to this legislation, TVA repurchased all of its outstanding Power Bonds issued to the FFB using funds obtained from short-term borrowings. TVA has not issued Power Bonds to the FFB since 1991, and TVA is now prohibited, by the above legislation, from obtaining financing from the FFB.

With the expiration of parts of the collective bargaining agreement between TVA and the Tennessee Valley Trades and Labor Council (the “Council”) on December 31, 1997, TVA exercised its right to give a 90-day notice to reopen the remainder of the agreement with the Council and potentially to cancel the agreement. In April 1998, negotiations pursuant to this reopener ended in impasse. To date, TVA has not exercised its right to cancel the agreement, and there is a pending lawsuit by the Council against TVA in which the Council claims that TVA cannot cancel the agreement at this time. In addition, TVA has notified the Council that a dispute exists concerning the employees who constitute an appropriate bargaining unit. Following a hearing on this matter, TVA recently issued a decision finding that one bargaining unit is appropriate for its power organizations and that another bargaining unit is appropriate for trades and labor work within two other organizations. These two units would replace the six separate bargaining units which represent trades and labor employees covered by the TVA-Council agreement. The Council’s position is that there is no bargaining unit dispute. Under the collective bargaining agreement, bargaining unit disputes may be appealed to arbitration. See “Employees” in the current Information Statement.

TVA submitted a proposal to the U.S. Department of Energy (“DOE”) to complete Bellefonte as a nuclear plant and to operate it to produce tritium for DOE in addition to electricity. See “Nuclear Power Program” in the current Information Statement. In this proposal, Unit One of Watts Bar Nuclear Plant could be used as a backup to

Bellefonte, if necessary. TVA's second proposal to DOE to provide irradiation services to produce tritium at only Unit One of the Watts Bar Nuclear Plant has expired.

In June 1998, following a reevaluation of the likelihood of recovery and the cost of proceeding, TVA withdrew its U.S.\$54 million stranded cost claim against Bristol, Virginia. This withdrawal has no impact on TVA's contracts with the 159 distributors of TVA power, all of which have long-term contracts with TVA. See "Competition" in the current Information Statement.

In late September 1998, the U.S. Environmental Protection Agency (the "EPA") finalized a rule requiring revisions to State Implementation Plans for nitrogen oxide reductions. The rule requires states to submit amendments to their plans to EPA for its review and approval by September 24, 1999. TVA has developed and is implementing a plan to reduce nitrogen oxide emissions at its coal-fired plants by 168,000 tons per year by 2003. Under this plan, TVA will install selective catalytic reduction systems at a number of its coal-fired plants. This plan is consistent with the type of controls that would be needed to comply with EPA's new requirements, though the strategy will not by itself bring TVA into compliance with expected revisions to the State plans. The existing TVA strategy is expected to cost between U.S.\$500 million and U.S.\$600 million, in addition to amounts TVA has already incurred to comply with the 1990 Clean Air Act Amendments. See "Environmental Matters" in the current Information Statement.

1998 Management's Discussion and Analysis and Financial Statements

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

TVA is one of the largest electric power systems in the United States, generating over 155 billion kilowatt-hours (kWh) of electricity in 1998. TVA is primarily a wholesaler of power. Its customers include three major groups: (1) distributors, consisting of municipal and cooperative systems; (2) industries that have large or unusual loads; and (3) federal agencies. In addition, TVA sells and buys power through exchange power agreements with most of the surrounding electric systems. TVA's power-service area covers 80,000 square miles in the Southeastern United States, including most of Tennessee and parts of Mississippi, Kentucky, Alabama, Georgia, North Carolina, and Virginia. TVA also manages the Tennessee River, the nation's fifth-largest river system.

TVA is a wholly owned corporate agency and instrumentality of the United States, established by Congress in 1933 primarily to develop and manage the resources of the Tennessee Valley region and to strengthen the regional and national economy and the national defense.

The programs at TVA consist of power and nonpower programs. TVA's electric system operations are required to be self-supporting from power system revenues, which were about \$6.7 billion in 1998. No tax dollars fund TVA's power program.

Unless otherwise indicated, years (1998, 1997, etc.) in this discussion refer to TVA's fiscal years ended September 30. References to "notes" are to the Notes to the 1998 Financial Statements.

Competition and Industry Restructuring

TVA and Competition

Electric power industry restructuring is changing the way TVA and utilities across the nation generate, transmit and distribute electricity. TVA is positioning itself to compete successfully and fairly in a restructured marketplace by sustaining excellent operational performance and achieving greater financial flexibility.

In April 1998, the TVA Board consolidated TVA's power production, transmission and resource stewardship functions under its Chief Operating Officer as part of TVA's continuing preparation for success in the restructured utility industry. TVA believes that consolidating these functions will allow TVA to serve the Tennessee Valley better in a competitive market while setting a standard for public responsibility in universal access, customer service and reliability, economic development and environmental protection.

It is not unreasonable to expect that in the event any restructuring legislation is enacted, such legislation would enable TVA and the distributors of TVA power to take part, reciprocally, in competition outside the area for which they can now be a source of electric power supply. TVA cannot, however, predict the form that any restructuring legislation may take, and there is no guarantee that TVA will be able to sell power outside its current service area.

TVA's power supply contracts with distributors with the shortest minimum term are those which provide for termination on no less than five years' notice, which in no instance can be given before 2002. In today's competitive environment, some of the municipal and cooperative distributors may consider alternative wholesale supply arrangements upon expiration or termination of their power contracts with TVA.

Progress on 10-Year Business Plan

TVA's management continues to develop plans and strategies to position TVA to fairly compete in a restructured electricity market. In July 1997, TVA announced its 10-Year Business Plan (the Plan), which set a target for a 15 percent reduction in the total cost of power by 2007.

The Plan incorporated an action by the Board of Directors approving an electric rate increase of 5.5 percent for residential and commercial customers effective October 1, 1997. The Plan also included initiatives to reduce fuel, labor, and supply costs, and offered the opportunity to TVA's distributor customers to change their power contracts from a rolling ten-year term to a rolling five-year term that first allows notice of termination to be given five years from the effective date of the amendment allowing the distributor a shorter term. The Plan was built on assumptions that TVA believed to be reasonable, based upon then current knowledge and predictions for the future. However, TVA expects conditions to change and will periodically update the Plan to reflect these changes.

As of September 30, 1998, TVA has reduced total debt by more than \$1 billion since September 30, 1996. TVA's total cost of power for 1998 approximated 4 cents per kWh. Both of these achievements reflect performance in line with the Plan targets.

Legislative Activity

In March 1998, the Clinton administration proposed a Comprehensive Electricity Competition Plan (the Competition Plan), which addresses various aspects of national retail competition in the electric power industry. The Competition Plan includes extension of the Federal Energy Regulatory Commission's (FERC's) general regulatory authority to cover transmission service by cooperatives and all government-owned electric systems, including TVA. In addition, the Competition Plan notes that the Clinton administration is considering issues relating to the role that the TVA power system should play in the electric power industry after nationwide competition has begun. The Competition Plan further notes that the administration expects the recommendations of the Tennessee Valley Electric System Advisory Committee (the Advisory Committee) regarding TVA to provide the administration with a broad framework for bringing competition to TVA and restructuring its operations. The Advisory Committee is a subcommittee of the Secretary of Energy's Advisory Board and includes representatives of TVA, TVA customers, potential competitors, power marketers and various other interest groups in the Tennessee Valley.

Although Congress did not enact retail choice legislation during 1998, TVA expects that retail electric competition bills will continue to be introduced in the next session of Congress and will receive considerable attention. TVA supports competition in the electric utility industry and will work to promote choice in a manner that benefits all TVA customers.

Public Responsibility

Public power entities, including TVA, supply over 24 percent of the electricity consumed in the United States. The service territory covered by public power, however, spans a much greater percentage of the country's land mass, including much of the rural areas of the country. These statistics highlight the fundamental role of public utilities — serving the interests of all customers, even those in remote areas of the country, and providing adequate, reliable electricity at reasonable prices.

In a restructured market, it is possible for some consumers to benefit from retail choice and lower prices, while other consumers such as small commercial customers or those in rural areas may be placed at a disadvantage because providing reliable service to these customers may not prove cost-effective for private utilities.

TVA is an advocate for the public's interest in universal access, customer service and reliability, economic development and environmental protection. TVA will continue to work actively with Congress in an effort to ensure that the public's interests in these important areas are addressed through the development of an equitable, effective framework for success in a restructured marketplace.

Results of Operations

Net income for 1998 amounted to \$233 million, an increase of \$225 million from net income of \$8 million in 1997. The increase in earnings resulted primarily from a rate increase effective October 1, 1997, coupled with relatively hotter weather during the summer of 1998. Net income for 1997 was \$8 million compared with \$61 million for 1996. This decline was primarily driven by mild weather in 1997 compared to 1996.

Operating Revenues

Operating revenues were \$6,729 million in 1998 compared with \$5,934 million in 1997. The \$795 million increase was primarily due to additional revenues from the 1998 rate increase, coupled with an increase in energy sales to municipalities and cooperatives as a result of the hot summer during 1998. The TVA service area experienced 2.2 percent greater heating degree days and 46.2 percent greater cooling degree days during 1998 compared with 1997. Accordingly, total kilowatt-hour (kWh) sales excluding off-system sales increased 7.7 billion kWh, from 139.7 billion in 1997 to 147.4 billion in 1998.

The \$17 million decrease in operating revenues from 1996 to 1997 was primarily due to a decrease in kWh sales excluding off-system sales of approximately 0.9 billion kWh, from 140.6 billion in 1996 to 139.7 billion in 1997. The decrease in kWh sales primarily resulted from milder weather conditions in 1997 compared to 1996.

Operating Expenses

Operating expenses increased \$469 million, or 11.5 percent, from \$4,080 million in 1997 to \$4,549 million in 1998. The increase in operating expenses is primarily due to higher fuel and purchased power expense in 1998 as a result of higher system generation and greater purchases of power at higher prices, coupled with an increase in operating and maintenance expense.

Total operating expenses increased \$166 million in 1997, or 4.2 percent, from \$3,914 million in 1996 to \$4,080 million in 1997. The operation of the Watts Bar 1 and Browns Ferry 3 nuclear units for the entire year of 1997 resulted in higher depreciation and operating expenses in 1997 compared with 1996.

Other Income and Expenses

TVA had net other income of \$12 million in 1998 compared with net other income of \$157 million in 1997 and expense of \$10 million in 1996. The 1997 net other income consisted primarily of investment earnings of the decommissioning trust funds of \$138 million.

Interest Expense

Gross interest expense declined \$70 million from \$2,084 million in 1997 to \$2,014 million in 1998. Total outstanding indebtedness, net of unamortized discounts and certain other adjustments as of September 30, 1998, was \$26.3 billion, with an average interest rate of 7.45 percent, compared with \$26.9 billion, with an average interest rate of 7.56 percent as of September 30, 1997. The allowance for funds used during construction decreased from \$81 million in 1997 to \$55 million in 1998 as a result of the continued decline in overall construction spending.

Gross interest expense for 1997 remained relatively unchanged from 1996, resulting from a relatively constant level of outstanding debt of \$27.3 billion as of September 30, 1996, compared with \$26.9 billion as of September 30, 1997. In addition, allowance for funds used during construction declined \$36 million from \$117 million in 1996 to \$81 million in 1997.

Liquidity and Capital Resources

Capital Structure

During the first 25 years of TVA's existence, the U.S. Government made appropriation investments in TVA power facilities. In 1959, TVA received congressional approval to issue bonds to finance its growing power program. For the last four decades, TVA's power program has been required to be self-supporting from revenues and capital it raised through its issuance of debt. As a result, TVA funds its capital requirements through internal cash generation or through borrowings (subject to a congressionally mandated \$30 billion limit).

A return on the U.S. Government's initial appropriation investment in TVA power facilities, plus a repayment of the initial investment, is specified by law. The payment for 1998 was \$60 million and total cumulative repayments and return on investment by TVA to the U.S. Treasury exceed \$3 billion.

Cash Flows

Net cash provided by operations for 1998, 1997, and 1996 was \$1,394 million, \$1,066 million, and \$910 million, respectively. This positive trend reflects improvements made in TVA's operations during the three-year period coupled with the rate increase in 1998.

Net cash used in investing activities for 1998, 1997, and 1996 was \$742 million, \$580 million, and \$1,254 million, respectively. These changes reflect the annual decreases in construction spending, as well as the 1997 sale of certain receivables.

Net cash (used in)/provided by financing activities for 1998, 1997, and 1996 was \$(560) million, \$(425) million, and \$530 million, respectively. The cash used in financing activities during 1997 and 1998 reflects the aggregate repayment of total outstanding debt of over \$1 billion.

Capital Resources

During 1998, TVA accessed the capital markets through cost-effective long-term financing structures and continued to expand the investor base by tapping the global and retail markets. The proceeds from the 1998 borrowings were used to refinance existing debt.

Systems Operations

Over the last five years, TVA has made significant investments in its fossil plants through capital improvements and major maintenance projects to ensure continued operation at high performance levels, reduce operating costs and meet regulatory requirements. These investments have resulted in almost 1,500 megawatts of increased generating capacity and an increase in fossil generation of more than 20 percent since the late 1980s. Unplanned outages of the hydro system have been reduced to a level of less than half the national average. TVA has begun a Hydro Modernization Program which involves upgrading of 24 hydro plants. Upon completion, 88 units will have been upgraded for an aggregate increase in capacity of over 500 megawatts.

TVA is a dual-peaking utility. TVA met an all-time system peak demand of 27,253 megawatts on June 24, 1998 when the average temperature in the seven-state region was 94 degrees Fahrenheit (34.4 degrees Celsius). The winter system peak demand was 26,670 megawatts achieved on January 17, 1997 when the average temperature was 10 degrees Fahrenheit (-12.2 degrees Celsius). TVA met the all-time summer demand without any customer curtailment and was still able to help neighboring power systems meet their high demands as well.

To ensure that TVA will continue to meet growing demand, TVA plans to install additional peaking capacity at one or more of its fossil plants by the summer of 2000. TVA is negotiating a contract to install up to eight natural-gas combustion turbines, pending environmental and technical review of the locations. The Gallatin and Johnsonville fossil plants, which have existing combustion turbines, are being considered as sites for the new turbines.

TVA is also seeking competitive proposals from independent power producers and distributors of TVA power for arrangements involving a mix of firm and optional peaking power. Under the arrangements, TVA could purchase 500 to 600 megawatts of gas-generated power to meet peak demand beginning June 1, 2001, and 500 to 600 megawatts of power to meet peak demand beginning June 1, 2002.

TVA may enter into additional electricity futures contracts for the sole purpose of limiting or otherwise hedging TVA's economic risks directly associated with electric power generation, purchases, and sales.

For a discussion of TVA's nuclear program, see note 2.

Other Issues

Year 2000 Readiness

The "Year 2000 issue" concerns the inability of information technology resources to properly recognize and process date-sensitive information related to the year 2000 and beyond. Since TVA's operations are extensively computerized and are also dependent upon the systems of others with which it conducts business, the failure by TVA or others with which it conducts business to become Year 2000 compliant on a timely basis could have a significant adverse effect on, among other things, TVA's results of operations, liquidity and financial condition, as well as TVA's generation and transmission operations. Specific risks to TVA associated with the Year 2000 issue include, but are not limited to, power production and delivery interruptions and administrative and accounting systems malfunctions.

TVA is taking measures to address the impact of the Year 2000 issue on its information technology systems and other systems that may be affected by the Year 2000 issue. TVA's Year 2000 efforts have focused on the following six areas: (1) computer hardware and equipment, (2) application software, (3) systems software, (4) embedded controls, (5) facilities, and (6) telecommunications. TVA's Year 2000 efforts with respect to each of these areas consist of five phases: (1) developing a Year 2000 remediation strategy, (2) inventorying and assessing the priority of items that may be affected by the Year 2000 issue, (3) replacing, repairing, or converting items affected by the Year 2000 issue, (4) testing and validating the Year 2000 readiness of replaced, repaired and converted items and (5) implementing the replaced, repaired and converted items.

TVA has developed a Year 2000 remediation strategy and has completed its initial inventory and the majority of its assessments of mission-critical items in each of the six areas discussed above. In addition, TVA has commenced its remediation, testing and implementation of mission-critical items in each of these areas. As of September 30, 1998, TVA's remediation, testing and implementation activities with respect to mission-critical computer hardware and equipment, application software, systems software, facilities, and telecommunication systems were approximately 80 percent, 30 percent, 90 percent, 95 percent, and 42 percent complete, respectively. TVA expects to complete its remediation, testing and implementation activities in each of these areas by March 1999 except for certain activities that will be scheduled throughout 1999 to minimize disruption of operations.

With respect to embedded controls, TVA's remediation, testing and implementation activities have focused on controls that affect the following four areas: (1) nuclear operations, (2) fossil operations, (3) hydro operations, and (4) transmission and power supply operations. As of September 30, 1998, remediation, testing and implementation activities for embedded controls critical to TVA's nuclear, fossil, hydro, and transmission and power supply operations were approximately 10 percent, 15 percent, 60 percent, and 25 percent complete, respectively, and are expected to be completed by July 1999, November 1999, January 1999, and May 1999, respectively.

The Nuclear Regulatory Commission (the "NRC") has notified all utilities operating nuclear power plants that they are required to inform the NRC of steps they are taking to ensure that their computer systems will function properly by the year 2000. In connection therewith, the NRC required each such utility to submit a written indication of, among other things, whether it is pursuing a plan to solve its Year 2000 problems, similar to the plan outlined in the publication *Nuclear Utility Year 2000 Readiness* (the "NEI/NUSMG Plan"). In addition, not later than July 1, 1999, each such utility must submit a written response confirming that its plants are Year 2000 ready, or if its plants are not ready, the utility must provide a status report of work remaining to be done. TVA submitted its required response on July 22, 1998, indicating that it has pursued and is continuing a Year 2000 readiness program similar to that recommended in the NEI/NUSMG Plan.

In addition to remedying its own Year 2000 issues, TVA is communicating with suppliers, distributors, financial institutions and others with which it does business in an effort to assess the Year 2000 efforts of such entities and to share what TVA is doing to address its Year 2000 issues. As of September 30, 1998, TVA's assessment of the Year 2000 efforts of entities whose Year 2000 readiness is critical to TVA's operations was approximately 48 percent complete and is expected to be complete by June 30, 1999. Although TVA expresses no views about the adequacy of the Year 2000 conversion programs of the suppliers, distributors, financial institutions and other entities with which TVA interfaces, TVA will take the results of these assessments into account in developing its Year 2000 contingency plans.

TVA is in the early stages of developing contingency plans to address system failures that may result from Year 2000 problems. In addition, consistent with the General Accounting Office document *Year 2000 Computing Crisis: Business Continuity and Contingency Planning*, TVA has developed a business partnership program that includes elements for business continuity and contingency planning.

Although it is difficult to give an accurate estimate of the cost of TVA's Year 2000 work, TVA is allocating sufficient resources to address the Year 2000 issue and does not expect that such costs will be material to TVA's financial position and operations. The projected direct and indirect costs are estimated to be approximately \$38 million, of which approximately \$18 million had been expended as of September 30, 1998.

Labor Agreements

On September 30, 1998, TVA had 13,818 employees, of which 5,178 were trades and labor employees. Neither the federal labor laws covering most private sector employees, nor those covering most federal agencies are applicable to TVA; however, the TVA Board has a longstanding policy of recognizing and dealing with recognized representatives of its employees. This current structure has worked well for both TVA and its employees for more than 60 years. TVA employees are prohibited by federal law from engaging in strikes against TVA.

During late 1997 and 1998, TVA negotiated and entered into separate labor contracts with each of the four unions representing its salary policy employees, which contracts are effective through 2003 and contain supplementary agreements continuing through 2000. A similar agreement has been concluded with the Teamsters union and will be in effect through 2000. Provisions of these agreements include a significant degree of employment security for power-funded employees; a lump sum payment to employees in lieu of a base-wage increase for 1998; and for 1999 and beyond, negotiations on pay based on "total compensation," with additional flexibility to reward employees for their performance and productivity.

All annual trades and labor employees (excluding the Teamsters) are represented by six craft unions, through the Tennessee Valley Trades and Labor Council. TVA and the Council have been involved since the summer of 1997 in negotiating a new contractual arrangement. The parties' Framework Agreement, containing major aspects of the bargaining relationship, expired on December 31, 1997. TVA has also given notice for reopening the General Agreement and its Supplementary Schedules, which contain basic provisions on wages, hours, and conditions of employment. TVA's position is that it currently has the contractual right to cancel the General Agreement; however, that Agreement remains in effect at this time. There is also an ongoing dispute regarding appropriate bargaining units,

and a process to address such disputes has been initiated, but is currently in abeyance, while additional negotiations between TVA and the Council to resolve major bargaining issues are being conducted.

Litigation and Contingencies

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

Electricity Futures Trading Hub

The TVA control area has been selected by the Chicago Board of Trade (CBOT) as a hub for trading electricity futures. For this purpose, TVA's control area is defined as its electric power system consisting of its transmission and generating facilities in which a common automatic generation scheme is applied. This generation scheme matches TVA's generation (the power output of the generators within the system) with power purchases (capacity and energy purchased from outside entities), and maintains scheduled interchange and frequency with other utilities' control areas while providing sufficient capacity to maintain operating reserves. The TVA system has connections to other utilities which, along with TVA, cover 18 states and over 47 percent of the population of the United States.

Environmental Matters

TVA's activities are subject to various federal, state, and local environmental statutes and regulations. Major areas of regulation affecting TVA's activities include air and water pollution control and management and disposal of solid and hazardous wastes. Because TVA is a federal agency, it is subject only to those state and local environmental requirements for which Congress has clearly waived federal agency immunity. TVA's activities may, however, be subject to other environmental requirements that affect only federal agencies.

Annually, TVA incurs substantial costs associated with environmental regulatory legislation in the operation and management of its power and nonpower programs. The majority of costs and environmental issues are related to control of emissions from fossil fuel plants, impact studies on proposed projects, nuclear plant decommissioning, and storage and disposal of spent nuclear fuel.

TVA has incurred and continues to incur substantial capital expenditures and operating expenses to comply with environmental requirements (see note 9). TVA has spent more than \$2 billion on pollution control equipment to reduce sulfur-dioxide (SO₂) and nitrogen-oxide (NO_x) emissions at its coal-fired plants. To comply with the 1990 Clean Air Act Amendments, TVA has installed low-NO_x burners at some of its fossil units and is using additional technologies at its remaining units to reduce NO_x levels by about 40 percent by 2000.

During 1998, TVA unveiled a new clean-air strategy that will reduce NO_x emissions from its coal-fired plants by 168,000 tons per year by 2003. The installation of new equipment will improve local and regional air quality and allow Tennessee Valley states greater flexibility for industrial and economic growth in the region. The new measures focus on reducing local and regional ozone concentrations to the levels needed to avoid violating the new, more stringent ozone standard that was established by the EPA last year. Meeting the new ozone standard will help continue economic prosperity in the Tennessee Valley and help avoid placing burdensome and expensive requirements on Valley residents.

TVA's new strategy is consistent with the types of controls that would be needed to comply with the Environmental Protection Agency's (EPA's) mandated revisions to State Implementation Plans for reduction of ozone transport, though the strategy will not by itself bring TVA into compliance with expected revisions to state plans.

TVA will install equipment at its Allen, Cumberland, Bull Run, Paradise and Widows Creek fossil plants that breaks down nitrogen oxide into non-threatening nitrogen and water. The equipment is expected to be in place by 2003. Cost of implementation will be between \$500 million and \$600 million and is in addition to actions TVA is already taking to comply with the 1990 Clean Air Act Amendments.

The new reduction strategy, in conjunction with controls TVA is already implementing, will reduce NO_x emissions by 75 percent; however, additional steps will have to be taken to meet EPA ozone transport reduction requirements.

TVA is also evaluating competitive proposals for "green" power to reinforce its environmental stewardship role. By adding green power to its current energy supply mix, TVA would help reduce carbon dioxide and fine particulate emissions and ozone. During 1998, TVA requested proposals for alternative fuel sources and received 21 responses for projects by independent power producers involving wind, biomass or landfill gases. TVA hopes to begin offering green

power to residential customers by the summer of 2001. Whether there will be adequate demand for green power is not known at this time. It is estimated that the additional charge to residential customers who subscribe for green power would be \$2 to \$10 or more a month.

Nonpower Roles and Responsibilities

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

Funding for TVA's nonpower programs has come under attack by certain investor-owned utilities and members of Congress. In 1997, Congress voted to end federal appropriations to TVA for 1999 and beyond, but to require TVA to continue to fund its nonpower programs that constitute "essential stewardship activities" with revenues derived from one or more various sources, including power revenues. Nonetheless, in October 1998, Congress approved an appropriation of \$50 million for TVA's nonpower programs for 1999.

The protection and equitable distribution of public benefits to American citizens is incorporated into TVA's integrated system. This natural stewardship will continue as long as TVA remains a public enterprise.

Accounting Standards

Accounting for the Effects of Regulation

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

TVA has approximately \$1.9 billion of regulatory assets (see note 1 — Other deferred charges and Debt issue and reacquisition costs) along with approximately \$6.3 billion of deferred nuclear plants as of September 30, 1998. In the event that competition in the utility industry changes the application of SFAS No. 71, TVA would be required to evaluate such regulatory assets and deferred nuclear plants under the provisions of SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*. Statement 121 establishes requirements for evaluating and measuring asset impairments and states that regulatory assets that are no longer probable of recovery through future revenues be charged to earnings. Such an event may have a material adverse effect on future results of operations from the write-off of regulatory assets. However, TVA intends to seek full recovery of any regulatory assets that may result from TVA's transition to doing business in the competitive market.

New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) has recently issued the following statements that will be applicable to TVA:

Statement of Financial Accounting Standards (SFAS) No. 130, *Reporting Comprehensive Income*, which is effective for fiscal years beginning after December 15, 1997. This Statement establishes standards for reporting and display of comprehensive income and its components. Comprehensive income includes, but is not limited to, foreign currency translation adjustments and unrealized holding gains and losses on available-for-sale securities. TVA will adopt this Statement in 1999 and such adoption is not expected to have a material effect on TVA's financial position or results of operations.

Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which is intended to improve the effectiveness of current footnote disclosure requirements for employers' pensions and other retiree benefits. This Statement is effective for fiscal years beginning after December 15, 1997, although earlier application is encouraged. While this Statement will result in additional financial disclosures, it will not impact TVA's financial position or results of operations (see note 7).

In June 1998, the FASB issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Statement established accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded on the balance sheet as either an asset or

liability measured at its fair value. The Statement requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. TVA may engage in hedging activities using futures, forward contracts, options and swaps to hedge the impact of market fluctuations on energy commodity prices, interest rates and foreign currencies. TVA is currently assessing the effect, if any, on its financial statements of implementing SFAS No. 133. TVA will be required to adopt the standard in 2000.

In March 1998, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statements of Position (SOP) 98-01, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, which provides guidance on accounting for the costs of computer software developed or obtained for internal use. Under SOP 98-01, certain costs which are currently expensed may now be capitalized and amortized over some future period. The SOP is effective for fiscal years beginning after December 15, 1998, although earlier application is encouraged. The impact of the application of the provisions of this Statement on TVA's financial position or results of operations upon its adoption are not known at this time.

Nuclear Decommissioning Costs

The FASB has reached several tentative conclusions with respect to its project regarding the accounting for closure and removal of long-lived assets, including the decommissioning of nuclear generating units. It is uncertain when the final statement will be issued and what impact it may ultimately have on TVA's financial position or results of operations. Effective for 1998, TVA changed its method of accounting for decommissioning costs and related liabilities in order to comply with certain of the FASB's tentative conclusions, as well as certain rate-setting actions. TVA's current accounting policy recognizes all obligations related to closure and removal of its nuclear units as incurred. The liability for closure is measured as the present value of the estimated cash flows required to satisfy the related obligation and discounted at a determined risk free rate of interest. The corresponding charge to recognize the additional obligation was effected through the creation of a regulatory asset. TVA further modified its method of accounting for decommissioning costs such that earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred in accordance with SFAS No. 71.

1998 FINANCIAL STATEMENTS

TVA's audited financial statements for the fiscal year ended September 30, 1998 and the other periods indicated therein and the notes thereto are set forth below on pages C-20 to C-36.

