Tennessee Valley Authority

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

Quarterly Report

For the quarterly period ended March 31, 2006

Tennessee Valley Authority

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For the quarterly period ended March 31, 2006

This document contains the unaudited Quarterly Report of the Tennessee Valley Authority ("TVA") for the quarterly period ended March 31, 2006 (this "Quarterly Report"). TVA is not required to register securities under the Securities Act of 1933, as amended, and is currently not required to make periodic reports to the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934, as amended. Accordingly, TVA does not intend to file this report with the SEC. Due to legislation enacted in December 2004, beginning with its 2006 annual report, TVA will be required to file annual reports, quarterly reports, and current reports with the SEC under the Securities Exchange Act of 1934. Several portions of this Quarterly Report contain forward-looking statements, and reference is made to page 1 regarding such statements. This Quarterly Report should be read in conjunction with the 2005 Information Statement dated November 18, 2005 (as may be amended from time to time, the "2005 Information Statement").

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FORWARD-LOOKING STATEMENTS

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain asset retirement obligations; expectations about the adequacy of TVA’s nuclear decommissioning fund; estimates regarding the reduction of total financing obligations; the impact of new accounting pronouncements and interpretations, including Financial Accounting Standards Board (“FASB”) Interpretation No. 47, *“Accounting for Conditional Asset Retirement Obligations — an interpretation of FASB Statement No. 143;”* TVA’s plans to continue using short-term debt to meet current obligations; and the anticipated cost and timetable for returning Browns Ferry Unit 1 to service.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations, and administrative orders, especially those related to the restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; changes to the Anti-Cherrypicking Provision of the Federal Power Act (see *“Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “Risk Factors and Forward-Looking Statements” — “Risk of Loss of Customers”* in this Quarterly Report); legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA’s generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; damage to power production or transmission facilities or systems due to accidental events or terrorist activity; changes in accounting standards; and unforeseeable events. Additionally, other risks that may cause actual results to differ from the predicted results are set forth in *“Management's Discussion and Analysis of Financial Condition and Results of Operations” — “Risk Factors and Forward-Looking Statements”* in this Quarterly Report. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA’s business or cause results to differ materially from those contained in any forward-looking statement.

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

FINANCIAL INFORMATION

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

	Three months ended March 31		Six months ended March 31	
Operating revenues	2006	2005	2006	2005
Sales of electricity				
Municipalities and cooperatives	$ 1,750	$ 1,561	$ 3,519	$ 3,086
Industries directly served	246	236	476	451
Federal agencies and other	32	32	58	105
Other revenue	20	10	47	31
Total operating revenues	2,048	1,839	4,100	3,673
Operating expenses				
Fuel and purchased power	717	598	1,462	1,075
Operating and maintenance	567	584	1,167	1,166
Depreciation, amortization, and accretion	389	290	777	575
Tax-equivalents	93	90	187	181
Total operating expenses	1,766	1,562	3,593	2,997
Operating income	282	277	507	676
Other income	10	6	17	13
Other expense	–	–	–	(2)
Unrealized gain on derivative contracts, net	21	8	35	12
Interest expense				
Interest on debt	333	338	663	677
Amortization of debt discount, issue, and reacquisition costs, net	5	5	10	10
Allowance for funds used during construction and nuclear fuel expenditures	(39)	(28)	(75)	(54)
Net interest expense	299	315	598	633
Net income (loss)	$ 14	$ (24)	$ (39)	$ 66

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

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

ASSETS	March 31 2006	September 30 2005
Current assets		
Cash and cash equivalents	$ 501	$ 538
Restricted cash and investments (note 1)	138	107
Accounts receivable, net	1,000	1,145
Inventories and other	638	479
Total current assets	2,277	2,269
Property, plant, and equipment		
Completed plant	35,285	35,215
Less accumulated depreciation	(14,925)	(14,407)
Net completed plant	20,360	20,808
Construction in progress	3,116	2,643
Nuclear fuel and capital leases	510	437
Total property, plant, and equipment	23,986	23,888
Investment funds	937	858
Regulatory and other long-term assets (note 1)		
Deferred nuclear generating units	3,716	3,912
Other regulatory assets	2,238	2,367
Subtotal	5,954	6,279
Other long-term assets	1,436	1,272
Total regulatory and other long-term assets	7,390	7,551
Total assets	$ 34,590	$ 34,566
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	$ 848	$ 860
Accrued liabilities	260	274
Accrued interest	395	380
Current portion of lease/leaseback obligations	37	35
Current portion of energy prepayment obligations	106	106
Short-term debt	2,566	2,469
Current maturities of long-term debt, net (note 3)	1,905	2,693
Total current liabilities	6,117	6,817
Other liabilities		
Deferred liabilities	2,458	2,500
Regulatory liabilities (note 1)	987	897
Asset retirement obligations	1,821	1,857
Lease/leaseback obligations	1,083	1,108
Energy prepayment obligations	1,191	1,244
Total other liabilities	7,540	7,606
Long-term debt, net (note 3)	18,509	17,751
Total liabilities	32,166	32,174
Commitments and contingencies (note 6)		
Proprietary capital		
Appropriation investment	4,773	4,783
Retained earnings	1,202	1,244
Accumulated other comprehensive income	116	27
Accumulated net expense of nonpower programs	(3,667)	(3,662)
Total proprietary capital	2,424	2,392
Total liabilities and proprietary capital	$ 34,590	$ 34,566

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS (unaudited)

For the six months ended March 31
(in millions)

	2006	2005
Cash flows from operating activities		
Net (loss) income	$ (39)	$ 66
Items not requiring (providing) cash		
Depreciation, amortization, and accretion	833	639
Allowance for funds used during construction and nuclear fuel expenditures	(75)	(54)
Nuclear fuel amortization	67	65
Other, net	77	99
Changes in current assets and liabilities		
Accounts receivable, net	145	102
Inventories and other	(163)	(31)
Accounts payable and accrued liabilities	(58)	(41)
Accrued interest	15	14
Refueling outage costs	(34)	(71)
Other	(50)	(33)
Net cash provided by operating activities	718	755
Cash flows from investing activities		
Construction expenditures	(627)	(622)
Nuclear fuel expenditures	(147)	(118)
Allowance for funds used during construction and nuclear fuel expenditures	75	54
Investments		
Short-term investments, net	–	221
Change in restricted cash and investments	(31)	(124)
(Purchases) proceeds	(4)	1
Loans and other receivables		
Advances	(2)	(6)
Repayments	6	7
Proceeds from sale of receivable/loans	8	55
Net cash used in investing activities	(722)	(532)
Cash flows from financing activities		
Long-term debt		
Issues	68	24
Redemptions and repurchases	(155)	(177)
Short-term issues, net	97	104
Payments on combustion turbine financing	(17)	(17)
Payments on equipment financing	(6)	(6)
Proceeds from other financing activities	–	1
Financing costs, net	(2)	(1)
Payments to U.S. Treasury	(18)	(18)
Net cash used in financing activities	(33)	(90)
Net change in cash and cash equivalents	(37)	133
Cash and cash equivalents at beginning of period	538	519
Cash and cash equivalents at end of period	$ 501	$ 652

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

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

For the three months ended March 31, 2006 and 2005

	Appropriation Investment	Retained Earnings - Power Program	Accumulated Net Expense of Nonpower Programs	Accumulated Other Comprehensive Income	Total	Comprehensive Income (Loss)
Balance at December 31, 2004	$ 4,798	$ 1,251	$ (3,652)	$ 14	$ 2,411	
Net (loss)	–	(21)	(3)	–	(24)	$ (24)
Return on appropriation investment	–	(4)	–	–	(4)	–
Other comprehensive income (note 2)	–	–	–	30	30	30
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at March 31, 2005	$ 4,793	$ 1,226	$ (3,655)	$ 44	$ 2,408	$ 6
Balance at December 31, 2005	$ 4,778	$ 1,190	$ (3,665)	$ 44	$ 2,347	
Net income (loss)	–	16	(2)	–	14	$ 14
Return on appropriation investment	–	(4)	–	–	(4)	
Other comprehensive income (note 2)	–	–	–	72	72	72
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at March 31, 2006	$ 4,773	$ 1,202	$ (3,667)	$ 116	$ 2,424	$ 86

For the six months ended March 31, 2006 and 2005

	Appropriation Investment	Retained Earnings - Power Program	Accumulated Net Expense of Nonpower Programs	Accumulated Other Comprehensive Income (Loss)	Total	Comprehensive Income (Loss)
Balance at September 30, 2004	$ 4,803	$ 1,162	$ (3,649)	$ (52)	$ 2,264	
Net income (loss)	–	72	(6)	–	66	$ 66
Return on appropriation investment	–	(8)	–	–	(8)	–
Other comprehensive income (note 2)	–	–	–	96	96	96
Return of appropriation investment	(10)	–	–	–	(10)	–
Balance at March 31, 2005	$ 4,793	$ 1,226	$ (3,655)	$ 44	$ 2,408	$ 162
Balance at September 30, 2005	$ 4,783	$ 1,244	$ (3,662)	$ 27	$ 2,392	
Net (loss)	–	(34)	(5)	–	(39)	$ (39)
Return on appropriation investment	–	(8)	–	–	(8)	–
Other comprehensive income (note 2)	–	–	–	89	89	89
Return of appropriation investment	(10)	–	–	–	(10)	–
Balance at March 31, 2006	$ 4,773	$ 1,202	$ (3,667)	$ 116	$ 2,424	$ 50

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

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

1. Summary of Significant Accounting Policies

Organization
TVA is a wholly owned corporate agency and instrumentality of the United States and was established by Congress through the TVA Act of 1933, as amended, 16 U.S.C. §§ 831-831ee (2000 and Supp. III 2003) amended by the Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, div. C, tit. VI, 118 Stat. 2809, 2963 (the "TVA Act"). TVA is charged with providing navigable channels on the Tennessee River system, flood damage reduction, agricultural and industrial development, and electric power to the Tennessee Valley region. TVA carries out these responsibilities in a service area that centers on Tennessee and includes parts of Alabama, Georgia, Kentucky, Mississippi, North Carolina, and Virginia.

TVA's operations have historically been divided into two types of activities, the power program and the nonpower programs. Substantially all TVA revenues and assets are attributable to its power program. The power program has historically been separate and distinct from the nonpower programs and is required to be self-supporting from power revenues and proceeds from power program financings, such as proceeds from the issuance of debt. Although TVA no longer receives congressional appropriations, it is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Until 2000, most of the funding for TVA's nonpower programs was provided by congressional appropriations. These programs are now funded largely with power revenues. Certain nonpower activities are also funded with various revenues and user fees. Prior to 2004, TVA presented information separately on its power program and nonpower programs in its financial statements. Because of the change in funding explained above, beginning with the fourth quarter of 2004, TVA began presenting consolidated financial statements which include both power and nonpower activities.

Power rates are established by the TVA Board of Directors ("Board" or "TVA Board") as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; payments to states and counties in lieu of taxes; and debt service on outstanding indebtedness. Rates set by the Board are not subject to review or approval by any state or federal regulatory body. In a future restructured electric power industry, it is possible that the ability of the Board to set TVA's rates as specified in the TVA Act could be adversely affected by legislative changes or by competitive pressures (discussed in *"Management's Discussion and Analysis of Financial Condition and Results of Operations" — "TVA and Competition"* in Part II of the 2005 Information Statement).

Basis of Presentation
TVA prepares its interim financial statements in conformity with generally accepted accounting principles ("GAAP") accepted in the United States of America for interim financial information. Accordingly, TVA's interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Because the accompanying interim financial statements do not include all of the information and footnotes required by GAAP for complete financial statements, they should be read in conjunction with the audited financial statements for the year ended September 30, 2005, and the notes thereto, which are contained in the 2005 Information Statement.

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

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

Fiscal Year
TVA's fiscal year ends September 30. Unless otherwise indicated, years (2006, 2005, etc.) refer to TVA's fiscal years.

Reclassifications
Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation. Cash

flows of $202 million associated with the net activity of short-term investments were reclassified from cash provided by operating activities to cash provided by investing activities. The reclassification resulted in a decrease of cash from operating activities and conversely was an additional source of cash in investing activities on the 2005 Statement of Cash Flows. Additionally, restricted cash of $105 million was reclassified from cash and cash equivalents to use of funds from investing activities. See *Restricted Cash and Investments.* The reclassifications resulted in a net use of funds by investing activities of $97 million. These reclassifications had no effect on previously reported results of operations and net cash flows.

Restricted Cash and Investments

As of March 31, 2006, TVA had $138 million in restricted cash and investments on its balance sheet as a result of collateral posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap contract. Due to the uncertainty of the timing of the return of these funds to the counterparty, the funds are reported in RESTRICTED CASH AND INVESTMENTS and the corresponding liability is reported in ACCOUNTS PAYABLE on the March 31, 2006 Balance Sheet.

Accounts Receivables

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

	Accounts Receivable	
	At March 31 2006	At September 30 2005
Power receivables billed	$ 287	$ 323
Power receivables unbilled	689	787
Total power receivables	976	1,110
Other receivables	31	42
Allowance for uncollectible accounts	(7)	(7)
Net accounts receivable	$ 1,000	$ 1,145

Cost-Based Regulation

Regulatory assets represent costs capitalized under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 71, *"Accounting for the Effects of Certain Types of Regulation."* TVA's regulatory assets are shown as DEFERRED NUCLEAR GENERATING UNITS and OTHER REGULATORY ASSETS on the Balance Sheets. Components of OTHER REGULATORY ASSETS include certain charges related to the closure and removal from service of nuclear generating units, reacquisition costs of debt instruments, deferred outage costs, unrealized losses related to mark-to-market valuations of purchase power contracts, deferred capital lease asset costs and an adjustment to accrue the minimum pension liability. TVA's regulatory assets consist of the following:

	Regulatory Assets	
	At March 31 2006	At September 30 2005
Regulatory Assets:		
Adjustment to accrue minimum pension liability	$ 1,158	$ 1,158
Nuclear decommissioning costs	621	716
Debt reacquisition costs	256	264
Deferred outage costs	91	103
Capital leases	80	84
Unrealized losses related to mark-to-market valuation of purchase power contracts	32	42
Total other regulatory assets	2,238	2,367
Deferred nuclear generating units	3,716	3,912
Total regulatory assets	$ 5,954	$ 6,279

Regulatory liabilities accounted for under provisions of SFAS No. 71 consist of mark-to-market valuation gains on certain derivative contracts and capital leases. The balances of TVA's regulatory liabilities at March 31, 2006, and September 30, 2005, were $987 million and $897 million, respectively, and are included in REGULATORY LIABILITIES on the Balance Sheets.

