Tennessee Valley Authority

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

Quarterly Report

For the quarterly period ended June 30, 2006

Tennessee Valley Authority

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This document contains the unaudited Quarterly Report of the Tennessee Valley Authority ("TVA") for the quarterly period ended June 30, 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 (but are not limited to):

- Statements regarding strategic objectives;
- Projections regarding potential rate actions;
- Estimates of costs 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” — “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”* 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 June 30		Nine months ended June 30	
	2006	2005	2006	2005
Operating revenues				
Sales of electricity				
Municipalities and cooperatives	$ 1,903	$ 1,558	$ 5,422	$ 4,644
Industries directly served	275	247	751	698
Federal agencies and other	27	40	85	145
Other revenue	45	36	92	67
Total operating revenues	2,250	1,881	6,350	5,554
Operating expenses				
Fuel and purchased power	833	599	2,295	1,674
Operating and maintenance	585	575	1,752	1,741
Depreciation, amortization, and accretion	363	288	1,140	863
Tax-equivalents	93	91	280	272
Total operating expenses	1,874	1,553	5,467	4,550
Operating income	376	328	883	1,004
Other income	11	12	28	25
Other expense	(1)	(1)	(1)	(3)
Unrealized gain (loss) on derivative contracts, net	75	(44)	110	(32)
Interest expense				
Interest on debt	336	334	999	1,011
Amortization of debt discount, issue, and reacquisition costs, net	5	6	15	16
Allowance for funds used during construction and nuclear fuel expenditures	(42)	(30)	(117)	(84)
Net interest expense	299	310	897	943
Net income (loss)	$ 162	$ (15)	$ 123	$ 51

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

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

ASSETS	June 30 2006	September 30 2005
Current assets		
Cash and cash equivalents	$ 501	$ 538
Restricted cash and investments (note 1)	178	107
Accounts receivable, net	1,178	1,145
Inventories and other	638	479
Total current assets	2,495	2,269
Property, plant, and equipment		
Completed plant	35,310	35,215
Less accumulated depreciation	(15,121)	(14,407)
Net completed plant	20,189	20,808
Construction in progress	3,322	2,643
Nuclear fuel and capital leases	549	437
Total property, plant, and equipment	24,060	23,888
Investment funds	929	858
Regulatory and other long-term assets (note 1)		
Deferred nuclear generating units	3,618	3,912
Other regulatory assets	2,091	2,367
Subtotal	5,709	6,279
Other long-term assets	1,333	1,272
Total regulatory and other long-term assets	7,042	7,551
Total assets	$ 34,526	$ 34,566
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	$ 1,000	$ 860
Accrued liabilities	266	274
Accrued interest	298	380
Current portion of lease/leaseback obligations	37	35
Current portion of energy prepayment obligations	106	106
Short-term debt	1,575	2,469
Current maturities of long-term debt, net (note 3)	1,963	2,693
Total current liabilities	5,245	6,817
Other liabilities		
Deferred liabilities	2,420	2,500
Regulatory liabilities (note 1)	762	897
Asset retirement obligations	1,692	1,857
Lease/leaseback obligations	1,074	1,108
Energy prepayment obligations	1,165	1,244
Total other liabilities	7,113	7,606
Long-term debt, net (note 3)	19,597	17,751
Total liabilities	31,955	32,174
Commitments and contingencies (note 6)		
Proprietary capital		
Appropriation investment	4,768	4,783
Retained earnings	1,360	1,244
Accumulated other comprehensive income	112	27
Accumulated net expense of nonpower programs	(3,669)	(3,662)
Total proprietary capital	2,571	2,392
Total liabilities and proprietary capital	$ 34,526	$ 34,566

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS (unaudited)

For the nine months ended June 30
(in millions)

	2006	2005
Cash flows from operating activities		
Net income	$ 123	$ 51
Items not requiring (providing) cash		
Depreciation, amortization, and accretion	1,222	961
Allowance for funds used during construction and nuclear fuel expenditures	(117)	(84)
Nuclear fuel amortization	96	95
Net realized and unrealized mark-to-market and hedging transactions	(110)	32
Other, net	161	160
Changes in current assets and liabilities		
Accounts receivable, net	(33)	29
Inventories and other	(168)	(57)
Accounts payable and accrued liabilities	101	(69)
Accrued interest	(83)	(116)
Refueling outage costs	(59)	(119)
Other	(32)	(37)
Net cash provided by operating activities	1,101	846
Cash flows from investing activities		
Construction expenditures	(947)	(933)
Nuclear fuel expenditures	(216)	(124)
Allowance for funds used during construction and nuclear fuel expenditures	117	84
Change in restricted cash and investments	(71)	(79)
Investments		
Short-term investments, net	–	335
(Purchase) maturity of long-term investments, net	(4)	1
Loans and other receivables		
Advances	(11)	(8)
Repayments	10	12
Proceeds from sale of receivables/loans	7	55
Other, net	(1)	1
Net cash used in investing activities	(1,116)	(656)
Cash flows from financing activities		
Long-term debt		
Issues	1,105	1,630
Redemptions and repurchases	(159)	(2,365)
Short-term (redemptions) issues, net	(894)	658
Payments on combustion turbine financing	(26)	(26)
Payments on equipment financing	(6)	(6)
Proceeds from other financing activities	–	6
Financing costs, net	(13)	(18)
Payments to U.S. Treasury	(29)	(26)
Net cash used in financing activities	(22)	(147)
Net change in cash and cash equivalents	(37)	43
Cash and cash equivalents at beginning of period	538	519
Cash and cash equivalents at end of period	$ 501	$ 562