1998 Financial Statements

Balance Sheets At September 30

	Power program		All programs	
	1998	1997	1998	1997
	(in millions)			
ASSETS				
Current Assets				
Cash and cash equivalents	\$ 391	\$ 299	\$ 451	\$ 374
Accounts receivable	796	701	796	707
Inventories at average cost and other				
Fuel	153	112	153	112
Other	316	287	316	287
Total current assets	1,656	1,399	1,716	1,480
Property, Plant, and Equipment				
Completed plant	29,055	28,528	30,166	29,632
Less accumulated depreciation	(7,945)	(7,178)	(8,243)	(7,469)
Net completed plant	21,110	21,350	21,923	22,163
Construction in progress	548	605	558	622
Deferred nuclear generating units	6,311	6,303	6,311	6,303
Nuclear fuel and capital leases	922	1,040	922	1,040
Total property, plant, and equipment	28,891	29,298	29,714	30,128
Investment Funds	578	561	578	561
Deferred Charges and Other Assets				
Loans and other long-term receivables	104	121	151	170
Debt issue and reacquisition costs	861	1,096	861	1,096
Other deferred charges	1,525	1,209	1,525	1,209
Total deferred charges and other assets	2,490	2,426	2,537	2,475
Total assets	\$33,615	\$33,684	\$34,545	\$34,644
LIABILITIES AND PROPRIETARY CAPITAL				
Current Liabilities				
Accounts payable	\$ 521	\$ 468	\$ 538	\$ 487
Accrued liabilities	175	161	180	172
Accrued interest	487	499	487	499
Discount notes	1,757	2,151	1,757	2,151
Current maturities of long-term debt	1,500	574	1,500	574
Total current liabilities	4,440	3,853	4,462	3,883
Other Liabilities	2,007	1,704	2,007	1,704
Long-Term Debt				
Public bonds — senior	19,127	20,354	19,127	20,354
Federal Financing Bank — senior	3,200	3,200	3,200	3,200
Public bonds — subordinated	1,100	1,100	1,100	1,100
Unamortized discount and other adjustments	(407)	(502)	(407)	(502)
Total long-term debt	23,020	24,152	23,020	24,152
Proprietary Capital				
Appropriation investment	568	588	4,936	4,887
Retained earnings reinvested in power program	3,580	3,387	3,580	3,387
Accumulated net expense of nonpower programs	—	—	(3,460)	(3,369)
Total proprietary capital	4,148	3,975	5,056	4,905
Total liabilities and proprietary capital	\$33,615	\$33,684	\$34,545	\$34,644

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

1998 Financial Statements
Statements of Income — Power Program
For the Years Ended September 30

	<u>1998</u>	<u>1997</u>	<u>1996</u>
	(in millions)		
Operating Revenues			
Sales of electricity			
Municipalities and cooperatives	\$5,554	\$4,811	\$4,980
Industries directly served	523	464	452
Federal agencies and other	556	561	430
Other revenue	<u>96</u>	<u>98</u>	<u>89</u>
Total operating revenues	6,729	5,934	5,951
Operating Expenses			
Fuel and purchased power	1,900	1,593	1,536
Operating and maintenance	1,347	1,201	1,218
Depreciation and amortization	1,038	1,014	904
Tax-equivalents	<u>264</u>	<u>272</u>	<u>256</u>
Total operating expenses	<u>4,549</u>	<u>4,080</u>	<u>3,914</u>
Operating Income	2,180	1,854	2,037
Other income (expense), net	<u>12</u>	<u>157</u>	<u>(10)</u>
Income before interest expense	2,192	2,011	2,027
Interest Expense			
Interest on debt	1,930	1,993	1,965
Amortization of debt discount, issue, and reacquisition costs, net	84	91	118
Allowance for funds used during construction	<u>(55)</u>	<u>(81)</u>	<u>(117)</u>
Net interest expense	<u>1,959</u>	<u>2,003</u>	<u>1,966</u>
Net income	<u>\$ 233</u>	<u>\$ 8</u>	<u>\$ 61</u>

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

1998 Financial Statements
Statements of Cash Flows
For the Years Ended September 30

	Power program			All programs		
	1998	1997	1996	1998	1997	1996
	(in millions)					
Cash Flows from Operating Activities						
Net power income	\$ 233	\$ 8	\$ 61	\$ 233	\$ 8	\$ 61
Net expense of nonpower programs	—	—	—	(91)	(121)	(127)
Items not requiring (providing) cash						
Depreciation and amortization	1,090	1,066	924	1,103	1,080	938
Allowance for funds used during construction	(55)	(81)	(117)	(55)	(81)	(117)
Nuclear fuel amortization	264	196	156	264	196	156
Other, net	(2)	(151)	162	9	(151)	164
Changes in current assets and liabilities						
Accounts receivable	(95)	(24)	(1)	(89)	(21)	7
Inventories and other	(72)	(19)	(22)	(72)	(19)	(22)
Accounts payable and accrued liabilities	72	56	(246)	59	52	(250)
Accrued interest	(11)	1	43	(11)	1	43
Other	(30)	14	(50)	(36)	14	(50)
Net cash provided by operating activities	1,394	1,066	910	1,314	958	803
Cash Flows from Investing Activities						
Construction expenditures	(637)	(722)	(1,107)	(642)	(733)	(1,121)
Allowance for funds used during construction	55	81	117	55	81	117
Nuclear fuel	(151)	(159)	(76)	(151)	(159)	(76)
Proceeds from sale of investments	—	513	—	—	513	—
Purchases of investments	—	(483)	(162)	—	(483)	(162)
Proceeds from sale of loans receivable	—	211	—	—	211	—
Other, net	(9)	(21)	(26)	(8)	(13)	(13)
Net cash used in investing activities	(742)	(580)	(1,254)	(746)	(583)	(1,255)
Cash Flows from Financing Activities						
Long-term debt						
Issues	4,625	3,100	4,400	4,625	3,100	4,400
Redemptions	(4,930)	(3,829)	(2,706)	(4,930)	(3,829)	(2,706)
Short-term borrowings, net	(394)	377	(1,057)	(394)	377	(1,057)
Debt issue and reacquisition costs, net	199	(12)	(44)	199	(12)	(44)
Congressional appropriations	—	—	—	69	106	109
Payments to U.S. Treasury	(60)	(61)	(63)	(60)	(61)	(63)
Net cash (used in) provided by financing activities ..	(560)	(425)	530	(491)	(319)	639
Net change in cash and cash equivalents	92	61	186	77	56	187
Cash and cash equivalents at beginning of period ...	299	238	52	374	318	131
Cash and Cash Equivalents at End of Period	\$ 391	\$ 299	\$ 238	\$ 451	\$ 374	\$ 318

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

**1998 Financial Statements
Power Program**

**Statements of Changes in Proprietary Capital
For the Years Ended September 30**

	<u>1998</u>	<u>1997</u>	<u>1996</u>
	(in millions)		
Retained earnings reinvested at beginning of period	\$3,387	\$3,420	\$3,402
Net income	233	8	61
Return on appropriation investment	<u>(40)</u>	<u>(41)</u>	<u>(43)</u>
Retained Earnings Reinvested at End of Period	3,580	3,387	3,420
Appropriation investment at beginning of period	588	608	628
Return of appropriation investment	<u>(20)</u>	<u>(20)</u>	<u>(20)</u>
Appropriation investment at end of period	<u>568</u>	<u>588</u>	<u>608</u>
Proprietary Capital at End of Period	<u>\$4,148</u>	<u>\$3,975</u>	<u>\$4,028</u>

Nonpower Programs

**Statements of Net Expense
For the Years Ended September 30**

	<u>1998</u>	<u>1997</u>	<u>1996</u>
	(in millions)		
Water and Land Stewardship	\$ 65	\$ 78	\$ 75
Land Between The Lakes	8	7	7
Economic Development	8	22	25
Environmental Research Center	<u>10</u>	<u>14</u>	<u>20</u>
Net Expense	<u>\$ 91</u>	<u>\$ 121</u>	<u>\$ 127</u>

Nonpower Programs

**Statements of Changes in Proprietary Capital
For the Years Ended September 30**

	<u>1998</u>	<u>1997</u>	<u>1996</u>
	(in millions)		
Proprietary capital at beginning of period	\$ 930	\$ 944	\$ 964
Congressional appropriations	69	106	109
Net expense	(91)	(121)	(127)
Other, net	<u>—</u>	<u>1</u>	<u>(2)</u>
Proprietary Capital at End of Period	<u>\$ 908</u>	<u>\$ 930</u>	<u>\$ 944</u>

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

Notes to Financial Statements

1. Summary of significant accounting policies

General

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

TVA's programs are divided into two types of activities — the power program and the nonpower programs. Substantially all TVA revenues and assets are attributable to the power program. The power program has historically been separate and distinct from the nonpower programs and is required to be self-supporting from power revenues and proceeds from the issuance of debt. The power program receives no congressional appropriations and is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Most of the funding for TVA's nonpower programs has historically been provided by congressional appropriations. Certain nonpower activities are also funded by various revenues and user fees. Financial accounts for the power and nonpower programs are kept separately.

Power rates are established by the TVA Board of Directors as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; payments to states in lieu of taxes; and debt service on outstanding indebtedness.

Fiscal year

Unless otherwise indicated, years (1998, 1997, etc.) refer to TVA's fiscal years ended September 30.

Revenue

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

Off-system sales are presented in the accompanying statements of income-power program as a component of Sales of electricity — Federal agencies and other. Prior to 1998, off-system sales and purchases under exchange power agreements were reflected on a net basis in fuel and purchased power expense. Off-system sales for 1997 and 1996 have been reclassified to conform with the 1998 presentation.

Property, plant and equipment, and depreciation

Additions to plant are recorded at cost, which includes direct and indirect costs and an allowance for funds used during construction. The cost of current repairs and minor replacements is charged to operating expense. The TVA Act requires TVA's Board of Directors to allocate the cost of completed multi-purpose projects between the power and nonpower programs, subject to the approval of the President of the United States. The original cost of property retired, together with removal costs less salvage value, is charged to accumulated depreciation. Depreciation is generally computed on a straight-line basis over the estimated service lives of the various classes of assets. Depreciation expense expressed as a percentage of the average annual depreciable completed plant was 3.23 percent for 1998 and 3.21 percent for 1997 and 1996.

Decommissioning costs

Effective for 1998, TVA changed its method of accounting for decommissioning costs and related liabilities. TVA's current accounting policy recognizes as incurred all obligations related to closure and removal of its nuclear units. The charge to recognize the additional obligation in 1998 was effected through the creation of a regulatory asset. TVA further modified its accounting methodology such that earnings from decommissioning investments, amortization of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred (see note 9 — Decommissioning costs). The effect of the change was to decrease 1998 depreciation expense approximately

Notes to Financial Statements — (Continued)

\$38 million — primarily due to the deferral of the decommissioning components of earnings, amortization and interest.

During 1997, the excess of decommissioning investment earnings over the annual decommissioning provision was recorded as other income. Of the total investment earnings of \$151 million, \$13 million was recorded as an offset to the decommissioning provision, with the \$138 million excess recorded as other income. During 1996, the annual decommissioning provision of \$30 million exceeded the earnings from decommissioning fund investments of \$17 million and the \$13 million excess was charged to depreciation expense.

Allowance for funds used during construction

The practice of capitalizing an allowance for funds used during construction is followed in the power program. The allowance is applicable to construction in progress, excluding deferred nuclear generating units.

Loans and other long-term receivables

In June 1997, TVA entered into a five-year agreement with a bank pursuant to which TVA agreed to sell certain receivables relating to TVA's consumer energy-conservation programs. As of September 30, 1998, approximately \$218 million of the receivables have been sold for proceeds equal to their carrying amount. Under the terms of the agreement, TVA has retained substantially the same risk of credit loss as if the receivables had not been sold and, accordingly, an appropriate liability account has been established.

Other deferred charges

Deferred charges primarily include prepaid pension costs and regulatory assets capitalized under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. At September 30, 1998, other deferred charges included total unamortized regulatory assets of \$1,260 million — of which \$342 million represents a capitalized interest component of nuclear fuel; \$377 million represents a transition obligation related to the adoption of SFAS No. 112, *Employers Accounting for Postemployment Benefits*; \$478 million represents an additional obligation related to the closure and removal of nuclear units (see Note 1 — Decommissioning costs); and \$63 million represents TVA's portion of the costs for decommissioning the Department of Energy's (DOE) nuclear waste disposal facility. At September 30, 1997, the unamortized balances of regulatory assets of \$950 million included \$468 million representing a capitalized interest component of nuclear fuel; \$411 million representing a transition obligation related to the adoption of SFAS No. 112; and \$71 million representing TVA's portion of the costs for decommissioning the DOE's nuclear waste disposal facility. These regulatory assets have historically been amortized over periods ranging from eight to 15 years, generally on a straight-line basis.

Investment funds

Investment funds consist primarily of a portfolio of investments in trusts designated for funding nuclear decommissioning requirements (see note 9). These funds are invested in portfolios generally designed to earn returns in line with overall equity market performance.

Debt issue and reacquisition costs

Issue and reacquisition expenses, call premiums and other related costs are deferred and amortized (accrued), respectively, on a straight-line basis over the term of the related outstanding securities.

TVA has incurred premiums related to certain advanced refundings, and also received premiums from the monetization of certain call provisions. In accordance with regulatory practices, TVA has deferred these premiums and is amortizing such premiums ratably through the maturity dates of the new debt issues. The unamortized balances of such regulatory assets at September 30, 1998 and 1997 were \$674 million and \$983 million, respectively.

Tax-equivalents

The TVA Act requires TVA to make payments to states and local governments in which the power operations of the corporation are conducted. The basic amount is 5 percent of gross revenues from the prior years' sale of power to other than federal agencies and interchange sales with other utilities, with the provision for minimum payments under certain circumstances.

Notes to Financial Statements — (Continued)

Interest and capital costs

During 1998, 1997, and 1996, cash paid for interest on outstanding indebtedness (net of amount capitalized) was \$1,886 million, \$1,911 million, and \$1,805 million, respectively. In addition to paying interest on outstanding indebtedness, the TVA Act requires TVA to make annual payments to the U.S. Treasury. The annual Treasury payments represent a repayment of the original appropriation investment, along with a return on the appropriation investment. TVA paid \$20 million each year for 1998, 1997 and 1996 as a repayment of the appropriation investment. TVA paid \$40 million to the U.S. Treasury in 1998 as a return on the appropriation investment, while paying \$41 million in 1997 and \$43 million in 1996.

Risk-management activities

TVA is exposed to market risk from changes in interest rates and currency exchange rates. To manage volatility relating to these exposures, TVA has entered into various derivative transactions, principally interest rate swap agreements and foreign currency swap contracts. TVA is exposed to credit losses in the event of nonperformance by counter-parties on the risk-management instruments. TVA monitors such risk and does not believe that there is a significant risk of nonperformance by any of the parties of these instruments.

Additionally, TVA may engage in hedging activities using forwards, futures or options to hedge the impact of market fluctuations on energy commodity prices. TVA currently accounts for these transactions using the deferral method and gains and losses are recognized in the accompanying financial statements when the related hedged transaction occurs. TVA's risk management policies allow the use of derivative financial instruments to manage financial exposures, but prohibits the use of these instruments for speculative or trading purposes.

Cash and cash equivalents

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

Research and development costs

Expenditures related to research and development costs of new or existing products and processes are expensed as incurred. The amounts charged against income were \$36 million in 1998, \$44 million in 1997, and \$45 million in 1996.

Insurance

TVA is primarily self-insured for property loss, workers' compensation, general liability, and automotive liability. TVA is also self-insured for health care claims for eligible active and retired employees. Consulting actuaries assist TVA in determining certain liabilities for self-insured claims. TVA maintains nuclear liability insurance and nuclear property, decommissioning and decontamination insurance with an outside party (see note 9).

Management estimates

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

1999 regulatory and financial reporting accounting changes

The TVA Board of Directors has approved the following accounting changes effective October 1, 1998: 1) Reclassification of an additional \$332 million from nuclear fuel inventory to deferred charges. The regulatory asset will be amortized on a straight-line basis over an estimated three-year period, and interest will no longer be capitalized on TVA's nuclear fuel investment; 2) Maintenance costs incurred during nuclear fuel outages will be deferred and amortized on a straight-line basis over the estimated period until the next refueling outage, rather than expensed when incurred; 3) Debt issue and reacquisition costs will be amortized on a pooled basis over the weighted average life of TVA's public debt portfolio, rather than separately amortized over the respective terms of the related outstanding securities; 4) Annual provisions for amortization of deferred charges will be adjusted as necessary in order to achieve certain earnings levels as set forth in resolutions adopted annually by the TVA Board of Directors in connection with

Notes to Financial Statements — (Continued)

the rate review process. The targeted earnings levels will be based on the earnings requirements of the TVA Act and the Basic TVA Power Bond Resolution (see note 5). Such adjustments may result in either contracting or extending the estimated amortization periods, which range from three to 15 years.

2. Nuclear power program

The nuclear power program at September 30, 1998, consists of nine units — five operating, three deferred, and one inoperative — at four locations, with investments in property, plant and equipment as follows and in the status indicated:

	Operating units	Installed capacity (megawatts)	Completed plant, net	Construction in progress	Deferred units	Fuel investment
(dollars in millions)						
Browns Ferry*	2	2,304	\$ 3,328	\$ 50	\$ —	\$ 337
Sequoyah	2	2,442	2,047	37	—	241
Watts Bar	1	1,270	6,541	14	1,717	121
Bellefonte	—	—	—	—	4,594	—
Raw materials	—	—	—	—	—	28
Total	<u>5</u>	<u>6,016</u>	<u>\$ 11,916</u>	<u>\$ 101</u>	<u>\$ 6,311</u>	<u>\$ 727</u>

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

Browns Ferry 1, taken off-line in 1985 for modifications and improvements, will continue to remain in an inoperative status until its ultimate disposition is determined. For financial reporting purposes, the undepreciated cost of Browns Ferry 1 of \$73 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period.

Watts Bar 1 began operating commercially during 1996. In 1988, TVA suspended construction activities on Watts Bar 2, and the unit is currently in lay-up. Bellefonte 1 and 2 were deferred in 1988 and 1985, respectively. Estimated 1999 expenditures for the three deferred units total \$10 million and are limited to lay-up, maintenance and ensuring that options remain viable.

In 1993, TVA began an integrated resource planning process to determine TVA's strategy for meeting future customer energy demands. As part of this long-term energy strategy, TVA reevaluated the need for finishing Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. In December 1994, TVA determined it will not, by itself, complete Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. TVA's IRP identified as a viable option the conversion of the Bellefonte facility to a combined-cycle plant utilizing natural gas or gasified coal. In 1997, an independent team of technical and financial experts completed a feasibility study to evaluate options for the conversion of the Bellefonte Nuclear Plant to a fossil fuel-fired plant. The feasibility study indicates that one of the most economical fossil conversion strategies is to complete Bellefonte as a natural gas-fired combined-cycle plant. TVA also issued an Environmental Impact Statement (EIS) assessing the environmental impacts of various fossil conversion options. The EIS identified the natural gas-fired combined-cycle plant alternative as the preferred option. In addition, TVA submitted a proposal to DOE to complete Bellefonte as a nuclear plant and to operate it to produce tritium for DOE in addition to electricity. Further action will depend on DOE's evaluation of and response to the TVA proposal and DOE's other potential options to produce tritium.

While the future decisions on these deferred units will ultimately impact the method of cost recovery, the TVA Board has determined that it will establish rate adjustments and operating policies to ensure full recovery of the cost of these units and compliance with the requirements of the TVA Act.

Notes to Financial Statements — (Continued)

3. Completed plant — power program

Completed plant of the power program consists of the following at September 30:

	1998			1997		
	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Net</u>	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Net</u>
	(in millions)					
Fossil plants	\$ 7,780	\$ 3,181	\$ 4,599	\$ 7,427	\$ 2,954	\$ 4,473
Nuclear plants	14,613	2,697	11,916	14,514	2,277	12,237
Transmission	3,265	1,038	2,227	3,144	982	2,162
Hydro plants	1,424	491	933	1,382	471	911
Other	1,973	538	1,435	2,061	494	1,567
Total	<u>\$29,055</u>	<u>\$ 7,945</u>	<u>\$21,110</u>	<u>\$28,528</u>	<u>\$ 7,178</u>	<u>\$21,350</u>

4. Appropriation investment — power program

The TVA Act requires TVA to make annual payments to the U.S. Treasury from net power proceeds as a return on the appropriations investment in the power system and as a repayment of that investment. The payments required by the TVA Act may be deferred under certain circumstances for not more than two years. The annual repayment amount is \$20 million. The return is based on the appropriation investment as of the beginning of the year and the computed average interest rate payable by the U.S. Treasury on its total marketable public obligations as of the same date (6.71 percent at September 30, 1997.)

5. Debt

Borrowing authority

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

Notes to Financial Statements — (Continued)

Debt outstanding

Debt outstanding at September 30, 1998 and 1997 consisted of the following:

	1998	1997
	(in millions)	
SHORT-TERM DEBT		
Held by the public		
Discount notes (net of discount)	\$ 1,757	\$ 2,151
Current maturities of long-term debt — 5.88%	1,500	574
Total short-term debt	3,257	2,725
LONG-TERM DEBT		
Held by the public — senior		
Maturing in 1999	—	2,450
Maturing in 2000 — 6.00% to 8.375%	1,250	1,000
Maturing in 2001 — 5.28% to 6.50%	2,100	1,800
Maturing in 2002 — 6.875% to 7.45%	—	1,500
Maturing in 2003 — 6.125%	1,250	1,250
Maturing in years 2004 through 2044 — 5.98% to 8.625%	14,527	12,354
Held by Federal Financing Bank — senior		
Maturing in 2003 through 2016 — 8.535% to 11.695%	3,200	3,200
Held by the public — subordinated		
Maturing in 2045 through 2046 — 7.50% to 8.00%	1,100	1,100
Total long-term debt	23,427	24,654
Unamortized discount and other adjustments	(407)	(502)
Net long-term debt	23,020	24,152
TOTAL DEBT	\$26,277	\$26,877

Short-term debt

The weighted average rates applicable to short-term debt outstanding in the public market as of September 30, 1998 and 1997, were 5.54 percent and 5.56 percent, respectively. During 1998, 1997, and 1996, the maximum outstanding balance of short-term borrowings held by the public was (in millions) \$2,914, \$3,962, and \$3,537, respectively, and the average amounts (and weighted average interest rates) of such borrowings were approximately (in millions), \$2,234 (5.58 percent), \$2,743 (5.47 percent), and \$2,692 (5.50 percent), respectively.

Put and call options

Bond issues of \$9.1 billion held by the public are redeemable in whole or in part, at TVA's option, on call dates ranging from the present to July 2020 at call prices ranging from 100 percent to 106.7 percent of the principal amount. During 1998, TVA monetized the call provisions on approximately \$2 billion of public bond issues. Additionally, TVA has bond issues of \$2.1 billion held by the public that are redeemable in whole or in part at the option of the respective bondholders. One bond issue totaling \$500 million, which matures in July 2045, is redeemable in 2001 by the bondholders. A second issue totaling \$121 million, which matures in April 2036, is redeemable in 2006 at the option of the bondholders, and a third issue totaling \$1.5 billion, which matures in April 2036, is redeemable in 1999 or 2006 at the option of the bondholders. A fourth issue totaling \$250 million, which matures in January 2018, includes a provision for a right of redemption upon the death of a beneficial owner in certain specified circumstances. All of these issues are reported in the debt schedule with maturity dates corresponding to the earliest redeemable dates.

Bond discount and premium

Discounts and premiums on power borrowings are deferred and amortized (accreted), respectively, as components of interest expense on a straight-line basis over the term of the related outstanding securities.

Notes to Financial Statements — (Continued)

Foreign currency transaction and interest rate swap

During 1996, TVA entered into a currency swap contract as a hedge for a foreign currency denominated debt transaction where TVA issued 1.5 billion Deutschemark bonds, the cash flows of which were swapped for those of a U.S. dollar obligation of \$1 billion. Any gain (loss) on the debt instrument due to the foreign currency transaction is offset by a loss (gain) on the swap contract. At September 30, 1998 and 1997 the currency transaction resulted in gains of \$102 million and \$131 million, respectively, which are included in the account "unamortized discount and other adjustments." The offsetting loss on the swap contract is recorded as a deferred liability. If any loss/gain were to be incurred as a result of the early termination of the swap contract, any resulting charge (income) would be amortized over the remaining life of the bond as a component of interest expense.

Additionally, in 1997, TVA entered into a 10-year fixed rate interest swap agreement with a notional amount of \$300 million. Such agreement was entered into to hedge TVA's inflation exposure related to its inflation-indexed accreting principal bonds.

Subsequent event

During October 1998, Congress passed legislation enabling TVA to refinance \$3.2 billion in TVA bonds issued to the Federal Financing Bank. TVA retired these bonds on October 23, 1998, through proceeds from short-term borrowings and expects to refinance on a long-term basis in 1999.

6. Fair value of financial instruments

TVA uses the methods and assumptions described below to estimate the fair values of each significant class of financial instrument.

Cash and cash equivalents and short-term debt

The carrying amount approximates fair value because of the short-term maturity of these instruments.

Investment funds

At September 30, 1998, these investments were classified as trading securities and carried at their fair value.

Loans and other long-term receivables

Fair values for these homogeneous categories of loans and receivables are estimated by determining the present value of future cash flows using the current rates at which similar loans are presently made to borrowers with similar credit ratings and for the same remaining maturities.

Bonds

Fair value of long-term debt traded in the public market is determined by multiplying the par value of the bonds by the quoted market price (asked price) nearest the balance sheet date. The fair value of other long-term debt and long-term debt held by the Federal Financing Bank is estimated by determining the present value of future cash flows using rates of financial instruments with quoted market prices of similar characteristics and the same remaining maturities.

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

	1998		1997	
	Carrying amount	Fair amount	Carrying amount	Fair amount
	(in millions)			
Cash and cash equivalents	\$ 451	\$ 451	\$ 374	\$ 374
Investment funds	578	578	561	561
Loans and other long-term receivables	151	151	170	160
Short-term debt	1,757	1,757	2,151	2,151
Long-term debt, including current maturities	24,927	26,732	25,228	26,127

Notes to Financial Statements — (Continued)

The fair market value of the financial instruments held at September 30, 1998, may not be representative of the actual gains or losses that will be recorded when these instruments mature or if they are called or presented for early redemption.

7. Benefit plans

Pension plan

TVA has a defined benefit plan for most full-time employees that provides two benefit structures, the Original Benefit Structure and the Cash Balance Benefit Structure. The plan assets are primarily stocks and bonds. TVA contributes to the plan such amounts as are agreed upon between TVA and the TVA Retirement System board of directors, which in no event would be less than the amount necessary on an actuarial basis to provide assets sufficient to meet obligations for benefits.

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

The Cash Balance Benefit Structure was implemented January 1, 1996. The pension benefit for participants in the Cash Balance Benefit Structure is based on credits accumulated in the member's account and member's age. A member's account receives credits each pay period equal to 6.0 percent of his or her straight-time earnings. The account also increases at an interest rate equal to the change in the Consumer Price Index plus 3.0 percent, which amounted to 5.82 percent for 1998 and 1997.

During 1998, TVA effected plan amendments such that certain pension benefits were enhanced resulting in approximately \$590 million in additional pension plan benefit obligations.

The components of pension expense for the years ended September 30 were:

	1998	1997	1996
	(in millions)		
PENSION EXPENSE:			
Service cost	\$ 67	\$ 70	\$ 72
Interest cost on projected benefit obligation	328	308	309
Actual return on assets	(223)	(1,334)	(616)
Net amortization and deferral	(256)	899	217
NET PENSION INCOME	\$ (84)	\$ (57)	\$ (18)
FUNDED STATUS:			
Actuarial present value of benefit obligations:			
Vested benefit obligation	\$ (5,098)	\$ (3,770)	\$ (3,506)
Nonvested benefits	(10)	(48)	(50)
Accumulated benefit obligation	(5,108)	(3,818)	(3,556)
Effects of projected future compensation	(537)	(391)	(401)
Projected benefit obligation	(5,645)	(4,209)	(3,957)
Plan assets at fair value	5,968	5,962	4,851
Excess of plan assets over projected benefit obligation	323	1,753	894
Unrecognized prior service cost	470	(7)	(7)
Unrecognized net gain	(572)	(1,529)	(763)
Unrecognized net obligation being amortized over 15 years beginning October 1, 1987	—	—	2
PREPAID PENSION COST	\$ 221	\$ 217	\$ 126

The discount rate used to determine the actuarial present value of the projected benefit obligation was 7.0 percent in 1998 and 8.0 percent in 1997 and 1996. The assumed annual rates of increase in future compensation levels for 1998, 1997 and 1996 ranged from 3.3 to 8.3 percent. The expected long-term rate of return on plan assets was 11.0 percent for 1998, 1997, and 1996.

Notes to Financial Statements — (Continued)

Other postretirement benefits

TVA sponsors an unfunded defined benefit postretirement plan that provides for contributions toward the cost of retirees' medical coverage. The plan covers employees who, at retirement, are age 60 and older (or who are age 50 and have at least five years of service). TVA's contributions are a flat dollar amount based upon the participants' age and years of service and certain payments toward the plan costs.

In connection with the pension plan benefit amendments, TVA also effected other postretirement benefit plan amendments during 1998 such that certain retiree health benefits were discontinued, resulting in approximately \$120 million in reduced other postretirement benefit obligations.

The annual assumed cost trend for covered benefits is 10.0 percent in 1998, decreasing by one-half percent per year to a level of 5.0 percent in 2008 and thereafter. For 1997 and 1996, an annual trend rate of 10.5 percent and 11.0 percent, respectively, was assumed. The effect of the change in assumptions on a cost basis was not significant. Increasing the assumed healthcare cost trend rates by 1.0 percent would increase the accumulated postretirement benefit obligation (APBO) as of September 30, 1998, by \$17 million and the aggregated service and interest cost components of net periodic postretirement benefit cost for 1998 by \$2 million.

The weighted average discount rate used in determining the APBO was 7.0 percent for 1998 and 8.0 percent for 1997 and 1996. Any net unrecognized gain or loss resulting from experience different from that assumed or from changes in assumptions, in excess of 10.0 percent of the APBO, is amortized over the average remaining service period of active plan participants.

The following sets forth the plan's funded status at September 30:

	1998	1997	1996
	(in millions)		
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION (APBO)			
Retirees	\$118	\$220	\$230
Fully eligible active plan participants	1	2	4
Other active plan participants	87	126	187
APBO	206	348	421
Unrecognized prior service costs	25	—	—
Unrecognized net (loss) gain	(5)	—	(95)
ACCRUED POSTRETIREMENT BENEFIT COST	\$226	\$348	\$326
NET PERIODIC POSTRETIREMENT BENEFIT COST			
Service cost	\$ 8	\$ 13	\$ 8
Interest cost	26	32	24
Amortization of loss	—	4	—
NET PERIODIC POSTRETIREMENT BENEFIT COST	\$ 34	\$ 49	\$ 32

Other postemployment benefits

Other postemployment benefits include workers' compensation provided to former or inactive employees, their beneficiaries and covered dependents after employment but before retirement. Adoption of Statement of Financial Accounting Standards No. 112, *Employers Accounting for Postemployment Benefits* (SFAS No. 112) in 1995 changed TVA's method of accounting from recognizing costs as benefits are paid to accruing the expected costs of providing these benefits. This resulted in recognition of an original transition obligation of approximately \$280 million. During 1996, TVA made adjustments to certain assumptions utilized in the determination of the obligation at September 30, 1996, which resulted in an increase in the original transition obligation of approximately \$194 million. In connection with the adoption of SFAS No. 112, and related approval by its Board of Directors, TVA recorded the transition obligation as a regulatory asset. The regulatory asset is being amortized over approximately 15 years, whereby the annual expense will approximate the expense that would be recorded on an as-paid basis.

Notes to Financial Statements — (Continued)

Early-out and accelerated severance packages

In 1997 and 1996, TVA provided both voluntary and involuntary severance packages, which affected an aggregate of approximately 2,500 employees. During this period, severance costs totaled approximately \$48 million and consisted primarily of severance pay (\$75 million) and a related pension curtailment gain of \$27 million. The aggregate costs of the severance packages have been charged to the power program primarily as other expense during 1997 and 1996 in the amounts of \$11 million and \$35 million, respectively, and the nonpower program as nonpower expense during 1997 and 1996 in the amounts of \$8 million and \$6 million, respectively.

8. Major customers

One municipal customer accounts for approximately 10 percent of total power sales and four other municipal customers account for an additional aggregate 19 percent of total power sales. These five municipal customers purchase power from TVA under long-term contracts for terms of 20 years, which require a notice of 10 years to terminate.

9. Construction expenditures and commitments and contingencies

Leases

Certain property, plant and equipment are leased under agreements with terms ranging from one to 30 years. Most of the agreements include purchase options or renewal options that cover substantially all the economic lives of the properties. Obligations under capital lease agreements in effect at September 30, 1998, total \$36 million annually through 2003, and an aggregate of \$264 million thereafter, for a total commitment of \$444 million, which includes an interest element of \$249 million.

Construction expenditures

Construction expenditures, including capitalized interest, are estimated to be approximately \$828 million for 1999 and \$719 million for 2000. These estimates are revised periodically to reflect changes in economic conditions and other factors considered in their determination.

Fuel purchase commitments

TVA has entered into approximately \$2.6 billion in long-term commitments ranging in terms of up to seven years for the purchase of coal, and approximately \$216 million in long-term commitments ranging in terms of up to five years for the purchase of uranium.

Contingencies

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

In accordance with NRC regulations, TVA carries property and decontamination insurance of \$1.06 billion at each licensed nuclear plant for the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums of up to a maximum of approximately \$22 million.

Clean Air legislation. The Clean Air Act Amendments of 1990 require coal-fired generation units to reduce their sulfur dioxide and nitrogen oxide emissions in two phases in order to control acid rain. The Phase I compliance period commenced on January 1, 1995, for sulfur dioxide and January 1, 1996, for nitrogen oxide, while the Phase II compliance period commences on January 1, 2000. Based on the level of emissions, 26 of TVA's 59 operating coal-fired units are classified as Phase I units, with the remaining units being Phase II units. Compliance with these requirements has resulted in substantial expenditures for the reduction of emissions at TVA's coal-fired generating plants.