Regulatory Liabilities

	At March 31 2006	At September 30 2005
Regulatory Liabilities:		
Unrealized gain on coal purchase contracts	$ 890	$ 791
Capital lease liability	97	106
Total regulatory liabilities	$ 987	$ 897

Asset Retirement Obligations

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

In March 2005 and 2006, TVA made revisions to the amount and timing of certain cash flow estimates related to its nuclear asset retirement obligations. The revisions in cost were based on new engineering analyses of certain components of the cost performed annually in accordance with requirements of the Nuclear Regulatory Commission ("NRC"). The effect of the changes in estimates produced obligations that were less than the amounts originally recorded on an accreted basis. Accordingly, TVA made adjustments in the recorded amounts to properly reflect such revised balances based on the latest cost estimates. In 2005, the adjustments resulted in an aggregate decrease of $25 million in the asset retirement obligations ("ARO"), a $7 million reduction in the asset base, a $3 million reduction in accumulated depreciation, and a decrease of $21 million in the originally recorded regulatory asset. The 2006 adjustments resulted in an aggregate decrease of $89 million in the ARO, a $29 million reduction in the asset base, a $12 million reduction in accumulated depreciation, and a decrease of $72 million in the originally recorded regulatory asset which TVA recorded in accordance with SFAS No. 71. Therefore, the result of the changes described does not impact net income for the six month periods ended March 31, 2006, and 2005.

During the first six months of 2005, TVA's total ARO liability increased $25 million due to accretion expense of $50 million partially offset by the $25 million revision to the nuclear ARO described above. The nuclear accretion expense of $44 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $6 million, related to coal-fired and gas/oil plants, was expensed during 2005. During the first six months of 2006, TVA's total ARO liability decreased $36 million due to accretion expense of $53 million offset by the $89 million revision to the nuclear ARO described above. The nuclear accretion expense of $46 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $7 million, related to coal-fired and gas/oil plants, was expensed during 2006.

During the first quarter of 2005, there was a change in the estimated closure date related to the Bellefonte diesel generators. The original estimate assumed plant closure in 2029 and a six-year waiting period before closure work would begin in 2035. The new estimate assumes that closure work will begin at the date the plant ceases to operate in 2029. This change to the prior estimate resulted in a decrease in the total future liability of nearly $1 million and an increase in the current net present value of the ARO asset and liability of less than $0.1 million. Additionally, TVA is evaluating the potential implications of Financial Accounting Standards Board ("FASB") Interpretation No. 47 ("FIN No. 47"), *"Accounting for Conditional Asset Retirement Obligations–an Interpretation of SFAS No. 143,"* issued in March 2005. See *Impact of New Accounting Pronouncements and Interpretations.* This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. TVA will apply this guidance beginning with the fiscal year ending September 30, 2006.

Reconciliation of Asset Retirement Obligation Liability

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
Balance at beginning of period	$ 1,883	$ 1,807	$ 1,857	$ 1,782
Liabilities settled	–	–	–	–
Accretion expense	27	25	53	50
Revisions in estimated cash flows	(89)	(25)	(89)	(25)
Balance at end of period	$ 1,821	$ 1,807	$ 1,821	$ 1,807

Energy Prepayment Obligations

As of March 31, 2006, TVA had entered into sales agreements for 54.5 Discounted Energy Units totalling $54.5 million. Total credits applied to power billings on a cumulative basis during the life of the program through March 31, 2006, exceed $17 million. Of this amount, over $1 million was recognized as revenue for the quarterly periods ended March 31, 2006, and 2005.

In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment is being applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was $1.5 billion. Total credits applied to power billings on a cumulative basis during the life of the program through March 31, 2006, exceed $240 million. Of this amount, $25 million was recognized as revenue for the quarterly periods ended March 31, 2006, and 2005. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At March 31, 2006, and September 30, 2005, obligations under these prepayment programs were $1,297 million and $1,350 million, respectively. The amounts are included in Energy Prepayment Obligations and Current Portion of Energy Prepayment Obligations on the March 31, 2006, and September 30, 2005, Balance Sheets. There have been no energy prepayment transactions during 2005 and 2006.

Reduction in Workforce

During 2004, organizations within TVA performed program and staffing reviews to identify surplus staffing situations. For the areas identified as having surplus staffing, TVA provided the opportunity for certain qualifying employees to apply for voluntary resignations beginning in February 2004. In conjunction with the voluntary reduction process, TVA also instituted an involuntary reduction in force ("RIF") for certain employees. As of March 31, 2006, there were approximately 700 employees impacted by the combined RIF actions. TVA has recognized total expense in the amount of $42 million for termination costs incurred through March 31, 2006. Payout of benefits occurs when employees retire from TVA, and substantially all affected employees had retired by the end of 2005.

Termination Costs Liability Activity

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
Termination costs liability at beginning of period	$ 3	$ 10	$ 4	$ 14
Liabilities incurred	1	–	2	1
Actual costs paid	(1)	(3)	(2)	(8)
Estimated medical benefits paid	(1)	1	(2)	1
Termination costs liability at end of period	$ 2	$ 8	$ 2	$ 8

Impact of New Accounting Pronouncements and Interpretations

Variable Interest Entities. In January 2003, the FASB published FASB Interpretation No. 46, *"Consolidation of Variable Interest Entities,"* which was revised by FASB Interpretation No. 46R ("46R") in December 2003. FIN 46(R) establishes consolidation criteria for entities for which "control" is not easily discernable under Accounting Research Bulletin ("ARB") 51, *"Consolidated Financial Statements,"* which is based on the premise that holders of the equity of an entity control the entity by virtue of voting rights. FIN 46(R) provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial interests rather than from voting interests. FIN 46(R) defines the term "variable interest entity" ("VIE") and is based on the premise that if a business enterprise absorbs a majority of the VIE's expected losses and/or receives a majority of its expected residual returns (measures of risk and reward), that enterprise (the primary beneficiary) is deemed to have a controlling financial interest in the VIE. An enterprise that bears the majority of the economic risk is considered to have a controlling financial interest in a VIE, even if it has no decision making (voting) authority or equity interest. TVA adopted FIN 46 and FIN 46(R) effective October 1, 2005, for VIEs created before December 31, 2003, and immediately for VIEs created after December 31, 2003.

In February 1997, TVA entered a purchase power agreement with Choctaw Generation, Inc. (subsequently assigned to Choctaw Generation Limited Partnership) to purchase all the power generated from its facility located in Choctaw County, Mississippi. The facility had a committed capacity of 440 megawatts and the term of the agreement was 30 years. Under the accounting guidance provided by FIN 46(R), TVA may be deemed to be the primary beneficiary under the contract; however, TVA does not have access to the financial records of Choctaw Generation Limited Partnership. As a result, TVA was unable to determine whether FIN 46(R) would require TVA to consolidate Choctaw Generation

Limited Partnerships' balance sheet, results of operations, and cash flows for the quarter and six months ended March 31, 2006. Power purchases for the first six months of 2006 under the agreement totaled $63 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

On April 13, 2006, the FASB issued FIN 46(R)-6, *"Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R),"* which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46. FIN 46(R)-6 is to be applied prospectively to all entities with which that enterprise first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FIN 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. TVA will apply this guidance beginning with the annual reporting period ending September 30, 2006. The adoption of this guidance is not expected to have a material impact on TVA's results of operations or financial condition.

Conditional Asset Retirement Obligations. In March 2005, the FASB issued FIN No. 47, *"Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143."* This interpretation clarifies that the term conditional asset retirement obligation ("conditional ARO") as used in SFAS No. 143, *"Accounting for Asset Retirement Obligations,"* refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Thus, the timing and (or) method of settlement may be conditional on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional ARO if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional ARO should be recognized when incurred. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an ARO. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. TVA will apply this guidance beginning with the fiscal year ending September 30, 2006. TVA is evaluating the potential implications of this interpretation on its AROs, which may or may not be material to its financial position or results of operations.

Accounting Changes and Error Corrections. In May 2005, the FASB issued SFAS No. 154, *"Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3,"* which replaces *"Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes,"* and FASB Statement No. 3, *"Reporting Accounting Changes in Interim Financial Statements."* This statement applies to all voluntary changes in accounting principles and also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires, unless impracticable, retrospective application to prior periods' financial statements of changes in accounting principles. If it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. This statement also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. The statement will become effective for TVA beginning in 2007 with early adoption permitted for accounting changes and corrections of errors made in fiscal years beginning after May 2005, the date the statement was issued.

Accounting for Inventory Transactions. At its September 28, 2005, meeting, the FASB reached consensus on Emerging Issues Task Force ("EITF") Issue No. 04-13, *"Accounting for Purchases and Sales of Inventory with the Same Counterparty."* In certain situations, a company may enter into a nonmonetary transaction to sell inventory to another company in the same line of business from which it also purchases inventory. Questions have arisen regarding how the guidance in APB Opinion No. 29, *"Accounting for Nonmonetary Transactions,"* should be applied in these situations. The consensus reached states that inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying Opinion 29. The Task Force also agreed that the issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more inventory transactions with the same counterparty should be considered as a single nonmonetary inventory transaction within the scope of Opinion 29. The Task Force also reached a consensus that a nonmonetary exchange within the same line of business involving the transfer of raw materials in exchange for the receipt of raw materials should not be recognized at fair value. This EITF should be applied to transactions completed in reporting periods beginning after March 15, 2006, whether pursuant to arrangements that were in place at the date of initial application of the consensus or arrangements executed subsequent to that date. The carrying amount of the inventory that was acquired under these types of arrangements prior to the initial application of the consensus, and that still remains in an entity's statement of financial position at the date of initial application of the consensus, should not be adjusted for this consensus. TVA adopted EITF Issue No. 04-13 beginning in the second quarter of 2006. The adoption of EITF Issue No. 04-13 did not have a material impact on TVA's results of operations or financial condition.

Put and Call Options. In September 2005, the Derivatives Implementation Group ("DIG") of the FASB discussed several issues related to the settlement of a debtor's obligation on the exercise of a call or put option and the exercise only by the debtor of the right to accelerate settlement of a debt with an embedded call option. DIG Implementation Issue No. B38, *"Embedded Derivatives: Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option,"* addresses whether the settlement of a debtor's obligation on exercise of a call or put option meets the net settlement criterion in paragraph 9(a) of SFAS No. 133, as amended. DIG Implementation Issue No. B39, *"Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor,"* addresses whether or not Paragraph 13(b) of SFAS No. 133, as amended, applies to a call option embedded with a debt host if the right to accelerate settlement of the debt can be exercised only by the debtor. The effective date of the implementation guidance in these issues is the first day of the first fiscal quarter beginning after December 15, 2005. The issue became effective for TVA beginning in the second quarter of 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

Accounting for Rental Costs. On October 6, 2005, the FASB issued FSP FAS 13-1, *"Accounting for Rental Costs Incurred during a Construction Period."* The FASB concludes in this FSP that rental costs associated with ground or building operating leases that are incurred during a construction period should be expensed. FASB Technical Bulletin ("FTB") No. 88-1, *"Issues Relating to Accounting for Leases,"* requires that rental costs associated with operating leases be allocated on a straight-line basis in accordance with FASB Statement No. 13, *"Accounting for Leases,"* and FTB 85-3, *"Accounting for Operating Leases with Scheduled Rent Increases,"* starting with the beginning of the lease term. The FASB believes there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. TVA began applying this guidance beginning with the quarterly reporting period ending March 31, 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

Impairment of Investments. On November 3, 2005, the FASB released FSP FAS 115-1 and FAS 124-1,"*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."* This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of an "other-than-temporary" impairment and requires certain disclosures about unrealized losses that have not been recognized as "other-than-temporary" impairments. TVA began applying this guidance beginning with the quarterly reporting period ending March 31, 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

2. Accumulated Other Comprehensive Income

SFAS No. 130, *"Reporting Comprehensive Income,"* requires the disclosure of comprehensive income to reflect changes in capital that result from transactions and economic events from non-owner sources. The increase for the three months and six months ended March 31, 2006, and 2005, is due to unrealized gains related to mark-to-market valuation adjustments for certain derivative instruments.

Accumulated Other Comprehensive Income (Loss) Activity

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
Accumulated other comprehensive income (loss) at beginning of period	$ 44	$ 14	$ 27	$ (52)
Changes in fair value				
Inflation swap	5	4	(5)	5
Foreign currency swaps	67	26	94	91
Accumulated other comprehensive income at end of period	$ 116	$ 44	$ 116	$ 44

3. Debt Securities

Debt Securities Activity

TVA issues power bonds pursuant to Section 15d of the TVA Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution. Power Bonds in each series must be further authorized by Supplemental Resolutions. The table below summarizes TVA's debt securities activity for the period from October 1, 2005, to March 31, 2006.

	Date	Amount	Interest Rate
Redemptions/Maturities:			
electronotes®	First Quarter 2006	$ 152	5.88%
	Second Quarter 2006	3	4.93%
		$ 155	
Issues:			
electronotes®	First Quarter 2006	$ 49	5.19%
	Second Quarter 2006	19	5.36%
		$ 68	

Note:
electronotes® interest rate is a weighted average rate.

Debt Outstanding

Debt outstanding at March 31, 2006, includes net translation losses of $113 million related to long-term debt and a translation gain of $70 million related to the current portion of long-term debt. The unamortized discount balance at March 31, 2006, was $167 million.

4. Risk Management Activities and Derivative Transactions

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

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

Mark-to-Market Values of Derivative Transactions
Asset/(Liability)

	At March 31 2006	At September 30 2005
Inflation swap	$ 18	$ 17
Interest rate swap	(114)	(158)
Currency swaps:		
Deutschemark (DM1.5 billion)	(36)	(68)
Sterling (GBP200 million)	32	21
Sterling (GBP250 million)	113	89
Sterling (GBP150 million)	53	36
Total currency swaps	162	78
Swaptions:		
$1 billion notional	(265)	(314)
$28 million notional	(3)	(4)
$14 million notional	(1)	(2)
Total swaptions	(269)	(320)
Coal contracts	890	791
Purchase power contracts	(32)	(42)

5. Benefit Plans

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

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

	Pension Benefits Three Months Ended March 31		**Other Benefits** Three Months Ended March 31		**Pension Benefits** Six Months Ended March 31		**Other Benefits** Six Months Ended March 31	
	2006	2005	2006	2005	2006	2005	2006	2005
Service Cost	$ 31	$ 31	$ 2	$ 1	$ 63	$ 62	$ 4	$ 3
Interest Cost	110	110	6	7	220	219	14	13
Expected return on plan assets	(122)	(115)	–	–	(245)	(229)	–	–
Amortization of prior service costs	9	9	2	2	18	18	3	3
Amortization of losses	33	32	4	3	66	65	8	5
Net periodic benefit	$ 61	$ 67	$ 14	$ 13	$ 122	$ 135	$ 29	$ 24

The Board approved $75 million in pension contributions during 2006. During the six months ended March 31, 2006, TVA made approximately $37 million in contributions and plans to contribute another $38 million by the end of the year. TVA does not separately set aside assets to fund other benefit costs, but rather funds such costs on an as-paid basis. TVA provided approximately $10 million during the six months ended March 31, 2006, to fund other benefits costs.