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 June 30, 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 March 31, 2005	$ 4,793	$ 1,226	$ (3,655)	$ 44	$ 2,408	
Net (loss)	–	(10)	(5)	–	(15)	$ (15)
Return on appropriation investment	–	(3)	–	–	(3)	–
Other comprehensive loss (note 2)	–	–	–	(40)	(40)	(40)
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at June 30, 2005	$ 4,788	$ 1,213	$ (3,660)	$ 4	$ 2,345	$ (55)
Balance at March 31, 2006	$ 4,773	$ 1,202	$ (3,667)	$ 116	$ 2,424	
Net income (loss)	–	164	(2)	–	162	$ 162
Return on appropriation investment	–	(6)	–	–	(6)	
Other comprehensive loss (note 2)	–	–	–	(4)	(4)	(4)
Return of appropriation investment	(5)	–	–	–	(5)	–
Balance at June 30, 2006	$ 4,768	$ 1,360	$ (3,669)	$ 112	$ 2,571	$ 158

For the nine months ended June 30, 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)	–	62	(11)	–	51	$ 51
Return on appropriation investment	–	(11)	–	–	(11)	–
Other comprehensive income (note 2)	–	–	–	56	56	56
Return of appropriation investment	(15)	–	–	–	(15)	–
Balance at June 30, 2005	$ 4,788	$ 1,213	$ (3,660)	$ 4	$ 2,345	$ 107
Balance at September 30, 2005	$ 4,783	$ 1,244	$ (3,662)	$ 27	$ 2,392	
Net income (loss)	–	130	(7)	–	123	$ 123
Return on appropriation investment	–	(14)	–	–	(14)	–
Other comprehensive income (note 2)	–	–	–	85	85	85
Return of appropriation investment	(15)	–	–	–	(15)	–
Balance at June 30, 2006	$ 4,768	$ 1,360	$ (3,669)	$ 112	$ 2,571	$ 208

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

CONDENSED 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.

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 $321 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 reduced cash flows from operating activities and reduced net cash used in investing activities. Additionally, cash of $22 million received under a collateral provision of a

swap agreement had been reported as CASH AND CASH EQUIVALENTS. This amount has been reclassified to RESTRICTED CASH AND INVESTMENTS from CASH AND CASH EQUIVALENTS. This reclassification increased the cash used in investing activities and reduced the net change in cash and cash equivalents as well as reduced the cash and cash equivalents at end of period. See *Restricted Cash and Investments*.

CASH AND CASH EQUIVALENTS on the June 30, 2005 Balance Sheet was originally reported as $584 million. Because of the nature of the collateral, CASH AND CASH EQUIVALENTS has been reclassified as $562 million and RESTRICTED CASH AND INVESTMENTS as $36 million.

Restricted Cash and Investments

As of June 30, 2006, TVA had $178 million in RESTRICTED CASH AND INVESTMENTS on its Balance Sheet related to collateral posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap agreement, which result in the funds being reported in RESTRICTED CASH AND INVESTMENTS. The corresponding liability is reported in ACCOUNTS PAYABLE on the June 30, 2006 Balance Sheet.

Accounts Receivable

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

	Accounts Receivable	
	At June 30 2006	At September 30 2005
Power receivables billed	$ 227	$ 323
Power receivables unbilled	882	787
Total power receivables	1,109	1,110
Other receivables	76	42
Allowance for uncollectible accounts	(7)	(7)
Net accounts receivable	$ 1,178	$ 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 June 30 2006	At September 30 2005
Regulatory Assets:		
Adjustment to accrue minimum pension liability	$ 1,158	$ 1,158
Nuclear decommissioning costs	487	716
Debt reacquisition costs	250	264
Deferred outage costs	95	103
Capital leases	79	84
Unrealized losses related to mark-to-market valuation of purchase power contracts	22	42
Total other regulatory assets	2,091	2,367
Deferred nuclear generating units	3,618	3,912
Total regulatory assets	$ 5,709	$ 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 June 30, 2006, and September 30, 2005, were $762 million and $897 million, respectively, and are included in REGULATORY LIABILITIES on the Balance Sheets.

	Regulatory Liabilities	
	At June 30 2006	At September 30 2005
Unrealized gain on coal purchase contracts	$ 670	$ 791
Capital lease liability	92	106
Total regulatory liabilities	$ 762	$ 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 nine month periods ended June 30, 2006, and 2005.

During the first nine months of 2005, TVA's total ARO liability increased $50 million due to accretion expense of $75 million partially offset by the $25 million revision to the nuclear ARO described above. The nuclear accretion expense of $65 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $10 million, related to coal-fired and gas/oil plants, was expensed during 2005.