Notes to Financial Statements — (Continued)

TVA's strategy for complying with the 1990 Amendments includes the use of scrubbers at two fossil units and the use of lower-sulfur coal at other fossil units to reduce sulfur dioxide. TVA has completed all planned scrubbers and is on schedule to complete the change-over to lower-sulfur coal.

Nitrogen oxide reductions were required for 19 of TVA's Phase I units. These reductions were achieved through the installation of low-nitrogen-oxide burners at 13 units. TVA is in compliance with all Phase I requirements and is currently installing nitrogen oxide reduction equipment to bring TVA's remaining units in compliance with Phase II nitrogen oxide emission requirements.

Expenditures related to the Clean Air projects during 1998 and 1997 were approximately \$64 million and \$40 million, respectively. TVA has already completed the actions necessary to achieve Phase I compliance for both sulfur dioxide and nitrogen oxide emissions, and TVA is proceeding to take actions to comply with Phase II requirements that become effective in the year 2000 or after.

The total cost of compliance cannot reasonably be determined at this time because of the uncertainties surrounding emerging Environmental Protection Agency regulations, resultant compliance strategies, potential for development of new emission control technologies and future amendments to the legislation.

Hazardous substances. The release and cleanup of hazardous substances are regulated under the Comprehensive Environmental Response, Compensation, and Liability Act. In a manner similar to many other industries and power systems, TVA has generated or used hazardous substances over the years. TVA has been identified as a potentially responsible party with respect to five off-site disposal areas. TVA's liability at these sites has not yet been determined. In addition, TVA is currently investigating one other site that TVA owns. TVA may have cleanup responsibilities at this site by virtue of its control of the property. TVA's potential liabilities for its share of cleanup costs at all of these sites are uncertain but are not expected to be substantial.

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

Decommissioning costs. Provision for decommissioning costs of nuclear generating units is based on the estimated cost to dismantle and decontaminate the facilities to meet NRC criteria for license termination. The Financial Accounting Standards Board (FASB) has reached several tentative conclusions with respect to its project regarding the accounting for closure and removal of long-lived assets, including the decommissioning of nuclear generating units. It is uncertain when the final statement will be issued and what impact it may ultimately have on TVA's financial position or results of operations. Effective for 1998, TVA changed its method of accounting for decommissioning costs and related liabilities in order to comply with certain of the FASB's tentative conclusions, as well as certain rate-setting actions.

TVA's current accounting policy recognizes as incurred all obligations related to closure and removal of its nuclear units. The liability for closure is measured as the present value of the estimated cash flows required to satisfy the related obligation and discounted at a determined risk-free rate of interest. The corresponding charge to recognize the additional obligation was effected through the creation of a regulatory asset. TVA further modified its method of accounting for decommissioning costs such that earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred in accordance with SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. At September 30, 1998, the present value of the estimated future decommissioning cost of \$814 million was included in other liabilities. The decommissioning cost estimates from a 1995 study are based on prompt dismantlement and removal of the plant from service. The actual decommissioning costs may vary from the estimates because of changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology and changes in the cost of labor, materials and equipment.

TVA maintains an investment trust fund to provide funding for the decommissioning of nuclear power plants. In May 1997, TVA sold the entire \$402 million equity index fund portfolio and transferred the proceeds to trust portfolios managed by independent money managers. During 1997, TVA recognized \$151 million of income related to the fund, which included an \$81 million gain on the sale of fund investments and \$70 million in net appreciation and interest

Notes to Financial Statements — (Continued)

income. As of September 30, 1998, the decommissioning trust fund investments totaled \$571 million and were invested in securities designed to achieve a return in line with overall equity market performance.

Effective September 22, 1998 the NRC amended its regulations regarding decommissioning funding. TVA is studying the change in regulation for potential impacts on both the required amount of funding and the nature of the trust accounts. The new regulation becomes effective on November 23, 1998 and is not expected to have a material impact on TVA's financial position or results of operations.

Cost-based regulation. As a regulated entity, TVA is subject to the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. Accordingly, TVA records certain assets and liabilities that result from the effects of the ratemaking process that would not be recorded under generally accepted accounting principles for non-regulated entities. Currently, the electric utility industry is predominantly regulated on a basis designed to recover the cost of providing electric power to its customers. If cost-based regulation were to be discontinued in the industry for any reason, profits could be reduced and utilities might be required to reduce their asset balances to reflect a market basis less than cost. Discontinuance of cost-based regulation would also require affected utilities to write-off their associated regulatory assets. Such regulatory assets for TVA total approximately \$1.9 billion at September 30, 1998, along with approximately \$6.3 billion of deferred nuclear plants. Management cannot predict the potential impact, if any, of the change in the regulatory environment on TVA's future financial position and results of operations.

10. Nonpower programs

TVA's nonpower programs provide various public services, including managing navigable river channels, providing flood control and overseeing certain recreation facilities. The nonpower programs encompass general stewardship of land, water and wildlife resources. TVA's nonpower programs also conduct certain research and development activities in pollution prevention and remediation.

Funding for the nonpower programs has historically been primarily provided through federal appropriations. Certain nonpower program activities are also funded by user fees and outside services revenues. In 1997, Congress passed legislation that anticipated no further appropriations to TVA after 1998 and required TVA to fund its nonpower programs that constitute "essential stewardship activities" from one or more sources, including power revenues. Nonetheless, in October 1998, Congress appropriated \$50 million for TVA's nonpower programs for 1999.

The completed plant of the nonpower programs consists of multipurpose dams and other plant. At September 30, 1998, the net completed plant balances for multipurpose dams and other plant were \$698 million and \$115 million, respectively. At September 30, 1997, the net completed plant balances for multipurpose dams and other plant were \$699 million and \$113 million, respectively.

Report of Independent Accountants

To the Board of Directors of the Tennessee Valley Authority

In our opinion, the accompanying balance sheets (power program and all programs) and the related statements of income (power program), changes in proprietary capital (power program and nonpower programs), net expense (nonpower programs) and cash flows (power program and all programs) present fairly, in all material respects, the financial position of the power program and all programs of the Tennessee Valley Authority as of September 30, 1998 and 1997, the results of operations of the power program and nonpower programs and cash flows of the power program and all programs for each of the three years in the period ended September 30, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Tennessee Valley Authority's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

In accordance with Government Auditing Standards, we have also issued a report, dated October 23, 1998, on our consideration of the Tennessee Valley Authority's internal controls over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP
Knoxville, Tennessee
October 23, 1998

Report of Management

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

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

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

/s/ DAVID N. SMITH

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

Description of Bonds

General

The Bonds are to be issued pursuant to authority vested in TVA by the Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution adopted on October 6, 1960, as amended on September 28, 1976, October 17, 1989 and March 25, 1992 (the “Basic Resolution”), and the Supplemental Resolution authorizing the Bonds adopted on November 18, 1998 (the “Supplemental Resolution” and together with the Basic Resolution, the “Resolutions”). TVA will enter into a Global Agency Agreement to be dated as of December 2, 1998 (the “Global Agency Agreement”) with The Chase Manhattan Bank, as global agent (including its successors, the “Global Agent”) and, acting through its London branch, as paying agent (including its successors, the “GBP Paying Agent”). The U.S. Secretary of the Treasury has approved the time of issuance of, and the maximum rate of interest to be borne by, the Bonds in compliance with Section 15d(c) of the Act. The Bonds represent obligations of TVA payable solely from TVA’s Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America.

The Act authorizes TVA to issue and sell bonds, notes and other evidences of indebtedness (hereinafter collectively referred to as “Evidences of Indebtedness”) to assist in financing its power program and to refund such Evidences of Indebtedness. Evidences of Indebtedness issued pursuant to Section 2.2 of the Basic Resolution designated as Tennessee Valley Authority Power Bonds are herein referred to as “Power Bonds”. The aggregate amount of Evidences of Indebtedness at any one time outstanding is limited to U.S. \$30 billion. As of September 30, 1998 TVA had approximately U.S.\$25.7 billion and DM 1.5 billion (issued in September 1996) of Evidences of Indebtedness outstanding. At the time TVA issued such DM Evidences of Indebtedness, TVA entered into a currency swap agreement to hedge against fluctuations in such currency. For information with respect to TVA’s Power Bonds and the Basic Resolution, see “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Issuance of Additional Bonds and Other Evidences of Indebtedness” in the current Information Statement.

The summaries herein of certain provisions of the Act, the Resolutions and the Global Agency Agreement do not purport to be complete and are qualified in their entirety by reference to all the provisions of the Act, the Resolutions and the Global Agency Agreement, copies of which may be obtained upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902, Attention: Vice President and Treasurer, or by calling (423) 632-3366 in the United States. Copies of such documents will be on file and available for inspection during normal business hours at the office of the Global Agent at 450 West 33rd Street, New York, New York 10001 U.S.A., at the office of the GBP Paying Agent at Trinity Tower, 9 Thomas More Street, London, England E1 9YT and at the office of the Listing Agent at 43 Boulevard Royal L-2955, Luxembourg, R.C. Luxembourg B6395.

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

The Bonds rank equally as to the application of Net Power Proceeds with all other Power Bonds. As to the application of Net Power Proceeds, Power Bonds currently rank senior to other Evidences of Indebtedness as to principal and on parity with or senior to other Evidences of Indebtedness as to interest. At some future date prior to maturity of the Bonds, Evidences of Indebtedness other than Power Bonds may also rank on parity with Bonds as to principal. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Amendments to the Basic Resolution to Become Effective in the Future” in the current Information Statement. For a further discussion of the application of Net Power Proceeds, see “Certain Provisions of the Tennessee Valley Authority Act” and “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Application of Net Power Proceeds” in the current Information Statement.

There is no limit on other indebtedness or securities which may be issued by TVA and no financial or similar restrictions on TVA, except as provided under the Act, the Basic Resolution and the Supplemental Resolution. TVA

issues its Discount Notes pursuant to Section 15d of the Act and in accordance with Section 2.5 of the Basic Resolution. TVA may also issue Other Indebtedness in addition to Power Bonds and Discount Notes. Other Indebtedness, such as TVA's Quarterly Income Debt Securities, are issued pursuant to Section 15d of the Act and under appropriate authorizing resolutions. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" in the current Information Statement.

The Bonds, which are to be issued in an aggregate principal amount of £200,000,000, will bear interest from December 2, 1998 at the rate set forth on the cover page of this Offering Circular and will mature on June 7, 2021 (the "Maturity Date"). Interest on the Bonds will be payable semi-annually in arrear on December 7 and June 7 of each year (each an "Interest Payment Date"), commencing June 7, 1999, to the persons in whose names the Bonds are registered at the close of business on the day fifteen days (the "Record Date") prior to such Interest Payment Dates, whether or not such day is a Business Day. Interest will be calculated on the basis of a 360-day year consisting of twelve 30-day months. Any such interest not so punctually paid or duly provided for will forthwith cease to be payable to the person in whose name the Bonds are registered on such Record Date and may be paid to the person in whose name the Bonds are registered at the close of business on a special record date for the payment of such defaulted interest to be fixed by TVA or may be paid at any time in any other lawful manner not inconsistent with the requirements of the Stock Exchanges. The Bonds will not be subject to redemption prior to maturity and are not entitled to the benefit of any sinking fund. The Bonds will be repaid at 100 percent of the principal amount thereof, together with interest accrued and unpaid thereon, on the Maturity Date. No registrations of transfers or exchanges of Bonds shall be made for a period of 10 days preceding any Interest Payment Date.

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

Certain certification requirements are applicable to payments of interest on the Bonds. The registered holder or other persons otherwise required to withhold tax may require the beneficial owner of a Bond, as a condition of payment of amounts due with respect to such Bond, to present on a timely basis an appropriate United States Internal Revenue Service Form W-8 (or successor form) or other appropriate form to enable such person to determine its duties and liabilities with respect to any taxes or other charges that may be required to be deducted or withheld under U.S. law or any reporting or other requirements thereunder. See "United States Tax Matters". In the event that any withholding or other tax or information reporting requirements should be imposed by any jurisdiction, TVA has no obligation to pay additional interest or other amounts as a consequence thereof and will not redeem the Bonds prior to their stated maturity.

Under the Supplemental Resolution, actions taken by TVA pursuant to U.S. Public Law No. 105-62 shall not be considered an event of default or a breach under the Resolutions. Public Law No. 105-62 provides, among other things, that TVA is required, beginning October 1, 1998, to fund nonpower programs that constitute "essential stewardship activities" with revenues derived from one or more of various sources, including power revenues, notwithstanding provisions of the Act and power bond covenants to the contrary. See the discussion of Public Law 105-62 in "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" — "Recent Legislation" in the current Information Statement.

Redemption

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

Form and Denominations

The Bonds will be represented by one or more global securities (collectively, the "Global Bond") registered in the name of Cede, as nominee of DTC. The Global Bond will be held by the Global Agent, at its New York branch, as custodian for DTC. The Bonds will be issued only in fully registered form, without coupons, and, in the case of any definitive Bonds issued in exchange for the Global Bond, as provided below, in denominations of £1,000 and integral multiples thereof.

Except as set forth below, the Global Bond may be transferred, in whole and not in part, only to DTC, another nominee of DTC or a successor of DTC or its nominee.

Beneficial interests in the Bonds will be represented, and transfers of such beneficial interests will be effected, through accounts of financial institutions acting on behalf of beneficial owners as direct and indirect participants in DTC. Such beneficial interests will be in denominations of £1,000 and integral multiples thereof. Investors may hold beneficial interests in the Bonds through DTC, Euroclear or Cedelbank, if such investors are participants in such systems, or indirectly through organizations that are participants in such systems. Euroclear and Cedelbank hold beneficial interests in the Bonds on behalf of their own participants through their indirect accounts at DTC.

Transfers of beneficial interests in the Bonds between DTC participants shall be effected in accordance with the procedures established for this purpose by DTC. Transfers of beneficial interests in the Bonds between Euroclear participants, between Cedelbank participants and between Euroclear participants on the one hand and Cedelbank participants on the other hand shall be effected in accordance with procedures established for these purposes by Euroclear and Cedelbank. Transfers of beneficial interests in Bonds between DTC participants on the one hand and participants of Euroclear or Cedelbank on the other hand will be settled in accordance with the usual rules and operating procedures established by DTC, Euroclear and Cedelbank. See “Clearance and Settlement”.

DTC may grant proxies or otherwise authorize DTC participants (or persons holding beneficial interests in the Bonds through such DTC participants) to exercise any rights of a holder or take any other actions that a holder is entitled to take under the Resolutions, the Global Agency Agreement or the Bonds. Under its usual procedures, DTC would mail an omnibus proxy to TVA assigning Cede’s consenting or voting rights to those DTC participants to whose accounts the Bonds are credited on a record date as soon as possible after such record date.

Persons who are not DTC participants may beneficially own Bonds held by DTC only through direct or indirect participants in DTC, including Euroclear and Cedelbank. So long as Cede, as the nominee of DTC, is the registered owner of the Global Bond, Cede for all purposes will be considered the sole holder of the Bonds under the Resolutions, the Global Agency Agreement and the Bonds. Except as provided below, owners of beneficial interests in the Bonds represented by the Global Bond will not be entitled to have Bonds registered in their names, will not receive or be entitled to receive physical delivery of Bonds in definitive form and will not be considered to be the holders thereof under the Resolutions, the Global Agency Agreement or the Bonds. Accordingly, any person owning a beneficial interest in the Bonds represented by the Global Bond must rely on the procedures of DTC and, to the extent relevant, Euroclear or Cedelbank, and, if such person is not a participant, on the procedures of the participant through which such person owns its interest, to exercise any rights of a holder of Bonds. TVA understands that, under existing industry practice, in the event that an owner of a beneficial interest in the Bonds represented by the Global Bond desires to take any action that Cede, as the holder of such Global Bond, is entitled to take, Cede would authorize the participants to take such action, and the participants would authorize beneficial owners owning through such participants to take such action or would otherwise act upon the instructions of beneficial owners owning through them.

Payment

Pursuant to the Global Agency Agreement and except as described below, TVA has directed the Global Agent or GBP Paying Agent, as the case may be, to make payments of principal and interest on the Bonds to the registered holder of the Bonds, which shall be a nominee of DTC as long as DTC holds the Global Bond. TVA understands that DTC will, upon receipt of any payment of principal of or interest on the Global Bond, credit DTC participants’ accounts with payment in amounts proportionate to their respective beneficial interests in the principal amount of the Global Bond as shown on the records of DTC. Payments by DTC participants to owners of beneficial interests in the Bonds held through such participants will be the responsibility of such participants, as is now the case with securities held for the accounts of customers registered in “street name”. Distributions with respect to interests in Bonds held through Euroclear or Cedelbank will be credited to the cash accounts of Euroclear participants or Cedelbank participants in accordance with the relevant system’s rules and procedures, to the extent received by its depository. None of TVA, the Global Agent or the GBP Paying Agent will have any responsibility or liability for any aspect of the records relating to, or payments made or to be made on account of, beneficial ownership interests in the Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

Payment of principal of and interest on the Global Bond will be made to the GBP Paying Agent in British pounds sterling. Except as described below, investors holding beneficial interests in the Bonds through Euroclear or Cedelbank will be paid in British pounds sterling.

A person holding interests in the Global Bond directly through DTC (a “DTC Direct Participant”) shall receive payments of principal and interest in respect of the Bonds in U.S. dollars, unless such DTC Direct Participant elects to

receive payments in British pounds sterling. See “Clearance and Settlement” — “Payment”. In the event that a DTC Direct Participant shall not have made such election in respect of any payment of principal or interest, the aggregate amount designated for all such DTC Direct Participants in respect of such payment (the “GBP Conversion Amount”) shall be converted (or caused to be converted) by the Global Agent (or, if TVA has appointed a leading foreign exchange bank in connection with the Bonds (the “Exchange Dealer”), the Exchange Dealer) into U.S. dollars and paid by the Global Agent by wire transfer of same-day funds to the registered holder of the Global Bond for payment through DTC’s settlement system to the relevant DTC participants. TVA understands that Euroclear and Cedelbank will elect to receive all payments of principal and interest in respect of the Bonds held through them in British pounds sterling. In the event that such election is not made, each individual holder of a beneficial interest in the Global Bond holding through Euroclear or Cedelbank must make arrangements with Euroclear or Cedelbank, in accordance with their usual rules and operating procedures, in order to avoid payment in U.S. dollars. All costs of any conversion into U.S. dollars will be borne by the relevant holders of beneficial interests receiving such payments by deduction from such payments. Any such conversion shall be based on The Chase Manhattan Bank’s (or, if an Exchange Dealer has been appointed, the Exchange Dealer’s) bid quotation, at or prior to 11:00 a.m., New York time, on the second Business Day preceding the relevant payment date, for the purchase by the Global Agent (or, if an Exchange Dealer has been appointed, the Exchange Dealer) of the GBP Conversion Amount of U.S. dollars for settlement on such payment date. If such bid quotation is not available for any reason, the Global Agent (or, if an Exchange Dealer has been appointed, the Exchange Dealer) shall endeavor to obtain a bid quotation from a leading foreign exchange bank in New York City selected by the Global Agent (or, if an Exchange Dealer has been appointed, the Exchange Dealer) for such purpose. If no bid quotation from a leading foreign exchange bank is available, payment of the GBP Conversion Amount will be made in British pounds sterling to the account or accounts specified by DTC to the GBP Paying Agent.

In addition to acting in its capacities as GBP Paying Agent and Global Agent, The Chase Manhattan Bank may act as a foreign exchange dealer for purposes of converting British pounds sterling to U.S. dollars as described in the paragraph above and, when acting as a foreign exchange dealer, The Chase Manhattan Bank will derive profits from such activities in addition to the fees earned by it for its services as GBP Paying Agent and Global Agent. Each such conversion will be made on such terms, conditions and charges not inconsistent with the terms of the Bonds as The Chase Manhattan Bank (or, if an Exchange Dealer has been appointed, the Exchange Dealer) may from time to time establish in accordance with its regular foreign exchange practices, and subject to applicable U.S. law and regulations.

A DTC Direct Participant may elect to receive payment of the principal of, or interest with respect to, the Bonds in British pounds sterling by causing DTC to notify the Global Agent and the GBP Paying Agent by the time specified below of (i) such DTC Direct Participant’s election to receive all or a portion of such payment in British pounds sterling and (ii) wire transfer instructions to a British pound sterling account in the United Kingdom. Such election in respect of any payment must be made by the DTC Direct Participant at the time and in the manner required by the DTC procedures applicable from time to time and shall, in accordance with such procedures, be irrevocable and shall relate only to such payment. See “Currency Conversion and Foreign Exchange Risks”. DTC notifications of such election, wire transfer instructions and the amount payable in British pounds sterling must be received by the Global Agent and the GBP Paying Agent prior to 5:00 p.m. New York time on the fifth New York Business Day (as defined herein) following the relevant Record Date in the case of interest, and prior to 5:00 p.m. New York time on the tenth day prior to the payment date for the payment of principal. Any payments in British pounds sterling shall be made by wire transfer of same-day funds to British pound sterling accounts designated by DTC. The term “New York Business Day” shall mean any day other than a Saturday or Sunday or a day on which banking institutions in New York City are authorized or required by law or executive order to close.

If the British pound sterling is converted into or replaced by another currency pursuant to law having general and direct applicability to the United Kingdom (including, for the avoidance of doubt, European Community laws), any payment in respect of the Bonds by TVA shall be made in the currency into or by which the British pound sterling has been so converted or replaced, based on the conversion or other equivalency rate prescribed by law having general and direct applicability in the United Kingdom (including, for the avoidance of doubt, European Community laws) at the time of such payment. If any currency is introduced in the United Kingdom on the basis of a legally enforceable equivalency to the British pound sterling pursuant to law having general and direct applicability in the United Kingdom (including, for the avoidance of doubt, European Community laws) in preparation for conversion of the British pound sterling into, or replacement of the British pound sterling by, such other currency, TVA shall be entitled, at its option, to make any payment in respect of the Bonds in such other currency based on the equivalency rate prescribed by law having general and direct applicability in the United Kingdom (including, for the avoidance of

doubt, European Community laws) at the time of such payment. A payment made by TVA in a currency other than the British pound sterling in accordance with the terms of this paragraph shall not, by itself, constitute a default in TVA's obligations under the Bonds. The occurrence or nonoccurrence of a currency conversion, replacement or introduction of a type described in this paragraph, by itself, shall not (i) be deemed to be a modification or amendment of the terms or provisions of the Bonds by TVA, (ii) entitle TVA to avoid its obligations under the Bonds or (iii) entitle TVA or any holder of a Bond to rescission of the purchase and sale of any Bond or to reformation of any of the terms or provisions thereof on the grounds of impossibility or impracticability of performance, frustration of purpose or otherwise.

Definitive Bonds

If DTC notifies TVA that it is unwilling or unable to continue as depository for the Global Bond or ceases to be a clearing agency registered under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act") at a time when it is required to be so registered and a successor depository is not appointed by TVA within 90 days after receiving such notice or becoming aware that DTC is no longer so registered, TVA will issue or cause to be issued Bonds in definitive form in exchange for the Global Bond. Bonds issued in definitive form will be issued only in fully registered form, without coupons, in denominations of £1,000 and integral multiples thereof. Any Bonds so issued will be registered in such names, and in such denominations, as DTC shall request. In the event that TVA issues Bonds in definitive registered form, TVA will appoint a paying and transfer agent in Luxembourg (the "Luxembourg Paying and Transfer Agent"). Such Bonds may be presented for registration of transfer or exchange, in whole or in part, at the office of the Global Agent in New York City or the office of the Luxembourg Paying and Transfer Agent in Luxembourg, and principal thereof and interest thereon will be payable at the offices of the Global Agent, the GBP Paying Agent or the Luxembourg Paying and Transfer Agent (upon presentation and surrender of such Bonds in the case of payments of principal), provided that interest thereon may be paid by check mailed to the registered holders of the definitive Bonds or, at the option of TVA, by electronically transferring funds to such holders. The GBP Paying Agent or the Luxembourg Paying and Transfer Agent shall make all payments of principal of and interest on a Bond in definitive form to the holder thereof in British pounds sterling unless the holder of such Bond makes an election to receive such payments in U.S. dollars in accordance with the terms of the Bond. If any payment on a Bond in definitive form is due on a Business Day which is not a day on which banks are open for business in Luxembourg, then payment will not be made on any of the Bonds presented for payment in Luxembourg until the next succeeding day which is both a Business Day and a day on which banks are open for business in Luxembourg. Payment on such succeeding day will be with the same force and effect as if made on the due date for payment, and no additional payment will be made in respect of such delay. In the case of a transfer in part of a holding of Bonds held in definitive form, a new definitive Bond shall be issued to the transferee in respect of the part transferred and a further new definitive Bond shall be issued to the transferor in respect of the balance of the holding of Bonds not transferred. Such new definitive Bonds shall be available at the office of the Luxembourg Paying and Transfer Agent or the Global Agent, as the case may be.

Agents

TVA has agreed, in each case subject to applicable laws and regulations and the provisions of the Bonds and the Resolutions, so long as the Bonds are outstanding, to maintain a Global Agent and a GBP Paying Agent and, so long as the Bonds are listed on the Luxembourg Stock Exchange, a Special Agent in Luxembourg, which will act as an intermediary between TVA and investors in the Bonds. The Global Agent initially will be The Chase Manhattan Bank and the GBP Paying Agent initially will be The Chase Manhattan Bank, acting through its London branch. The Special Agent initially will be Kredietbank S.A. Luxembourgeoise. The addresses of the Global Agent, GBP Paying Agent and Special Agent are set forth on the back cover page hereof. In addition, as discussed above, in the event that TVA issues Bonds in definitive registered form, TVA will appoint a Luxembourg Paying and Transfer Agent.

Modification and Amendment

TVA may modify or amend any of the terms or provisions of the Bonds in accordance with the provisions for such modifications and amendments contained in the Basic Resolution. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" — "Modifications of Resolutions and Outstanding Bonds" in the current Information Statement. Notwithstanding such provisions contained in the Basic Resolution, TVA may not change the currency of payment of principal of or interest on the Bonds without the consent of the registered holders of all of the outstanding Bonds (other than as described in the last paragraph under "Payment" above).

The Global Agency Agreement may be modified or amended by the mutual agreement of TVA and the Global Agent, without the consent of the holders of the Bonds, in order (1) to add other covenants and agreements to be observed by TVA or to eliminate any right, power or privilege conferred upon TVA, (2) to correct any defect, ambiguity or inconsistency in, or to make provisions in regard to matters or questions arising under, the Global Agency Agreement, so long as such amendments are not contrary to, or inconsistent with, the Global Agency Agreement or the Bonds, (3) to effect the issuance of additional Bonds in one or more future installments as discussed below under “Possible Future Issuances” or (4) to make any other modification or amendment to the Global Agency Agreement which TVA in its written opinion to the Global Agent may determine will not materially and adversely affect the interests of holders of the Bonds, to all of which each holder of any Bond shall, by acceptance of such Bonds, consent.

Events of Default; No Acceleration Rights

The Bonds will not contain any provisions permitting acceleration of maturity thereof on the occurrence of any default. For a description of events constituting a default under the Bonds, and the rights of holders of the Bonds upon the occurrence of such events, see “Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Events of Default” in the current Information Statement.

Possible Future Issuances

The Supplemental Resolution provides that, at the option of TVA, additional Bonds may be issued in one or more future installments pursuant to an amendment to the Supplemental Resolution not requiring the consent of holders of Bonds. Additional Bonds so issued shall be identical in all respects to the Bonds offered hereby (with any related changes in the issue date, issue price and interest commencement date).

Governing Law; Judgment

The Global Agency Agreement and the Bonds shall be governed by and construed in accordance with the laws of the State of New York, to the extent such law is not inconsistent with U.S. federal law. Absent TVA’s submission to service of process in the United Kingdom and submission to the jurisdiction of the English courts, suit could not be brought by a holder of Bonds in the United Kingdom.

In the event an action based on the Bonds were commenced in a state court in the State of New York, the Judiciary Law of the State of New York would require that such court grant judgment in British pounds sterling but that such judgment be converted into U.S. dollars at the rate of exchange prevailing on the date of entry of the judgment. Accordingly, holders of beneficial interests in the Bonds would bear the risk of exchange rate fluctuations between the time the amount of the judgment is calculated and the time such amount is converted from U.S. dollars into British pounds sterling.

Listings

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

Notices

All notices will be delivered in writing to each holder of the Bonds. If at the time of such notice the Bonds are represented by the Global Bond, such notice shall be delivered to DTC and shall be deemed to have been given three Business Days after delivery to DTC. If at the time of such notice the Bonds are not represented by the Global Bond, such notice shall be delivered to the registered holders of the Bonds and in such case shall be deemed to have been given three Business Days after the mailing of such notice by first class mail.

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

Clearance and Settlement

Although DTC, Euroclear and Cedelbank have agreed to the procedures provided below in order to facilitate transfers of beneficial interests in the Bonds among participants of DTC, Euroclear and Cedelbank, they are under no obligation to perform or continue to perform such procedures and such procedures may be modified or discontinued at any time. None of TVA, the Manager, the Global Agent or the GBP Paying Agent will have any responsibility for the performance by DTC, Euroclear or Cedelbank or their respective participants or indirect participants of their respective obligations under the rules and procedures governing their operations. The following information on clearance and settlement is based on information provided by the several clearing systems identified herein.

Certification and Custody

Clearing and settlement arrangements, including the existing links between DTC, Euroclear and Cedelbank, will provide investors access to three major clearing systems. At initial settlement, the Bonds will be represented by the Global Bond, which will not be exchangeable for Bonds in definitive form except in the limited circumstances described herein. Financial institutions that are direct participants in DTC will hold direct beneficial interests in the Bonds through their accounts at DTC. Investors electing to hold beneficial interests in the Bonds through financial institutions other than DTC will hold indirect interests in the Global Bond.

Payment

Principal and interest payments on the Bonds will be made by TVA to the GBP Paying Agent in British pounds sterling as set forth under “Description of Bonds” — “Payment”. Pursuant to the Global Agency Agreement, TVA has directed the Global Agent or GBP Paying Agent, as the case may be, to make payments of principal and interest on the Bonds to the registered holder of the Global Bond except in the case of DTC Direct Participants electing to be paid in British pounds sterling as described above. See “Description of the Bonds” — “Payment”. All payments duly made by TVA through the Global Agent or GBP Paying Agent, as the case may be, to the registered holder of the Global Bond shall discharge the liability of TVA under the Bonds to the extent of the sum or sums so paid. Therefore, after such payments have been duly made, payments by DTC Direct Participants and indirect DTC participants to owners of beneficial interests in the Bonds will be governed by standing instructions and customary practices, as is now the case with securities held for the accounts of customers in bearer form or registered in “street name”, and will be the responsibility of the DTC Direct Participants or indirect DTC participants. None of TVA, the Manager (except as a direct or indirect participant of DTC), the Global Agent or the GBP Paying Agent will have any responsibility or liability for any aspect of the records relating to or payments made or to be made on account of beneficial interests in the Bonds or for maintaining, supervising or reviewing any records relating to such beneficial interests.