6. Commitments and Contingencies

The estimated cash commitments for TVA as of March 31, 2006, are as follows:

Cash Requirements and Contractual Obligations

	2006*	2007	2008	2009	2010	Thereafter	Total
Debt	$ 3,566	$ 975	$ 91	$ 2,030	$ 42	$ 16,400	$ 23,104
Interest on debt	611	1,120	1,100	1,044	989	14,702	19,566
Leases	47	92	82	70	64	46	401
Lease/leaseback	36	85	89	85	89	1,209	1,593
Power purchase obligations	97	172	140	145	147	3,745	4,446
Other obligations	207	150	111	5	3	7	483
Fuel purchase obligations	728	524	449	397	380	604	3,082
Pension contribution	38	–	–	–	–	–	38
Total	$ 5,330	$ 3,118	$ 2,062	$ 3,776	$ 1,714	$ 36,713	$ 52,713

* Period April 1 – September 30, 2006

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

Contractual Obligations Related to Energy Prepayments

	2006*	2007	2008	2009	2010	Thereafter	Total
Energy prepayment obligations	$ 53	$ 106	$ 106	$ 105	$ 105	$ 822	$ 1,297

* Period April 1 – September 30, 2006

Contingencies
Fuel Fabrication Claims. On November 9, 2005, TVA received two invoices totaling $76 million from Areva ("Areva") and an affiliated company, the successor of Babcock and Wilcox Company ("B&W"). In 1970, TVA and B&W entered into a contract for fuel fabrication services for Bellefonte. Areva's invoices are based upon its belief that the 1970 contract required TVA to buy more fuel fabrication services from B&W than TVA actually purchased. TVA is reviewing Areva's claim and has requested Areva to provide more information about several aspects of its claim. TVA is awaiting a response from Areva.

Bear Creek Dam Seepage. Bear Creek Dam is experiencing foundation problems as evidenced by seepage through the foundation of the dam. TVA is initiating a study to evaluate long-term options related to seepage at Bear Creek Dam. A draft schedule and budget have been developed for the study, which will identify potential alternatives for resolution in accordance with National Environmental Policy Act guidelines. Communications with local leaders and key stakeholders are beginning.

New Source Review Program. On March 17, 2006, the United States Court of Appeals for the District of Columbia Circuit struck down the Environmental Protection Agency's modification of the new source review program under the Clean Air Act ("CAA"). The rule allowed power plants and other facilities to replace existing equipment with its functional equivalent without undergoing the extensive review necessary for modifications determined to be new sources if the replacement did not exceed 20 percent of the value of the facility. The ramifications of this decision for TVA and other utilities remain uncertain.

7. Legal Proceedings

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the U.S. District Court for the Northern District of Alabama alleging that TVA overcharged for economy surplus power ("ESP") during the summer of 1998. The lawsuit was filed as a class action on behalf of industrial customers who participated in TVA's ESP program. Under ESP contracts, the hourly ESP energy price is calculated using TVA's actual incremental cost of supplying the ESP load in each hour. The plaintiff alleges that TVA overcharged for ESP during the summer of 1998 by including in the price of ESP some costs that were added to TVA's incremental cost. The complaint seeks over $100 million in damages on behalf of Birmingham Steel and the other class members. In September 2002, the district court decertified the class and then dismissed Birmingham Steel's individual claim without prejudice on a jurisdictional issue. The class lawyers appealed the ruling on class decertification, and in December 2003, the U.S. Court of Appeals for the Eleventh Circuit ("Eleventh Circuit") reversed that ruling and sent the case back to the district court to allow the class lawyers a reasonable time to find a new class representative. The district court allowed the substitution of Johns Manville Corporation to represent the class. Motions for summary judgment were filed in October 2005. On April 18, 2006, the district court ruled in the plaintiff's favor on the issue of liability. Specifically, the court held that TVA could only charge ESP customers for the costs of power purchased in advance ("forwards") during the hours TVA actually needed the power to supply ESP, and that TVA's charges for approximately 500 hours of forwards breached the contracts. The court rejected TVA's position that the additional price charged for all hours represented actual incremental costs incurred by TVA in supplying ESP and thus was an appropriate part of the ESP contract price. The court also held that, while there are disputed factual issues as to TVA's defenses, plaintiff was entitled to summary judgment on liability issues. The court has indicated that it will hold a trial on the issue of damages, but no date has yet been set. TVA is currently evaluating the decision and TVA's options in responding to the decision, as well as any potential damages.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of certain of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory limitations period. As to the plaintiffs' allegations of federal law violations, the court found that Congress had specifically authorized TVA to set the rates charged by distributors via its contracts. In the face of such express Congressional authorization, the plaintiffs' federal law claims failed as a matter of law and were dismissed with prejudice, precluding them from being brought again. The plaintiffs moved for reconsideration of the dismissal, and the judge denied the plaintiffs' motion. The plaintiffs subsequently appealed to the U.S. Court of Appeals for the Sixth Circuit ("Sixth Circuit"). Briefing was completed in February 2006. No date for oral argument has been set at this time. TVA has no further or new conclusions concerning the case.

In July 2004, two lawsuits were filed against TVA in federal court in New York, New York alleging that global warming is a public nuisance and that carbon dioxide ("CO_2") emissions from TVA's fossil-fired electric generating facilities should be ordered abated because they contribute to causing the nuisance. The first case was filed by the States of California, Connecticut, Iowa, New Jersey, New York, Rhode Island, Vermont, and Wisconsin and the City of New York against TVA, American Electric Power, Inc., American Electric Power Service Corporation, Southern Company, Xcel Energy, Inc., and Cinergy Corporation. The second case, which alleges both public and private nuisance, was filed against the same defendants by Open Space Institute, Inc., Open Space Conservancy, Inc., and the Audubon Society of New Hampshire. There are no Clean Air Act ("CAA") requirements limiting CO_2 emissions, and, accordingly, the suits do not involve allegations of regulatory noncompliance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO_2 emissions and then reduce these emissions by an unspecified percentage each year for at least a decade. In September 2005, the district court dismissed both lawsuits, concluding that they raised political questions that should not be decided by the courts. The plaintiffs have filed notices of appeal to the U.S. Court of Appeals for the Second Circuit. Briefing was concluded in February 2006. Oral argument has been set for June 7, 2006.

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with U.S. Department of Energy ("DOE") for the disposal of spent nuclear fuel ("SNF"). Payments to DOE are based upon TVA's nuclear generation and charged to nuclear fuel expense. Although the contracts called for DOE to begin accepting SNF from the utilities by January 31, 1998, DOE announced that it will not begin picking up spent nuclear fuel from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools of borated water at its nuclear sites. Although TVA would have had sufficient space to continue to store SNF in those storage pools at its Sequoyah and Browns Ferry Nuclear Plants indefinitely had DOE begun accepting SNF, DOE's failure to do so required TVA to construct dry cask storage facilities at its Browns Ferry and Sequoyah Nuclear Plants and to purchase special storage containers for the SNF. (Watts Bar Nuclear Plant currently has sufficient storage capacity in its spent fuel pool to last until 2018.) Both Sequoyah's and Browns Ferry's dry cask storage facilities are operational. To recover the cost of providing long-term, on-site storage for SNF, TVA filed a breach of contract suit against the United States in the Court of Federal Claims in 2001. The case went to trial in June 2005, and the proof centered on TVA's claims through 2004. On January 31, 2006, the Court of Federal Claims issued a decision in TVA's favor, awarding TVA nearly $35 million, substantially all the damages sought in the suit. Under the decision, TVA retains the right to bring lawsuits to recover for extra costs incurred after September 30, 2004. On April 3, 2006, the United States filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit.

The National Parks Conservation Association, Inc. ("NPCA"), and Sierra Club, Inc. ("Sierra Club") filed suit in 2001 in federal district court in Birmingham, Alabama, alleging TVA violated the CAA and implementing regulations at Unit 5 of TVA's Colbert Fossil Plant ("Colbert"). Plaintiffs allege that TVA made major modifications to Unit 5 without obtaining preconstruction permits (in alleged violation of the Prevention of Significant Deterioration ("PSD") program and the Nonattainment New Source Review ("NNSR") program) and without complying with emission standards (in alleged violation of the New Source Performance Standards ("NSPS") program). Plaintiffs seek injunctive relief, civil penalties of $25,000 per day for each violation before January 30, 1997, and $27,500 per day for each violation after that date, an order that TVA pay up to $100,000 for beneficial mitigation projects, and costs of litigation, including attorney and expert witness fees. On November 29, 2005, the court held on sovereign immunity grounds that plaintiffs could not seek civil penalties against TVA. On January 17, 2006, the district court issued a final order dismissing the action, on the basis that plaintiffs failed to provide adequate notice of NSPS claims and that the statute of limitations curtailed the PSD and NNSR claims. Plaintiffs filed a notice of appeal to the Eleventh Circuit on January 25, 2006. If the decision is reversed on appeal, there is a reasonable possibility that TVA will be found liable, and ordered to install additional controls on Unit 5.

The NPCA and the Sierra Club filed suit in the Eastern District of Tennessee in 2001 alleging that TVA modified its Bull Run Fossil Plant ("Bull Run") without complying with the New Source Review requirements of the CAA. In March 2005, the district court granted TVA's motion to dismiss the lawsuit in the Bull Run case on statute of limitation grounds. The plaintiffs' motion for reconsideration was denied, and they have appealed to the Court of Appeals for the Sixth Circuit. Twelve states have filed amicus curie briefs with the Sixth Circuit supporting the appeal filed by the plaintiffs. The states are New York, Connecticut, Illinois, Iowa, Maryland, New Hampshire, New Jersey, New Mexico, Rhode Island, Kentucky, Massachusetts, and Pennsylvania. Several Ohio utilities filed an amicus curie brief with the Sixth Circuit supporting TVA. Briefing is expected to be completed in May 2006. No oral argument date has been set.

The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert between July 1, 1997, and June 30, 2002. The groups sought a court order that potentially could require TVA to incur substantial costs, in addition to the costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately $250 million. On September 14, 2004, the court found that TVA had not violated the CAA because all of the challenged emissions were within Alabama's two percent de minimis rule (which provided a safe harbor if emissions did not exceed allowable opacity limits more than two percent each quarter), and the complaint was dismissed in its entirety. The plaintiffs appealed the district court's decision to the Eleventh Circuit. On November 22, 2005, the Eleventh Circuit issued its opinion, affirming the lower court in part and reversing in part. The Eleventh Circuit held that the Alabama de minimis rule was not applicable because it attempted to revise the opacity limits without going through the appropriate amendment process and receiving Environmental Protection Agency ("EPA") approval. The appeals court therefore reversed summary judgment in favor of TVA and indicated that it would remand the case to the district court for further proceedings. The Eleventh Circuit affirmed the lower court's dismissal of the claims for civil penalties, holding that sovereign immunity principles preclude assessing civil penalties in citizen suits brought under the CAA against federal entities such as TVA. The lower court has indicated that it views the Eleventh Circuit's decision as a determination that TVA is in violation of opacity requirements at Colbert. On February 28, 2006, the Eleventh Circuit denied TVA's petition for a rehearing, and the case was then remanded to the district court. The plaintiffs have filed a motion for summary judgment, which TVA has opposed.

On January 30, 2006, North Carolina's Attorney General filed suit against TVA alleging that TVA's operation of its coal-fired power plants in Tennessee, Alabama, and Kentucky constitute public nuisances. TVA moved to dismiss the case on grounds that the case is not suitable for judicial resolution because of separation of powers principles and the Supremacy Clause. TVA expects briefing on the motion to be completed in May 2006.

In 2005, the State of North Carolina petitioned the EPA under Section 126 of the CAA to impose additional emission reductions requirements for sulfur dioxide and nitrous oxides emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama, where TVA's coal-fired power plants are located. In March 2006, the EPA denied the North Carolina petition primarily on the basis that the Clean Air Interstate Rule remedies the problem.

It is not possible to predict with certainty whether TVA will incur any liability or to estimate the damages, if any, that TVA might incur in connection with the lawsuits described above except as specifically noted. TVA has recognized charges to earnings and actual costs, including legal fees and expenses, related to litigation. No assurance can be given that TVA will not be subject to significant additional claims and material additional liabilities. If actual liabilities significantly exceed the estimates made, the results of operations, liquidity, and financial condition could be materially adversely affected.

8. Stewardship Responsibilities

During the second quarter of 2006, TVA continued to conduct certain nonpower programs including managing navigable river channels, providing flood control and overseeing certain recreation facilities. TVA's responsibilities in connection with these programs include general stewardship of land, water, and wildlife resources.

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

Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. TVA primarily is using power revenues (along with user fees and other forms of nonpower revenues) to continue to fund these stewardship activities. TVA spent approximately $38 million on essential stewardship activities during the first six months of 2006 and $36 million during the first six months of 2005, and recognized depreciation expense on nonpower assets of $5 million in each six month period.

9. Subsequent Events

<u>Debt Securities</u>
In April 2006, TVA issued $1 billion of 50-year global power bonds which mature April 1, 2056, and have a coupon rate of 5.375 percent.

Also in April 2006, TVA issued $21 million of electronotes® with an interest rate of 5.13 percent which mature in 2010 and are callable beginning in 2007.

In May 2006, TVA issued $6 million of electronotes® with an interest rate of 5.25 percent which mature in 2011 and are callable beginning in 2007.

Legal Proceedings

In April 2006, TVA was added as defendant to a class action lawsuit brought in federal court by fourteen residents of Mississippi who were allegedly injured by Hurricane Katrina. The plaintiffs have sued several large oil companies and an oil company trade association, three large chemical companies and a chemical trade association, and 31 large companies involved in the mining and burning of coal, including TVA and other utilities. The theory of the case is that defendants' greenhouse gas emissions contributed to global warming and were a proximate and direct cause of the increase in the destructive force of Hurricane Katrina. The plaintiffs are seeking monetary damages among other relief. TVA is still examining the case and evaluating its options at this time.

Bellefonte Construction Permits

In December 2005, TVA notified the NRC that it has placed Bellefonte Nuclear Plant Units 1 and 2 in terminated status and that it intends to submit for NRC approval a request for withdrawal of construction permits for these units. Canceling the construction status of the existing plant facilities and withdrawal of the related construction permits are necessary in order to facilitate other future uses of the Bellefonte site. The placement of the partially constructed Bellefonte units in terminated status does not prevent the future use of the Bellefonte site for other uses, including the construction of any new nuclear or non-nuclear power facilities. On April 6, 2006, TVA sent its letter requesting withdrawal of the construction permits and attached its redress plan for the site. TVA requested prompt review and approval "to allow redress activities to commence supporting optimal use of the site."

Browns Ferry License Extension

On May 4, 2006, the NRC approved TVA's application for license extension at each of TVA's three Browns Ferry units. As a result of the NRC's action, each unit's license has been extended 20 years, which will allow TVA to produce power from the facilities until 2033, 2034, and 2036 for Units 1, 2, and 3, respectively. This license extension has the effect of improving the funded status of TVA's Nuclear Decommissioning Trust ("NDT") versus the present value of the estimated decommissioning costs by (1) extending the decommissioning dates of the three Browns Ferry units and thereby pushing the decommissioning liability for these units further into the future and (2) extending the investment horizon for the assets in the NDT.

Transmission System

Powerful spring storms, including 40 tornadoes reported in the TVA service area, damaged TVA and power distributor systems in Middle Tennessee and Kentucky on April 7 and 8, 2006. Earlier the same week, on April 2, 2006, another powerful storm system brought at least 16 tornadoes to the western and central portions of the service territory, also damaging TVA and power distributor systems.

Several 500-kV, 161-kV, and lower voltage TVA transmission lines suffered damage, but the bulk transmission system remained stable throughout both storms. Service was restored to all TVA customer delivery points within hours of the storms via alternate transmission paths. Numerous line sections not immediately affecting customer delivery points remained out of service for several days as repairs were made. TVA activated its Transmission Emergency Operations Center to support both its own recovery and that of the power distributors' systems. Cost estimates for repairs from both storms are about $4 million, which were covered through storm contingency funds.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") explains the results of operations and general financial condition of TVA. The MD&A should be read in conjunction with the accompanying Financial Statements and the 2005 Information Statement.

Overview

TVA continues to evaluate and focus on four strategic areas outlined in the Strategic Plan adopted in 2004:

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

For an in-depth discussion of TVA's business strategy and economic factors, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations"* in TVA's 2005 Information Statement.

Material Changes in Liquidity and Capital Resources

Comparative Cash Flow Analysis
Net cash provided by operating activities decreased $37 million from $755 million to $718 million for the six month periods ending March 31, 2005, and 2006, respectively. The decrease is primarily due to an increase in cash outlays for fuel and purchased power of $385 million primarily due to higher coal prices and higher market prices for purchased power. Other contributing factors include:

- An increase in cash used for working capital components of $105 million, which is discussed below; and
- An increase in cash outlays for routine and recurring operating costs of $21 million.

These items were offset by:

- An increase in cash-related operating revenues of $447 million primarily due to increased rates; and
- A decrease of $12 million for expenditures for fossil and hydro outages.

Cash used for working capital components increased $105 million, from net cash provided of $44 million in the first six months of 2005 to net cash used of $61 million in the first six months of 2006. This increase resulted from:

- A larger increase in inventories and other assets of $132 million in the first six months of 2006 as compared to the same time in 2005, primarily due to higher fuel inventory prices and the rebuilding of combustion turbine plant inventories through the second quarter of 2006.
- A larger decrease in accounts payable and accrued liabilities of $17 million due to higher payments for fuel and purchased power and lower fiscal year-to-date increase in collateral deposits held (these deposits were a $124 million source of cash in the first six months of 2005 and $31 million source of cash in the first six months of 2006). These items, however, were offset by one-time payments of $40 million for the Browns Ferry Unit 1 restart and $9 million for a breach of contract settlement each made during the first quarter of 2005.

These items were partially offset by a larger source from the collections of accounts receivable of $43 million due to higher late summer power sales in 2005.

Cash used in investing activities increased $190 million, from $532 million to $722 million for the six month periods ending March 31, 2005, and 2006, respectively, primarily due to:

- A $29 million increase in expenditures related to nuclear fuel for the Sequoyah Unit 1 fuel reload scheduled to be completed in mid-May and expenditures related to uranium, conversion, and enrichment for Browns Ferry Unit 1;
- Sales of short-term investments of $221 million in 2005 not present in the current year; and
- A decrease in proceeds received from the sale of certain receivables/loans of $47 million compared to the same period of 2005.

These items were offset by:

- An increase in funds from Allowance for Funds Used During Construction (“AFUDC”) of $21 million; and
- A smaller increase in restricted cash and investments of $93 million resulting from a smaller increase in collateral deposits posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap contract.

Net cash used in financing activities was $33 million for the first six months of 2006, compared with $90 million for the same period of 2005. The change is related primarily to:

- An increase of $44 million in long-term debt issues for the first six months of 2006 as compared to the same period of 2005; and
- A decrease of $22 million in long-term debt redemptions.

These items were partially offset by a slight decrease in net short-term issues from $104 million in the first six months of 2005 to $97 million in the same period of 2006.

Working Capital

TVA historically has negative working capital due to the significant amount of short-term debt included in current liabilities on the balance sheet. At March 31, 2006, TVA had negative working capital of $3,840 million, largely attributable to current maturities of long-term debt of $1,905 million and short-term indebtedness of $2,566 million. The table below summarizes the components of working capital and discount notes with maturities of less than 90 days. It is TVA’s current cash management policy to use a combination of its U.S. Treasury note and discount notes to meet current obligations. TVA plans to continue to use such financing instruments to meet liquidity requirements. In the foreseeable future, TVA may continue to refinance short-term debt to long-term to take advantage of more favorable interest rates. See note 9—*Debt Securities.*

Working Capital and Short-Term Debt

	March 31 2006	September 30 2005
Current assets	$ 2,277	$ 2,269
Current liabilities	(6,117)	(6,817)
Working capital	$ (3,840)	$ (4,548)
Discount notes <90 days	$ 2,566	$ 2,469
Current maturities of long-term debt	1,905	2,693
Total short-term debt	$ 4,471	$ 5,162

TVA has a short-term revolving credit facility agreement with a national bank until May 22, 2006. The facility provides TVA with an unsecured revolving line of credit of up to $2.5 billion. The interest rate on any borrowing under this agreement is variable and based on market factors and the rating of TVA’s senior unsecured long-term non-credit enhanced debt at the time TVA draws on the facility. TVA is required to pay an unused facility fee on the portion of the $2.5 billion against which TVA has not borrowed. This fee is similar to fees charged in the banking industry to similar customers for similar products and may fluctuate depending upon the rating of TVA’s senior unsecured long-term non-credit enhanced debt. There were no outstanding borrowings under the facility at March 31, 2006. TVA anticipates renewing this line of credit for a period not to exceed one year.

Capital Resources

Debt Securities Activity. From October 1, 2005, to March 31, 2006, TVA redeemed at par $155 million of electronotes® carrying an average interest rate of 5.86 percent. During the same period, TVA issued $68 million of electronotes® with an average interest rate of 5.24 percent.

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

Energy Prepayment Obligations. As of March 31, 2006, TVA had entered into sales agreements for 54.5 Discounted Energy Units totalling $54.5 million. Total credits applied to power billings on a cumulative basis during the life of the program through March 31, 2006, exceed $17 million. Of this amount, over $1 million was recognized as revenue for the quarterly periods ended March 31, 2006, and 2005.

In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment is being applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was $1.5 billion. Total credits applied to power billings on a cumulative basis during the life of the program through March 31, 2006, exceed $240 million. Of this amount, $25 million was recognized as revenue for the quarterly periods ended March 31, 2006, and 2005. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At March 31, 2006, and September 30, 2005, obligations under these prepayment programs were $1,297 million and $1,350 million, respectively. The amounts are included in Energy Prepayment Obligations and Current Portion of Energy Prepayment Obligations on the March 31, 2006, and September 30, 2005, Balance Sheets. There have been no energy prepayment transactions during 2005 and 2006.

Cash Requirements and Contractual Obligations
The estimated cash commitments for TVA as of March 31, 2006 are as follows:

Cash Requirements and Contractual Obligations

	2006*	2007	2008	2009	2010	Thereafter	Total
Debt	$ 3,566	$ 975	$ 91	$ 2,030	$ 42	$ 16,400	$ 23,104
Interest on debt	611	1,120	1,100	1,044	989	14,702	19,566
Leases	47	92	82	70	64	46	401
Lease/leaseback	36	85	89	85	89	1,209	1,593
Power purchase obligations	97	172	140	145	147	3,745	4,446
Other obligations	207	150	111	5	3	7	483
Fuel purchase obligations	728	524	449	397	380	604	3,082
Pension contribution	38	–	–	–	–	–	38
Total	$ 5,330	$ 3,118	$ 2,062	$ 3,776	$ 1,714	$ 36,713	$ 52,713

* Period April 1 – September 30, 2006

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

Contractual Obligations Related to Energy Prepayments

	2006*	2007	2008	2009	2010	Thereafter	Total
Energy prepayment obligations	$ 53	$ 106	$ 106	$ 105	$ 105	$ 822	$ 1,297

* Period April 1 – September 30, 2006

As of March 31, 2006, TVA's decommissioning funds totaled approximately $910 million. In October 2003, TVA provided a schedule of annual funding targets to the Nuclear Regulatory Commission ("NRC") and committed to make contributions to the decommissioning trust or provide other methods of funding assurance whenever the trust funds fall below 95 percent of the relevant funding target. In March 2006, TVA reviewed the funding status of the Nuclear Decommissioning Trust ("NDT") versus its liabilities in accordance with NRC requirements. TVA Nuclear recalculated the estimated cost of decommissioning based on updated Bureau of Labor Statistics indices through December 2005. The estimates continue to be based on the waste process indices in the NRC guidance documents. The funding target at the end of calendar year 2005 was $790 million at which time the NDT balance was $856 million. At March 31, 2006 the NDT balance of approximately $910 million is less than the present value of the estimated future decommissioning costs calculated in accordance with a formula provided by the NRC. See note 9—*Browns Ferry License Extension* and *"Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Critical Accounting Policies and Estimates" — "Nuclear Decommissioning"* in the 2005 Information Statement.

Results of Operations

Net income for the second quarter of 2006 was $14 million compared to net loss of $24 million for the same period of 2005. Significant items contributing to the $38 million increase in net income for the three months ended March 31, 2006, as compared to March 31, 2005, include:

- A net $189 million increase in revenues from municipalities and cooperatives due to a $209 million increase attributable to higher average rates as a result of the October 1, 2005, rate increase and increased sales volume partially offset by a $20 million reserve for litigation;
- A $17 million decrease in operating and maintenance expense as a result of fewer fossil outages and outage days;
- A $13 million increase in net unrealized gain on derivative contracts reflecting an increase in interest rates from the second quarter of 2005 to the second quarter of 2006; and
- A $16 million decrease in net interest expense due to decreased long-term interest rates and increased AFUDC.

These items were partially offset by:

- A $107 million increase in fuel expense attributable to higher market prices and increased generation at the combustion turbine plants;
- A $12 million increase in purchased power expense as a result of higher market prices; and
- A $93 million increase in amortization largely due to the amortization of deferred cost of nuclear generating units at Bellefonte Nuclear Plant.

Net loss through the first two quarters of 2006 was $39 million compared to net income of $66 million for the same period of 2005. Significant items contributing to the $105 million change in net income for the six months ended March 31, 2006, as compared to March 31, 2005, include:

- A $57 million decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) attributable to decreased generation available for sale and unfavorable market conditions;
- A $202 million increase in fuel expense as a result of higher market prices and increased generation at the combustion turbine plants;
- A $185 million increase in purchased power expense primarily due to higher market prices; and
- A $192 million increase in amortization mainly attributable to the amortization of deferred cost of nuclear generating units at Bellefonte Nuclear Plant.

These items were partially offset by:

- A net $433 million increase in revenues from municipalities and cooperatives due to a $453 million increase attributable to higher average rates as a result of the October 1, 2005, rate increase and increased volume partially offset by a $20 million reserve for litigation;
- A $23 million increase in net unrealized gain on derivative contracts reflecting an increase in interest rates from the first two quarters of 2005 to the first two quarters of 2006; and
- A $35 million decrease in net interest expense attributable to decreased long-term interest rates and increased AFUDC.

Operating Revenues

A detailed table of operating revenue for the three and six month periods ended March 31, 2006, and 2005 is as follows:

Operating Revenues

	Three Months Ended March 31			Six Months Ended March 31		
	2006	2005	Percent Change	2006	2005	Percent Change
Operating revenues						
Sales of electricity						
Municipalities and cooperatives	$ 1,750	$ 1,561	12.1%	$ 3,519	$ 3,086	14.0%
Industries directly served	246	236	4.2%	476	451	5.5%
Federal agencies and other	32	32	0.0%	58	105	(44.8%)
Other revenue	20	10	100.0%	47	31	51.6%
Total operating revenues	$ 2,048	$ 1,839	11.4%	$ 4,100	$ 3,673	11.6%

Significant items contributing to the $209 million increase in operating revenue for the three months ended March 31, 2006, as compared to March 31, 2005, include:

- A net $189 million increase in revenues from municipalities and cooperatives due to a $209 million increase as a result of average rates increasing 12.7 percent and increased volume partially offset by a $20 million reserve for litigation;
- A $10 million increase in revenues from directly served industries primarily due to average rates growing seven percent; and
- A $10 million increase in other revenue attributable to increased nonutility services and wheeling activity.

The rate increase, effective the first quarter of 2006, contributed about $121 million to the increase in revenues on firm-based products in the second quarter of 2006 over the same three-month period in 2005. An additional $94 million is due to higher average rates related to a shift in product and customer mix and higher rates for variable priced products.

These items were partially offset by a $5 million decrease in off-system sales (included in Federal Agencies and Other) as a result of decreased generation available for sale and unfavorable market conditions.

Significant items contributing to the $427 million increase in operating revenue for the six months ended March 31, 2006, as compared to March 31, 2005, include:

- A net $433 million increase in revenues from municipalities and cooperatives due to a $453 million increase as a result of average rates increasing 11.5 percent and increased volume partially offset by a $20 million reserve for litigation;
- A $25 million increase in revenues from directly served industries mainly attributable to average rates growing 28.0 percent; and
- A $16 million increase in other revenue as a result of increased nonutility services and wheeling activity.

The rate increase contributed about $196 million to the increase in revenues on firm-based products during the first six months of 2006 over the same six month period in 2005. An additional $180 million is due to higher average rates related to a shift in product and customer mix and higher rates for variable priced products.

These items were partially offset by a $57 million decrease in off-system sales (included in Federal Agencies and Other) due to decreased generation available for sale and unfavorable market conditions.