The Clearing Systems

DTC

DTC is a limited purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code and a “clearing agency” registered pursuant to the provisions of Section 17A of the Exchange Act. DTC was created to hold securities for its participants and to facilitate the clearance and settlement of securities transactions between participants through electronic book-entry changes in accounts of its participants, thereby eliminating the need for physical movement of certificates. DTC participants include securities brokers and dealers (including the Manager), banks, trust companies and clearing corporations and may include certain other organizations. DTC is owned by a number of its direct participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Indirect access to the DTC system also is available to indirect DTC participants such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a DTC participant, either directly or indirectly. The rules applicable to DTC and its participants are on file with the U.S. Securities and Exchange Commission.

Because DTC can act only on behalf of DTC Direct Participants, who in turn act on behalf of indirect DTC participants and certain banks, the ability of an owner of a beneficial interest in the Bonds to pledge such interest to persons or entities that do not participate in the DTC system, or otherwise take actions in respect of such interest, may be limited by the lack of a definitive certificate for such interest. The laws of some jurisdictions require that certain

persons take physical delivery of securities in definitive form. Consequently, the ability to transfer beneficial interests in Bonds to such persons may be limited. In addition, beneficial owners of Bonds held through the DTC system will receive distributions of principal and interest on the Bonds only through DTC participants.

DTC management is aware that some computer applications, systems, and the like for processing data (“Systems”) that are dependent upon calendar dates, including dates before, on and after January 1, 2000, may encounter “Year 2000 problems”. DTC has informed its DTC Direct Participants and other members of the financial community (the “Industry”) that it has developed and is implementing a program so that its Systems, as the same relate to the timely payment of distributions (including principal and income payments) to securityholders, book-entry deliveries, and settlement of trades within DTC (“DTC Services”), continue to function appropriately. This program includes a technical assessment and a remediation plan, each of which is complete. Additionally, DTC’s plan includes a testing phase, which is expected to be completed within appropriate time frames.

However, DTC’s ability to perform properly its services is also dependent upon other parties, including but not limited to issuers and their agents, as well as third party vendors from whom DTC licenses software and hardware, and third party vendors on whom DTC relies for information or the provision of services, including telecommunication and electrical utility service providers, among others. DTC has informed the Industry that it is contacting (and will continue to contact) third party vendors from whom DTC acquires services to: (i) impress upon them the importance of such services being Year 2000 compliant; and (ii) determine the extent of their efforts for Year 2000 remediation (and, as appropriate, testing) of their services. In addition, DTC is in the process of developing such contingency plans as it deems appropriate.

According to DTC, the foregoing information with respect to DTC has been provided to the Industry for informational purposes only and is not intended to serve as a representation, warranty, or contract modification of any kind.

Cedelbank and Euroclear

Cedelbank and Euroclear each hold securities for their customers and facilitate the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Cedelbank and Euroclear provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Cedelbank and Euroclear also deal with domestic securities markets in several countries through established depository and custodial relationships. Cedelbank and Euroclear have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

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

Initial Settlement

The Global Bond will be delivered at initial settlement to The Chase Manhattan Bank, in New York, as custodian for DTC. Initial settlement for the Bonds will be made in immediately available British pound sterling funds (*i.e.*, for value on the date of delivery of the Bonds). However, the Manager is prepared to arrange for the conversion of U.S. dollars into British pounds sterling to enable United States investors to make payments in British pounds sterling. See “Currency Conversions and Foreign Exchange Risks”.

Customary settlement procedures will be followed for participants of each system at initial settlement. Settlement procedures applicable to British pound sterling eurobonds will be followed for primary market purchasers which are Euroclear or Cedelbank participants, and beneficial interests in the Bonds will be credited to their securities accounts on the business day following the settlement date against payment for value on the settlement date. Primary market purchasers which are DTC participants can have their securities accounts with DTC credited with beneficial interests in the Bonds (i) free of payment if they have arranged for payment in British pounds sterling outside DTC and (ii) against payment in U.S. dollars in same-day funds on the settlement date through DTC’s Same-Day Funds Settlement System.

Secondary Market

Secondary market sales of beneficial interests in Bonds for settlement within each clearing system will be settled in accordance with the rules and procedures established by the relevant system. Sales to be settled within Euroclear or

Cedelbank and between Euroclear and Cedelbank will normally settle on a three business day basis unless parties specify a different period (which may be as short as two business days). Sales to be settled within DTC will be settled using the procedures applicable to U.S. corporate debt obligations in DTC's Same-Day Funds Settlement System in same-day funds, if payment is effected in U.S. dollars, or free of payment, if payment is not effected in U.S. dollars. In such case, separate payment arrangements outside of DTC are required to be made between the DTC participants.

Secondary market sales of beneficial interests in Bonds for settlement between DTC on the one hand and Euroclear or Cedelbank on the other hand will be settled in accordance with the usual rules and operating procedures established by DTC, Euroclear and Cedelbank. For sales that are cleared and settled through DTC and Euroclear or Cedelbank, because of time zone differences, in some cases the securities account of an investor in one clearing system may be credited during the settlement processing day immediately following the settlement date of the other clearing system, and the cash account will be credited for value on the settlement date but may be available only as of the day immediately following such settlement date.

Currency Conversions and Foreign Exchange Risks

Currency Conversions

Initial purchasers of Bonds are required to make payment in British pounds sterling. The Manager is prepared to arrange for the conversion of U.S. dollars into British pounds sterling to enable investors in the United States to make payment in British pounds sterling. Each such conversion will be made by the Manager on such terms and subject to such conditions, limitations and charges as such Manager may from time to time establish in accordance with its regular foreign exchange practices, and subject to applicable U.S. laws and regulations. All costs of conversions will be borne by such investors. See "Foreign Exchange Risks".

TVA is required to make principal and interest payments in respect of the Bonds in British pounds sterling. However, a DTC Direct Participant will be paid in U.S. dollars converted or caused to be converted from such British pounds sterling by the Global Agent (or, if an Exchange Dealer has been appointed, the Exchange Dealer) unless the DTC Direct Participant elects to receive payments in British pounds sterling as described herein. TVA understands that Euroclear and Cedelbank will elect to receive all payments of principal and interest in respect of the Bonds held through them in British pounds sterling. In the event that such election is not made, each individual holder of a beneficial interest in the Global Bond holding through Euroclear or Cedelbank must make arrangements with Euroclear or Cedelbank, in accordance with their usual rules and procedures, in order to avoid payment in U.S. dollars. See "Description of Bonds" — "Payment".

As long as Bonds continue to be represented by the Global Bond, a holder of a beneficial interest in the Bonds may elect to receive payment in respect of principal of or interest on the Bonds in British pounds sterling instead of U.S. dollars, as set forth under "Description of Bonds" — "Payment", by notifying the DTC participant through which its Bonds are held on or prior to the applicable Record Date of (i) such investor's election to receive all or a portion of such payment in British pounds sterling, and (ii) wire transfer instructions to a British pound sterling account in the United Kingdom. DTC must be notified of such election and wire transfer instructions on or prior to the third New York Business Day after such Record Date for any payment of interest, and, on or prior to the twelfth day prior to the payment of principal. DTC will notify the Global Agent and the GBP Paying Agent of such election and wire transfer instructions on or prior to 5:00 p.m. New York time on the fifth New York Business Day after such Record Date for any payment of interest and on or prior to 5:00 p.m. New York time on the tenth day prior to the payment of principal. If complete instructions are forwarded to DTC through DTC participants and by DTC to the Global Agent and the GBP Paying Agent on or prior to such dates, such investor will receive payment in British pounds sterling outside DTC; otherwise, only U.S. dollar payments will be made by the Global Agent to DTC. All costs of such payment by wire transfer will be borne by holders of beneficial interests receiving such payments by deduction from such payments. See "Description of Bonds" — "Payment".

Foreign Exchange Risks

An investment in securities that are denominated in, and all payments in respect of which are to be made in, a currency other than the currency of the country in which the purchaser is resident or the currency in which the purchaser conducts its business or activities (the "home currency") entails significant risks not associated with a similar investment in a security denominated in the home currency. Such risks include, without limitation, the possibility of

significant changes in rates of exchange between the home currency and the U.S. dollar or British pound sterling and the possibility of the imposition or modification of foreign exchange controls with respect to the U.S. dollar or British pound sterling. Such risks generally depend on events over which TVA has no control, such as economic and political events and the supply of and demand for the U.S. dollar or British pound sterling and the home currency. In recent years, rates of exchange for certain currencies have been highly volatile, and such volatility may be expected to continue in the future. Fluctuations in any particular exchange rate that have occurred in the past are not necessarily indicative, however, of fluctuations in such rate that may occur during the term of the Bonds. Depreciation of the U.S. dollar or British pound sterling against the relevant home currency could result in a decrease in the effective yield of the Bonds below the interest rate thereof and, in certain circumstances, could result in a loss to the investor on a home currency basis.

This description of foreign currency risks does not describe all the risks of an investment in securities denominated in a currency other than the home currency. Prospective investors should consult their own financial and legal advisers as to the risks involved in an investment in the Bonds.

Legality of Investment in the United States

Each person or entity is advised to consult with its own counsel with respect to the legality of investment in the Bonds. Generally the following describes the legality of investment in the United States in Power Bonds.

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

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

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

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

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

U.S. federal credit unions may purchase Power Bonds. 12 U.S.C. § 1757(7)(E).

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

United States Tax Matters

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

consequences arising under the laws of any other taxing jurisdiction, and may not construe the following discussion as legal advice.

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

U.S. Beneficial Owners

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

Interest on a Bond will be taxable to a U.S. beneficial owner at the time that it is received or accrued, depending upon the U.S. beneficial owner’s method of accounting for United States federal income tax purposes. There is no special exemption for a Bond from United States federal income, estate and gift tax.

The amount of income recognized by a cash basis U.S. beneficial owner will be the U.S. dollar value of an interest payment, based on the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars.

Accrual basis U.S. beneficial owners may determine the amount of income recognized with respect to interest payments in accordance with two alternative methods, in either case regardless of whether the payments are in fact converted into U.S. dollars. Under the first method, the amount of income recognized will be based upon the average exchange rate in effect during the interest accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year). Under the second method, an accrual basis U.S. beneficial owner may elect to translate interest income into U.S. dollars at the exchange rate in effect on the last day of the accrual period (or, in the case of an accrual period that spans two taxable years, at the exchange rate in effect on the last day of the partial period within the taxable year). Additionally, if a payment of interest is actually received within five business days of the last day of the accrual period, an electing accrual basis U.S. beneficial owner may instead translate such accrued interest into U.S. dollars at the exchange rate in effect on the day of actual receipt. Any election to use the second method will apply to all debt instruments held by the U.S. beneficial owner at the beginning of the first taxable year to which the election applies or thereafter acquired by the U.S. beneficial owner, and will be irrevocable without the consent of the United States Internal Revenue Service. Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or retirement of a Bond), an accrual basis U.S. beneficial owner will recognize ordinary income or loss measured by the difference between (x) the exchange rate used to accrue interest income in accordance with the rules described above and (y) the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars. The foregoing rules relating to foreign currency exchange and loss (and the additional foreign currency rules discussed below) will apply even in the case of a DTC Direct Participant that receives payments of principal and interest in respect of the Bonds in U.S. dollars.

Upon a sale or exchange of a Bond, a U.S. beneficial owner generally will recognize gain or loss equal to the difference between the amount realized on the sale or exchange (not including any amounts attributable to accrued and unpaid interest) and the U.S. beneficial owner’s adjusted basis for the Bond for federal income tax purposes. A U.S. beneficial owner’s initial tax basis in a Bond will generally be its U.S. dollar cost. The U.S. dollar cost of a Bond purchased with foreign currency will generally be the U.S. dollar value of the purchase price on the date of purchase or, in the case of Bonds traded on an established securities market (within the meaning of Treasury Regulation Section 1.988-2(a)(iv)) that are purchased by a cash basis U.S. beneficial owner (or an electing accrual basis U.S. beneficial owner), on the settlement date for the purchase. The amount realized on a sale or retirement for an amount in a foreign currency will be the U.S. dollar value of such amount on the date of the sale or retirement or, in the case of Bonds traded on an established securities market (within the meaning of Treasury Regulation Section 1.988-2(a)(2)(iv)) that are sold by a cash basis U.S. beneficial owner (or an electing accrual basis U.S.

beneficial owner) on the settlement date of the sale. Except to the extent described in the next succeeding paragraph or attributable to accrued but unpaid interest, gain or loss recognized on the sale or retirement of a Bond will be capital gain or loss.

Gain or loss recognized by a U.S. beneficial owner on the sale or retirement of a Bond that is attributable to changes in exchange rates will be treated as ordinary income or loss. However, exchange gain or loss is taken into account only to the extent of the total gain or loss realized on the transaction.

Foreign currency received as interest on a Bond or on the sale or retirement of a Bond will have a tax basis equal to its U.S. dollar value at the time such interest is received or at the time of such sale or retirement. Any gain or loss recognized on a sale or other disposition of foreign currency (including its exchange for U.S. dollars) will be ordinary income or loss.

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

Market discount on the Bonds will be calculated in British pounds sterling (or a successor or a replacement currency, as described above under the heading “Description of Bonds” — “Payment”). Accrued market discount (other than market discount included in income on a current basis) will be translated into U.S. dollars at the spot rate on the date of disposition of the Bond. No part of such accrued market discount will be treated as exchange gain or loss. Market discount that is included in income on a current basis will be translated into U.S. dollars at the average exchange rate for the accrual period and, upon receipt of a payment attributable to such accrued market discount, exchange gain or loss shall be recognized based upon such average exchange rate and the exchange rate in effect on the date of receipt.

A U.S. beneficial owner who purchases a Bond for an amount greater than the amount payable at maturity of the Bond may elect to amortize the bond premium. In the case of a U.S. beneficial owner that makes an election to amortize bond premium or has previously made an election that remains in effect, amortizable bond premium on the Bond generally will be treated as a reduction of the interest income on a Bond on a constant yield basis (except to the extent regulations may provide otherwise) over the term of the Bond. The basis of a debt obligation purchased at a premium is reduced by the amount of amortized bond premium. An election to amortize bond premium generally applies to all debt instruments (other than tax-exempt obligations) held by the electing U.S. beneficial owner on the first day of the first taxable year to which the election applies or thereafter acquired by such owner, and is irrevocable without consent of the United States Internal Revenue Service. A U.S. beneficial owner should consult a tax advisor before making the election.

Amortizable bond premium on the Bonds will be computed in British pounds sterling (or a successor or a replacement currency, as described above under the heading “Description of Bonds” — “Payment”) and will reduce interest income in British pounds sterling (or such successor or replacement currency). At the time that amortizable bond premium offsets interest income, exchange gain or loss (taxable as ordinary income or loss), measured by the difference between exchange rates at that time and at the time of the acquisition of the Bonds, will be realized with respect to such amount.

Non-U.S. Beneficial Owners

Generally, a Bondholder that is not a U.S. Person and that has no connection with the United States other than holding the Bond (a “non-U.S. beneficial owner”) will not be subject to United States federal withholding tax on interest on a Bond. To qualify for the exemption from withholding, the last U.S. Person in the chain of payment prior to payment to a non-U.S. beneficial owner (the “Withholding Agent”) must have received in the year in which such a payment occurs, or in either of the two preceding years, a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is not a U.S. beneficial owner and (iii) provides the name and address of the beneficial owner. The statement may be made on a United States Internal Revenue Service Form W-8 or substantially similar substitute form, and the beneficial owner must inform the Withholding Agent of any change in the

information on the statement within 30 days of such change. If a Bond is held through a securities clearing organization or certain other financial institutions, the organization or institution may provide a signed statement to the Withholding Agent. However, in such case, the signed statement must be accompanied by a copy of a Form W-8 or substitute form provided by the beneficial owner to the organization or institution holding the Bond on behalf of the beneficial owner.

Recently issued regulations would provide alternative methods for satisfying the certification requirements described above (the “New Regulations”). The New Regulations also would require, in the case of Bonds held by a foreign partnership, that (a) the certification described above be provided by the partners rather than by the foreign partnership and (b) the partnership provide certain information, including a United States taxpayer identification number. A look-through rule would apply in the case of tiered partnerships. The New Regulations are generally effective for payments made after 1999. There can be no assurance that the New Regulations will not be amended prior to the date they first become effective.

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

Backup Withholding

Backup withholding of United States federal income tax at a rate of 31% may apply to payments made in respect of the Bonds to beneficial owners who are not exempt recipients and who fail to provide certain identifying information (such as the beneficial owner’s taxpayer identification number) in the manner required. Generally, individuals are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients. Payments made in respect of the Bonds to a U.S. beneficial owner must be reported to the United States Internal Revenue Service, unless such U.S. beneficial owner is an exempt recipient or establishes an exemption. Compliance with the identification procedures (described in the preceding section) would generally establish an exemption from backup withholding for those non-U.S. beneficial owners who are not exempt recipients.

In addition, upon the sale of a Bond to (or through) a broker, the broker must withhold at a rate of 31% of the reportable payment, unless either (i) the broker determines that the seller is a corporation or other exempt recipient or (ii) the seller provides, in the required manner, certain identifying information and, in the case of a non-U.S. beneficial owner, certifies that such seller is a non-U.S. beneficial owner (and certain other conditions are met). Such a sale must also be reported by the broker to the United States Internal Revenue Service, unless either (i) the broker determines that the seller is an exempt recipient or (ii) the seller certifies its non-U.S. status (and certain other conditions are met). Certification of the beneficial owner’s non-U.S. status usually would be made on Form W-8 under penalties of perjury, although in certain cases it may be possible to submit other documentary evidence. The term “broker” generally includes all persons who, in the ordinary course of a trade or business, stand ready to effect sales made by others, as well as brokers and dealers registered as such under the laws of the United States or a state. These requirements generally will apply to a United States office of a broker, and the information reporting requirements generally will apply to a foreign office of a United States broker, as well as to a foreign office of a foreign broker if the broker is (i) a controlled foreign corporation within the meaning of Section 957(a) of the Internal Revenue Code, (ii) a foreign person 50% or more of whose gross income from all sources for the 3-year period ending with the close of its taxable year preceding the payment (or for such part of the period that the foreign broker has been in existence) was effectively connected with the conduct of a trade or business within the United States or (iii) under the New Regulations (applicable with respect to payments made after 1999), a foreign partnership if it is engaged in a trade or business in the United States or if 50% or more of its income or capital interests are held by U.S. Persons.

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

Subscription and Selling

Subject to the terms and conditions set forth in the Subscription Agreement relating to the Bonds, TVA has agreed to sell to J.P. Morgan Securities Ltd. (the “Manager”), and the Manager has agreed to purchase, £200,000,000 aggregate principal amount of the Bonds.

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

The Manager has advised TVA that it proposes to offer all or part of the Bonds directly to the public initially at the offering prices set forth on the cover page of this Offering Circular and to dealers at such prices less a concession not in excess of .250% of the principal amount thereof. After the initial offering, the public offering price and concession may be changed.

The Manager represents, warrants and agrees to and with TVA that the Manager and its Affiliates (as defined herein) (i) have not offered or sold Bonds and, prior to six months after the Closing Date, will not offer or sell any Bonds to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995; (ii) have complied and will comply with all applicable provisions of the United Kingdom Financial Services Act 1986 with respect to anything done by it in relation to the Bonds in, from or otherwise involving the United Kingdom; and (iii) have only issued or passed on and will only issue or pass on in the United Kingdom any document received by it in connection with an issue of Bonds to a person who is of a kind described in Article 11(3) of the United Kingdom Financial Services Act 1986 (Investment Advertisements) (Exemptions) Order 1996 (as amended) or is a person to whom such document may otherwise lawfully be issued or passed on. The term “Affiliate” means any person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the Manager. For purposes of this definition of Affiliate, the term “control” (including the terms “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies, including without limitation the investment or trading decisions of a person, whether through ownership of voting securities, by contract or otherwise.

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

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

In connection with issuing the Bonds, TVA entered into a related transaction with an Affiliate of the Manager, as a result of which the Affiliate may receive compensation.

General Information

1. The issuance of the Bonds was authorized pursuant to the Resolutions. At the date of issue, all necessary legal authorizations for issuance of the Bonds will have been obtained by TVA.
2. The Bonds have been accepted for clearance by Euroclear and Cedelbank. The identifying numbers are as set forth on page C-6.
3. There has been no material adverse change in the financial position of TVA since September 30, 1998.
4. There is no litigation, actual or threatened, which relates to TVA and to which TVA is a party or of which TVA has been notified that it will be made a party which is material in the context of the issuance of the Bonds.
5. In connection with the Luxembourg Stock Exchange listing application, copies of the Act, the Resolutions and book-entry regulations of TVA and a legal notice relating to the issuance of the Bonds will be deposited prior to listing with the *Greffier en Chef du Tribunal D'Arrondissement de et à Luxembourg*, where copies thereof may be obtained upon request. Copies of the Act, the Resolutions, the Global Agency Agreement, annual and quarterly financial reports, and Information Statements and supplements thereto of TVA will be available for inspection and may be obtained at the office of the Special Agent, free of charge, as long as the Bonds are listed on the Luxembourg Stock Exchange. TVA will comply with the listing rules of the Luxembourg Stock Exchange.
6. The Bonds are longer term debt securities issued in accordance with the regulations made under section 4 of the United Kingdom Banking Act 1987, as amended. TVA is not an authorised institution or a European authorised institution. Repayment of the principal and payment of any interest or premium in connection with the Bonds have not been guaranteed.

INFORMATION STATEMENT

TENNESSEE VALLEY AUTHORITY

A Wholly Owned Corporate Agency
and Instrumentality of the

UNITED STATES OF AMERICA

The Tennessee Valley Authority (“TVA” or the “Corporation”) presents this Information Statement (“Statement”) for the information of potential purchasers of its Power Bonds (the “New Power Bonds”), including its First Installment Series Bonds (the “Installment Bonds” — sometimes called “FISBS”), its Discount Notes and such other evidences of indebtedness (“Other Indebtedness”) it may issue pursuant to the Act (as defined below). New Power Bonds are to be issued pursuant to authority vested in TVA by the Tennessee Valley Authority Act of 1933, as amended (the “Act”), and the Basic Tennessee Valley Authority Power Bond Resolution adopted by the Board of Directors of TVA (the “Board”) on October 6, 1960, as amended on September 28, 1976, October 17, 1989, and March 25, 1992 (the “Basic Resolution”). Discount Notes and Other Indebtedness are issued pursuant to the Act and their respective authorizing resolutions.

TVA may from time to time offer New Power Bonds and Other Indebtedness and may offer on a continuous basis Discount Notes for sale by direct placements or through selected investment dealers, dealer banks, underwriters, or underwriting syndicates as TVA deems appropriate. Information concerning particular offerings of New Power Bonds, Discount Notes or Other Indebtedness will be described in an appropriate offering circular and in any supplement thereto. This Statement, and any supplement hereto, should be read in conjunction with the offering circular and any supplement thereto for the particular New Power Bonds, Discount Notes or Other Indebtedness being offered.

This Statement will be updated by supplements or replaced from time to time to reflect annual financial results of the Corporation and as otherwise determined appropriate by the Corporation. Any provisions herein modified or superseded shall not be deemed, except as so modified, to constitute a part of this Statement. Additional copies of this Statement may be obtained upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902, Attention: Vice President and Treasurer, or by calling (423) 632-3366.

No salesperson, dealer or other person has been authorized to give any information or to make any representations not contained herein or in a specific offering circular or supplement approved by TVA, and, if given or made, such information or representation must not be relied upon as having been authorized by TVA. This Statement and any offering circular or supplement do not constitute an offer to sell or a solicitation of any offer to buy any of the New Power Bonds, Discount Notes or Other Indebtedness offered thereby in any jurisdiction to any person to whom it is unlawful to make such offer in such jurisdiction. The delivery of this Statement and any offering circular or supplement at any time does not imply that the information given herein or therein is correct at any time subsequent to its respective date.

THE NEW POWER BONDS, DISCOUNT NOTES, AND OTHER INDEBTEDNESS OF TVA WILL NOT BE OBLIGATIONS OF, NOR WILL PAYMENT OF PRINCIPAL THEREOF OR ANY INTEREST THEREON BE GUARANTEED BY, THE UNITED STATES OF AMERICA. PRINCIPAL AND INTEREST, IF ANY, WILL BE PAYABLE SOLELY FROM TVA’S NET POWER PROCEEDS AS HEREIN DEFINED. THE NEW POWER BONDS, DISCOUNT NOTES, AND OTHER INDEBTEDNESS ARE NOT REQUIRED TO BE REGISTERED UNDER THE SECURITIES ACT OF 1933. ACCORDINGLY, NO REGISTRATION STATEMENT HAS BEEN, AND NONE WILL BE, FILED WITH THE SECURITIES AND EXCHANGE COMMISSION. TVA IS NOT SUBJECT TO THE PERIODIC REPORTING REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934.

This Statement describes the business and operations of TVA as of its date and the financial condition of TVA as of the date of the financial statements included herein. Recipients of this Statement should retain it for future reference until such time as a subsequent Statement is made available by TVA, but delivery or retention of this Statement after the date hereof shall not create any implication that the information provided herein is correct at any time after the date hereof, and TVA assumes no duty to update this Statement after the date hereof, except as described above.

The date of this Information Statement is February 27, 1998.

FORWARD-LOOKING STATEMENTS

This Statement contains forward-looking statements relating to future events and future performance. Any statements regarding expectations, beliefs, plans, projections, estimates, objectives, intentions or assumptions or otherwise relating to future events or performance may be forward-looking. Some examples include statements regarding TVA's projections of future power and energy requirements, future costs related to environmental compliance, and targets for TVA's future competitive position. Although TVA believes that these statements are accurate, TVA does not guarantee their accuracy. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. Such factors include, among other things, new laws and regulations, especially those related to the deregulation of electric utilities, the status of TVA as a government agency, and various environmental matters; increased competition among electric utilities; legal and administrative proceedings affecting TVA; the financial environment; performance of TVA's generating facilities; fuel prices; the demand for electricity; weather conditions; changes in accounting standards; and unforeseeable adverse events.

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THE TENNESSEE VALLEY AUTHORITY

TVA is one of the largest electric power systems in the United States, having produced nearly 153 billion kilowatt-hours (“kWh”) of electricity in fiscal 1997. TVA is a wholly owned corporate agency and instrumentality of the United States established by the Act with the objective of developing the resources of the Tennessee Valley region.

TVA’s activities fall into two types of programs — the power program and the nonpower programs. Financial accounts for the two types of activities are kept separately. Substantially all of TVA’s revenues and assets are attributable to the power program, which is required to be self-supporting from the revenues it produces and capital it raises through its power program borrowings. TVA is authorized by the Act to issue Power Bonds, Discount Notes, and Other Indebtedness (collectively, “Evidences of Indebtedness”) in an amount not exceeding \$30 billion outstanding at any one time, the proceeds of which may be used only for the power program. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness”. Historically, most of the funding for TVA’s nonpower programs has been provided by congressional appropriations. Additional funds have been obtained from revenues and user fees from the nonpower programs. For fiscal years 1997 and 1998 Congress appropriated \$106 million and \$70 million, respectively, for the nonpower programs. The appropriations act for fiscal 1998 anticipates no appropriations for TVA’s nonpower programs for fiscal 1999 and thereafter and provides that essential stewardship activities are to be funded from other sources, which may include certain power revenues. For a discussion of recent legislation relating to TVA’s power and nonpower programs, see “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Recent Legislation”.

In the Act, Congress has reserved the right to alter, amend or repeal the Act, but has provided that no amendment or repeal shall operate to impair the obligation of any contract made by TVA in the exercise of any power conferred by the Act. For a discussion of recent legislation relating to the TVA Act, see “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Recent Legislation”.

TVA is administered by the Board, which is composed of three persons appointed by the President and confirmed by the Senate. Appointments are for nine-year staggered terms with one term expiring with each three-year interval. The Board has sole authority for determining the rates which TVA charges for power. The Act requires the Corporation to charge rates for power which, 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 Evidences of Indebtedness, including provision and maintenance of reserve funds and other funds established in connection therewith; and annual payments to the U.S. Treasury (the “Treasury”) in repayment of and as a return on the government’s appropriation investment in TVA power facilities. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness”. Such appropriation investment totaled \$588 million as of September 30, 1997. See “Certain Provisions of the Tennessee Valley Authority Act” — “Payments to the Treasury”.

TVA is required annually to file with the President and with the Congress a financial statement and a complete report as to the business of the Corporation. The Comptroller General of the United States is authorized to periodically audit the transactions of TVA.

Under certain conditions, TVA may borrow from the Treasury up to \$150 million for a period of one year or less. Any issuance by TVA of Evidences of Indebtedness with a term of one year or longer is subject to the approval of the Secretary of the Treasury as to the issue date and maximum interest rate. The borrowing authority of TVA is treated as budget authority by the Office of Management and Budget for purposes of the budget of the United States.

Income on Evidences of Indebtedness issued by TVA is subject to various federal tax consequences. Under the Act, Evidences of Indebtedness are exempt both as to principal and interest from all taxation now or hereafter imposed by any state or local taxing authority except estate, inheritance and gift taxes. This exemption might not extend to franchise or other non-property taxes in lieu thereof imposed on corporations or to gain or loss realized upon the sale or exchange of an Evidence of Indebtedness, notwithstanding that such gain might in some cases be treated as interest income for United States federal income tax purposes.

SELECTED FINANCIAL DATA

The following selected financial data of TVA's power program for the fiscal years 1993 through 1997 have been derived from TVA's audited financial statements. These data should be read in conjunction with the audited financial statements and notes thereto (the "Financial Statements") presented herein.

Condensed Statements of Income (dollars in millions)

	Fiscal Year Ended September 30				
	1997	1996	1995	1994	1993
Operating Revenues	\$ 5,552	\$ 5,693	\$ 5,375	\$ 5,401	\$ 5,276
Operating Expenses	<u>3,698</u>	<u>3,656</u>	<u>3,448</u>	<u>3,461</u>	<u>3,269</u>
Operating Income	1,854	2,037	1,927	1,940	2,007
Other Income and Expense, Net	<u>157</u>	<u>(10)</u>	<u>(91)</u>	<u>(59)</u>	<u>23</u>
Income Before Interest Expense	2,011	2,027	1,836	1,881	2,030
Interest Expense	2,084	2,083	2,024	1,853	1,777
Allowance for Funds Used During Construction	<u>(81)</u>	<u>(117)</u>	<u>(198)</u>	<u>(123)</u>	<u>(58)</u>
Net Interest Expense	<u>2,003</u>	<u>1,966</u>	<u>1,826</u>	<u>1,730</u>	<u>1,719</u>
Net Income	<u>\$ 8</u>	<u>\$ 61</u>	<u>\$ 10</u>	<u>\$ 151</u>	<u>\$ 311</u>
Ratio of Earnings to Fixed Charges(1)	1.00	1.03	1.01	1.08	1.18

Condensed Balance Sheet (in millions)

	September 30				
	1997	1996	1995	1994	1993
Assets					
Current Assets	\$ 1,399	\$ 1,306	\$ 1,088	\$ 1,025	\$ 1,434
Property, Plant, and Equipment	29,298	29,521	29,301	28,071	27,888
Investment Funds	561	440	260	150	—
Deferred Charges and Other Assets	<u>2,426</u>	<u>2,762</u>	<u>2,644</u>	<u>2,596</u>	<u>1,601</u>
TOTAL ASSETS	<u>\$33,684</u>	<u>\$34,029</u>	<u>\$33,293</u>	<u>\$31,842</u>	<u>\$30,923</u>
Liabilities and Proprietary Capital					
Current Liabilities	\$ 3,853	\$ 5,101	\$ 5,416	\$ 4,591	\$ 4,942
Other Liabilities	1,704	1,580	1,264	963	1,034
Long-Term Debt	24,152	23,320	22,583	22,206	20,954
Proprietary Capital	<u>3,975</u>	<u>4,028</u>	<u>4,030</u>	<u>4,082</u>	<u>3,993</u>
TOTAL LIABILITIES AND PROPRIETARY CAPITAL	<u>\$33,684</u>	<u>\$34,029</u>	<u>\$33,293</u>	<u>\$31,842</u>	<u>\$30,923</u>

(1) Ratio of Earnings to Fixed Charges (unaudited) is calculated by dividing Net Income plus Interest Expense by Interest Expense.

COMPARATIVE FIVE-YEAR DATA

Statistical and Financial Summaries

	For the Years Ended September 30,				
	1997	1996	1995	1994	1993
Sales (millions of kilowatt-hours (“kWh”))					
Municipalities and cooperatives	114,771	117,035	110,245	108,073	105,566
Industries directly served	17,359	16,599	16,684	15,792	16,196
Federal agencies	7,567	6,966	7,226	4,407	2,382
Total sales	<u>139,697</u>	<u>140,600</u>	<u>134,155</u>	<u>128,272</u>	<u>124,144</u>
Operating revenues (millions of dollars)					
Electric					
Municipalities and cooperatives	\$ 4,811	\$ 4,980	\$ 4,654	\$ 4,582	\$ 4,479
Industries directly served	464	452	460	452	472
Federal agencies	179	172	179	296	254
Other	98	89	82	71	71
Total revenues	<u>\$ 5,552</u>	<u>\$ 5,693</u>	<u>\$ 5,375</u>	<u>\$ 5,401</u>	<u>\$ 5,276</u>
Revenue per kilowatt-hour (cents) (a)	3.90	3.99	3.94	4.03	4.06
Net winter dependable generating capacity (megawatts)					
Hydro(b)	5,384	5,298	5,225	5,242	4,885
Fossil	15,014	15,012	15,032	15,032	15,088
Nuclear units in service	5,625	5,545	3,342	3,342	3,365
Combustion turbine	2,394	2,268	2,232	2,264	2,284
Total capacity	<u>28,417</u>	<u>28,123</u>	<u>25,831</u>	<u>25,880</u>	<u>25,622</u>
System peak load (megawatts) — summer	26,661	25,376	25,496	23,398	23,878
System peak load (megawatts) — winter	26,670	25,995	24,676	24,723	21,666
Percent gross generation by fuel source					
Fossil	61%	65%	71%	72%	77%
Hydro	11%	11%	12%	14%	13%
Nuclear	28%	24%	17%	14%	10%
Fuel cost per kilowatt-hour (cents)					
Fossil	1.23	1.23	1.26	1.34	1.27
Nuclear(c)58	.56	.61	1.10	1.09
Aggregate fuel cost per kWh net thermal generation	1.04	1.06	1.14	1.31	1.25
Fuel data					
Net thermal generation (millions of kWh)	135,735	131,898	118,097	110,643	109,968
Billion Btu	1,381,837	1,338,157	1,197,295	1,120,868	1,105,395
Fuel expense (millions of dollars)	1,406	1,395	1,348	1,450	1,375
Cost per million Btu (cents)	101.73	104.22	112.61	129.40	124.42
Net heat rate, fossil only (Btu’s per kWh)	10,180	10,145	10,138	10,131	10,052

(a) Excludes Department of Energy settlement payment of \$160 million for the years 1993 and 1994.

(b) Includes 405 megawatts of dependable capacity from the Corps of Engineers projects on the Cumberland River system.

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

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

Results of Operations

Operating Environment

Net income for fiscal 1997 amounted to \$8 million, down from \$61 million for fiscal 1996. The reduction in earnings resulted from lower operating income attributable principally to mild weather experienced within TVA's service area during the winter and summer months of fiscal 1997, partially offset by other income related to certain investment earnings.

Net income for fiscal 1996 was \$61 million compared with \$10 million for fiscal 1995. This improvement was primarily driven by sales growth and increased operating efficiencies.

Operating Revenues

Operating revenues were \$5,552 million in fiscal 1997 compared with \$5,693 million in fiscal 1996 and \$5,375 million in fiscal 1995. The \$141 million decrease in fiscal 1997 as compared to fiscal 1996 was primarily due to a decrease in energy sales to municipalities and cooperatives as a result of the cool summer and warm winter during fiscal 1997. The TVA service area experienced 17 percent lower heating degree days and 11 percent lower cooling degree days during fiscal 1997 compared with fiscal 1996. Accordingly, total kWh sales decreased 0.9 billion kWh, from 140.6 billion in fiscal 1996 to 139.7 billion in fiscal 1997.

The \$318 million increase in operating revenues from fiscal 1995 to fiscal 1996 was primarily due to an increase in kWh sales of approximately six billion kWh (4.5 percent), from 134 billion in fiscal 1995 to over 140 billion in fiscal 1996, combined with an increase in the revenue per kWh of approximately 0.05 cents (1.3 percent), from 3.94 cents in fiscal 1995 to 3.99 cents in fiscal 1996. The increase in kWh sales primarily resulted from overall growth within the municipalities and cooperatives segment and more extreme weather conditions in fiscal 1996.

Operating Expenses

Operating expenses increased \$42 million, or 1.2 percent, from \$3,656 million in fiscal 1996 to \$3,698 million in fiscal 1997. The operation of the Watts Bar Unit One and Browns Ferry Unit Three nuclear units for the entire fiscal year of 1997 resulted in higher depreciation and operating expenses in fiscal 1997 as compared with fiscal 1996. These expenses, however, were partially offset by lower net fuel and purchased power expense in fiscal 1997 compared with fiscal 1996 as a result of greater generation of lower-cost nuclear power and the decrease in total power sales for fiscal 1997.

Total operating expenses increased \$208 million in fiscal 1996 versus fiscal 1995, or 6.0 percent, from \$3,448 million to \$3,656 million. The increase resulted primarily from increased generation during fiscal 1996 and the introduction of the two nuclear units to the power system. While operating and maintenance costs increased \$168 million, and depreciation and amortization expenses increased \$201 million, net fuel and purchased power expense declined \$165 million in fiscal 1996 compared with fiscal 1995 due to favorable fuel prices and greater off-system power sales.

Other Income and Expenses

TVA had net other income of \$157 million in fiscal 1997 compared with net other expense of \$10 million in fiscal 1996 and \$91 million in fiscal 1995. The fiscal 1997 net other income consisted primarily of net investment earnings of the decommissioning trust funds of \$138 million. The fiscal 1995 net expense was primarily composed of a \$136 million charge for a voluntary early-out package offered employees, partially offset by the recognition of an \$81 million deferred gain from a fiscal 1993 sale of investments.

Interest Expense

Gross interest expense remained essentially unchanged at \$2,084 million in fiscal 1997 compared with \$2,083 million in fiscal 1996. Total outstanding indebtedness net of unamortized discounts and other adjustments as of September 30, 1997, was \$26.9 billion, with an average interest rate of 7.56 percent, compared with \$27.3 billion, with an average interest rate of 7.60 percent as of September 30, 1996. The allowance for funds used during construction decreased from \$117 million in fiscal 1996 to \$81 million in fiscal 1997 as a result of the decline in overall construction spending.

Gross interest expense for fiscal 1996 increased \$59 million from \$2,024 million in fiscal 1995 to \$2,083 million in fiscal 1996. This increase resulted from an increase in total outstanding debt from \$26.7 billion as of September 30, 1995, to \$27.3 billion as of September 30, 1996. In addition, allowance for funds used during construction declined \$81 million from \$198 million in fiscal 1995 to \$117 million in fiscal 1996 due to the reduction of the overall level of capital spending in fiscal 1996.

Liquidity and Capital Resources

Capital Structure

Through fiscal 1959, the U.S. Government made appropriation investments of nearly \$1,365 million in TVA's power program. In 1959, TVA received its current congressional approval to issue bonds to finance its growing power program. Since that time, TVA's power program has been required to be self-supporting from revenues it produces and capital it raises through its power program borrowings. Because TVA is wholly owned by the U.S. Government, TVA does not issue equity securities. As a result, TVA raises its capital requirements through the internal generation of funds or through borrowings subject to a congressionally mandated \$30 billion limit. In fiscal 1997, TVA reduced its total outstanding debt by approximately \$348 million. This is the first time since 1961 that TVA has ended a fiscal year with a net reduction in outstanding debt. See "Competition" for a discussion of TVA's plans to reduce its debt in the future.

Like stockholders in investor-owned companies, the U.S. Government expects to earn a return on its investment. The rate of return on this investment, plus a repayment of the initial investment, is specified by law. Total repayments and return on investment by TVA to the U.S. Treasury exceed \$3 billion.

Capital Expenditures

Cash required by TVA for capital expenditures totaled \$641 million, \$990 million and \$1.7 billion for fiscal 1997, 1996 and 1995, respectively. The reductions reflect the decline in construction spending resulting from the return of Browns Ferry Unit Three to commercial operation in January 1996, the commencement of commercial operation at Watts Bar Unit One in May 1996 and the Board's decision not to complete or restart certain other nuclear units. See "Nuclear Power Program" — "Status of Certain Nuclear Units". TVA's current forecast for capital expenditures, including capitalized interest, totals \$733 million for fiscal 1998, which it expects to fund from internally generated funds.

Financing Activities

Long-term debt and cash from operations are used to finance capital expenditures. Short-term debt and cash from operations are used to manage daily cash needs. In fiscal 1997 TVA issued \$3.1 billion in long-term bonds, the proceeds of which were used to refinance existing debt.

In October and December 1997, TVA issued in the public market \$250 million in Power Bonds (due 1999) and \$750 million in Power Bonds (due 2017), respectively, to retire existing debt.

In January 1998, TVA issued in the public market \$250 million in Power Bonds (due 2018) and \$1,000 million in Power Bonds (due 2038) to retire existing debt.

Subsequent to September 30, 1997, TVA monetized the call provisions on approximately \$2 billion of its Power Bonds. The premiums received by TVA have been deferred and are being amortized over the term of the agreements.

Cash Flows

Net cash provided by operations for fiscal 1997, 1996 and 1995 was \$1,066 million, \$910 million, and \$802 million, respectively. This positive trend reflects continued improvements in TVA's operations during the three-year period.

Net cash used in investing activities for fiscal 1997, 1996 and 1995 was \$580 million, \$1,254 million and \$1,871 million, respectively. These reductions reflect the decline in construction spending from \$1,868 million in fiscal 1995 to \$722 million in fiscal 1997.

Net cash (used in)/provided by financing activities for fiscal 1997, 1996 and 1995 was (\$425) million, \$530 million and \$1,119 million, respectively. The cash used in financing activities during fiscal 1997 reflects the repayment of total outstanding debt of approximately \$348 million.

Accounting for the Effects of Regulation

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

TVA has approximately \$1.9 billion of regulatory assets (see Note 1 of the accompanying Financial Statements — "Other deferred charges" and "Debt issue and reacquisition costs") along with approximately \$6.3 billion of deferred nuclear plants as of September 30, 1997. In the event that competition in the utility industry changes the application of SFAS No. 71, TVA would be required to evaluate such regulatory assets under the provisions of SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of*. Statement 121 establishes requirements for evaluating and measuring asset impairments and provides that regulatory assets that are no longer probable of recovery through future revenues be charged to earnings. Such an event may have an adverse effect on future results of operations from the write-off of regulatory assets. However, TVA intends to seek full recovery of any regulatory assets that may result from TVA's transition to doing business in the competitive market.

Year 2000 Costs

TVA is evaluating the potential impact of the "Year 2000" problem on its operations. The Year 2000 problem, which is common to most companies, concerns the inability of information systems, such as computer software programs, to process date sensitive information related to the Year 2000 and beyond. TVA has established an enterprise-wide team to develop a plan and strategy, organize resources, assess the impact, and develop solutions. While it is not possible, at present, to give an accurate estimate of the cost of this work, TVA is allocating sufficient resources to address the Year 2000 problem and does not expect that such costs will be material to TVA's operations.

THE AREA SUPPLIED BY TVA

TVA supplies power in most of Tennessee, northern Alabama, northeastern Mississippi, and southwestern Kentucky, and in small portions of Georgia, North Carolina and Virginia. The population of the area served by TVA is over 7 million. Subject to certain minor exceptions, TVA may not without specific authorization by act of Congress enter into contracts which would have the effect of making it or its distributors a source of power supply outside the area for which TVA or its distributors were the primary source of power supply on July 1, 1957.

TVA is primarily a wholesaler of power. Its customers are composed of three major groups: (1) distributors, consisting of municipal and cooperative systems; (2) industries which have large or unusual loads; and (3) federal agencies. In addition, TVA has entered into exchange power arrangements with most of the surrounding electric systems.

RATES, CUSTOMERS AND MARKET

The Act delegates to the Board sole responsibility for establishing the rates which TVA charges and authorizes it to include in power contracts such terms and conditions as in its judgment may be necessary or desirable for carrying out the purposes of the Act. The Act requires the Corporation to charge rates for power which, 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 Evidences of Indebtedness, including provision and maintenance of reserve funds and other funds established in connection therewith; and annual payments to the Treasury in repayment of and as a return on the Government's appropriation investment in TVA power facilities. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" — "Rate Covenant" and "Recent Legislation". Rates set by the Board are not subject to review or approval by any state or federal regulatory body. See "Competition".

A summary of power program operating revenues by customer type for each of the last five fiscal years ended September 30 is shown in the Comparative Five-Year Data, presented on page 3.

Municipal and Cooperative Distributors

TVA has long-term wholesale power contracts with 159 municipal and cooperative distributors. Such contracts are for terms of 20 years and require distributors to purchase substantially all of their electric power and energy requirements from TVA. Most distributors purchase power under a contract that requires 10 years' notice to terminate the contract and further provides that on each annual anniversary of the contract (beginning with the tenth anniversary) one additional year is automatically added to the term. Six distributors' power contract term arrangements require 15 years' notice to terminate the contract. On each annual anniversary of these contracts (beginning with the fifth anniversary) one additional year is automatically added to the term. As part of the arrangement, TVA agreed that these term arrangements are deemed to provide for adequate recovery by TVA of any investment in generation, transformation, or transmission facilities for service to the distributor. Municipal and cooperative distributors accounted for approximately 87 percent of total power revenues in fiscal 1997. See "Competition".

A number of TVA distributors, including some with the largest loads, have been expressing interest in revising the wholesale power contracts to allow them more options with respect to contract term and other matters. TVA has indicated its willingness to work with distributors to accommodate their desire for more flexibility. In this regard, the TVA Board recently approved offering distributors the option of moving from 10 or 15-year termination notice periods to a 5-year termination notice period. Such contract amendments are being conditioned upon such notice not being given during the first five years after the effective date of the revision. TVA is also agreeing that these term arrangements and existing 10 years' notice contracts are deemed to provide for adequate recovery by TVA of any investment in generation, transformation, or transmission facilities for service to the distributor. For a discussion of events which may affect TVA's relationships with its distributors, see "Competition".

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

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

Industries and Federal Agencies Served Directly

Contracts with industries served directly by TVA normally are for terms of 10 years but are subject to termination by TVA or the customer upon a minimum notice period that varies according to the customer's contract demand and the period of time service has been provided at that location. Industries directly served accounted for approximately 8 percent of power revenues in fiscal 1997. The power sold directly to industries is delivered under contracts at rates established by TVA. Such rates are the same as those charged by distributors to large industries (those with demand greater than 25,000 kilowatts ("kW")) they serve. Power is sold to federal agencies under the same contract terms and rates as directly served industries.

COMPETITION

The electric utility industry has become increasingly competitive in the past decade. Competition is expected to intensify in the future as a result of federally encouraged deregulation of utilities affecting the wholesale power markets and various provisions of the Energy Policy Act of 1992 ("Energy Act"). Chief among the provisions of this act which will further intensify the competitive environment are amendments (1) to the Federal Power Act that give the Federal Energy Regulatory Commission ("FERC") greater authority to order electric utilities with transmission lines to wheel (transmit) power over their systems for electric power generating entities; and (2) to the Public Utility Holding Company Act of 1935 that allow the creation of certain kinds of power generating entities without the entities or their parent corporations being made subject to regulation by the Securities and Exchange Commission under that act.

Nevertheless, a special provision in the Energy Act (the "anti-cherry picking provision") prevents the wheeling authority of FERC from being used to provide TVA-served municipal and cooperative distributors with an alternative source of power supply. That provision excludes from the wheeling authority the wheeling of electric energy that will be consumed within the area that may be served by TVA and the distributors (except for Bristol, Virginia).

Several important regulatory rulings were issued during 1996 that will continue to have a significant impact on TVA. In April 1996, FERC issued Order Nos. 888 and 889. Order No. 888 requires FERC-regulated utilities that own, control, or operate transmission lines to file nondiscriminatory open-access tariffs that offer others certain basic types of transmission service. Order No. 889 requires FERC-regulated utilities to participate in an electronic information system known as the Open Access Same-time Information System ("OASIS"), which allows for the electronic communication of information about transmission systems and services to all potential customers at the same time. This rule also requires FERC-regulated utilities to functionally separate their wholesale power marketing and transmission operations. FERC also issued a Notice of Proposed Rulemaking ("NOPR") to obtain comments on a system for reserving capacity on utilities' own and others' transmission lines.

In response to these rulings, TVA has taken steps to voluntarily comply with FERC orders. Specifically, TVA has adopted changes (effective January 1, 1997) to its existing guidelines, originally adopted by the TVA Board in 1994, which offer transmission service patterned after the open-access tariff but consistent with the TVA Act and the Energy Act. TVA posts available transmission capacity and conducts transmission business through an OASIS on the Internet. TVA has implemented a Code of Conduct based on FERC's standards contained in Order No. 889. Actions under this Code of Conduct include separating TVA's operations for transmission requests, scheduling, and transmission system security from TVA's wholesale off-system sales activities.

Although other power suppliers, under certain circumstances, may sell power in the area where TVA power is distributed, there are statutory provisions restricting TVA from expanding the area in which it is a source of power supply. It is important that TVA market power at rates competitive with other suppliers in the region. TVA believes that its ten years of stable rates during the period fiscal 1988 through fiscal 1997 have assisted distributors of TVA power in competing for new commercial and industrial loads.

In 1997 at least seven bills had been introduced in the current Congress that would mandate or promote competition in electric service at the retail level. These bills, like ones introduced during the last Congress,

would also result in other major changes in the electric power industry that would significantly impact both privately owned companies and publicly owned electric power suppliers like TVA and the distributors of TVA power. The amount of government regulation, particularly for the latter, would greatly increase. In spite of their purpose to increase competition, some of these bills, as presently drafted, would not permit TVA and the distributors of TVA power to compete for customers outside the area for which TVA may be a source of power supply but would allow others to compete for customers of TVA and the distributors of TVA power. The Senate has not held formal hearings on these bills, but two days of hearings were held in the House in October 1997. Hearings on various topics of competition and electric industry restructuring have also been held in the House and Senate. TVA anticipates that in the event any retail choice legislation is enacted, such legislation would enable TVA and the distributors of TVA power to take part, reciprocally, in retail competition outside the area for which they can now be a source of electric power supply. The introduction of additional bills is expected during 1998, and this legislation is expected to receive serious congressional consideration. Although some key members of Congress have expressed an intention to complete action on retail competition legislation in 1998, final enactment remains uncertain.

Retail competition legislation raises serious issues for TVA, as it does for the rest of the electric utility industry. Among the issues which could have the greatest impact on the TVA system are: (1) the right to continue recovery of the costs of assets which would no longer be economical under full and open market competition; (2) whether TVA and its distributors will be able to sell power outside the TVA service area; (3) whether Congress will attempt to shorten the terms of TVA's present wholesale power contracts with its distributors; and (4) whether TVA rates will be regulated by FERC.

Three bills have been introduced in this Congress that would require the disposition of certain federally-owned hydroelectric system assets. None of these bills is applicable to TVA. Other such bills, which may include TVA, may be introduced. A similar proposal was not enacted during the past Congress. In TVA's opinion, enactment of such legislation is unlikely.

In today's competitive environment, some of the municipal and cooperative distributors may consider alternative wholesale supply arrangements upon expiration or termination of their power contracts with TVA. In February 1997 the city council of Bristol, Virginia ("Bristol") approved a recommendation from the Bristol Virginia Utilities Board that Bristol accept an offer from Cinergy to supply its power in the future. In April 1997 Cinergy requested that TVA provide transmission service to enable Cinergy to provide electricity to Bristol. TVA agreed to provide that service consistent with FERC's open-access transmission orders and contingent upon stranded investment cost recovery determined in accordance with applicable law. In June 1997 Cinergy initiated a FERC proceeding to require TVA to provide transmission service upon terms more favorable to Cinergy. Among the terms being challenged is TVA's demand for payment of stranded investment costs. On November 25, 1997, FERC issued an order referring the matter to an administrative law judge for an evidentiary hearing on TVA's stranded cost claim. TVA and Cinergy attempted to negotiate the terms and conditions under which TVA would provide transmission service for the supply of power to Bristol. In addition to the stranded cost issue, the parties could not agree on three operational issues. All of these issues have been submitted to FERC for resolution. On December 31, 1997, the power contract between TVA and Bristol ended, and Bristol ceased being a TVA distributor. TVA is providing transmission service to Cinergy under an interim arrangement pending resolution of the outstanding issues.

TVA's management continues to develop plans and strategies it believes will help position TVA to successfully compete in a deregulated electricity market both within the Tennessee Valley and nationwide. In July 1997 Chief Financial Officer David Smith released the TVA Ten Year Business Outlook which sets targets for a 50 percent reduction in debt and a 15 percent reduction in the total cost of power by 2007. This plan recommended a price increase for fiscal year 1998 that would result in a 5.5 percent increase in TVA's power revenues, the first such increase in ten years. In August 1997, the TVA Board approved an increase in rates designed to provide such additional power revenues, and on October 1, 1997, TVA implemented the rate increase. The Ten Year Business Outlook also calls for TVA initiatives to reduce fuel, labor, and supply costs, with a proposed reduction of approximately 700 employees in TVA's power program workforce. In addition, the plan recommended offering the opportunity to TVA's distributor customers to change their power contracts after five years from a rolling ten-year term to a rolling five-year term. The Board subsequently

approved making such arrangements available to the municipal and cooperative customers served by TVA. See “Rates, Customers and Markets” — “Municipal and Cooperative Distributors”. The plan has been built on assumptions that TVA believes to be reasonable, based upon today’s knowledge and predictions for the future. However, future events may upset these assumptions and lead to plan modifications.

In January 1998, TVA and the Tennessee Valley Public Power Association (the “TVPPA”), which represents the interests of distributors of TVA power, issued a joint statement indicating their consensus regarding legislative positions on the restructuring of the electric utility industry. The statement recommends, among other things, that in the event customer choice legislation is enacted at the federal level: (1) the anti-cherry picking provision of the Energy Act and the territorial limitations which restrict the area in which TVA and its distributors may be a source of power (the “fence”) be removed, provided that (a) the distributors’ contracts are modified to shorten terms and termination notice and to allow distributors to purchase partial requirements from TVA, (b) the issue of stranded investment is addressed, and (c) TVA is required to grant access to its transmission system at reasonable charges to permit power to be transmitted to or on behalf of the distributors; (2) any recovery of TVA’s stranded investment costs be subject to FERC approval, not be allowed prior to termination of a contract, and not be allowed after October 1, 2007 unless TVA and the distributor otherwise agree; (3) TVA’s rights to serve new retail customers be subject to certain conditions and restrictions benefiting the distributors; (4) TVA generally be required to offer long-term, all-requirements power to distributors at wholesale rates no less favorable than that offered to new wholesale customers; (5) TVA continue to have the statutory authority to set certain terms and conditions in its all-requirements wholesale power contracts with distributors so as to facilitate the TVA Act’s mandate that TVA power be distributed at the lowest feasible rates; and (6) TVA have no authority to approve retail rates or other conditions of retail service except under certain limited circumstances.

Representatives of three of the largest distributors of TVA power, the municipal power systems of Knoxville, Memphis, and Nashville, Tennessee, have also expressed positions on issues concerning restructuring of the electric utility industry, some of which differ from the positions set forth in the joint statement issued by TVA and TVPPA.

TVA anticipates that discussions with distributors regarding a wide range of issues involving the restructuring of the electric utility industry, including the issues noted above, will continue throughout the national restructuring process.

TVA has begun under the auspices of the Department of Energy (“DOE”) a regional process to gather views from a wide variety of stakeholder groups as to the role the TVA power system should play in the electric utility industry after nationwide competition has begun.

In August 1995, the General Accounting Office (“GAO”) issued a report which, among other things, focused on TVA’s level of debt, rates, competitive position and deferred nuclear assets. The report raised the issue of whether TVA would be able to recover all the costs of its deferred nuclear assets and the financial and competitive impact this would have. While GAO is authorized to assist the Congress by evaluating government programs and activities and may make recommendations in this regard, it has no authority to order or direct that any action be taken. The report relating to TVA did not make any specific recommendations. TVA furnished to GAO a detailed response as to why the report is flawed in its analysis. GAO included TVA’s response in the report appendix.

A September 1997 report by GAO on the recurring and potential future costs to the federal government of its electricity-related programs concluded with respect to TVA that (1) the federal government’s initial appropriation investment in TVA and debt obligations held by the Federal Financing Bank result in no net cost to the federal government; (2) as long as TVA’s power program remains in a protected position similar to a traditional regulated utility, the risk of loss to the federal government is remote; and (3) if TVA is required to compete with other electric utilities at a time when wholesale prices are expected to fall, it is reasonably possible that losses to the federal government would occur if the government decided to voluntarily take any actions to prevent default on TVA’s debt service requirements, even though TVA’s debt is not guaranteed by the federal government. TVA does not agree with GAO’s assessment of the risk of loss to the federal government. TVA’s comments on the assessment are included in Volume 2 of the GAO report.

In November 1997 the Congressional Budget Office (the "CBO") released a study discussing the federal government's role in supplying electricity and possible options for changing that role. Among other things, the study found that the government could save money over the long term by selling many of the facilities it now uses to supply electric power but that the government may want to stay in the electric power business for other reasons. With regard to TVA, the CBO estimated that, depending on the market value at which TVA could be sold, the government could currently lose up to \$5.6 billion or gain up to \$2.5 billion by divesting itself of TVA. The study also cites what it terms "financial challenges" that TVA now faces and will face in the near future that could affect its earnings potential and ability to cover its capital obligations. TVA expresses no opinion on the accuracy of the CBO's study or on the likelihood of any change in the government owned status of TVA.

In June 1997 Representative Bob Clement introduced a bill in the House of Representatives to create the "TVA 2000 Regional Commission". Under the bill, a twelve-member Commission (appointed by the President and by House and Senate leaders) representing a diversity of Tennessee Valley interests would complete a study and submit its report by the end of 1998. The Commission would conduct a comprehensive legal and factual study of the navigational, flood control, economic development, recreational, and economic impacts of the future structure, competitiveness and economic viability of TVA.

POWER AND ENERGY REQUIREMENTS

TVA prepares annual forecasts of future power and energy requirements as part of its planning and budgeting process. TVA's forecast procedure involves producing a range of load forecasts for the explicit purpose of bounding the range of uncertainty associated with load growth. The load forecasts are produced probabilistically. TVA believes that the high load forecast has a 90 percent probability that actual load will be less than forecast, that the medium load forecast has a 50 percent probability that actual load will be less than forecast, and that the low load forecast has a 10 percent probability that actual load will be less than forecast. TVA's current load forecast through fiscal year 2000 reflects an average annual load growth rate of 5.0 percent, 2.5 percent, and 0.5 percent for the high, medium, and low load forecasts, respectively. TVA's total system energy requirements through fiscal year 2000 reflect an average annual growth rate of 5.1 percent, 2.4 percent, and (0.3) percent for the high, medium, and low load forecasts, respectively. Numerous factors could cause actual results to differ materially from TVA's forecasts.

Various provisions in the Energy Act make changes in a wide range of laws affecting energy use and development in the United States. In addition to various other features, some of which are discussed herein, this act establishes a statutory framework for how TVA plans and selects methods for meeting future energy needs.

TVA may enter into electricity futures contracts for the sole purpose of limiting or otherwise hedging TVA's economic risks directly associated with electric power generation, purchases, and sales. The Chicago Board of Trade has proposed designating the TVA power transmission system as a hub for electricity futures contracts. This proposal is subject to review by the Commodity Futures Trading Commission.

POWER SYSTEM

TVA's power generating facilities at September 30, 1997, included 29 hydroelectric plants, 11 coal-fired plants, 3 nuclear plants, 1 pumped storage hydroelectric plant and 4 combustion turbine plants. Power is delivered to TVA customers over a transmission system of approximately 16,600 miles of lines, including 2,400 miles of extra-high-voltage (500,000 volt) transmission lines. The system interconnects with neighboring power systems at numerous points, and TVA has various types of interchange arrangements with these systems. The extent and types of interchange transactions depend upon the characteristics of the systems' loads, the management policies of the systems and other factors. Interchange arrangements are an essential part of TVA's efforts to minimize investment in electrical facilities, increase the reliability of service, effect operating economies and minimize the cost of electric energy.

In March 1997 a suit was filed in the United States District Court in Birmingham, Alabama, by four individuals challenging TVA's sale of power to Trico Steel Company, L.L.C. ("Trico"). Plaintiffs, who

claimed to be employees of Trico’s competitors, claimed that the TVA Act does not permit TVA to sell power to a limited liability company such as Trico; that the pricing provisions of TVA’s power supply contract with Trico violated various sections of the TVA Act; and that the TVA Board’s actions with respect to the Trico contract were unconstitutional because a provision of the TVA Act violates the separation of powers doctrine. Plaintiffs did not ask for monetary damages but sought to enjoin TVA from selling power to Trico and from issuing any additional power bonds until the alleged problems were corrected. TVA filed a motion asking the court to dismiss the complaint on several legal grounds. The court, on September 24, 1997, granted TVA’s motion and dismissed the lawsuit. The court held that the fixing of TVA’s rates is not subject to judicial review and that plaintiffs did not have standing to maintain the lawsuit since they had not suffered the requisite injury. The court did not reach the other issues in the case. The plaintiffs have appealed the decision.

During the fiscal year ended September 30, 1997, 61 percent of the power generated by the TVA coordinated system was by fossil fired plants, 28 percent by nuclear, and 11 percent by hydro. Coal consumption during this time was 39.8 million tons. Coal is purchased under contracts ranging from a single delivery to deliveries over several years. TVA coal inventory levels vary from plant to plant based upon a simulated inventory model. As of September 30, 1997, TVA had approximately 21 days’ coal supply in inventory at full burn. See “Nuclear Power Program” — “Nuclear Fuel” for a discussion of TVA’s nuclear fuel supplies. Management believes the sources and availability of fuel materials essential to its business should be adequate for the foreseeable future.