A detailed table of electricity sales for the three and six month periods ended March 31, 2006, and 2005 is as follows:

Electricity Sales

	Three Months Ended March 31			Six Months Ended March 31		
(millions of kWh)	2006	2005	Percent Change	2006	2005	Percent Change
Sales of electricity						
Municipalities and cooperatives	32,828	32,651	0.5%	65,932	64,136	2.8%
Industries directly served	8,166	8,374	(2.5%)	16,078	16,615	(3.2%)
Federal agencies and other	591	698	(15.3%)	1,050	2,466	(57.4%)
Total sales of electricity	41,585	41,723	(0.3%)	83,060	83,217	(0.2%)

Significant items contributing to the 138 million kilowatt-hour decrease in electricity sales for the three months ended March 31, 2006, as compared to March 31, 2005, include:

- A 208 million kilowatt-hour decrease in sales to directly served industries attributable to decreased demand by a couple of large volume customers; and
- A 158 million kilowatt-hour decrease in off-system sales (included in Federal Agencies and Other) as a result of decreased generation available for sale and unfavorable market conditions.

These items were partially offset by:

- A 177 million kilowatt-hour increase in sales to municipalities and cooperatives due to increased power demand reflecting favorable economic conditions; and
- A 50 million kilowatt-hour increase in sales to federal agencies (included in Federal Agencies and Other) attributable to increased power demand reflecting favorable economic conditions.

Significant items contributing to the 157 million kilowatt-hour decrease in electricity sales for the six months ended March 31, 2006, as compared to March 31, 2005, include:

- A 537 million kilowatt-hour decrease in sales to industries directly served as a result of decreased demand by a couple of large volume customers; and
- A 1,504 million kilowatt-hour decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) due to decreased generation available for sale and unfavorable market conditions.

These items were partially offset by:

- A 1,796 million kilowatt-hour increase in sales to municipalities and cooperatives attributable to increased power demand reflecting favorable economic conditions; and
- An 87 million kilowatt-hour increase in sales to federal agencies (included in FEDERAL AGENCIES AND OTHER) as a result of increased power demand reflecting favorable economic conditions.

Operating Expenses

A detailed table of operating expenses for the three and six month periods ended March 31, 2006, and 2005, is as follows:

Operating Expense

	Three Months Ended March 31			Six Months Ended March 31		
	2006	2005	Percent Change	2006	2005	Percent Change
Operating expenses						
Fuel and purchased power	$ 717	$ 598	19.9%	$ 1,462	$ 1,075	36.0%
Operating and maintenance	567	584	(2.9%)	1,167	1,166	0.1%
Depreciation, amortization, and accretion	389	290	34.1%	777	575	35.1%
Tax-equivalents	93	90	3.3%	187	181	3.3%
Total operating expenses	$ 1,766	$ 1,562	13.1%	$ 3,593	$ 2,997	19.9%

A significant driver contributing to the $204 million increase in total operating expenses for the three months ended March 31, 2006, as compared to March 31, 2005, was lower hydro generation (see *"Risk Factors and Forward-Looking Statements" — "Weather Risk"*) which contributed in part to:

- A $105 million increase in fossil fuel cost due in part to higher market prices and increased generation at the combustion turbine plants; and
- A $12 million increase in purchased power cost attributable in part to increased market prices for power.

Additionally, amortization expense increased $93 million largely as a result of the amortization of the deferred cost of nuclear generating units at Bellefonte Nuclear Plant.

These items were partially offset by a $17 million decrease in operating and maintenance expense due to fewer fossil outages and outage days.

A significant driver contributing to the $596 million increase in total operating expenses for the six months ended March 31, 2006, as compared to March 31, 2005 was lower hydro generation (see *"Risk Factors and Forward-Looking Statements" — "Weather Risk"*) which contributed in part to:

- A $199 million increase in fossil fuel cost due in part to higher market prices and increased generation at the combustion turbine plants; and
- A $185 million increase in purchased power cost attributable in part to increased market prices for power and an increase in the amount of power purchased.

Additionally, amortization expense increased $192 million largely as a result of the amortization of the deferred cost of nuclear generating units at Bellefonte Nuclear Plant.

Other Income

Other income was $4 million higher for the three months and six months periods ended March 31, 2006, as compared to the same periods of 2005, as a result of interest earnings on the collateral deposit funds held by TVA. See note 1—*Restricted Cash and Investments.*

Other Expense

The $2 million decrease in other expense for the six months ended March 31, 2006, as compared to the same period of 2005, is primarily due to the $2 million loss on the sale of distributor loan program receivables in 2005.

Unrealized Gain on Derivative Contracts, Net

Significant items contributing to the $13 million increase in net unrealized gain on derivative contracts for the three months ended March 31, 2006, as compared to the same period in 2005 include:

- A $34 million net gain on the mark-to-market valuation adjustment of an interest rate swap contract; and
- A $77 million net gain on the mark-to-market valuation adjustment of swaption contracts, which was offset by a $98 million net loss on the mark-to-market valuation of an embedded call option.

Significant items contributing to the $23 million increase in net unrealized gain on derivative contracts for the six months ended March 31, 2006, as compared to the same period in 2005 include:

- A $38 million net gain on the mark-to-market valuation adjustment of an interest rate swap contract;
- A $82 million net gain on the mark-to-market valuation adjustment of swaption contracts, which was offset by a $103 million net loss on the mark-to-market valuation of an embedded call option; and
- A $6 million unrealized net loss related to the mark-to-market valuation of sulfur dioxide ("SO_2") emissions allowance call options during the first quarter of 2005.

Interest Expense

A detailed table of interest expense for the three and six month periods ended March 31, 2006, and 2005 is as follows:

Interest Expense

	Three Months Ended March 31			Six Months Ended March 31		
	2006	2005	Percent Change	2006	2005	Percent Change
Interest expense						
Interest on debt	$ 333	$ 338	(1.5%)	$ 663	$ 677	(2.1%)
Amortization of debt discount, issue and reacquisition costs	5	5	0.0%	10	10	0.0%
Allowance for funds used during construction	(39)	(28)	39.3%	(75)	(54)	38.9%
Net interest expenses	$ 299	$ 315	(5.1%)	$ 598	$ 633	(5.5%)

Significant items contributing to the $16 million decrease in net interest expense for the three months ended March 31, 2006, as compared to March 31, 2005, include:

- A decrease in the average long-term interest rate from 6.30 percent to 6.07 percent,
- A reduction of $719 million in the average balance of long-term outstanding debt, and
- An $11 million increase in AFUDC due to a higher level of construction work-in-progress in 2006.

These items were partially offset by:

- An increase in the average discount note interest rate from 2.37 percent to 4.33 percent, and
- An increase of $677 million in the average balance of discount notes outstanding.

Significant items contributing to the $35 million decrease in net interest expense for the six months ended March 31, 2006, as compared to March 31, 2005, include:

- A decrease in the average long-term interest rate from 6.42 percent to 6.06 percent,
- A reduction of $319 million in the average balance of long-term outstanding debt, and
- A $21 million increase in AFUDC due to a higher level of construction work-in-progress in 2006.

These items were partially offset by:

- An increase in the average discount note interest rate from 2.14 percent to 4.13 percent, and
- An increase of $639 million in the average balance of discount notes outstanding.

Impact of New Accounting Pronouncements and Interpretations

Variable Interest Entities
In January 2003, the FASB published FASB Interpretation No. 46, *"Consolidation of Variable Interest Entities,"* which was revised by FASB Interpretation No. 46R ("46R") in December 2003. FIN 46(R) establishes consolidation criteria for entities for which "control" is not easily discernable under Accounting Research Bulletin ("ARB") 51, *"Consolidated Financial Statements,"* which is based on the premise that holders of the equity of an entity control the entity by virtue of voting rights. FIN 46(R) provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial interests rather than from voting interests. FIN 46(R) defines the term "variable interest entity" ("VIE") and is based on the premise that if a business enterprise absorbs a majority of the VIE's expected losses and/or receives a majority of its expected residual returns (measures of risk and reward), that enterprise (the primary beneficiary) is deemed to have a controlling financial interest in the VIE. An enterprise that bears the majority of the economic risk is considered to have a controlling financial interest in a VIE, even if it has no decision making (voting) authority or equity interest. TVA adopted FIN 46 and FIN 46(R) effective October 1, 2005, for VIEs created before December 31, 2003, and immediately for VIEs created after December 31, 2003.

In February 1997, TVA entered a purchase power agreement with Choctaw Generation, Inc. (subsequently assigned to Choctaw Generation Limited Partnership) to purchase all the power generated from its facility located in Choctaw County, Mississippi. The facility had a committed capacity of 440 megawatts and the term of the agreement was 30 years. Under the accounting guidance provided by FIN 46(R), TVA may be deemed to be the primary beneficiary under the contract; however, TVA does not have access to the financial records of Choctaw Generation Limited Partnership. As a result, TVA was unable to determine whether FIN 46R would require TVA to consolidate Choctaw Generation Limited Partnerships' balance sheet, results of operations and cash flows for the quarter and six months ended March 31, 2006. Power purchases for the first six months of 2006 under the agreement totaled $63 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

On April 13, 2006, the FASB issued FIN 46(R)-6, "*Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R),"* which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46. FIN 46(R)-6 is to be applied prospectively to all entities with which that enterprise first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FIN 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. TVA will apply this guidance beginning with the annual reporting period ending September 30, 2006. The adoption of this guidance is not expected to have a material impact on TVA's results of operations or financial condition.

Conditional Asset Retirement Obligations
In March 2005, the FASB issued FIN No. 47, *"Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143."* This interpretation clarifies that the term conditional asset retirement obligation ("conditional ARO") as used in SFAS No. 143, *"Accounting for Asset Retirement Obligations,"* refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Thus, the timing and (or) method of settlement may be conditional on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional ARO if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional ARO should be recognized when incurred. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an ARO. This interpretation is effective no later than the end of fiscal years ending after December 15, 2005. TVA will apply this guidance beginning with the fiscal year ending September 30, 2006. TVA is evaluating the potential implications of this interpretation on its AROs, which may or may not be material to its financial position or results of operations.

Accounting Changes and Error Corrections
In May 2005, the FASB issued SFAS No. 154, *"Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3,"* which replaces *"Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes,"* and FASB Statement No. 3, *"Reporting Accounting Changes in Interim Financial Statements."* This statement applies to all voluntary changes in accounting principles and also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires, unless impracticable, retrospective application to prior periods' financial statements of changes in accounting principles. If it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is

practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. This statement also requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. The statement will become effective for TVA beginning in 2007 with early adoption permitted for accounting changes and corrections of errors made in fiscal years beginning after May 2005 — the date the statement was issued.

<u>Accounting for Inventory Transactions</u>
At its September 28, 2005, meeting, the FASB reached consensus on Emerging Issues Task Force ("EITF") Issue No. 04-13, *"Accounting for Purchases and Sales of Inventory with the Same Counterparty."* In certain situations, a company may enter into a nonmonetary transaction to sell inventory to another company in the same line of business from which it also purchases inventory. Questions have arisen regarding how the guidance in APB Opinion No. 29, "*Accounting for Nonmonetary Transactions,"* should be applied in these situations. The consensus reached states that inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying Opinion 29. The Task Force also agreed that the issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more inventory transactions with the same counterparty should be considered as a single nonmonetary inventory transaction within the scope of Opinion 29. The Task Force also reached a consensus that a nonmonetary exchange within the same line of business involving the transfer of raw materials in exchange for the receipt of raw materials should not be recognized at fair value. This EITF should be applied to transactions completed in reporting periods beginning after March 15, 2006, whether pursuant to arrangements that were in place at the date of initial application of the consensus or arrangements executed subsequent to that date. The carrying amount of the inventory that was acquired under these types of arrangements prior to the initial application of the consensus, and that still remains in an entity's statement of financial position at the date of initial application of the consensus, should not be adjusted for this consensus. TVA adopted EITF Issue No. 04-13 beginning in the second quarter of 2006. The adoption of EITF Issue No. 04-13 did not have a material impact on TVA's results of operations or financial condition.

<u>Put and Call Options</u>
In September 2005, the Derivatives Implementation Group ("DIG") of the FASB discussed several issues related to the settlement of a debtor's obligation on the exercise of a call or put option and the exercise only by the debtor of the right to accelerate settlement of a debt with an embedded call option. DIG Implementation Issue No. B38, *"Embedded Derivatives: Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option,"* addresses whether the settlement of a debtor's obligation on exercise of a call or put option meets the net settlement criterion in paragraph 9(a) of SFAS No. 133, as amended. DIG Implementation Issue No. B39, *"Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor,"* addresses whether or not Paragraph 13(b) of SFAS No. 133, as amended, applies to a call option embedded with a debt host if the right to accelerate settlement of the debt can be exercised only by the debtor. The effective date of the implementation guidance in these issues is the first day of the first fiscal quarter beginning after December 15, 2005. The issue became effective for TVA beginning in the second quarter of 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

<u>Accounting for Rental Costs</u>
On October 6, 2005, the FASB issued FSP FAS 13-1, *"Accounting for Rental Costs Incurred during a Construction Period."* The FASB concludes in this FSP that rental costs associated with ground or building operating leases that are incurred during a construction period should be expensed. FASB Technical Bulletin ("FTB") No. 88-1, *"Issues Relating to Accounting for Leases,"* requires that rental costs associated with operating leases be allocated on a straight-line basis in accordance with FASB Statement No. 13, *"Accounting for Leases,"* and FTB 85-3, *"Accounting for Operating Leases with Scheduled Rent Increases,"* starting with the beginning of the lease term. The FASB believes there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. TVA began applying this guidance in the quarterly reporting period ending March 31, 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

<u>Impairment of Investments</u>
On November 3, 2005, the FASB released FSP FAS 115-1 and FAS 124-1, *"The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."* This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of an "other-than-temporary"

impairment and requires certain disclosures about unrealized losses that have not been recognized as "other-than-temporary" impairments. TVA began applying this guidance beginning with the quarterly reporting period ending March 31, 2006. The adoption of this guidance did not have a material impact on TVA's results of operations or financial condition.

Risk Factors and Forward-Looking Statements

Weather Risk

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

Water runoff was 57 percent of the planned amount through the first two quarters of the fiscal year, which has reduced TVA's hydro generation as well as the amount of water available for recreation and for cooling TVA's nuclear and coal-fired plants.

Operational Risk

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

Annual financial targets can be noticeably influenced by the unforeseen interruption of key generating facilities during peak seasons, and the likeliness of such interruptions increases with an aging generation fleet. TVA does, however, have outage insurance in place which is intended to minimize the financial impact of interruptions.