TVA’s power system is one of the largest in the United States in capacity and in energy production. Its size permitted the construction of large facilities which resulted in lower unit costs. Most of TVA’s dams were completed years ago when construction costs were far below present-day levels. Because most of the dams are multipurpose, their cost is shared by navigation, flood control, recreation and local economic development, as well as by power; thus, each purpose is served at a substantially lower cost than if the dams had been built for a single purpose.

Generating Resources

The following table summarizes the winter net dependable capacity (“NDC”) in megawatts (“MW”) on this coordinated system as of September 30, 1997:

	<u>Generating Units</u>	<u>Winter NDC MW(1)</u>
TVA Hydro Plants	109	3,129
TAPOCO Hydro Plants		318(2)
Corps of Engineers Hydro Plants.....		405(3)
TVA Pumped Storage Facility.....	4	<u>1,532</u>
Total Hydro		5,384
Fossil	59	15,014
Nuclear	5	5,625
Combustion Turbine	48	<u>2,394</u>
Total NDC		<u><u>28,417</u></u>

- (1) NDC as stated is the net power output which can be obtained for a period adequate to satisfy the daily load patterns under expected conditions of operation with equipment in an average state of maintenance. For planning purposes, TVA currently estimates summer dependable total hydro capacity of approximately 5,615 MW; coal-fired capacity of approximately 14,679 MW; nuclear power capacity of approximately 5,479 MW; and combustion turbine capacity of approximately 2,045 MW, for a total summer NDC of approximately 27,818 MW.
- (2) Four hydro plants owned by TAPOCO, Inc., a subsidiary of the Aluminum Company of America (“Alcoa”), are operated as part of the TVA power system. Under contractual arrangements with TAPOCO, electric power generated at these facilities is supplied to TVA. In return, TVA supplies electric power for Alcoa’s aluminum plant operations located in Tennessee.

- (3) The Corps of Engineers' plants on the Cumberland River system have a total installed capacity of 853 MW, of which 405 MW of NDC is available to TVA under a marketing agreement with the Southeastern Power Administration.

Under arrangements among TVA, the Corps of Engineers (the "CORPS") and the Southeastern Power Administration ("SEPA"), 8 hydro plants of the CORPS comprising the Cumberland River system are operated in coordination with the TVA system. These arrangements further provide for capacity (405 MW) and energy from the Cumberland River system to be supplied to TVA by SEPA at the points of generation, and the price paid for the power to be based on the operating and maintenance expenses and amortization of the power facilities. A portion of the output of the Cumberland River system is also made available to SEPA's customers outside the TVA region. The agreement with SEPA covering these arrangements for power from the Cumberland River system can be terminated upon three years' notice.

TVA has contracted with Choctaw Generation, Inc. to purchase and take delivery of up to 440 MW of power over a 30-year term from a lignite power plant to be constructed in Mississippi, contingent upon satisfactory completion of all necessary environmental reviews. Commercial operation of the plant is currently scheduled for January 2001. The owner of the facility has construction and operating risks, and if the owner fails to deliver the required energy, the owner will be responsible for securing replacement power for TVA at the contractually agreed price.

Integrated Resource Plan

In December 1995, the Board approved TVA's Integrated Resource Plan ("IRP") which presents TVA's strategy for meeting future customer energy demands. The IRP identifies a 25-year least-cost energy resource strategy for TVA's power system. TVA's IRP strategy relies on a portfolio of energy resource options that made up the best strategies evaluated for the TVA power system. These strategies performed well across all of the IRP evaluation criteria including debt, rates, costs, reliability, and environmental impacts and regulations. These strategies are designed to enable TVA to respond to future demands in a manner that maintains flexibility and enhances its competitive position. Included in the portfolio are customer service options such as energy conservation and load management; supply side options, including power purchased from other producers; and investigation and use of renewable energy.

Since the final IRP was issued in December 1995, TVA has undertaken the following actions identified in the IRP.

1. Purchased 2,000 MW of options of future peak and base-load capacity to meet future power needs in the Tennessee Valley region.

2. Issued an Environmental Impact Statement evaluating the conversion of Bellefonte Nuclear Plant to a fossil fuel-fired plant. A feasibility study performed by an outside team of technical and financial experts concluded that one of the most economical fossil conversion strategies was to complete Bellefonte as a natural gas-fired combined-cycle plant. In addition, TVA submitted a proposal to DOE to complete Bellefonte as a nuclear plant and to operate it to produce tritium for DOE in addition to electricity. TVA also proposed providing irradiation services to produce tritium at Unit One of the Watts Bar Nuclear Plant. Further action will depend on DOE's evaluation of and response to the TVA proposals and other potential options to produce tritium. See "Nuclear Power Program" — "Status of Certain Nuclear Units".

3. Implemented or began pilot programs for the following energy service programs:

- Residential demand-side management programs such as a heat pump retrofit program, a new homes program, an energy self-audit and student-audit program, and a low income demonstration program.
- An energy service company pilot designed to encourage the efficient use of electricity in the commercial and industrial sectors.
- Beneficial electrification programs designed to encourage efficient heating and air conditioning in residential and commercial establishments, commercial cooking, residential security lighting, and industrial electrotechnologies.

- Load management activities which include water heater control, storage water heaters, and real time pricing.
4. Continued research into several renewable energy technologies such as wind, biomass, and landfill methane.

TVA continues to review and update its resource plans. To date, several internal options have been approved including upgrades to combustion turbine units, upgrades to Raccoon Mountain Pumped Storage Plant, and fossil plant improvements. Discussions with suppliers of peaking power are underway to determine if other options should be pursued.

NUCLEAR POWER PROGRAM

Overview

TVA has five operating nuclear units at three locations: Sequoyah Units One and Two, Browns Ferry Units Two and Three and Watts Bar Unit One. Construction activities at three additional units have been suspended and one licensed unit remains in an inoperative status. See detailed discussions on all operating and inoperative nuclear units in the sections below and Note 2 of the accompanying Financial Statements.

Sequoyah

Sequoyah is a two-unit plant located approximately 7.5 miles northeast of the city limits of Chattanooga, Tennessee, with pressurized water reactors supplied by Westinghouse Electric Corporation. Each unit is rated at 1,147 MW net electrical output. TVA received an Operating License for Unit One in 1980, and the unit began commercial operation in 1981. TVA received an Operating License for Unit Two in 1981, and the unit began commercial operation in 1982. The Operating Licenses expire 40 years after issuance. The plant was designed and built and is operated by TVA. TVA voluntarily shut down both units in 1985 in response to technical and operational concerns.

Both Sequoyah units returned to commercial operation in 1988 and were removed from the NRC's list of plants that require close monitoring in 1989. Sequoyah Units One and Two have recorded an 82.5 average percent equivalent availability for the three years ending September 1997. (The "equivalent availability" is the ratio of the energy a unit could have generated, if called on, to the energy the unit would have produced if it had run at full load over the entire period, expressed as a percentage).

Browns Ferry

Browns Ferry is a three-unit plant located approximately 10 miles southwest of Athens, Alabama, with boiling water reactors supplied by General Electric Company. Each unit is rated at 1,065 MW net electrical output. The plant was designed and built and is operated by TVA. TVA received Operating Licenses for Units One, Two, and Three in 1973, 1974 and 1976, respectively. They began commercial operation in 1974, 1975 and 1977, respectively. The Operating Licenses for these units expire 40 years after issuance. Units One, Two and Three were voluntarily shut down by TVA in 1985 in response to technical and operational concerns.

Browns Ferry Unit Two was returned to commercial operation in 1991 and was removed from the NRC's list of plants requiring continued close monitoring in 1992. Browns Ferry Unit Two has recorded an 86.8 average percent equivalent availability factor for the three years ending September 1997.

Browns Ferry Unit Three was restarted in November 1995 and returned to commercial operation in January 1996. In June 1996 the NRC removed Browns Ferry Unit Three from the list of plants warranting close monitoring. Browns Ferry Unit Three recorded a 90.9 percent equivalent availability factor from restart through September 30, 1997.

Browns Ferry Unit One has been idled since March 1985. Major modifications would be required to bring the plant to current standards. At September 30, 1997 the undepreciated cost of Browns Ferry Unit One was \$80 million. In 1994 preliminary cost estimates based on IRP information indicated that cost associated with

returning Unit One to service would have been between \$1.2 and \$3.2 billion. See “Status of Certain Nuclear Units” for discussion of the status of Browns Ferry Unit One.

Watts Bar

Watts Bar is a two-unit power plant located approximately 50 miles northeast of Chattanooga, Tennessee, with pressurized water reactors supplied by Westinghouse Electric Corporation. Unit One is rated at 1,154 MW net electrical output. The plant was designed and has been built to its present level of completion by TVA. The Construction Permit for Unit Two expires in December 1999.

Although physical construction of Watts Bar Unit One was substantially complete in 1985, efforts to obtain an Operating License were delayed due to numerous safety concerns. Overall plant design was reverified and extensive modifications were made. The NRC granted TVA a license to operate Unit One at up to five percent of rated power in November 1995 and at full power in February 1996. Watts Bar Unit One successfully completed all power ascension testing activities and commenced full power commercial operation in May 1996. The Operating License for Unit One expires 40 years after issuance. Since beginning commercial operation, the plant has operated at an 82.1 percent equivalent availability factor through September 30, 1997.

In 1988, TVA suspended construction activities at Watts Bar Unit Two because of a reduction in the forecasted load growth. Total investment in Unit Two at September 30, 1997, was \$1.7 billion, including capitalized interest. In 1994 preliminary cost estimates based on IRP information indicated that the cost associated with completing Unit Two would have been between \$1.1 and \$2.9 billion. See “Status of Certain Nuclear Units” for discussion of the status of Unit Two.

Bellefonte

Bellefonte is a two-unit power plant located approximately 59 miles southwest of Chattanooga with pressurized water reactors supplied by Babcock & Wilcox Company rated at 1,212 MW net electrical output each. The plant was designed and has been built to its present level of completion by TVA. Construction Permits were obtained from the NRC for both units in December 1974.

TVA deferred construction activities on Bellefonte Unit Two because of a reduction in forecasted load growth in October 1985. Construction activity was deferred on Unit One in July 1988. In March 1993, TVA notified the NRC of its plans to resume completion activities at Bellefonte, but no construction activities have occurred since 1988. Construction Permits for Unit One and Unit Two have been extended by the NRC to 2001 and 2004, respectively.

As of September 30, 1997, TVA had \$4.6 billion, including capitalized interest, invested in these units. See “Status of Certain Nuclear Units” for discussion of Bellefonte’s current status. In 1994 preliminary cost estimates based on IRP information indicated that cost associated with completing the Bellefonte units would have been between \$1.3 and \$3.5 billion for Unit One and \$900 million and \$2.4 billion for Unit Two.

Status of Certain Nuclear Units

Preliminary cost estimates, utilizing the IRP (see “Power System” — “Integrated Resource Plan”), showed that completing the units at Bellefonte and Watts Bar Unit Two may not be economically feasible. As a result, the Board in December 1994 announced a major change in policy declaring that TVA will not, by itself, complete Bellefonte Units One and Two and Watts Bar Unit Two as nuclear units. In addition, the Board decided that Browns Ferry Unit One should continue in its inoperative status.

TVA’s IRP identified as a viable option the conversion of the Bellefonte facility to a combined-cycle plant utilizing natural gas or gasified coal. In 1997 an independent team of technical and financial experts completed a feasibility study to evaluate options for the conversion of Bellefonte Nuclear Plant to a fossil fuel-fired plant. The feasibility study indicates that one of the most economical fossil conversion strategies is to complete Bellefonte as a natural gas-fired combined-cycle plant. TVA also issued an Environmental Impact Statement (“EIS”) assessing the environmental impacts of various fossil conversion options. The EIS

identified the natural gas-fired combined-cycle plant alternative as the preferred option. In addition, TVA submitted a proposal to DOE to complete Bellefonte as a nuclear plant and to operate it to produce tritium for DOE in addition to electricity. TVA also proposed providing irradiation services to produce tritium at Unit One of the Watts Bar Nuclear Plant. Further action will depend on DOE's evaluation of and response to the TVA proposal and DOE's other potential options to produce tritium.

At September 30, 1997, TVA's total investment in Bellefonte Units One and Two, Watts Bar Unit Two and Browns Ferry Unit One was \$7.0 billion. The future decisions on these units will ultimately impact the method of cost recovery, and the TVA Board has determined that it will establish rate adjustments and operating policies to ensure full recovery of the cost of these units and compliance with the requirements of the TVA Act.

Because of extensive regulatory requirements and the resulting delays which are often very lengthy, estimates of the cost to complete nuclear plants have typically been unreliable. No assurance can be given that TVA's cost estimates would not be changed significantly if a decision is made to complete or operate any of the inoperative units.

Nuclear Fuel

TVA owns all nuclear fuel held for its nuclear units (operating and deferred). The net book value of such fuel was \$840 million as of September 30, 1997. See Note 2 of the accompanying Financial Statements. TVA currently has sufficient inventory to last until late 1998.

TVA's investment in the fuel being used in the Sequoyah, Watts Bar and Browns Ferry units is being amortized and accounted for as a fuel expense. The Bellefonte initial cores have been defabricated and uranium from these cores has been used in the Sequoyah and Browns Ferry units with the net book value assigned accordingly.

Nuclear Waste

Spent Nuclear Fuel

The Nuclear Waste Policy Act of 1982 (the "NWP") provides that the federal government has the responsibility for the permanent disposal of spent nuclear fuel but charges each nuclear power system with the responsibility for the cost of such permanent disposal. The NWP requires each nuclear power system to enter into a disposal contract with DOE for such material. The contract requires each nuclear power system to pay a fee which is currently one mill per kWh for the net electricity generated by each of its reactors and sold. Although it is uncertain when DOE will be able to begin accepting spent nuclear fuel, TVA believes its spent fuel efforts will ensure that sufficient cost-effective at-reactor storage is available to meet all of TVA's spent fuel storage requirements until DOE is prepared to accept TVA's spent fuel.

TVA presently has the capability to store its spent fuel at Sequoyah through the year 2002, at Browns Ferry Units One and Two through the year 2011, and at Browns Ferry Unit Three through the year 2000. Based on a one unit operation, Watts Bar storage capability will be sufficient until 2018. Plans are in place to extend storage capacity at Browns Ferry Unit Three until 2006. TVA plans to extend storage capability through life-of-plant if necessary by using higher density racks in its existing storage pools or dry storage casks. Additional storage capacity increases will require NRC approval. However, all of the above methods of extending storage capability have been licensed by the NRC at other facilities.

Low-Level Radioactive Waste

Disposal costs for low-level radioactive waste that result from normal operation of nuclear units have increased significantly in recent years. Pursuant to the Low-Level Radioactive Waste Policy Act, each state is responsible for disposal of low-level waste generated in that state. States may form regional compacts to jointly fulfill their responsibilities. The States of Tennessee and Alabama (where TVA nuclear plants are located) have joined with other southeastern states to form the Southeast Compact Commission for Low-Level

Radioactive Waste Management. This commission regulates the siting of new disposal facilities and the disposal of low-level waste within the southeastern states.

Until July 1995, the low-level waste generators located in the Southeastern states were required to dispose of their waste at the Barnwell, South Carolina disposal facility. South Carolina has withdrawn from the Southeast Compact Commission in order to open the Barnwell facility to all states except North Carolina. The states participating in the Southeast Compact Commission have selected North Carolina as the host state to select, license, and construct a new disposal site. TVA plans to continue to use the Barnwell facility for low-level radioactive waste disposal until the North Carolina facility is opened. Should either or both of the disposal facilities close unexpectedly, low-level radioactive waste will be stored in on-site facilities at the TVA nuclear plants. These facilities are sized to handle any anticipated storage needs for the foreseeable life of the plants.

Nuclear Insurance

The indemnification and limitation of liability plan afforded the United States nuclear industry by the Price-Anderson Act was extended for an additional 15 years in 1988, with certain provisions of the Price-Anderson Act now due to expire on August 1, 2002. The 1988 amendments and the 1993 inflation adjustment to the Price-Anderson Act substantially increased the limit of liability from an accident at an NRC-licensed reactor, and this amount is now approximately \$8.7 billion (\$79 million for each of the NRC-licensed reactors in the United States), composed of primary and secondary layers of financial protection. For further information about this nuclear liability insurance and its deferred premium see Note 10 of the accompanying Financial Statements. TVA, in accordance with industry practice, maintains certain liability insurance coverage for workers at the nuclear sites.

NRC regulations require nuclear power plant licensees to obtain, and TVA has acquired, onsite property damage insurance coverage of \$1.06 billion per nuclear site. Some of the nuclear property insurance may require the payment of retrospective premiums of up to approximately \$32.0 million (retrospective premium amount as of November 1997) in the event that losses by another insured party or TVA exceed available funds. In accordance with NRC regulations, the proceeds of nuclear property insurance are used first to ensure that the reactor is in safe and stable condition and that it can be maintained in a condition that prevents significant risk to the public. Next, the proceeds go for decontamination or, if necessary, decommissioning the reactor. Any excess proceeds insure against casualties to property.

Decommissioning

In prior years, the excess of the annual decommissioning provision over earnings from any investments designated for funding decommissioning costs has been charged to depreciation expense. Investments were made in amounts sufficient to fully fund all estimated decommissioning costs. Effective for fiscal 1998, TVA changed its method of accounting for decommissioning costs and related liabilities. TVA's current accounting policy recognizes, as incurred, all obligations related to closure or removal of its nuclear units. The liability for closure is measured at the present value of the estimated cash flows required to satisfy the related obligation and discounted at a determined risk free rate of interest. The corresponding charge to recognize the additional obligation was effected through the creation of a regulatory asset. TVA further modified its method of accounting for decommissioning costs such that earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred in accordance with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation." The book value of TVA's decommissioning fund investments was \$553 million at September 30, 1997. See Notes 1 and 10 of the accompanying Financial Statements.

ENVIRONMENTAL MATTERS

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

those state and local environmental requirements for which Congress has clearly waived federal agency immunity. Respecting the major environmental areas (air, water and waste), limited waivers have been enacted by Congress. TVA's activities may also be subject to other narrower environmental requirements or to environmental requirements which affect only federal activities.

TVA has incurred and continues to incur substantial capital expenditures and operating expenses to comply with environmental requirements. See Note 10 of the accompanying Financial Statements. Because of the continually changing nature of these requirements, the total amount of these costs is not now determinable. It is anticipated that environmental requirements will become more stringent and that compliance costs will increase, perhaps by substantial amounts.

Air Pollution

Under the Clean Air Act, the United States Environmental Protection Agency (the "EPA") has promulgated national ambient air quality standards for certain air pollutants, including sulfur dioxide, particulate matter and nitrogen oxide. Coal-fired generating units are major sources of these pollutants. TVA also operates other smaller sources. The States of Alabama and Tennessee and the Commonwealth of Kentucky have promulgated implementation plans which regulate sources within their boundaries, including TVA sources, in order to achieve and maintain the national ambient standards. TVA has installed control equipment and employs control strategies to comply with applicable state-established emission limitations. TVA estimates that it spent about \$1.4 billion in capital costs on air pollution control activities prior to the 1990 Clean Air Act Amendments.

The acid rain control provisions of the 1990 Amendments to the Clean Air Act establish a number of new requirements for utilities. These requirements are being implemented by EPA and states in two phases. TVA's Phase I affected units were brought into compliance at a capital cost of approximately \$750 million (exclusive of interest expenses). TVA's current Phase 2 compliance strategy is expected to result in capital costs of approximately \$550 million.

Several EPA developments may affect the air pollution control requirements that are applicable to TVA's fossil plants. States and EPA are considering how the long-range transportation of both nitrogen oxide, which contributes to the formation of ozone, and ozone may contribute to violations of the ozone ambient air quality standard in downwind states. Eight northeastern states have petitioned EPA to order upwind states — including Alabama, Kentucky, and Tennessee — to reduce their nitrogen oxide emissions. Also, EPA has proposed that nitrogen oxide emissions be reduced in 22 eastern states including Alabama, Kentucky, and Tennessee. Most of these reductions would come from utility units. EPA has also made the ozone ambient standard and the particulate matter standard more stringent along with proposed rules to reduce regional haze. These actions may lead to additional reductions of utility nitrogen oxide and sulfur dioxide emissions beyond those required by the acid rain provisions of the 1990 amendments. The costs for such additional reductions are unknown at this time but could exceed \$2.5 billion.

The ozone ambient standard was exceeded in the Memphis, Tennessee area in the summer of 1995, and this triggered the Memphis-Shelby County ozone maintenance-contingency plan. Under this contingency plan, sources of nitrogen oxide within Shelby County can be required to further reduce emissions. TVA has agreed to reduce Allen Fossil Plant's nitrogen oxide emissions to help address this problem. The costs of doing this will not be substantial.

Under DOE's Climate Challenge Program, TVA entered into an agreement with DOE in 1993 to reduce greenhouse gas emissions (e.g., carbon dioxide) by 22.7 million tons by the year 2000. The costs of this voluntary effort have not been substantial. Efforts are being made internationally to obtain binding commitments from countries to reduce their greenhouse gas emissions. Negotiations were completed in December 1997 on a United Nations framework convention on climate change. Under this convention, some industrialized nations, including the United States, will have to reduce their greenhouse gas emissions. If this treaty is approved by the United States, utilities would likely be required to reduce their greenhouse gas emissions, and the cost to TVA could be substantial.

Water Pollution

Under the Clean Water Act, every point source which discharges pollutants into waters of the United States must obtain a National Pollutant Discharge Elimination System (“NPDES”) permit specifying the allowable quantity and characteristics of the pollutants discharged. TVA’s various point sources have received NPDES permits, including all of its major generating units. Compliance with NPDES requirements has necessitated substantial expenditures and may require additional, substantial expenditures in the future as NPDES permits come up for renewal and applicable requirements are made more stringent.

The Clean Water Act allows the permitting authority to establish thermal limits less stringent than the water quality criteria if the discharger can demonstrate that the alternate limit will assure protection and propagation of a balanced, indigenous aquatic population. TVA has now been issued alternate limits at several of its facilities, and it is meeting these limits. EPA has underway a rulemaking that would address the design of water intakes. The rulemaking is not expected to be completed for several years but could require changes to be made at TVA facilities. The cost of such changes is uncertain.

Solid and Hazardous Waste Management

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

Under the Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”), the release and cleanup of hazardous substances are regulated. Certain persons who are associated with the release of hazardous substances to the environment can be held responsible for their cleanup, regardless of when the substances were released or when the specific person may have been associated with the substance. This liability under CERCLA is generally viewed as joint and several. TVA, in a manner similar to other industries and power systems, has generated or used hazardous substances over the years. In connection with these activities, TVA has been identified as a potentially responsible party with respect to three non-TVA sites at which TVA hazardous substances were disposed and which have not yet been resolved. In addition, TVA is currently investigating two other sites at which TVA is either an owner or a partial owner and for which TVA may have cleanup responsibilities by virtue of its control of the property. TVA’s potential liabilities for its share of cleanup costs at these sites are uncertain but in total should be less than \$10 million.

Miscellaneous

Polychlorinated biphenyls (“PCBs”) have been widely used as insulating fluids in electric equipment (e.g., transformers and capacitors). Use of such equipment and the cleanup of released PCBs are regulated by EPA under the Toxic Substances Control Act. The TVA power system uses thousands of pieces of equipment which contain some level of PCBs. Most of this equipment can continue to be operated under EPA’s PCB regulations for the remainder of its useful lives, but TVA is phasing out much of this equipment as a matter of policy. The cost of phasing out the remainder of this equipment should not exceed \$40 million (equipment replacement and disposal costs) but cannot be accurately determined at this time. TVA has in place detailed procedures to conform its operations to EPA’s PCB regulations, and it has not incurred substantial costs in this area.

Many of TVA’s facilities were constructed at a time when asbestos was the insulation of choice by industry. Asbestos materials now require special handling and disposal when they are removed. Although not required, TVA is removing or encapsulating asbestos as appropriate.

There is public concern about whether there are adverse health effects from exposure to electric and magnetic fields (“EMF”). There are many sources of EMF, including electric transmission lines. Recent research, including a report from a National Academy of Sciences organization (the “NAS”), has confirmed that there is no conclusive evidence that EMF causes adverse health effects. A report by the National Cancer Institute on the scientific evidence has now confirmed the NAS conclusions. However, research in this area continues. Substantial costs could be incurred by electric systems, including TVA, if EMF levels from transmission lines have to be reduced, but this appears unlikely at this time.

As a federal agency, TVA is required to consider the potential environmental effects of major federal actions affecting the quality of the human environment under the National Environmental Policy Act (the “NEPA”) and implementing regulations and to make these evaluations available to the public. TVA has incorporated the NEPA review process into its decision making process. NEPA-related costs are incurred continuously but not in substantial amounts.

INSURANCE

TVA does not generally carry property damage or public liability insurance except as may be required or appropriate with respect to nuclear facilities and except to the extent it may do so as part of an owner-controlled insurance program it has implemented for some large contracts requiring on-site labor. Liability for service-connected injuries to employees is governed by the Federal Employees’ Compensation Act. See “Nuclear Power Program” — “Nuclear Insurance” herein and Note 10 of the accompanying Financial Statements for additional information with respect to insurance.

MANAGEMENT

TVA is administered by a board of directors composed of three persons appointed by the President and confirmed by the Senate. The Board and selected officers, their ages, their years of employment with TVA and principal occupations for recent years are as follows:

<u>Name and Title</u>	<u>Age</u>	<u>Year Commenced Employment</u>	<u>Year Term Expires</u>
Craven Crowell Chairman	54	1993	2002
Johnny H. Hayes Director	57	1993	2005
William H. Kennoy Director	61	1991	1999
Joseph W. Dickey Chief Operating Officer & Executive Vice President, Fossil and Hydro Power Group	53	1991	
Oswald J. Zeringue Chief Nuclear Officer & Executive Vice President	52	1989	
David N. Smith Chief Financial Officer & Executive Vice President, Financial Services	54	1995	
Norman A. Zigrossi Chief Administrative Officer & Executive Vice President, Business Services	62	1986	
Edward S. Christenbury General Counsel and Secretary	56	1987	

Mr. Crowell was appointed to the Board in July 1993. Prior to his current position, he served as Chief of Staff for Jim Sasser, Tennessee's then senior U.S. Senator (1989-1993), as Vice President of TVA's Office of Governmental & Public Affairs (1988-1989), and as TVA's Director of Information (1980-1988).

Mr. Hayes was initially appointed to the Board in July 1993 to fill the remainder of a Board term which expired in May 1996. Subsequently he received a recess appointment to the Board and was then appointed for a full term (until 2005). Prior to his current position, he served as the State of Tennessee's Commissioner of Economic and Community Development (1992-1993) and as Tennessee's Commissioner of Employment Security (1991-1992).

Mr. Kennoy was appointed to the Board in April 1991. Prior to his current position, he served as President of Kennoy Engineers for twenty-five years.

Mr. Dickey was named Chief Operating Officer in February 1994 and additionally was named Executive Vice President in October 1996. Prior to his current position, he served as TVA's Senior Vice President, Fossil and Hydro Power (1991-1994), as Vice President of Power Resources (Florida Power & Light Co.) (1988-1991), and as Vice President, Nuclear Energy (Florida Power & Light Co.) (1985-1988).

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

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

Mr. Zigrossi was named Chief Administrative Officer in February 1994 and additionally was named Executive Vice President, Business Services, in October 1996. Prior to his current position, he served as TVA's President, Resource Group (1992-1994) and as TVA's Inspector General (1986-1992).

Mr. Christenbury assumed the position of General Counsel of TVA in January 1987. Prior to his current position, he served as an Assistant General Counsel at the NRC (1980-1987).

EMPLOYEES

On December 31, 1997, TVA had about 14,200 employees, of which approximately 5,200 were trades and labor employees. Neither the federal labor laws covering most private sector employers, nor those covering most federal agencies are applicable to TVA; however, the Board has a longstanding policy of recognizing and dealing with recognized representatives of its employees. TVA employees are prohibited by federal law from engaging in strikes against TVA. In 1992, TVA entered into separate long-term agreements with the Tennessee Valley Trades and Labor Council ("Council"), the Salary Policy Employee Panel ("Panel"), and the International Brotherhood of Teamsters ("Teamsters"). One agreement recognized the Panel for collective bargaining purposes for 20 years. The other recognizes the Council and Teamsters for collective bargaining purposes for 15 years. About 77 percent of TVA's employees are in these bargaining units. TVA's labor agreements typically provide for negotiation of most provisions except monetary matters about every three years; wage and salary and benefit negotiations or adjustments generally occur annually. Unresolved disputes over rates of pay for trades and labor employees are resolved by binding decisions of the Secretary of Labor, while pay and monetary benefits disputes for other represented employees are resolved through binding arbitration. TVA's hourly construction, modification and supplemental maintenance work is now performed by contractors primarily under project labor agreements negotiated by TVA and the Council. Permanent craft operating and regular maintenance work continues to be performed by annual TVA employees represented by the Council for operating and maintenance employees, and by the Teamsters for materials handling work.

During mid-1997, negotiations between TVA and the Council (which is comprised of six unions representing annual trades and labor employees, including those working inside the power plants) were

delayed for about three months because of lawsuits filed by some Council unions, but there are now no legal restrictions on continuance of negotiations. The parties reopened negotiation sessions but have since reached an impasse. The collective bargaining agreement with the Council has no specific expiration date; however, it contains provisions for possible expiration of major parts of the agreement upon six months' notice, which notice TVA gave the Council in June 1997. With the expiration of parts of the agreement on December 31, 1997, TVA exercised its right to give a 90-day notice to reopen the remainder of the agreement with the Council, and potentially to cancel the agreement. In October, TVA concluded negotiations with the Teamsters for a new agreement.

The agreements with the Panel (which had been comprised of five unions representing white collar employees) also had no expiration date but provided for possible expiration of major parts of the agreement in 1999, upon 12 months' notice. However, in September 1997, two unions formerly belonging to the Panel, which together represent about 64 percent of the employees represented by Panel-affiliated unions, notified TVA and the Panel that they had disaffiliated from the Panel. After the Panel failed to provide TVA assurances that it could fulfill its contractual obligation to speak for all Panel unions, TVA informed the Panel that because it was in material breach of the TVA-Panel agreement, it was no longer appropriate for TVA to continue bargaining with the Panel. TVA, however, informed each of the five affected unions that it would recognize and separately bargain with each for their existing separate bargaining unit and that it was willing to extend to each of them, on an interim basis, the terms of the former TVA-Panel agreement, to the extent applicable to individual unions. To date, the two unions which notified the Panel of their disaffiliation have agreed to interim agreements, and each of these unions has concluded negotiations for a new separate agreement with TVA. Another former Panel union has accepted TVA's offer of an interim agreement through April 30, 1998, and agreed to negotiate for a new separate agreement, without prejudice to either party's position regarding the current validity of the TVA-Panel agreement. Those negotiations have concluded without agreement, but that union is polling its membership regarding TVA's last offer. A fourth Panel union has yet to accept TVA's offer of an interim agreement. (The bargaining unit for the remaining union has been merged into one of the other former Panel unions with whom TVA has reached agreement.)

Salaries of regular TVA employees are limited by a federal pay cap (Executive Level IV, currently \$118,400). This had led in the past to difficulties in the recruitment and retention of top management talent, and continues to be an issue which TVA must face in its recruitment and retention efforts. The impact of the pay cap has been alleviated somewhat by the increases in TVA's pay cap since January 1990 from \$80,700 to \$118,400. TVA has also addressed this issue by developing and implementing supplementary compensation arrangements, which have substantially reduced the impact of the pay cap. In TVA's opinion, the implementation of these arrangements is within TVA's legal authority. The GAO has expressed the opinion that some of these arrangements are not within TVA's legal authority. However, GAO has no authority to issue binding legal opinions on this matter or to stop any TVA payments. Congress is aware of TVA's supplemental compensation arrangements and has not taken any action that would undermine TVA's position that the arrangements are within its legal authority. Recently, TVA's executive compensation arrangements have come under increasing scrutiny from some members of Congress. It is possible that this scrutiny could result in legislative proposals to limit TVA's authority in this area. TVA has recently contracted with a national compensation management firm to determine whether TVA's executive compensation arrangements are appropriate to attract and retain the caliber of executive talent required to manage TVA's power system.

In October 1995, the President issued an Executive Order requiring Government corporations, including TVA, to submit information to the Office of Management and Budget ("OMB") on bonuses paid to its senior executives. Those bonuses and the information supporting them were last reported to OMB in December 1997 and were also publicly disseminated. OMB approval of TVA's bonuses is not required.

CERTAIN PROVISIONS OF THE TENNESSEE VALLEY AUTHORITY ACT

The following summarizes certain provisions of the Act.

Payments in Lieu of Taxes

TVA is not subject to federal income taxes or to taxation by states or their subdivisions. However, the Act requires TVA to make payments in lieu of taxes to states and counties in which the power operations of the Corporation are conducted. The basic amount is 5 percent of gross revenues from the sale of power to other than federal agencies during the preceding year, with the provision for minimum payments under certain circumstances.

Payments to the Treasury

The Act requires TVA to make certain payments into the Treasury each year from Net Power Proceeds in excess of those required for debt service as a return on and reduction of the Appropriation Investment. Net Power Proceeds are defined as the remainder of TVA's Gross Power Revenues after deducting the cost of operating, maintaining and administering its power properties (including multiple-purpose properties in the proportion that multiple-purpose costs are allocated to power) and payments to states and counties in lieu of taxes, but before deducting depreciation accruals or other charges representing the amortization of capital expenditures, plus the net proceeds of the sale or other disposition of any power facility or interest therein.

Acquisition of Real Estate

The Act empowers TVA to acquire real estate in the name of the United States of America by purchase or by exercise of the right of eminent domain, "and thereupon all such real estate shall be entrusted to the Corporation as the agent of the United States to accomplish the purposes of [the] Act". Since nearly all of TVA's properties, including powerhouses and transmission line rights-of-way, constitute real estate, title to which is held in the name of the United States and entrusted to TVA as agent of the United States, all references in this Statement to "TVA properties" and the like, and to the amounts invested therein, should be read and construed in the light of this provision of the Act.

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

TVA's Power Bonds are issued pursuant to Section 15d of the Act and pursuant to the Basic Resolution. At December 31, 1997, TVA had outstanding U.S. \$23.1 billion and DM 1.5 billion (issued in September 1996) principal amount of Power Bonds. Power Bonds may be issued only to provide capital for TVA's power program (including refunding any Evidences of Indebtedness issued for like purposes) and only as authorized by law at the time of issuance. Power Bonds are payable as to both principal and interest solely from Net Power Proceeds but may, at the option of TVA, be paid from the proceeds of refunding obligations or other funds legally available for such payment. Power Bonds are not obligations of, or guaranteed by, the United States of America. Net Power Proceeds for fiscal 1997, 1996, and 1995 were \$2.9 billion, \$2.9 billion and \$2.6 billion, respectively. Power Bonds of each series must be further authorized by Supplemental Resolution.

TVA intends from time to time to issue New Power Bonds with maturities and on terms determined in light of market conditions at the time of sale. The New Power Bonds may be sold to dealers or underwriters, who may resell the New Power Bonds in public offerings or otherwise. In addition, New Power Bonds may be sold by TVA directly or through other entities.

Except for FISBS described below, the specific aggregate principal amount, maturity, interest rate or method for determining such rate, interest payment dates, if any, purchase price to be paid to TVA, any terms for redemption or other special terms, form and denomination of New Power Bonds, information as to any stock exchange listing, and the names of any dealers, underwriters or agents, together with a description of any amendments or supplements to the Basic Resolution in connection with the sale of New Power Bonds being

offered at a particular time, will be set forth in an offering circular, and any appropriate supplement thereto, together with the terms of such New Power Bonds.

New Power Bonds include TVA's FISBS that may be issued from time to time in installments with maturities of from one year to fifty years. TVA intends to offer FISBS for sale on a continuous basis to members of a group of securities dealers selected by TVA, who will resell such FISBS. The aggregate principal amount of all such Installment Bonds will not exceed \$4 billion at any one time outstanding and the maximum effective rate payable on any such Installment Bonds will not exceed 10 percent.

Information relating to FISBS will be set forth in an Installment Bonds offering circular and any appropriate amendment or supplement thereto. At the time of each sale TVA will determine if the FISBS then being sold will be subject to redemption prior to the maturity date and will establish the purchase price, principal amount, interest rate or interest rate formula, maturity date, and certain other terms of such sale.

TVA's Discount Notes are also issued pursuant to Section 15d of the Act and in accord with Section 2.5 of the Basic Resolution. As of December 31, 1997, TVA had outstanding approximately \$2.6 billion in Discount Notes. The Discount Notes are payable solely from Net Power Proceeds (but may, at the option of TVA, be paid from the proceeds of refunding obligations or other funds legally available for such payment) and are not obligations of, or guaranteed by, the United States of America.

TVA intends to offer Discount Notes for sale on a continuous basis to a group of securities dealers selected by TVA, who will resell such notes. Discount Notes will be issued in such form and upon such terms and conditions as deemed appropriate by TVA. Certain information respecting Discount Notes will be set forth in a Discount Notes offering circular and any appropriate supplement thereto.

TVA from time to time may issue Other Indebtedness, in addition to New Power Bonds and Discount Notes, to assist in financing its Power Program. Other Indebtedness, such as Quarterly Income Debt Securities ("QIDS"), are issued pursuant to Section 15d of the Act and under appropriate authorizing resolutions. At December 31, 1997, TVA had outstanding \$1.1 billion principal amount of QIDS.

Subordinated debt securities, such as QIDS, may be issued from time to time by TVA with maturities and on terms determined in light of market conditions at the time of sale. These subordinated debt securities may be sold to dealers or underwriters, who may resell them in public offerings or otherwise. In addition, the subordinated debt securities may be sold by TVA directly or through other entities. TVA subordinated debt securities will be payable as to both principal and interest solely from Net Power Proceeds (but may, at the option of TVA, be paid from the proceeds of refunding obligations or other funds legally available for such payment) and will not be obligations of, or guaranteed by, the United States of America.

The specific aggregate principal amount, maturity, interest rate or method for determining such rate, interest payment dates, if any, purchase price to be paid to TVA, any terms for redemption or other special terms, form and denomination of Other Indebtedness, information as to any stock exchange listing, and the names of any dealers, underwriters or agents, will be set forth in an offering circular, and any appropriate supplement thereto, together with the terms of such Other Indebtedness.

The following summary of certain provisions of the Basic Resolution does not purport to be complete and is qualified in its entirety by reference to the full text of the Basic Resolution. See also "Recent Legislation".

Application of Net Power Proceeds

Section 2.3 of the Basic Resolution provides as follows:

Net Power Proceeds shall be applied, and the Corporation hereby specifically pledges them for application, first to payments due as interest on Bonds, on Bond Anticipation Obligations, and on any Evidences of Indebtedness issued pursuant to Section 2.5 which rank on a parity with Bonds as to interest; to payments of the principal due on Bonds for the payment of which other provisions have not

been made; and to meeting requirements of sinking funds or other analogous funds under any Supplemental Resolutions. The remaining Net Power Proceeds shall be used only for:

(a) Required interest payments on any Evidences of Indebtedness issued pursuant to Section 2.5 which do not rank on a parity with Bonds as to interest.

(b) Required payments of or on account of principal of any Evidences of Indebtedness other than Bonds.

(c) Minimum payments into the United States Treasury required by the Act in repayment of and as a return on the Appropriation Investment.

(d) Investment in Power Assets, additional reductions of the Corporation's capital obligations, and other lawful purposes related to the Power Program; provided, however, that payments into the United States Treasury in any fiscal year in reduction of the Appropriation Investment in addition to the minimum amounts required for such purpose by the Act may be made only if there is a net reduction during such year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes, and only to such extent that the percentage of aggregate reduction in the Appropriation Investment during such year does not exceed the percentage of net reduction during the year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes.

Section 2.4 of the Basic Resolution provides as follows:

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

Section 2.5 of the Basic Resolution provides as follows:

To assist in financing its Power Program the Corporation may issue Evidences of Indebtedness other than Bonds and Bond Anticipation Obligations, which may be payable out of Net Power Proceeds subject to the provisions of Section 2.3 hereof, but no such other Evidences of Indebtedness shall rank on a parity with or ahead of the Bonds as to payments on account of the principal thereof or rank ahead of the Bonds as to payments on account of the interest thereon.

See "Amendments to the Basic Resolution to Become Effective in the Future" for a discussion of amendments that will affect the above provisions of Sections 2.3 and 2.5 of the Basic Resolution. See "Recent Legislation" for a discussion of legislation relating to appropriations for TVA's nonpower programs and the funding of such programs, including the use of power revenues.

Rate Covenant

Section 3.2 of the Basic Resolution provides as follows:

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

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

regard for the primary objectives of the Act, including the objective that power shall be sold at rates as low as are feasible.

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

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

Covenant for Protection of Bondholders’ Investment

Under the Act and Section 3.3 of the Basic Resolution, TVA must, in each successive 5-year period beginning October 1, 1960, use either for the reduction of its capital obligations (including Evidences of Indebtedness and the Appropriation Investment) or for investment in Power Assets an amount of Net Power Proceeds at least equal to the sum of (1) depreciation accruals and other charges representing the amortization of capital expenditures and (2) the net proceeds from any disposition of power facilities.

Depreciation

The Basic Resolution requires TVA to accrue, in accordance with a recognized method, annual amounts for depreciation of its power properties (except land and other nondepreciable property) which will amortize their original cost less anticipated net salvage value within their expected useful lives. TVA has provided allowances for depreciation of its power properties (except land and other nondepreciable property) on a straight-line basis during their expected useful lives.

Issuance of Additional Bonds and Other Evidences of Indebtedness

The Act presently limits the issuance of Evidences of Indebtedness by TVA to a total of \$30 billion outstanding at any one time to assist in financing TVA’s power program (and for refunding). At December 31, 1997, TVA had approximately U.S.\$26.8 billion and DM 1.5 billion (issued in September 1996) of Evidences of Indebtedness outstanding. The Basic Resolution permits the issuance of Power Bonds only to provide capital for TVA’s power program, including the refunding of any Evidences of Indebtedness issued for that purpose.

Power Bonds, the terms and conditions of which may not be inconsistent with the Basic Resolution, must also be authorized by Supplemental Resolution.

The issuance of Power Bonds is limited as follows by the Basic Resolution:

Each Supplemental Resolution authorizing the issuance of Power Bonds must contain a finding by the Board that after the Power Bonds authorized thereby have been issued, Gross Power Revenues will be adequate to meet the requirements of the Basic Resolution with respect to rates and the application of depreciation accruals. These requirements are described under “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Rate Covenant” and — “Covenant for Protection of Bondholders’ Investment”.

The amount of Power Bonds outstanding may not be increased unless net power income (after interest expense and depreciation charges but before payments as a return on or in reduction of the appropriation investment) for the latest five fiscal years has aggregated at least \$200 million. Moreover, that minimum requirement is increased by \$15 million for each ¼ percent (or major fraction thereof) by which the average for those five years of the October 1 average interest rate payable by the United States Treasury upon its total marketable public obligations exceeds 3¼ percent. See Section 3.4 of the Basic Resolution and “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Amendments to the Basic Resolution to Become Effective in the Future”.

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

Evidences of Indebtedness (such as Discount Notes) other than Power Bonds and Bond Anticipation Obligations may also be issued to assist in financing TVA’s power program. They may be payable out of Net Power Proceeds subject to the provisions of Section 2.3 of the Basic Resolution. They may not rank on a parity with or ahead of the Power Bonds as to principal or ahead of them as to interest. See “Amendments to the Basic Resolution to Become Effective in the Future”.

Mortgaging and Disposal of Power Properties

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

Modifications of Resolutions and Outstanding Bonds

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

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

Events of Default

Any of the following shall be deemed an Event of Default under the Basic Resolution: (i) default in the payment of the principal or redemption price of any Power Bond when due and payable at maturity, by call for redemption, or otherwise; (ii) default in the payment of any installment of interest on any Power Bond when due and payable for more than 30 days; or (iii) failure of TVA to duly perform any other covenant, condition

or agreement contained in the Power Bonds or in the Basic Resolution or any Supplemental Resolution for 90 days after written notice specifying such failure has been given to TVA by the holders of at least 5 percent in aggregate principal amount of the then outstanding Power Bonds.

Upon any such Event of Default, the holders of the Power Bonds may proceed to protect and enforce their respective rights, subject to the restrictions described below. The holders of at least 5 percent in aggregate principal amount of Power Bonds then outstanding shall, subject to certain restrictions, have the right and power to institute a proceeding (i) to enforce TVA's covenants and agreements, (ii) to enjoin any acts in violation of the rights of holders of Power Bonds, and (iii) to protect and enforce the rights of holders of Power Bonds. Power Bonds do not provide for acceleration upon an Event of Default.

Such holders have no right to bring any such action or proceeding against TVA unless they have given TVA written notice of an Event of Default, and TVA has had a reasonable opportunity to take appropriate corrective action with respect thereto and has failed or refused to do so.

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

Amendments to the Basic Resolution to Become Effective in the Future

On March 25, 1992, TVA adopted a resolution amending the Basic Resolution, entitled "Fourth Amendatory Resolution to Basic Tennessee Valley Authority Power Bond Resolution" (the "Fourth Amendatory Resolution"). The amendments to the Basic Resolution made by the Fourth Amendatory Resolution will become effective only at such time as either (a) all Power Bonds issued prior to the date of adoption of the Fourth Amendatory Resolution cease to be outstanding (which will occur not later than November 15, 2029) or (b) the holders of at least 66⅔ percent of the principal amount of all then outstanding Power Bonds issued prior to the adoption of the Fourth Amendatory Resolution consent in writing to such amendments. At such times as the amendments become effective, they shall apply to all Power Bonds. The holders of Power Bonds offered after March 25, 1992, shall be deemed to have given their consent to the effect that, at any time after the conditions set forth in (a) or (b) above have been met, the amendments to the Basic Resolution made by the Fourth Amendatory Resolution will become effective in the manner provided. No further vote or consent of the holders of Power Bonds offered after March 25, 1992, is required to permit such amendments to the Basic Resolution to become effective.

The Fourth Amendatory Resolution, when effective in accordance with its terms and the terms of the Basic Resolution as described above, will (1) delete from the Basic Resolution the limitation on issuance of Power Bonds set forth in Section 3.4 thereof and (2) amend the Basic Resolution to permit issuance of other Evidences of Indebtedness under Section 2.5 thereof that rank on a parity with Power Bonds as to principal and interest.

Section 3.4 of the Basic Resolution presently restricts TVA's ability to issue Power Bonds unless net power income (after interest expense and depreciation charges but before payments as a return on or in reduction of the Appropriation Investment) for the latest five fiscal years has aggregated at least \$200 million. That amount is increased by \$15 million for each ¼ percent (or major fraction thereof) by which the average for those five years of the October 1 average interest rates payable by the United States Treasury upon its total marketable public obligations exceeds 3¼ percent. Upon the effectiveness of the Fourth Amendatory Resolution (which eliminates Section 3.4) Sections 3.5 through 3.10 will be renumbered as appropriate.

The foregoing is a brief summary of certain provisions of the Fourth Amendatory Resolution. This summary is not to be considered a full statement of the terms of the Fourth Amendatory Resolution and, accordingly, is qualified by reference to the Fourth Amendatory Resolution. Copies in reasonable quantity of the Fourth Amendatory Resolution may be obtained upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902, Attention: Vice President and Treasurer, or by calling (423) 632-3366.

Recent Legislation

In October 1997, Congress enacted the Energy and Water Development Appropriations Act, 1998, Pub. L. No. 105-62, 111 Stat. 1320, 1338 (1997). The paragraph captioned "TENNESSEE VALLEY AUTHORITY" in Title IV of this act (such paragraph being hereinafter referred to as the "Appropriations Act paragraph") (1) appropriates \$70 million for TVA's nonpower programs in fiscal year 1998; (2) anticipates no further appropriations to TVA thereafter; and (3) requires TVA, beginning with October 1, 1998, to fund nonpower programs that constitute "essential stewardship activities" with revenues derived from one or more of various sources, including power revenues, notwithstanding provisions of the TVA Act and power bond covenants to the contrary. TVA has not yet made determinations as to funding its nonpower activities after September 30, 1998.

The Appropriations Act paragraph states;

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

However, the Clinton administration's proposed budget for fiscal year 1999 includes \$76.8 million for TVA's nonpower programs. TVA cannot predict whether Congress will approve this amount or otherwise appropriate funds for TVA's nonpower programs in fiscal year 1999 or thereafter.

In 1997 three other bills were introduced in Congress which, beginning with fiscal years 1998 to 2001, would eliminate the provision in the TVA Act permanently authorizing appropriations for TVA. TVA does not anticipate enactment of any of these three bills.

Stripping

Certain series of the Corporation's New Power Bonds (the "Eligible New Power Bonds") may be separated ("stripped") into their Interest and Principal Components (as hereinafter defined) and maintained as such on the book-entry records of the Federal Reserve Banks. The components of each Eligible New Power Bond are: each future interest payment due on or prior to the first date on which the Eligible New Power Bond is subject to redemption at the option of the Corporation (each an "Interest Component"); and the principal payment plus any interest payments after the first date on which the Eligible New Power Bond is subject to redemption at the option of the Corporation (the "Principal Component"). Each Interest Component and the Principal Component will receive an identifying designation and CUSIP number. A request for separation of an Eligible New Power Bond into its Interest and Principal Components must be made to the Federal Reserve Bank of New York ("FRBNY"). Currently the FRBNY does not charge a fee for stripping Eligible New Power Bonds. For an Eligible New Power Bond to be stripped into its Interest and Principal Components as described above, the principal amount of the Eligible New Power Bond must be in an amount that, based on the stated interest rate of the Eligible New Power Bonds, will produce a semi-annual interest payment of \$1,000 or multiples thereof. The minimum principal amounts required to strip an Eligible New Power Bond at

various interest rates, as well as the interest payments corresponding to those minimum principal amounts, may be obtained by calling the Corporation's Vice President and Treasurer at (423) 632-3366, and the minimum principal amount required to strip an Eligible New Power Bond will be disclosed in a related offering circular except for Installment Bonds. Interest and Principal Components will be obligations of TVA payable solely from TVA's Net Power Proceeds.

Once a New Power Bond has been stripped into its Interest and Principal Components, the Interest and Principal Components may be maintained and transferred on the book-entry system of the Federal Reserve Banks in integral multiples of \$1,000. Payments on the Interest and Principal Components will be made on the applicable payment dates on the related New Power Bonds by crediting holders' accounts at the FRBNY. At the request of a holder and on the holder's payment of a fee (currently the FRBNY's fee applicable to on-line book-entry securities transfers), the FRBNY will restore ("reconstitute") the unmatured Interest and Principal Components of a stripped New Power Bond to their fully constituted form. Holders wishing to reconstitute the unmatured Interest and Principal Components of a stripped New Power Bond to their fully constituted form must (i) produce all outstanding Interest and Principal Components for a stripped New Power Bond and (ii) comply with all applicable requirements of the FRBNY governing the stripping and reconstitution of securities.

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

The Interest and Principal Components of Eligible New Power Bonds could be subject to restrictions or requirements with respect to the legality of investment therein which do not apply to New Power Bonds held in their fully constituted form. Thus, each person or entity is advised to consult with its own counsel with respect to the legality of investment in Interest and Principal Components.

INDEPENDENT ACCOUNTANTS

The financial statements of TVA at September 30, 1997, and 1996 and for each of the three fiscal years in the period ended September 30, 1997, appended hereto as part of this Information Statement, have been audited by Coopers & Lybrand L.L.P., independent accountants, as set forth in their report, dated October 23, 1997, which report is also appended hereto.

* * * * *

Any statements in this Information Statement involving matters of opinion, whether or not expressly so stated, are intended as such and not as representations of fact. This Information Statement is not to be construed as a contract or agreement with the purchaser of any of the New Power Bonds, Discount Notes or Other Indebtedness.

This Information Statement has been approved by a duly authorized officer of the Tennessee Valley Authority.

Tennessee Valley Authority

By: /s/ JOHN M. HOSKINS
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Dated February 27, 1998

TENNESSEE VALLEY AUTHORITY
FINANCIAL STATEMENTS
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TENNESSEE VALLEY AUTHORITY

BALANCE SHEETS

At September 30, 1997 and 1996

	Power program		All programs	
	1997	1996	1997	1996
	(in millions)			
ASSETS				
Current Assets				
Cash and cash equivalents	\$ 299	\$ 238	\$ 374	\$ 318
Accounts receivable	701	680	707	689
Inventories at average cost and other				
Fuel	112	110	112	110
Other	287	278	287	278
Total current assets	1,399	1,306	1,480	1,395
Property, Plant and Equipment				
Completed plant	28,528	27,955	29,632	29,069
Less accumulated depreciation	(7,178)	(6,553)	(7,469)	(6,854)
Net completed plant	21,350	21,402	22,163	22,215
Construction in progress	605	744	622	764
Deferred nuclear generating units	6,303	6,293	6,303	6,293
Nuclear fuel and capital leases	1,040	1,082	1,040	1,082
Total property, plant and equipment	29,298	29,521	30,128	30,354
Investment Funds	561	440	561	440
Deferred Charges and Other Assets				
Loans and other long-term receivables	121	319	170	375
Debt issue and reacquisition costs	1,096	1,162	1,096	1,162
Other deferred charges	1,209	1,281	1,209	1,281
Total deferred charges and other assets	2,426	2,762	2,475	2,818
Total assets	\$33,684	\$34,029	\$34,644	\$35,007
LIABILITIES AND PROPRIETARY CAPITAL				
Current Liabilities				
Accounts payable	\$ 468	\$ 392	\$ 487	\$ 417
Accrued liabilities	161	187	172	196
Accrued interest	499	498	499	498
Discount notes	2,151	1,774	2,151	1,774
Current maturities of long-term debt	574	2,250	574	2,250
Total current liabilities	3,853	5,101	3,883	5,135
Other Liabilities	1,704	1,580	1,704	1,580
Long-term Debt				
Public bonds — senior	20,354	19,403	20,354	19,403
Federal Financing Bank — senior	3,200	3,200	3,200	3,200
Public bonds — subordinated	1,100	1,100	1,100	1,100
Unamortized discount and other adjustments	(502)	(383)	(502)	(383)
Total long-term debt	24,152	23,320	24,152	23,320
Proprietary Capital				
Appropriation investment	588	608	4,887	4,800
Retained earnings reinvested in power program	3,387	3,420	3,387	3,420
Accumulated net expense of nonpower programs	—	—	(3,369)	(3,248)
Total proprietary capital	3,975	4,028	4,905	4,972
Total liabilities and proprietary capital	\$33,684	\$34,029	\$34,644	\$35,007

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF INCOME — POWER PROGRAM
For the Years Ended September 30, 1997, 1996 and 1995

	<u>1997</u>	<u>1996</u>	<u>1995</u>
	(in millions)		
Operating Revenues			
Sales of electricity			
Municipalities and cooperatives	\$4,811	\$4,980	\$4,654
Industries directly served	464	452	460
Federal agencies	179	172	179
Other	98	89	82
Total operating revenues	5,552	5,693	5,375
Operating Expenses			
Fuel and purchased power, net	1,211	1,278	1,443
Operating and maintenance	1,201	1,218	1,050
Depreciation and amortization	1,014	904	703
Tax-equivalents	272	256	252
Total operating expenses	3,698	3,656	3,448
Operating income	1,854	2,037	1,927
Other Income (Expense), Net	157	(10)	(91)
Income before interest expense	2,011	2,027	1,836
Interest Expense			
Interest on debt	1,993	1,965	1,908
Amortization of debt discount, issue, and reacquisition costs, net	91	118	116
Allowance for funds used during construction	(81)	(117)	(198)
Net interest expense	2,003	1,966	1,826
Net Income	\$ 8	\$ 61	\$ 10

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS
For the Years Ended September 30, 1997, 1996, and 1995

	Power program			All programs		
	1997	1996	1995	1997	1996	1995
	(in millions)					
Cash Flows From Operating Activities						
Net power income	\$ 8	\$ 61	\$ 10	\$ 8	\$ 61	\$ 10
Net expense of nonpower programs	—	—	—	(121)	(127)	(182)
Items not requiring (providing) cash						
Depreciation and amortization . .	1,066	924	715	1,080	938	728
Allowance for funds used during construction	(81)	(117)	(198)	(81)	(117)	(198)
Nuclear fuel amortization	196	156	112	196	156	112
Other, net	(151)	162	72	(151)	164	142
Changes in current assets and liabilities						
Accounts receivable	(24)	(1)	(5)	(21)	7	22
Inventories and other	(19)	(22)	(8)	(19)	(22)	(8)
Accounts payable and accrued liabilities	56	(246)	74	52	(250)	(36)
Accrued interest	1	43	31	1	43	31
Other	14	(50)	(1)	14	(50)	(2)
Net cash provided by operating activities	1,066	910	802	958	803	619
Cash Flows From Investing Activities						
Construction expenditures	(722)	(1,107)	(1,868)	(733)	(1,121)	(1,880)
Allowance for funds used during construction	81	117	198	81	117	198
Nuclear fuel	(159)	(76)	(77)	(159)	(76)	(77)
Proceeds from sale of investments	513	(162)	(100)	513	(162)	(100)
Purchases of investments	(483)	—	—	(483)	—	—
Proceeds from sale of loans receivable	211	—	—	211	—	—
Other, net	(21)	(26)	(24)	(13)	(13)	(39)
Net cash used in investing activities	(580)	(1,254)	(1,871)	(583)	(1,255)	(1,898)
Cash Flows From Financing Activities						
Long-term debt						
Issues	3,100	4,400	3,500	3,100	4,400	3,500
Redemptions	(3,829)	(2,706)	(2,503)	(3,829)	(2,706)	(2,503)
Short-term borrowings, net	377	(1,057)	222	377	(1,057)	222
Borrowing expenses, net	(12)	(44)	(38)	(12)	(44)	(38)
Congressional appropriations	—	—	—	106	109	139
Payments to U.S. Treasury	(61)	(63)	(62)	(61)	(63)	(62)
Net cash (used in) provided by financing activities	(425)	530	1,119	(319)	639	1,258
Net change in cash and cash equivalents	61	186	50	56	187	(21)
Cash at beginning of period	238	52	2	318	131	152
Cash at end of period	\$ 299	\$ 238	\$ 52	\$ 374	\$ 318	\$ 131

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

TENNESSEE VALLEY AUTHORITY

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL — POWER PROGRAM

	For the years ended September 30,		
	1997	1996	1995
	(in millions)		
Retained earnings reinvested at beginning of period	\$3,420	\$3,402	\$3,434
Net income	8	61	10
Return on appropriation investment	(41)	(43)	(42)
Retained earnings reinvested at end of period	3,387	3,420	3,402
Appropriation investment at beginning of period	608	628	648
Return of appropriation investment	(20)	(20)	(20)
Appropriation investment at end of period	588	608	628
Proprietary capital at end of period	<u>\$3,975</u>	<u>\$4,028</u>	<u>\$4,030</u>

STATEMENTS OF NET EXPENSE — NONPOWER PROGRAMS

	For the years ended September 30,		
	1997	1996	1995
	(in millions)		
Water and Land Stewardship	\$ 78	\$ 75	\$ 63
Land Between The Lakes	7	7	6
Economic Development	22	25	23
Environmental Research Center	14	20	21
Columbia Dam	—	—	69
Net expense	<u>\$121</u>	<u>\$127</u>	<u>\$182</u>

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL — NONPOWER PROGRAMS

	For the years ended September 30,		
	1997	1996	1995
	(in millions)		
Proprietary capital at beginning of period	\$944	\$ 964	\$1,007
Congressional appropriations	106	109	139
Net expense	(121)	(127)	(182)
Other, net	1	(2)	—
Proprietary capital at end of period	<u>\$930</u>	<u>\$ 944</u>	<u>\$ 964</u>

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

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

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

TVA's programs are divided into two types of activities — the power program and the non-power programs. Substantially all TVA revenues and assets are attributable to the power program. The power program is separate and distinct from the non-power programs and is required to be self-supporting from power revenues and funds borrowed from public markets. The power program receives no congressional appropriations and is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Most of the funding for TVA's non-power programs has been provided by congressional appropriations. Certain nonpower activities are also funded by various revenues and user fees. Financial accounts for the power and non-power programs are kept separately.

Power rates are established by the TVA Board of Directors as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance and administration of its power system; payments to states in lieu of taxes; and debt service on outstanding indebtedness.

Fiscal year

Unless otherwise indicated, years (1997, 1996, etc.) refer to TVA's fiscal years ended September 30.

Revenue recognition

Revenues from power sales are recorded as service is rendered to customers. TVA accrues estimated unbilled revenues for power sales provided to customers for the period of time from the end of the billing cycle to month-end.

Property, plant, and equipment, and depreciation

Additions to plant are recorded at cost, which includes direct and indirect costs such as general engineering, a portion of corporate overhead and an allowance for funds used during construction. The cost of current repairs and minor replacements is charged to operating expense. The TVA Act requires TVA's Board of Directors to allocate the cost of completed multi-purpose projects between the power and nonpower programs, subject to the approval of the President of the United States. The original cost of property retired, together with removal costs less salvage value, is charged to accumulated depreciation. Depreciation is generally computed on a straight-line basis over the estimated service lives of the various classes of assets. Depreciation expense expressed as a percentage of the average annual depreciable completed plant was 3.21 percent for 1997 and 1996 and 3.35 percent for 1995.

Decommissioning costs

During 1997 the excess of decommissioning investment earnings over the annual decommissioning provision was recorded as other income. Of the total investment earnings of \$151 million, \$13 million was recorded as an offset to the decommissioning provision, with the \$138 million excess recorded as other income. During 1996

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

the annual decommissioning provision of \$30 million exceeded the earnings from decommissioning fund investments of \$17 million and the \$13 million excess was charged to depreciation expense. During 1995, investment earnings approximated decommissioning expense and no decommissioning charges were made to depreciation expense.

Allowance for funds used during construction

The practice of capitalizing an allowance for funds used during construction is followed in the power program. The allowance is applicable to construction in progress excluding deferred nuclear generating units. In 1995, TVA changed its assumptions used in determining the interest rate used to calculate the allowance for funds used during construction. The change was made to more accurately reflect the nature of the indebtedness issued to fund construction. The effect of the change for 1995 was to increase the amount of interest capitalized by approximately \$56 million.