Additionally, during the quarter ended December 31, 2005, a supplier with whom TVA has contracts for purchased power filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. There is a possibility that the company may reject, or fail to perform, under an existing power purchase agreement. As of March 31, 2006, TVA has not received a termination notice, and the supplier has continued to perform its obligations under the contracts for purchased power. TVA currently has an agreement with the supplier for power through August 2007. See *"Quantitative and Qualitative Disclosures about Market Risk"—"Credit Risk."*

Rate Setting

In a future restructured electric power industry, it is possible that the ability of the Board to set TVA's rates as specified in the TVA Act could be adversely affected by legislative changes or by competitive pressures.

On February 13, 2006, the Board approved a 9.95 percent increase in firm wholesale electric rates effective on April 1, 2006. The rate increase is expected to provide approximately $388 million of additional revenue to TVA from power supplied during the remainder of 2006, creating an estimated $276 million in additional cash that TVA expects to receive from power bills becoming due before October 1, 2006. In addition, TVA is looking at other measures to defer, save, or reduce spending or cash reserves. The rate increase and these additional efforts are necessary to offset increased fuel and purchased power related costs, which from July 2005 to September 2006 are expected to exceed by over $500 million the amount projected in July 2005, when the TVA Board approved the previous rate increase. In addition, the Board directed TVA staff to proceed with testing a fuel cost adjustment mechanism that could be adopted in the future and used to adjust TVA's rates up and down as fuel and purchased power costs rise and fall.

Risk of Loss of Customers

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

While the Fence confines TVA to the Tennessee Valley, the so-called "Anti-Cherrypicking Provision" of the Federal Power Act provides that the Federal Energy Regulatory Commission ("FERC") cannot order TVA to deliver power from an outside source to a customer if the power would be consumed within the TVA service territory.

The Anti-Cherrypicking Provision minimizes the financial exposure of TVA and its customers to loss of distributor customers to balance the restrictions on TVA's selling power outside its service territory.

The Hopkinsville Electric System ("HES") Board of Directors voted March 28, 2006, to rescind its official notice canceling HES's power-supply contract with TVA. TVA and HES have reached agreement in principle on a contract amendment that would accommodate this request. HES, headquartered in Hopkinsville, Kentucky, provided notice of contract cancellation to TVA in August 2005, triggering a five-year notice period as provided for under the terms of the contract. During the notice period, HES remained a customer of TVA but had the opportunity to search for other power suppliers. During 2005, less than 0.3 percent of TVA's total operating revenues were from sales to HES.

On March 29, 2006, Duck River Electric Membership Corporation ("DREMC") and TVA executed a termination notice extension agreement that extends the termination date of DREMC's power contract with TVA from August 4, 2008, to August 4, 2010.

Since October 2002, nine of TVA's distributors have given notice to terminate their power contracts with TVA. Including the rescission of the HES contract cancellation, notices from three of these distributors have since been withdrawn and deemed to be of no force and effect by the mutual agreement of the distributors and TVA.

In January 2006, FERC issued a final order directing TVA to interconnect with the East Kentucky Power Cooperative ("EKPC") at three locations on the TVA transmission system. If upheld, this order would allow EKPC to interconnect with the TVA transmission system in a manner that will allow EKPC to provide power to Warren Rural Electric Cooperative Corporation ("WRECC") when WRECC's contract with TVA terminates in April 2008. TVA believes this would be contrary to the provisions of the Federal Power Act which restrict power providers from using TVA's transmission system to serve customers in TVA's service area. If FERC denies TVA's request for a rehearing in this matter, TVA may seek review in the federal court of appeals.

A number of TVA distributors, including some with the largest loads, have expressed interest in further revising their wholesale power contracts to allow them more options with respect to contract term and other matters, such as purchasing a portion of their power requirements from suppliers other than TVA. TVA is working with distributors and the Tennessee Valley Public Power Association, an association which includes most distributors of TVA power, to develop new long-term contract options and future wholesale pricing options.

Compliance with Environmental Regulations

As is the case across the utility industry and in other industrial sectors, TVA's activities are subject to certain federal, state and local environmental statutes and regulations, primarily in the areas of air quality control, water quality control and management and disposal of solid and hazardous wastes. TVA has incurred, and continues to incur, significant capital and operating/maintenance costs associated with compliance with evolving environmental regulations, many of which are associated with the operation of TVA's 59 coal-fired generating units. These costs could be even more significant in the future as a result of changes in legislation and other factors.

Through 2005, TVA had spent \$4.4 billion on clean air projects and plans to spend \$1.3 billion more on additional environmental projects, and the results from calendar year 2005 illustrate the progress that has resulted from this investment. Annual emissions of SO_2 and both annual and ozone season nitrogen oxide ("NO_x") emissions from TVA plants in calendar year 2005 were the lowest since all 59 coal-fired generating units have been in operation. Annual SO_2 emissions were down 80 percent from peak 1977 levels, and down 47 percent in the last ten years. Annual nitrogen oxide emissions were down 64 percent from the peak 1995 level, and ozone season NO_x emissions have been reduced by 80 percent since 1995. This achievement occurred during a year when fossil system generation was up 3.5 percent from the previous year, and the third highest calendar year generation in TVA's history. TVA continues to consider better, more cost-effective ways to further reduce emissions in light of evolving emission reduction requirements. TVA's objective is to optimize its coal-fired assets and strategy for compliance with clean air regulations by maintaining the flexibility to respond to changing market conditions and allowing an adequate timeline to mitigate uncertainties. In light of the continuing progress in reducing its emissions, TVA expects to have a several-year window available before deciding on significant additional investments beyond those already announced. TVA's plan will manage uncertainties and risks, provide flexibility to match predicted loads, and allow time to evaluate market conditions and make changes to other strategies as business conditions dictate.

Forward-Looking Statements

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain asset retirement obligations; expectations about the adequacy of TVA’s nuclear decommissioning fund; estimates regarding the reduction of total financing obligations; the impact of new accounting pronouncements and interpretations, including FASB Interpretation No. 47, *“Accounting for Conditional Asset Retirement Obligations — an interpretation of FASB Statement No. 143;”* TVA’s plans to continue using short-term debt to meet current obligations; and the anticipated cost and timetable for returning Browns Ferry Unit 1 to service.

Although TVA believes that the assumptions underlying the forward-looking statements are reasonable, TVA does not guarantee the accuracy of these statements. Numerous factors could cause actual results to differ materially from those in the forward-looking statements. These factors include, among other things, new laws, regulations, and administrative orders, especially those related to the restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; changes to the Anti-Cherrypicking Provision of the Federal Power Act (see *“Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “Risk Factors and Forward-Looking Statements” — “Risk of Loss of Customers”* in this Quarterly Report); legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA’s generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; damage to power production or transmission facilities or systems due to accidental events or terrorist activity; changes in accounting standards; and unforeseeable events. Additionally, other risks that may cause actual results to differ from the predicted results are set forth in *“Management's Discussion and Analysis of Financial Condition and Results of Operations” — “Risk Factors and Forward-Looking Statements”* in this Quarterly Report. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA’s business or cause results to differ materially from those contained in any forward-looking statement.

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

Other

TVA Governance

On March 31, 2006, six new TVA Board members took the oath of office and joined Bill Baxter and Skila Harris in holding the first Board meeting under the new governance structure established by the Consolidated Appropriations Act, 2005. In its first item of business, the new Board elected Knoxville businessman Bill Sansom as its chairman. The Board also appointed TVA President and Chief Operating Officer Tom Kilgore as Acting Chief Executive Officer. In addition to Mr. Sansom, the new Board members are Dennis Bottorff of Nashville, TN; Don DePriest of Columbus, MS; Mike Duncan of Inez, KY; Howard Thrailkill of Huntsville, AL; and Susan Richardson Williams of Knoxville, TN. President Bush has not yet announced his nominee for the remaining seat on the Board. See *“Management’s Discussion and Analysis of Financial Condition and Results of Operation” — “Legislative and Regulatory Matters” — “TVA Governance”* in the 2005 Information Statement.

Kentucky Distributors

In 2005, Senator Mitch McConnell of Kentucky introduced a bill, S. 1499, that would effectively remove any area within Kentucky from the requirements of the Anti-Cherrypicking Provision. If the bill were to become law as originally written, one possible effect would be that the FERC would have the authority to require TVA to wheel power from a supplier other than TVA for use inside that portion of TVA’s service area that is within Kentucky. The status of this bill is unclear and the likelihood of the bill’s requirements becoming law remains unknown. See *“Management’s Discussion and Analysis of Financial Condition and Results of Operation” — “Risk Management Activities” — “Risk of Loss of Customers”* in the 2005 Information Statement.

Fossil Fuels Inventories

As a result of hurricanes Katrina and Rita during the summer of 2005, 14 percent of the offshore Gulf of Mexico natural gas production remains shut-in (meaning the gas wells are not able to produce) although indications are that the situation is improving. TVA has natural gas supply in storage and plans to continue making forward purchases of natural gas to meet TVA’s expected demand.

In April 2006, two TVA coal suppliers which had previously experienced problems in meeting their production goals have reported that production at certain mines has restarted. One supplier resumed full production while the other was in start-up. A third coal supplier which has experienced problems was able to meet one-third of its scheduled production for March 2006. A fourth coal supplier remains unable to deliver due to mine problems.

Browns Ferry Unit 1

In May 2002, the TVA Board initiated activities for the return of Browns Ferry Unit 1 to service in order to meet long-term energy needs in the Tennessee Valley. It is anticipated the Browns Ferry Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately $1.8 billion. Unit 1 is expected to return to service in 2007, and the additional generating capacity is expected to lower the average cost of power and provide additional cash flow. As of March 31, 2006, TVA had incurred approximately $1.6 billion of costs (including AFUDC of $139 million) on the Browns Ferry Unit 1 restart project, the planned amount for this period. The restart project was over 81 percent complete at that date and on schedule for completion.

Bellefonte Nuclear Plant

In September 2005, NuStart Development LLC (“NuStart”) selected Bellefonte Nuclear Plant (“Bellefonte”) as one of the two sites in the country for a new advanced design nuclear plant. NuStart is an industry consortia comprised of eight utilities and two reactor vendors whose purpose is to satisfactorily demonstrate the new Nuclear Regulatory Commission licensing process for new nuclear plants. NuStart intends to seek a combined construction and operating license for the site for the new Advanced Passive 1000 reactor design by Westinghouse Electric Co. No decision has been made to actually build an advanced reactor at the site.

Fuel Fabrication Claims

On November 9, 2005, TVA received two invoices totaling $76 million from Areva (“Areva”) and an affiliated company, the successor of Babcock and Wilcox Company (“B&W”). In 1970, TVA and B&W entered into a contract for fuel fabrication services for Bellefonte. Areva’s invoices are based upon its belief that the 1970 contract required TVA to buy more fuel fabrication services from B&W than TVA actually purchased. TVA is reviewing Areva’s claim and has requested Areva to provide more information about several aspects of its claim. TVA is awaiting a response from Areva.

Bear Creek Dam Seepage

Bear Creek Dam is experiencing foundation problems as evidenced by seepage through the foundation of the dam. TVA is initiating a study to evaluate long-term options related to seepage at Bear Creek Dam. A draft schedule and budget have been developed for the study, which will identify potential alternatives for resolution in accordance with National Environmental Policy Act guidelines. Communications with local leaders and key stakeholders are beginning.

President’s 2007 Budget, TFO Reductions

On February 6, 2006, the Office of Management & Budget submitted the President’s 2007 budget to Congress. The budget calls for increased reductions in TVA’s total financing obligations (“TFOs”) through 2016. For 2007, the TFO reduction target is $529 million.

TVA estimates it will reduce TFOs by a total of $7.8 billion for 2004 through 2016. TVA defines TFOs as debt and certain debt-like instruments which include bonds, discount notes, lease/leaseback obligations and energy prepayments. This estimate is based on the assumptions that TVA will recover fuel and purchased-power cost increases through revenues and that TVA will be able to keep growth in other operating and maintenance costs at one-half of one percent (½ percent) below the rate of inflation. As with any type of long term planning, business model uncertainties and assumptions, most of which are out of TVA’s control, may negatively impact TVA’s ability to achieve the targeted reductions in TFOs. See *“Forward-Looking Statements.”*

Through 2005, TVA has reduced its TFOs by $2.1 billion since the beginning of 1997. As of March 31, 2006, TVA had $25.5 billion of TFOs outstanding.

Medicare Part D

Beginning in 2006, Medicare will provide prescription drug coverage under Medicare Part D to Medicare beneficiaries. For employers that provide prescription drug plans for retirees, a retiree drug subsidy is available if the plans pass a two-part actuarial equivalence test. TVA determined that its retiree prescription drug plan did not meet the second part of the test and that it could not continue to provide its then current plan for retirees and receive the direct subsidy from

Medicare. After analyzing the additional options available to employers for integration with Medicare Part D, TVA elected to provide an employer-sponsored Part D prescription drug plan, commonly referred to as an Enhanced PDP. The newly established Enhanced PDP (1) provides alternative coverage over and above Medicare standard Part D coverage for Medicare-eligible retirees who participate in TVA's Medicare supplement and (2) receives subsidies from Medicare that are required to be passed through to beneficiaries to reduce the drug portion of participant premiums.

New Source Review Program
On March 17, 2006, the United States Court of Appeals for the District of Columbia Circuit struck down the Environmental Protection Agency's modification of the new source review program under the Clean Air Act ("CAA"). The rule allowed power plants and other facilities to replace existing equipment with its functional equivalent without undergoing the extensive review necessary for modifications determined to be new sources if the replacement did not exceed 20 percent of the value of the facility. The ramifications of this decision for TVA and other utilities remain uncertain.

Tennessee Valley Business Development
TVA has established Valley Business Ventures, a new division created to help increase jobs and capital investment in high-growth industries and in companies owned by women and minorities in the TVA region. Representatives of TVA will work with economic development professionals, distributor customers, financial institutions, city and federal procurement officers, and high-growth company owners to increase business opportunities for high-growth companies and develop a comprehensive strategy for recruiting and growing companies owned by women and minorities in the Valley.

Subsequent Events

Debt Securities
In April 2006, TVA issued $1 billion of 50-year global power bonds which mature April 1, 2056, and have a coupon rate of 5.375 percent.

Also in April 2006, TVA issued $21 million of electronotes® with an interest rate of 5.13 percent which mature in 2010 and are callable beginning in 2007.

In May 2006, TVA issued $6 million of electronotes® with an interest rate of 5.25 percent which mature in 2011 and are callable beginning in 2007.