Loans and other long-term receivables

In June 1997, TVA entered into a five-year agreement with a bank pursuant to which TVA agreed to sell certain receivables relating to TVA's consumer energy-conservation programs. As of September 30, 1997, a \$211-million pool had been sold for proceeds equal to its carrying amount. In accordance with Statement of Financial Accounting Standards (SFAS) No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, the transaction has been reflected as a reduction of loans and other long-term receivables. Under the terms of the agreement, TVA has retained substantially the same risk of credit loss as if the receivables had not been sold and, accordingly, an appropriate liability account has been retained.

Other deferred charges

Deferred charges primarily include prepaid pension costs and regulatory assets capitalized under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. At September 30, 1997, other deferred charges included total unamortized regulatory assets of \$950 million — of which \$468 million represents a capitalized interest component of nuclear fuel; \$411 million represents a transition obligation related to the adoption of SFAS No. 112, *Employers Accounting for Postemployment Benefits*; and \$71 million represents TVA's portion of the costs for decommissioning the Department of Energy's nuclear waste disposal facility. At September 30, 1996, the unamortized balances of these three regulatory assets were \$595 million, \$446 million and \$81 million, respectively, for a total of \$1,122 million. These regulatory assets are being amortized over periods ranging from eight to 15 years, generally on a straight-line basis.

Investment funds

Investment funds consist primarily of a portfolio of investments in trusts designated for funding nuclear decommissioning requirements (see note 10). These funds, at September 30, 1997, were invested in portfolios generally designed to earn returns in line with overall equity market performance.

Debt issue and reacquisition costs

Issue and reacquisition expenses, call premiums and other related costs are deferred and amortized (accrued), respectively, on a straight-line basis over the term of the related outstanding securities.

TVA has also incurred premiums related to certain advanced refundings. In accordance with regulatory practices, TVA has deferred these premiums and is amortizing them to expense ratably through the maturity dates of the new debt issues. The unamortized balances of such regulatory assets at September 30, 1997 and 1996, were \$983 million and \$1,042 million, respectively.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Tax-equivalents

The TVA Act requires TVA to make payments to states and local governments in which the power operations of the corporation are conducted. The basic amount is 5 percent of gross revenues from the sale of power to other than federal agencies during the preceding year, with the provision for minimum payments under certain circumstances. Cash paid for tax-equivalents for 1997, 1996 and 1995 have been \$272 million, \$256 million and \$252 million, respectively.

Interest and capital costs

During 1997, 1996 and 1995, cash paid for interest on outstanding indebtedness (net of amount capitalized) was \$1,911 million, \$1,805 million and \$1,678 million, respectively. In addition to paying interest on outstanding indebtedness, the TVA Act requires TVA to make annual payments to the U.S. Treasury. The annual Treasury payments represent a repayment of the original appropriation investment, along with a return on the appropriation investment. TVA paid \$20 million each year for 1997, 1996 and 1995 as a repayment of the appropriation investment. TVA paid \$41 million to the U.S. Treasury in 1997 as a return on the appropriation investment, while paying \$43 million in 1996 and \$42 million in 1995.

Risk-management activities

TVA is exposed to market risk from changes in interest rates and currency exchange rates. To manage volatility relating to these exposures, TVA has entered into various derivative transactions, principally interest rate swap agreements and foreign currency swap contracts. TVA is exposed to credit losses in the event of nonperformance by counterparties on the risk-management instruments. TVA monitors such risk and does not believe that there is a significant risk of nonperformance by any of the parties of these instruments.

Statements of cash flows

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

Research and development costs

Expenditures related to research and development costs of new or existing products and processes are expensed as incurred. The amounts charged against income were \$44 million in 1997, \$45 million in 1996 and \$43 million in 1995.

Insurance

TVA is primarily self-insured for property loss, workers' compensation, general liability and automotive liability. TVA is also self-insured for health care claims for eligible active and retired employees. Consulting actuaries assist TVA in determining its liability for self-insured claims. TVA maintains nuclear liability insurance with an outside party (see note 10).

Management estimates

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

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

2. NUCLEAR POWER PROGRAM

The nuclear power program at September 30, 1997, consisted of nine units — five operating, three deferred, and one inoperative — at four locations, with investments in property, plant and equipment as follows and in the status indicated:

	<u>Operating units</u>	<u>Installed capacity (megawatts)</u>	<u>Completed plant, net</u> (in millions)	<u>Construction in progress</u>	<u>Deferred</u>	<u>Fuel investment</u>
Browns Ferry	2	2,304	\$ 3,508	\$ 44	\$ —	\$289
Sequoyah	2	2,442	2,055	77	—	146
Watts Bar	1	1,270	6,674	34	1,716	108
Bellefonte	—	—	—	—	4,587	—
Raw materials	—	—	—	—	—	297
Total	<u>5</u>	<u>6,016</u>	<u>\$12,237</u>	<u>\$155</u>	<u>\$6,303</u>	<u>\$840</u>

Browns Ferry 3, taken off-line in March 1985 for plant modifications and regulatory improvements, was returned to service in 1996. Browns Ferry 1, also taken off-line in 1985 for modifications and improvements, will continue to remain in an inoperative status until its ultimate disposition is determined. For financial reporting purposes, the undepreciated cost of Browns Ferry 1 of \$80 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period.

Watts Bar 1 began operating commercially during 1996. In 1988, TVA suspended construction activities on Watts Bar 2 and the unit is currently in lay-up. Bellefonte 1 and 2 were deferred in 1988 and 1985, respectively. Estimated 1998 expenditures for the three deferred units total \$9 million and are limited to lay-up, maintenance and ensuring that options remain viable.

In 1993, TVA began an integrated resource planning process to determine TVA's strategy for meeting future customer energy demands. As part of this long-term energy strategy, TVA re-evaluated the need for finishing Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. In December 1994, TVA determined it will not, by itself, complete Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. In the Integrated Resource Plan (IRP), TVA determined that it would study the potential for converting the Bellefonte Nuclear Plant to a combined cycle plant utilizing natural gas or gasified coal as the primary fuel and/or joint venturing with a partner for completion. The feasibility of converting Bellefonte to such an alternative fuel will require in-depth engineering and financial analyses; and accordingly, TVA is utilizing a team of technical and financial experts. The IRP also concluded that Watts Bar 2 should remain in deferred status until completion of the Bellefonte study. The impact on TVA's financial position of completing, converting or joint venturing these units will be determined upon completion of the Bellefonte study. The future decisions on these units will ultimately impact the method of cost recovery, and the TVA Board has determined that it will, at that time, establish rate adjustments and operating policies to ensure full recovery of the cost of these units and compliance with the requirements of the TVA Act. For financial reporting purposes, the cost of the three units is presented as deferred nuclear generating units.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

3. COMPLETED PLANT

Completed plant consists of the following at September 30:

<u>Power program</u>	<u>1997</u>			<u>1996</u>		
	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Net</u>	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Net</u>
	(in millions)					
Fossil plants	\$ 7,427	\$2,954	\$ 4,473	\$ 7,320	\$2,790	\$ 4,530
Nuclear plants	14,514	2,277	12,237	14,370	1,835	12,535
Transmission	3,144	982	2,162	2,911	943	1,968
Hydro plants	1,382	471	911	1,273	454	819
Other	2,061	494	1,567	2,081	531	1,550
Total power	<u>\$28,528</u>	<u>\$7,178</u>	<u>\$21,350</u>	<u>\$27,955</u>	<u>\$6,553</u>	<u>\$21,402</u>

4. LEASES

Certain property, plant and equipment are leased under agreements with terms ranging from one to 30 years. Most of the agreements include purchase options or renewal options that cover substantially all the economic lives of the properties. Obligations under capital lease agreements in effect as September 30 were:

<u>Fiscal year</u>	<u>General plant capital leases</u> (in millions)
1998	\$ 36
1999	36
2000	36
2001	36
2002	36
Thereafter	<u>301</u>
Total future minimum lease payments	481
Less interest element	<u>(280)</u>
Present value of future minimum lease payments	<u>\$ 201</u>

5. APPROPRIATION INVESTMENT — POWER PROGRAM

The TVA Act requires TVA to make annual payments to the U.S. Treasury from net power proceeds. The payments required by the TVA Act may be deferred under certain circumstance for not more than two years. The return is based on the appropriation investment as of the beginning of the year and the computed average interest rate payable by the U.S. Treasury on its total marketable public obligations as of the same date (6.71 percent at September 30, 1997).

6. DEBT

Borrowing authority

The TVA Act authorizes TVA to issue bonds, notes and other evidences of indebtedness up to a total of \$30 billion outstanding at any one time. TVA must meet certain cash flow and earnings tests that are contained in the TVA Act and the Basic TVA Power Bond Resolution. Debt service on these obligations, which is payable solely from TVA's net power proceeds, has precedence over the payment to the U.S. Treasury described in note 5.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Debt outstanding

Debt outstanding at September 30, 1997 and 1996 (excluding defeased debt of \$950 million at September 30, 1996, which is not considered by TVA to be debt that is subject to the \$30 billion bond limit), consisted of the following:

	1997	1996
	(in millions)	
Short-term debt		
Held by the public		
Discount notes (net of discount)	\$ 2,151	\$ 1,774
Current maturities of long-term debt — 5.07% to 5.98%	574	2,250
Total short-term debt	2,725	4,024
 Long-term debt		
Held by the public — senior		
Maturing in 1998	—	1,453
Maturing in 1999 — 5.88% to 6.58%	2,450	750
Maturing in 2000 — 8.375%	1,000	1,000
Maturing in 2001 — 6.00% to 6.50%	1,800	1,250
Maturing in years 2002 through 2045 — 6.125% to 8.625%	15,104	14,950
Held by Federal Financing Bank — senior		
Maturing in 2003 through 2016 — 8.535% to 11.695%	3,200	3,200
Held by the public — subordinated		
Maturing in 2045 through 2046 — 7.50% to 8.00%	1,100	1,100
Total long-term debt	24,654	23,703
Unamortized discount and other adjustments	(502)	(383)
Net long-term debt	24,152	23,320
Total debt	\$26,877	\$27,344

Short-term debt

The weighted average rates applicable to short-term debt outstanding in the public market as of September 30, 1997 and 1996, were 5.56 percent and 5.38 percent, respectively. During 1997, 1996 and 1995, the maximum outstanding balance of short-term borrowings held by the public was (in millions) \$3,962, \$3,537 and \$3,503 respectively, and the average amounts (and weighted average interest rates) of such borrowings were approximately (in millions), \$2,743 (5.47 percent), \$2,692 (5.50 percent) and \$2,743 (5.83 percent), respectively.

Put and call options

Bond issues of \$12.8 billion held by the public are redeemable in whole or in part, at TVA's option, on call dates ranging from the present to April 2012 at call prices ranging from 100 percent to 106.7 percent of the principal amount. Additionally, TVA has bond issues of \$2.1 billion held by the public that are redeemable in whole or in part at the option of the respective bondholders. One bond issue totaling \$500 million, which matures in July 2045, is redeemable in 2001 by the bondholders. A second issue totaling \$121.3 million, which matures in April 2036, is redeemable in 1998 or 2006 at the option of the bondholders and a third issue totaling \$1.5 billion, which matures in April 2036, is redeemable in 1999 or 2006 at the option of the bondholders. All of these issues are reported in the debt schedule with maturity dates corresponding to the earliest redeemable dates.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Subsequent to September 30, 1997, TVA monetized the call provisions on approximately \$1 billion of public bond issues. The premium received by TVA has been deferred and is being amortized over the term of the agreements.

Bond discount and premium

Discounts and premiums on power borrowings are deferred and amortized (accrued), respectively, as components of interest expense on a straight-line basis over the term of the related outstanding securities.

Foreign currency transaction and interest rate swap

During 1996, TVA entered into a currency swap contract as a hedge for a foreign currency denominated debt transaction where TVA issued 1.5 billion Deutschemark bonds, the cash flows of which were swapped for those of a U.S. dollar obligation of \$1 billion. Any gain (loss) on the debt instrument due to the foreign currency transaction is offset by a loss (gain) on the swap contract. At September 30, 1997 and 1996 the currency transaction resulted in gains of \$131 million and \$16 million, respectively, which are included in the account "unamortized discount and other adjustments." The offsetting loss on the swap contract is recorded as a deferred liability. If any loss/gain were to be incurred as a result of the early termination of the swap contract, any resulting charge (income) would be amortized over the remaining life of the bond as a component of interest expense.

Additionally, TVA entered into a 10-year fixed rate interest swap agreement with a notional amount of \$300 million. Such agreement was entered into to hedge TVA's inflation exposure related to its inflation-indexed accreting principal bonds.

7. FAIR VALUE OF FINANCIAL INSTRUMENTS

TVA uses the methods and assumptions described below to estimate the fair values of each significant class of financial instrument.

Cash and cash equivalents, and short-term debt

The carrying amount approximates fair value because of the short-term maturity of these instruments.

Investment funds

At September 30, 1997, these investments were classified as trading securities and carried at their fair value.

Loans and other long-term receivables

Fair values for these homogenous categories of loans and receivables are estimated by determining the present value of future cash flows using the current rates at which similar loans are presently made to borrowers with similar credit ratings and for the same remaining maturities.

Bonds

Fair value of long-term debt traded in the public market is determined by multiplying the par value of the bonds by the quoted market price (asked price) nearest the balance sheet date. The fair value of other long-term debt and long-term debt held by the Federal Financing Bank is estimated by determining the present value of future cash flows using rates of financial instruments with quoted market prices of similar characteristics and the same remaining maturities.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

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

	1997		1996	
	Carrying amount	Fair amount	Carrying amount	Fair amount
	(in millions)			
Cash and cash equivalents	\$ 374	\$ 374	\$ 318	\$ 318
Investment funds	561	561	440	440
Loans and other long-term receivables	170	160	375	365
Short-term debt	2,151	2,151	1,774	1,774
Long-term debt, including current maturities	25,228	26,127	25,953	26,562

The fair market value of the financial instruments held at September 30, 1997 may not be representative of the actual gains or losses that will be recorded when these instruments mature or if they are called or presented for early redemption.

8. BENEFIT PLANS

Pension plan

TVA has a defined benefit plan for most full-time employees that provides two benefit structures, the Original Benefit Structure and the Cash Balance Benefit Structure. The plan assets are primarily stocks and bonds. TVA contributes to the plan such amounts as are agreed upon between TVA and the TVA Retirement System board of directors, which in no event would be less than the amount necessary on an actuarial basis to provide assets sufficient to meet obligations for benefits. The pension benefit for participants in the Original Benefit Structure is based on the member's years of creditable service, average base pay for the highest three consecutive years and the pension rate for the member's age and years of service, less a Social Security offset.

The Cash Balance Benefit Structure was implemented January 1, 1996. The pension benefit for participants in the Cash Balance Benefit Structure is based on credits accumulated in the member's account and member's age. A member's account receives credits each pay period equal to 6 percent of his or her straight-time earnings. The account also increases at an interest rate equal to the change in the Consumer Price Index plus 3

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

percent, which amounted to 5.82 percent for both 1997 and 1996. The components of pension expense for the years ended September 30 were:

	1997	1996	1995
	(in millions)		
Pension expense:			
Service cost	\$ 70	\$ 72	\$ 62
Interest cost on projected benefit obligation	308	309	304
Actual return on assets	(1,334)	(616)	(816)
Net amortization and deferral	899	217	450
Net pension (income) expense	\$ (57)	\$ (18)	\$ —
Funded status:			
Actuarial present value of benefit obligations:			
Vested benefit obligation	\$(3,770)	\$(3,506)	\$(3,256)
Nonvested benefits	(48)	(50)	(113)
Accumulated benefit obligation	(3,818)	(3,556)	(3,369)
Effects of projected future compensation	(391)	(401)	(323)
Projected benefit obligation	(4,209)	(3,957)	(3,692)
Plan assets at fair value	5,962	4,851	4,375
Excess of plan assets over projected benefit obligation	1,753	894	683
Unrecognized net gain	(1,536)	(770)	(627)
Unrecognized net obligation being amortized over 15 years beginning October 1, 1987	—	2	2
Prepaid pension cost	\$ 217	\$ 126	\$ 58

The discount rate used to determine the actuarial present value of the projected benefit obligation was 8.0 percent in 1997 and 1996 and 7.5 percent in 1995. The assumed annual rates of increase in future compensation levels for 1997, 1996, and 1995 ranged from 3.3 to 8.3 percent. The expected long-term rate of return on plan assets was 11 percent for 1997, 1996 and 1995.

Other postretirement benefits

TVA sponsors an unfunded defined benefit postretirement plan that provides for contributions toward the cost of retirees' medical coverage. The plan covers employees who, at retirement, are age 60 and older (or who are age 50 and have at least five years of service). TVA's contributions are a flat dollar amount based upon the participants' age and years of service and certain payments toward the plan costs.

The annual assumed cost trend for covered benefits is 10.5 percent in 1997, decreasing by one-half percent per year reaching 5.0 percent in 2008 and thereafter. For 1996 and 1995, an annual trend rate of 11.0 percent and 11.5 percent, respectively, was assumed. The effect of the change in assumptions on a cost basis was not significant. Increasing the assumed health-care cost trend rates by 1 percent would increase the accumulated postretirement benefit obligation (APBO) as of September 30, 1997, by \$15 million and the aggregated service and interest cost components of net periodic postretirement benefit cost for 1997 by \$3 million.

The weighted average discount rate used in determining the APBO was 8.0 percent for 1997 and 1996, and 7.5 percent for 1995. Any net unrecognized gain or loss resulting from experience different from that assumed or

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

from changes in assumptions, in excess of 10 percent of the APBO, is amortized over the average remaining service period of active plan participants. The following sets forth the plan's funded status at September 30:

	<u>1997</u>	<u>1996</u>	<u>1995</u>
	(in millions)		
Accumulated postretirement benefit obligation (APBO)			
Retirees	\$220	\$230	\$214
Fully eligible active plan participants	2	4	1
Other active plan participants	126	187	116
APBO	348	421	331
Unrecognized net (loss) gain	—	(95)	(15)
Accrued postretirement benefit cost	<u>\$348</u>	<u>\$326</u>	<u>\$316</u>
Net periodic postretirement benefit cost			
Service cost	\$ 13	\$ 8	\$ 7
Interest cost	32	24	26
Amortization of loss	4	—	—
Net periodic postretirement benefit cost	<u>\$ 49</u>	<u>\$ 32</u>	<u>\$ 33</u>

Other postemployment benefits

Statement of Financial Accounting Standards No. 112, *Employers Accounting for Postemployment Benefits* (SFAS No. 112), applies to postemployment benefits, including workers' compensation provided to former or inactive employees, their beneficiaries and covered dependents after employment but before retirement. Adoption of SFAS No. 112 in 1995 changed TVA's method of accounting from recognizing costs as benefits are paid to accruing the expected costs of providing these benefits. This resulted in recognition of an original transition obligation of approximately \$280 million. During 1996, TVA made adjustments to certain assumptions utilized in the determination of the obligation at September 30, 1996, which resulted in an increase in the original transition obligation of approximately \$194 million. In connection with the adoption of SFAS No. 112, and related approval by its Board of Directors, TVA recorded the transition obligation as a regulatory asset. The regulatory asset is being amortized over approximately 15 years, whereby the annual expense will approximate the expense that would be recorded on an as-paid basis.

Early-out and accelerated severance packages

In 1997, 1996 and 1995 TVA provided both voluntary and involuntary severance packages, which affected an aggregate of approximately 4,900 employees. During this period, severance costs totaled approximately \$196 million and consisted primarily of severance pay (\$150 million) and other retirement and postretirement benefits (\$46 million). Also during 1997 TVA recognized a related pension curtailment gain of \$27 million. The aggregate costs of the severance packages have been charged to the power program primarily as other expense during 1997, 1996 and 1995 in the amounts of \$11 million, \$35 million and \$136 million, respectively, and the non-power program as non-power expense during 1997 and 1996 in the amounts of \$8 million and \$6 million, respectively.

9. MAJOR CUSTOMERS

One municipal customer accounts for approximately 9 percent of total power sales and four other municipal customers account for an additional aggregate 19 percent of total power sales. These five municipal customers purchase power from TVA under long-term contracts for terms of 20 years, which require 10-years notice to terminate.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

10. CONSTRUCTION EXPENDITURES AND COMMITMENTS AND CONTINGENCIES

Construction expenditures

Construction expenditures, including capitalized interest, are estimated to be approximately \$732 million for 1998 and \$659 million for 1999. These estimates are revised periodically to reflect changes in economic conditions and other factors considered in their determination.

Purchase commitments

TVA has entered into approximately \$2.3 billion in long-term commitments ranging in terms of up to eight years for the purchase of coal.

Contingencies

Nuclear insurance. The Price-Anderson Act sets forth an indemnification and limitation of liability plan for the U.S. nuclear industry. All Nuclear Regulatory Commission (NRC) licensees, including TVA, maintain nuclear liability insurance in the amount of \$200 million for each plant with an operating license. The second level of financial protection required is the industry's retrospective assessment plan, using deferred premium charges. The maximum amount of the deferred premium for each nuclear incident is approximately \$79 million per reactor, but not more than \$10 million per reactor may be charged in any one year for each incident. TVA could be required to pay a maximum of \$474 million per nuclear incident on the basis of its six licensed units, but it would have to pay no more than \$60 million per incident in any one year.

In accordance with NRC regulations, TVA carries property and decontamination insurance of \$1.06 billion at each licensed nuclear plant for the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums of up to a maximum of approximately \$34 million.

Clean Air legislation. The Clean Air Act Amendments of 1990 require fossil-fuel fired generation units to reduce their sulfur dioxide and nitrogen oxide emissions in two phases in order to control acid rain. The Phase I compliance period commenced on January 1, 1995, for sulfur dioxide and January 1, 1996, for nitrogen oxide, while the Phase II compliance period commences on January 1, 2000. Based on the level of emissions, 26 of TVA's 59 operating coal-fired units are classified as Phase I units, with the remaining units being Phase II units. Compliance with these requirements has resulted in substantial expenditures for the reduction of emissions at TVA's coal-fired generating plants.

TVA's compliance strategy to reduce sulfur dioxide emissions includes the use of scrubbers at six fossil units and the use of lower-sulfur coal at the remaining 53 fossil units. TVA has completed all planned scrubbers and is on schedule to complete the change-over to lower-sulfur coal.

Nitrogen oxide reductions are required for 19 of TVA's Phase I units. These reductions were achieved through the installation of low-nitrogen-oxide burners at 13 units. TVA is in compliance with all Phase I requirements and is currently installing nitrogen oxide reduction equipment to bring TVA's remaining units in compliance with Phase II nitrogen oxide emission requirements.

Expenditures related to the Clean Air projects during 1997 and 1996 were approximately \$40 million and \$80 million, respectively. TVA has already completed the actions necessary to achieve Phase I compliance for both sulfur dioxide and nitrogen oxide emissions, and TVA is proceeding to take actions to comply with Phase II requirements that become effective in the year 2000 or after. The total cost of compliance cannot reasonably be determined at this time because of the uncertainties surrounding final Environmental Protection Agency regulations, resultant compliance strategy, potential for development of new emission control technologies and future amendments to the legislation.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Hazardous substances. The release and cleanup of hazardous substances are regulated under the Comprehensive Environmental Response, Compensation, and Liability Act. In a manner similar to other industries and power systems, TVA has generated or used hazardous substances over the years. TVA has been identified as a potentially responsible party with respect to three off-site disposal areas. TVA's liability at these sites has not yet been determined. In addition, TVA is currently investigating two other sites that TVA either owns or partially owns. TVA may have cleanup responsibilities at those sites by virtue of its control of the property. TVA's potential liabilities for its share of cleanup costs at these sites are uncertain but are not expected to be substantial.

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

Decommissioning costs. Provision for decommissioning costs of nuclear generating units is based on the estimated cost to dismantle and decontaminate the facilities to meet NRC criteria for license termination. At September 30, 1997, the present value of the estimated future decommissioning cost of \$318 million was included in other liabilities. The decommissioning cost estimates from a 1995 study are based on prompt dismantlement and removal of the plant from service. The actual decommissioning costs may vary from the estimates because of changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology and changes in costs of labor, materials and equipment.

TVA maintains an investment trust fund to provide funding for the decommissioning of nuclear power plants. In September 1993, TVA sold the investment portfolio and realized a gain of \$163 million. TVA sold the investment portfolio and realized a gain of \$163 million. TVA recognized \$82 million of this gain in 1994 and \$81 million in 1995. During 1996, TVA took a number of related actions to establish a decommissioning fund that could reasonably be expected to provide substantially all of the funding required for decommissioning. TVA contributed an additional \$123 million, and separate decommissioning trusts were established for each of TVA's nuclear plants. As of September 30, 1996, the entire fund was invested in equity market index funds.

In May 1997, TVA sold the entire \$402 million equity index fund portfolio and transferred the proceeds to trust portfolios managed by independent money managers. During 1997, TVA recognized \$151 million of income related to the fund, which included an \$81 million gain on the sale of fund investments and \$70 million in net appreciation and interest income. As of September 30, 1997, the decommissioning trust fund investments totaled \$553 million and were invested in securities designed to achieve a return in line with overall equity market performance.

Cost-based regulation. As a regulated entity, TVA is subject to the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. Accordingly, TVA records certain assets and liabilities that result from the effects of the ratemaking process that would not be recorded under generally accepted accounting principles for non-regulated entities. Currently, the electric utility industry is predominantly regulated on a basis designed to recover the cost of providing electric power to its customers. If cost-based regulation were to be discontinued in the industry for any reason, profits could be reduced and utilities might be required to reduce their asset balances to reflect a market basis less than cost. Discontinuance of cost-based regulation would also require affected utilities to write off their associated regulatory assets. Such regulatory assets for TVA total approximately \$1.9 billion at September 30, 1997, along with approximately \$6.3 billion of deferred nuclear plants. Management cannot predict the potential impact, if any, of these competitive forces on TVA's future financial position and results of operations. However, TVA continues to position itself to effectively meet these challenges by maintaining prices that are locally, regionally and nationally competitive.

TENNESSEE VALLEY AUTHORITY
NOTES TO FINANCIAL STATEMENTS — (Continued)

11. NON-POWER PROGRAMS

TVA's non-power programs provide various public services, including managing navigable river channels, providing flood control and overseeing certain recreation facilities. The non-power programs encompass general stewardship of land, water and wildlife resources. TVA's non-power programs also conduct certain research and development activities in pollution prevention and remediation.

Funding for the non-power programs is primarily provided through federal appropriations. During 1997 and 1996, the non-power programs received appropriations of \$106 million and \$109 million, respectively. The 1998 appropriations bill approved \$70 million for non-power programs in 1998 and anticipates no further appropriation to TVA thereafter. Certain non-power program activities are also funded by user fees and outside services revenues. Notwithstanding the historical separation of the power and non-power programs and provisions of the TVA Act and bond covenants to the contrary, public law authorizes TVA to use power revenues to pay for non-power activities beginning in 1999.

During 1995, the non-power programs had a net expense of \$182 million, which included a \$69 million charge for the write-off of the Columbia Dam and Reservoir project. The Columbia Dam and Reservoir, a multi-purpose project financed by congressional appropriations, was suspended in prior years due to budget restrictions and environmental concerns. During 1995, TVA determined that the Columbia Dam would not be completed, and accordingly, the project cost was expensed.

The completed plant of the non-power programs consists of multipurpose dams and other plant. At September 30, 1997, the net completed plant balances for multipurpose dams and other plant were \$700 million and \$113 million, respectively. At September 30, 1996, the net completed plant balances for multipurpose dams and other plant were \$705 million and \$108 million, respectively.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors of the Tennessee Valley Authority

We have audited the accompanying balance sheets (power program and all programs) of the Tennessee Valley Authority as of September 30, 1997 and 1996, and the related statements of income (power program), changes in proprietary capital (power program and non-power programs), net expense (non-power programs) and cash flows (power program and all programs) for each of the three years in the period ended September 30, 1997. These financial statements are the responsibility of the Tennessee Valley Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the power program and all programs of the Tennessee Valley Authority as of September 30, 1997 and 1996, the results of operations of the power program and nonpower programs and cash flows of the power program and all programs for each of the three years in the period ended September 30, 1997, in conformity with generally accepted accounting principles.

As discussed in note 8 to the financial statements, in 1995 the Tennessee Valley Authority adopted Statement of Financial Accounting Standard No. 112, *Employers Accounting for Postemployment Benefits*.

In accordance with Government Auditing Standards, we have also issued a report, dated October 23, 1997, on our consideration of the Tennessee Valley Authority's internal controls over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants.

Coopers & Lybrand L.L.P.
Knoxville, Tennessee
October 23, 1997

REPORT OF MANAGEMENT

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

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

Coopers & Lybrand L.L.P. was engaged to audit the financial statements of the Tennessee Valley Authority and issue reports thereon. Its audits were conducted in accordance with generally accepted auditing standards. Such standards require a review of internal controls and an examination of selected transactions and other procedures sufficient to provide reasonable assurance that the financial statements neither are misleading nor contain material errors. The Report of Independent Accountants does not limit the responsibility of management for information contained in the financial statements and elsewhere in the annual report.

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



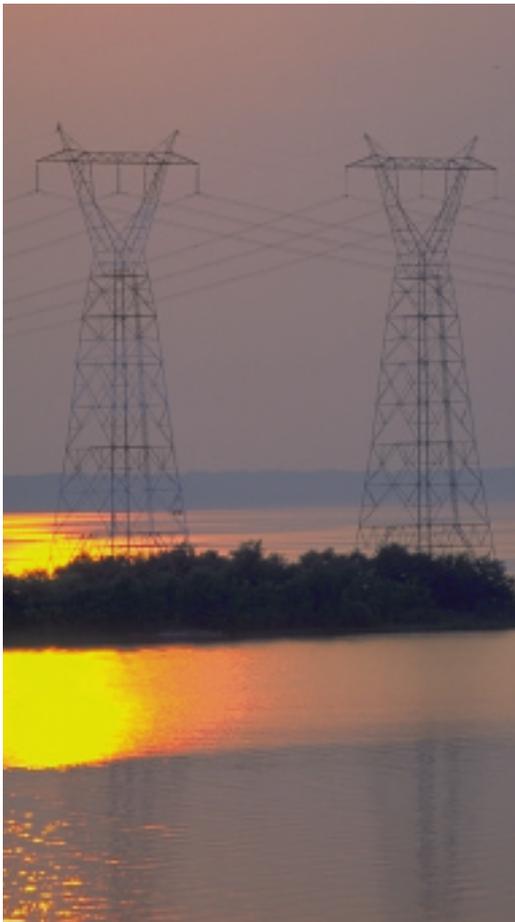
To be the recognized world leader in providing energy and related services, independently and in alliances with others, for society's global needs.



▲ *TVA is one of the largest power producers in the United States.*



▲ *TVA's electric generation facilities include state of the art computer controlled production.*



▲ *TVA's 16,600-mile system of transmission lines through seven states serves as a vital part of the United States energy infrastructure.*



▲ *TVA is environmentally sensitive in managing the thousands of acres along the Tennessee River system.*



▲ *The energy right program was developed jointly by TVA and its customers to promote energy conservation through more efficient power use.*



▲ *TVA manages the nation's fifth largest river system for flood control, navigation, power production and recreation.*

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