Legal Proceedings
In April 2006, TVA was added as defendant to a class action lawsuit brought in federal court by fourteen residents of Mississippi who were allegedly injured by Hurricane Katrina. The plaintiffs have sued several large oil companies and an oil company trade association, three large chemical companies and a chemical trade association, and 31 large companies involved in the mining and burning of coal, including TVA and other utilities. The theory of the case is that defendants' greenhouse gas emissions contributed to global warming and were a proximate and direct cause of the increase in the destructive force of Hurricane Katrina. The plaintiffs are seeking monetary damages among other relief. TVA is still examining the case and evaluating its options at this time.

Bellefonte Construction Permits
In December 2005, TVA notified the NRC that it has placed Bellefonte Nuclear Plant Units 1 and 2 in terminated status and that it intends to submit for NRC approval a request for withdrawal of construction permits for these units. Canceling the construction status of the existing plant facilities and withdrawal of the related construction permits are necessary in order to facilitate other future uses of the Bellefonte site. The placement of the partially constructed Bellefonte units in terminated status does not prevent the future use of the Bellefonte site for other uses, including the construction of any new nuclear or non-nuclear power facilities. On April 6, 2006, TVA sent its letter requesting withdrawal of the construction permits and attached its redress plan for the site. TVA requested prompt review and approval "to allow redress activities to commence supporting optimal use of the site."

Browns Ferry License Extension
On May 4, 2006, the NRC approved TVA's application for license extension at each of TVA's three Browns Ferry units. As a result of the NRC's action, each unit's license has been extended 20 years, which will allow TVA to produce power from the facilities until 2033, 2034, and 2036 for Units 1, 2, and 3, respectively. This license extension has the effect

of improving the funded status of TVA's Nuclear Decommissioning Trust ("NDT") versus the present value of the estimated decommissioning costs by (1) extending the decommissioning dates of the three Browns Ferry units and thereby pushing the decommissioning liability for these units further into the future and (2) extending the investment horizon for the assets in the NDT.

Transmission System

Powerful spring storms, including 40 tornadoes reported in the TVA service area, damaged TVA and power distributor systems in Middle Tennessee and Kentucky on April 7 and 8, 2006. Earlier the same week, on April 2, 2006, another powerful storm system brought at least 16 tornadoes to the western and central portions of the service territory, also damaging TVA and power distributor systems.

Several 500-kV, 161-kV, and lower voltage TVA transmission lines suffered damage, but the bulk transmission system remained stable throughout both storms. Service was restored to all TVA customer delivery points within hours of the storms via alternate transmission paths. Numerous line sections not immediately affecting customer delivery points remained out of service for several days as repairs were made. TVA activated its Transmission Emergency Operations Center to support both its own recovery and that of the power distributors' systems. Cost estimates for repairs from both storms are about $4 million, which were covered through storm contingency funds.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Through the normal course of its business, TVA is exposed to various market risks, including changes in interest rates, inflation rates, foreign currency exchange rates, and certain commodity and equity market prices. TVA is also exposed to losses in the event of counterparties' nonperformance and accordingly has established controls to determine the creditworthiness of counterparties in order to mitigate exposure to credit risk.

Mark-to-Market Valuation

TVA monitors the mark-to-market ("MTM") fair value of energy assets for the upcoming year. MTM analysis values contracts at their "fair value" (the value a willing third party would pay for the particular contract at the time a valuation is made). These analyses include, but are not limited to, native system load contracts, energy forwards, energy options, and other energy derivative instruments for unit specific generation units. Sensitivity analyses are performed on a weekly basis to determine the market price impact to the energy portfolio when the market price moves beyond TVA's projections.

When available, quoted market prices are used to record a contract's fair value. However, market values for energy trading contracts may not be readily determinable because the duration of the contracts exceeds the liquid activity in a particular market. If no active trading market exists for a commodity, holders of these contracts must calculate fair value using pricing models based on contracts with similar terms and risks.

Derivatives

To manage its risk exposures, TVA has entered into various derivative transactions. TVA risk management policies provide for the use of derivative financial instruments to manage financial exposures but prohibit the use of these instruments for speculative trading purposes. TVA accounts for these derivative instruments in accordance with the provisions of SFAS No. 133, *"Accounting for Derivative Instruments and Hedging Activities,"* as amended by SFAS No. 138, *"Accounting for Certain Derivative Instruments and Certain Hedging Activities,"* and SFAS No. 149, *"Amendment of Statement 133 on Derivative Instruments and Hedging Activities."*

Derivative contracts utilized by TVA include currency, inflation, and interest rate swap agreements, swaption agreements, and options and futures contracts on various commodities. An inflation swap is used to hedge TVA's exposure related to its inflation-indexed accreting principal bonds, and currency swap contracts are used as hedges for foreign currency denominated debt issues. These transactions qualify for cash flow hedge accounting treatment under SFAS No. 133, as amended. Consequently, the effective portions of gains and losses related to these types of contracts are deferred and reported in Accumulated Other Comprehensive Income (Loss) with corresponding adjustments to the derivatives' book values until the contracts actually settle. The ineffective portions of the derivatives' changes in fair value are recognized immediately in the determination of earnings.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on the Balance Sheets at March 31, 2006, include the following:

	Accumulated Other Comprehensive Income (Loss)	
	March 31, 2006	September 30, 2005
Inflation swaps	$ (3)	$ 2
Foreign currency swaps	119	25
Total	$ 116	$ 27

Accumulated Other Comprehensive Income

Other derivative contracts include swaption agreements, an interest rate swap, various purchased power option contracts, coal contracts that contain volume options, and options on futures contracts. One of TVA's swaption agreements qualifies for fair value hedge accounting under SFAS No. 133, as amended, and the gains and losses on the hedged item and the hedging item are recognized immediately in the determination of earnings. TVA elected to forego hedge accounting treatment for two other swaption agreements, and the gains and losses on these swaption agreements, as well as the gains and losses on an interest rate swap that does not qualify for hedge accounting treatment under SFAS No. 133, as amended, are recognized immediately in the determination of earnings.

TVA has purchased power option contracts and coal contracts that contain volume options. Gains or losses on these contracts are deferred and regarded as regulatory assets or liabilities in accordance with SFAS No. 71 until settlement, at which time they are recognized in fuel and purchased power expenses. This treatment reflects TVA's ability and intent to account for these derivative instruments on a settlement basis for rate-making purposes. In addition, TVA holds purchased options related to futures contracts, and the changes in fair value of these options are recognized immediately in the determination of earnings.

Credit Risk

TVA's credit risk has not changed materially from that reported in the 2005 Information Statement. However, during the quarter ended December 31, 2005, a supplier of purchased power filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. Because of the nature of business and the supplier's position in the marketplace, TVA is exposed to the supplier under various contractual arrangements. TVA does not expect to experience any cash losses as a result of the supplier's bankruptcy. Through March 31, 2006, the supplier has continued to perform under the contractual arrangements.

Emission Allowances

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

Financial Trading Program

A financial trading program to reduce TVA's economic risk exposure associated with TVA's physical electricity generation, purchases, and sales was approved by the Board on May 17, 2005. The program enables TVA to trade certain futures contracts and options on futures contracts for the purpose of managing economic risks directly associated with the cost of natural gas and fuel oil for TVA's power generation operations; broadens the type of risks that TVA can hedge to include economic risks directly associated with both the cost of natural gas for tolling agreements and purchase or sale arrangements where the energy price is based at least in part upon a fuel price index or proxy; and hedge risks more effectively by using swaps and options on swaps in addition to futures and options on futures. Trading is not authorized for speculative purposes.

At March 31, 2006, TVA had 574 derivative contracts outstanding under the program with an approximate net market value of $45 million. The program has enabled TVA to effectively hedge the price risk associated with a portion of its natural gas and power purchases. During the three-month period ended March 31, 2006, TVA recognized unrealized losses of approximately $7 million which did not include the previous quarter's unrealized loss of nearly $1 million. The programs cumulative unrealized loss is approximately $8 million which includes all such losses in purchased power expense for the period ending March 31, 2006.

Financial Trading Program Activity
Six Months Ended March 31

	2006 Notional Amount (in mmBtu)	Contract Value	2005 Notional Amount (in mmBtu)	Contract Value
Futures contracts				
Financial positions at beginning of period, net	880,000	$ 9.6	–	$ –
Purchased	5,570,000	53.0	770,000	5.0
Sold	(710,000)	(9.6)	(390,000)	(2.6)
Realized gains (losses)	–	–	–	–
Net positions–long	5,740,000	53.0	380,000	2.4
Options Contracts				
Financial positions at beginning of period, net	240,000	–	–	–
Calls purchased	–	–	250,000	0.2
Puts sold	–	–	500,000	(0.2)
Positions closed or expired	(240,000)	–	(240,000)	–
Net positions	–	–	510,000	–
Holding gains (losses)				
Unrealized gains at the beginning of period, net	–	0.5	–	–
Unrealized (losses) for the period	–	(8.2)	–	0.9
Unrealized (losses) at end of period, net	–	(7.7)	–	0.9
Financial positions at end of period, net	5,740,000	$ 45.3	890,000	$ 3.3

CONTROLS AND PROCEDURES

TVA maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its financial statements is recorded, processed, summarized, authorized and reported on a timely basis, and that such information is accumulated and communicated to TVA management, including the Acting Chief Executive Officer, President, and Chief Operating Officer; the Disclosure Control Committee; and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation has been performed under the supervision of TVA management, including the Acting Chief Executive Officer, President, and Chief Operating Officer and members of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) of the effectiveness of TVA's disclosure controls and procedures as of March 31, 2006. Based on that evaluation, the Acting Chief Executive Officer, President, and Chief Operating Officer and members of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) concluded that, as a result of internal control deficiencies (described below), TVA's disclosure controls and procedures were not effective as of March 31, 2006. However, to assess the financial statement impact of these internal control deficiencies, TVA performed additional analyses, interim procedures, and monitoring activities. As a result of these measures and through reliance on compensating controls, the Acting Chief Executive Officer, President, and Chief Operating Officer and members of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) have determined that there is reasonable assurance that the financial statements included in this report fairly present, in all material respects, TVA's financial condition, results of operations and cash flows as of, and for, the periods presented. However, these identified internal control deficiencies, if not remediated, could individually or in the aggregate result in a material weakness.

Note: The Public Company Accounting Oversight Board ("PCAOB") has defined significant deficiency as "a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected." Further, the PCAOB has defined material weakness as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

During the fourth quarter of 2005, TVA management identified a significant deficiency related to controls over the completeness, accuracy, and authorization of TVA's property, plant, and equipment transactions and balances. To remediate this deficiency, TVA is developing a new process for project approval to include the determination of proper project cost classification, formalizing the accounting review of account balances and transactions, and improving the documentation of management review and approval.

As of June 30, 2005, an internal control deficiency was identified related to TVA's general computer controls in the area of unrestricted access to data. General computer controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping ensure the continued operation of information systems. TVA is taking corrective actions to address this significant deficiency using stricter logging and monitoring processes for data changes and additional documentation and security procedures.

Previously, during the fourth quarter of 2004, management identified a significant deficiency related to TVA's end use billing arrangements with wholesale power customers. Under these arrangements, TVA relies on the customers to calculate major components of their own power bills. Without some assurance of the adequacy of customer internal controls, TVA cannot be reasonably satisfied that internal control deficiencies within the customer control environments do not exist. TVA has requested an annual Statement on Auditing Standards ("SAS") 70 internal control reports on 12 specific control objectives from customers and their third party billing processors. The first SAS 70 reports will be due to TVA on August 31, 2006.

In addition to the efforts taken and currently underway as described above, TVA has addressed an internal control deficiency in TVA's general computer controls related to program development, program changes, and access to programs by standardizing the evidence of approval for change authorization, using stricter logging and monitoring processes for program changes, and restricting access to the production environment.

TVA management has also addressed the internal control deficiency related to mark-to-market valuation of coal contracts that contain volumetric optionality by performing quarterly independent reviews of all new contracts to be included, supplements included, and changes made to the valuation model. TVA also implemented independent reviews of the input of contract terms into the valuation model and proper segregation of duties.

TVA management believes that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company can be detected. TVA's controls and procedures can only provide reasonable, not absolute, assurance that the objectives will be met. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

OTHER INFORMATION

LEGAL PROCEEDINGS

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the U.S. District Court for the Northern District of Alabama alleging that TVA overcharged for economy surplus power ("ESP") during the summer of 1998. The lawsuit was filed as a class action on behalf of industrial customers who participated in TVA's ESP program. Under ESP contracts, the hourly ESP energy price is calculated using TVA's actual incremental cost of supplying the ESP load in each hour. The plaintiff alleges that TVA overcharged for ESP during the summer of 1998 by including in the price of ESP some costs that were added to TVA's incremental cost. The complaint seeks over $100 million in damages on behalf of Birmingham Steel and the other class members. In September 2002, the district court decertified the class and then dismissed Birmingham Steel's individual claim without prejudice on a jurisdictional issue. The class lawyers appealed the ruling on class decertification, and in December 2003, the U.S. Court of Appeals for the Eleventh Circuit ("Eleventh Circuit") reversed that ruling and sent the case back to the district court to allow the class lawyers a reasonable time to find a new class representative. The district court allowed the substitution of Johns Manville Corporation to represent the class. Motions for summary judgment were filed in October 2005. On April 18, 2006, the district court ruled in the plaintiff's favor on the issue of liability. Specifically, the court held that TVA could only charge ESP customers for the costs of power purchased in advance ("forwards") during the hours TVA actually needed the power to supply ESP, and that TVA's charges for approximately 500 hours of forwards breached the contracts. The court rejected TVA's position that the additional price charged for all hours represented actual incremental costs incurred by TVA in supplying ESP and thus was an appropriate part of the ESP contract price. The court also held that, while there are disputed factual issues as to TVA's defenses, plaintiff was entitled to summary judgment on liability issues. The court has indicated that it will hold a trial on the issue of damages, but no date has yet been set. TVA is currently evaluating the decision and TVA's options in responding to the decision, as well as any potential damages.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of certain of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory limitations period. As to the plaintiffs' allegations of federal law violations, the court found that Congress had specifically authorized TVA to set the rates charged by distributors via its contracts. In the face of such express Congressional authorization, the plaintiffs' federal law claims failed as a matter of law and were dismissed with prejudice, precluding them from being brought again. The plaintiffs moved for reconsideration of the dismissal, and the judge denied the plaintiffs' motion. The plaintiffs subsequently appealed to the U.S. Court of Appeals for the Sixth Circuit ("Sixth Circuit"). Briefing was completed in February 2006. No date for oral argument has been set at this time. TVA has no further or new conclusions concerning the case.

In July 2004, two lawsuits were filed against TVA in federal court in New York, New York alleging that global warming is a public nuisance and that carbon dioxide ("CO_2") emissions from TVA's fossil-fired electric generating facilities should be ordered abated because they contribute to causing the nuisance. The first case was filed by the States of California, Connecticut, Iowa, New Jersey, New York, Rhode Island, Vermont, and Wisconsin and the City of New York against TVA, American Electric Power, Inc., American Electric Power Service Corporation, Southern Company, Xcel Energy, Inc., and Cinergy Corporation. The second case, which alleges both public and private nuisance, was filed against the same defendants by Open Space Institute, Inc., Open Space Conservancy, Inc., and the Audubon Society of New Hampshire. There are no Clean Air Act ("CAA") requirements limiting CO_2 emissions, and, accordingly, the suits do not involve allegations of regulatory noncompliance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO_2 emissions and then reduce these emissions by an specified percentage each year for at least a decade. In September 2005, the district court dismissed both lawsuits, concluding that they raised political questions that should not be decided by the courts. The plaintiffs have filed notices of appeal to the U.S. Court of Appeals for the Second Circuit. Briefing was concluded in February 2006. Oral argument has been set for June 7, 2006.

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with U.S. Department of Energy ("DOE") for the disposal of spent nuclear fuel ("SNF"). Payments to DOE are based upon TVA's nuclear generation and charged to nuclear fuel expense. Although the contracts called for DOE to begin accepting SNF from the utilities by January 31, 1998, DOE announced that it will not begin picking up spent nuclear fuel from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools of borated water at its nuclear sites. Although TVA would have had sufficient space to continue to store SNF in those storage pools at its Sequoyah and Browns Ferry Nuclear Plants indefinitely had DOE begun accepting SNF, DOE's failure to do so required TVA to construct dry cask storage facilities at its Browns Ferry and Sequoyah Nuclear Plants and to purchase special storage containers for the SNF. (Watts Bar Nuclear Plant currently has sufficient storage capacity in its spent fuel pool to last until 2018.) Both Sequoyah's and Browns Ferry's dry cask storage facilities are operational. To recover the cost of providing long-term, on-site storage for SNF, TVA filed a breach of contract suit against the United States in the Court of Federal Claims in 2001. The case went to trial in June 2005, and the proof centered on TVA's claims through 2004. On January 31, 2006, the Court of Federal Claims issued a decision in TVA's favor, awarding TVA nearly $35 million, substantially all the damages sought in the suit. Under the decision, TVA retains the right to bring lawsuits to recover for extra costs incurred after September 30, 2004. On April 3, 2006, the United States filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit.

The National Parks Conservation Association, Inc. ("NPCA"), and Sierra Club, Inc. ("Sierra Club") filed suit in 2001 in federal district court in Birmingham, Alabama, alleging TVA violated the CAA and implementing regulations at Unit 5 of TVA's Colbert Fossil Plant ("Colbert"). Plaintiffs allege that TVA made major modifications to Unit 5 without obtaining preconstruction permits (in alleged violation of the Prevention of Significant Deterioration ("PSD") program and the Nonattainment New Source Review ("NNSR") program) and without complying with emission standards (in alleged violation of the New Source Performance Standards ("NSPS") program). Plaintiffs seek injunctive relief, civil penalties of $25,000 per day for each violation before January 30, 1997, and $27,500 per day for each violation after that date, an order that TVA pay up to $100,000 for beneficial mitigation projects, and costs of litigation, including attorney and expert witness fees. On November 29, 2005, the court held on sovereign immunity grounds that plaintiffs could not seek civil penalties against TVA. On January 17, 2006, the district court issued a final order dismissing the action, on the basis that plaintiffs failed to provide adequate notice of NSPS claims and that the statute of limitations curtailed the PSD and NNSR claims. Plaintiffs filed a notice of appeal to the Eleventh Circuit on January 25, 2006. If the decision is reversed on appeal, there is a reasonable possibility that TVA will be found liable,and ordered to install additional controls on Unit 5.

NPCA and the Sierra Club filed suit in the Eastern District of Tennessee in 2001 alleging that TVA modified its Bull Run Fossil Plant ("Bull Run") without complying with the New Source Review requirements of the CAA. In March 2005, the district court granted TVA's motion to dismiss the lawsuit in the Bull Run case on statute of limitation grounds. The plaintiffs' motion for reconsideration was denied, and they have appealed to the Court of Appeals for the Sixth Circuit. Twelve states have filed amicus curie briefs with the Sixth Circuit supporting the appeal filed by the plaintiffs. The states are New York, Connecticut, Illinois, Iowa, Maryland, New Hampshire, New Jersey, New Mexico, Rhode Island, Kentucky, Massachusetts, and Pennsylvania. Several Ohio utilities filed an amicus curie brief with the Sixth Circuit supporting TVA. Briefing is expected to be completed in May 2006. No oral argument date has been set.

The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert between July 1, 1997, and June 30, 2002. The groups sought a court order that potentially could require TVA to incur substantial costs, in addition to the costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately $250 million. On September 14, 2004, the court found that TVA had not violated the CAA because all of the challenged emissions were within Alabama's two percent de minimis rule (which provided a safe harbor if emissions did not exceed allowable opacity limits more than two percent each quarter), and the complaint was dismissed in its entirety. The plaintiffs appealed the district court's decision to the Eleventh Circuit. On November 22, 2005, the Eleventh Circuit issued its opinion, affirming the lower court in part and reversing in part. The Eleventh Circuit held that the Alabama de minimis rule was not applicable because it attempted to revise the opacity limits without going through the appropriate amendment process and receiving Environmental Protection Agency ("EPA") approval. The appeals court therefore reversed summary judgment in favor of TVA and indicated that it would remand the case to the district court for further proceedings. The Eleventh Circuit affirmed the lower court's dismissal of the claims for civil penalties, holding that sovereign immunity principles preclude assessing civil penalties in citizen suits brought under the CAA against federal entities such as TVA. The lower court has indicated that it views the Eleventh Circuit's decision as a determination that TVA is in violation of opacity requirements at Colbert. On February 28, 2006, the Eleventh Circuit denied TVA's petition for a rehearing, and the case was then remanded to the district court. The plaintiffs have filed a motion for summary judgment, which TVA has opposed.

On January 30, 2006, North Carolina's Attorney General filed suit against TVA alleging that TVA's operation of its coal-fired power plants in Tennessee, Alabama, and Kentucky constitute public nuisances. TVA moved to dismiss the case on grounds that the case is not suitable for judicial resolution because of separation of powers principles and the Supremacy Clause. TVA expects briefing on the motion to be completed in May 2006.

In 2005, the State of North Carolina petitioned the EPA under Section 126 of the CAA to impose additional emission reductions requirements for sulfur dioxide and nitrous oxides emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama, where TVA's coal-fired power plants are located. In March 2006, the EPA denied the North Carolina petition primarily on the basis that the Clean Air Interstate Rule remedies the problem.

It is not possible to predict with certainty whether TVA will incur any liability or to estimate the damages, if any, that TVA might incur in connection with the lawsuits described above except as specifically noted. TVA has recognized charges to earnings and actual costs, including legal fees and expenses, related to litigation. No assurance can be given that TVA will not be subject to significant additional claims and material additional liabilities. If actual liabilities significantly exceed the estimates made, the results of operations, liquidity, and financial condition could be materially adversely affected.

BOARD ACTIONS

As of January 3, 2006, the Board approved the implementation of fiscal year 2006 pay adjustments for The Office and Professional International Employees Union.

As of January 3, 2006, the Board approved the implementation of fiscal year 2006 pay adjustments for Trades and Labor Annual employees and employees of TVA contractors represented by the Trades & Labor Councils.

As of January 31, 2006, the Board approved the retention of certain net power proceeds and certain nonpower proceeds pursuant to Section 26 of the TVA Act and payment of nonpower proceeds to the U.S. Treasury in accordance with Public Law No. 98-151.

As of February 3, 2006, the Board approved the sale at public auction of leasehold interests in the Summer Place Tower, Knoxville, Tennessee.

On February 13, 2006, the Board approved:

- Adjustments to the wholesale rate schedules, the resale rate schedules, and the schedules of customers served directly by TVA to remain in effect indefinitely, subject to any future rate change or rate adjustment, and subject to the previously established environmental adjustment which was set to remain in effect for ten years from the date of said environmental adjustment.
- A Fuel Cost Adjustment ("FCA") as the appropriate structure for adjusting TVA's rates to reflect changing fuel and purchased power costs beginning in October 2006, although any such FCA would still need to be approved by the Board.
- A public auction sale of leasehold interests or term easements and reaffirmation of the declaration of surplus and sale at public auction of the fee interest and conveyance of associated easements over portions of the Knoxville Office Complex East Tower, in Knoxville, Tennessee.

As of February 15, 2006, the Board approved TVA membership in NuStart Energy Development, LLC.

As of March 14, 2006, the Board approved resolutions (1) authorizing the issuance of up to $3.5 billion of power bonds during fiscal year 2006 and (2) increasing the amount of electronotes® that can be issued to $3 billion outstanding at any one time, and authorizing the use of swaps in connection with the issuance of new power bonds during 2006 as well as the issuances of electronotes® in order to (a) protect TVA against currency, interest rate, or other risks or (b) effectively convert fixed rate bonds into floating rate bonds.

As of March 27, 2006, the Board approved a change to the TVA Corporate Accountability and Disclosure Plan ("Plan") to have the President and Chief Operating Officer certify TVA's annual and quarterly financial reports until a Chief Executive Officer ("CEO") is appointed and, thereafter, the CEO will certify quarterly and financial reports. Previously the members of the Board certified annual and quarterly financial reports.

On March 31, 2006, the newly sworn in Board:

- Elected Bill Sansom as chairman of TVA's Board;
- Reaffirmed Tom Kilgore as president and chief operating officer and vested with him the authority of acting chief executive officer; and
- Established a By-Laws Committee to be chaired by Director Don DePriest.

ADDITIONAL INFORMATION

Management Changes

On January 6, 2006, Jon Rupert, Vice President of Browns Ferry Unit 1 Restart, retired from TVA. Masoud Bajestani, Senior Vice President of Maintenance Scheduling and Outage Coordination, has responsibility for the restart project on an interim basis until a final selection is made and approved.

On January 31, 2006, LeAnne Stribley, Executive Vice President of Administration, resigned from TVA. John E. Long, Jr., Chief Administrative Officer and Executive Vice President, Administrative Services, assumed responsibility for many of the former Administration organizations (including Facilities, Procurement, Information Services, TVA Police, and Enterprise Performance and Analysis) as part of a September 20, 2005, reorganization. See *"Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Other Matters" — "Organizational Structure Changes"* in the 2005 Information Statement.

River System Operations and Environment ("RSO&E") consolidated its Resource Stewardship and Environmental Policy and Planning ("EP&P") organizations into a new group called Environmental Stewardship and Policy, headed by Senior Vice President Bridgette Ellis. Ms. Ellis has served as Vice President of Resource Stewardship for five years and as acting Vice President of EP&P. She has more than 25 years of experience in resource management with TVA. She reports to Kate Jackson, Executive Vice President, RSO&E & Environmental Executive. The new organization supports business units throughout TVA in the areas of environmental policy, environmental consultation, cultural and heritage consultation, realty services, land management, recreation, natural resource management, and water quality. As of March 31, 2006, staff members in both organizations were consolidated into the new group. In addition, Environmental Training and its employees have transferred to Employee Technical Training and Organizational Effectiveness in Human Resources.

On March 7, 2006, TVA announced that Ellen Robinson, Executive Vice President, Communications, was resigning from TVA. Peyton T. Hairston, Jr., Senior Vice President, Employee Relations and Diversity, began serving as Senior Vice President, Communications, on March 13, 2006, and is reporting directly to Acting Chief Executive Officer, President, and Chief Operating Officer Tom D. Kilgore. While he serves in this capacity, he will continue to be responsible for the Equal Opportunity Compliance and Diversity Development functions. J. David Beckler, Senior Manager, Industrial Relations, will serve as Senior Vice President, Labor Relations, on an interim basis reporting to John E. Long, Jr., Chief Administrative Officer and Executive Vice President, Administrative Services.

Preston Swafford has been named to the new position of Senior Vice President of Nuclear Support in TVA Nuclear, and assumed the position on May 1, 2006. In his new position, Mr. Swafford is responsible for managing functions in several areas previously within the Nuclear Support organization, including Nuclear Assurance and Licensing, Emergency Services, Project Management, Medical Services and Nuclear Security. In addition, four other areas – Engineering and Technical Services, Fuels Projects and Disposal, Process Methods and Business Services – report to Mr. Swafford to better align support functions for TVA's nuclear plants. Mr. Swafford was previously Senior Vice President of Exelon Energy Delivery.

Rob Beecken, TVA Nuclear's Vice President of Nuclear Support, has been named to lead the new Enterprise System Project – a TVA-wide information-technology project critical to improving efficiency across the company. The project includes the Enterprise Asset Management Project, the IT Infrastructure Project, and the Financial Suite Project. Mr. Beecken reports directly to John E. Long, Jr., Chief Administrative Officer and Executive Vice President, Administrative Services. Mr. Beecken's primary responsibilities are to develop and effectively implement an information technology-application strategy for finance, accounting, treasury, projects, accounts payable, accounts receivable, third-party billing, supply chain, facilities, fleet management, work and asset management, and corrective action.

Keith Ridley of TVA's Economic Development staff has been named manager of Valley Business Ventures, a new division created to help increase jobs and capital investment in high-growth industries and in companies owned by women and minorities in the TVA region. Mr. Ridley will work with economic development professionals, distributor customers, financial institutions, city and federal procurement officers, and high-growth company owners to increase their business opportunities. His job responsibilities will include developing TVA's economic development programs for high-growth companies and developing a comprehensive strategy for recruiting and growing companies owned by women and minorities in the Valley.

CERTIFICATION OF THE ACTING CHIEF EXECUTIVE OFFICER, PRESIDENT, AND CHIEF OPERATING OFFICER

I, Tom D. Kilgore, certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended March 31, 2006;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this Report;
3. Based on my knowledge, the financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. The other certifier and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:

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

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

   c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended March 31, 2006, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and

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

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

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: May 12, 2006

Tom Kilgore

Tom D. Kilgore
Acting Chief Executive Officer, President,
and Chief Operating Officer

CERTIFICATION OF THE CHIEF FINANCIAL OFFICER

I, Michael E. Rescoe, certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended March 31, 2006;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this Report;
3. Based on my knowledge, the financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. The other certifier and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:

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

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

    c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended March 31, 2006, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and

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

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

    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: May 12, 2006

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

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E-mail alerts are messages that are sent to a subscriber's e-mail address whenever certain new information about TVA bonds is available. To subscribe to e-mail alerts, visit TVA's web site at: www.tva.com/finance

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