In May 2006, TVA received approval from the NRC which granted a 20-year license extension for the operation of its Browns Ferry Nuclear Plant. The license extension changes the timing of certain cash flow estimates utilized by TVA in the determination of the Browns Ferry ARO. Accordingly, TVA made adjustments to the Browns Ferry ARO and related accounts to reflect the revised cost estimates. TVA previously calculated the Browns Ferry ARO utilizing two equally weighted sets of estimated cash flows; one set based on a 40-year license life and a second set based on a 60-year license life. The cash flow estimates represented by the 40-year life are no longer applicable. The adjustments made are cumulative for the nine-month period and include reductions in the nuclear ARO of $153 million, a reduction in the incremental asset base cost of $31 million, a reduction in the asset's accumulated depreciation of $44 million, and a reduction in the regulatory asset of $166 million. The result of the changes described does not impact net income for any of the periods presented.

During the first nine months of 2006, TVA's total ARO decreased $165 million, net of all cumulative adjustments, due to combined accretion expense of $77 million offset by the $242 million in revisions to the nuclear ARO. The nuclear accretion expense of $67 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $10 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 June 30		Nine Months Ended June 30	
	2006	2005	2006	2005
Balance at beginning of period	$ 1,821	$ 1,807	$ 1,857	$ 1,782
Liabilities settled	–	–	–	–
Accretion expense	24	25	77	75
Revisions in estimated cash flows	(153)	–	(242)	(25)
Balance at end of period	$ 1,692	$ 1,832	$ 1,692	$ 1,832

Energy Prepayment Obligations

As of June 30, 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 June 30, 2006, exceed $18 million. Of this amount, over $1 million was recognized as revenue for the quarterly periods ended June 30, 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 June 30, 2006, exceed $265 million. Of this amount, $25 million was recognized as revenue for the quarterly periods ended June 30, 2006, and 2005. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At June 30, 2006, and September 30, 2005, obligations under these prepayment programs were $1,271 million and $1,350 million, respectively. The amounts are included in ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the June 30, 2006, and September 30, 2005, Balance Sheets. There have been no energy prepayment transactions during 2005 and 2006.

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 46R 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 46R provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial interests rather than from voting interests. FIN 46R 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 46R 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 46R, 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 nine months ended June 30, 2006. Power purchases for the first nine months of 2006 under the agreement totaled $91 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

On April 13, 2006, the FASB issued FASB Staff Position FIN 46R-6, *"Determining the Variability to Be Considered in Applying FASB Interpretation No. 46R,"* which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46. FIN 46R-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 46R when a reconsideration event has occurred pursuant to paragraph seven of FIN 46R 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. Additionally, TVA is evaluating the potential impacts of FIN No. 47. TVA is currently reviewing areas potentially giving rise to conditional AROs including costs associated with the removal and disposal of asbestos in assets such as fossil plants, hydro plants, and certain transmission facilities. Costs related to polychlorinated biphenyls ("PCBs") contained in transformers and substations are also currently under review. This interpretation is effective not 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. The potential impacts of this interpretation on its AROs may or may not be material to TVA's 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.

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.

Accounting for Defined Benefit Pension and Other Postretirement Plans. On July 26, 2006, FASB affirmed its previous decision to make the recognition provisions of its proposed standard, *"Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No 87, 88, 106 and 132(R)*," effective for public companies (as defined in FASB Statement No. 123 (revised 2004), *"Share-Based Payment"*) for fiscal years ending after December 15, 2006. This means TVA will be required to apply the new standard for its 2007 year-end financial statements and recognize on its 2007 balance sheets the funded status of their pension and other postretirement benefit plans. TVA is evaluating the implications of this standard which may or may not be material to its financial position or results of operations. However, had TVA been required to adopt the standard as of its last actuarial valuation date (September 30, 2005), TVA would have recorded the following amounts on its balance sheet for the year then ended: a regulatory asset of $1.0 billion, additional pension and postretirement obligations of $400 million and $300 million, respectively, and the elimination of a $300 million intangible asset representing unamortized prior service cost. The net effect of recognizing such amounts would have been to increase total assets and liabilities by $700 million at that date.

In August 2006, Congress passed the Pension Protection Act of 2006 (the "Pension Act"), which is awaiting signature by the President. TVA is currently assessing the applicability of the Pension Act's provisions to the TVA Retirement System ("TVARS"), and the effect of the Pension Act on TVARS is unknown at this time.

The Pension Act incorporates the provisions agreed to by the House-Senate conference on the separate pension reform bills passed earlier by the House and Senate. Those bills amended the Employee Retirement Income Security Act ("ERISA") and Section 412 of the Internal Revenue Code to provide new minimum funding rules for defined benefit plans. The TVARS defined benefit plan, as a governmental plan, is not subject to the minimum funding rules under ERISA and Section 412 of the Internal Revenue Code, and it is unclear the extent to which the Pension Act would have any effect on the TVARS defined benefit plan.

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 decrease for the

three months and increase for the nine months ended June 30, 2006, and 2005, is due to unrealized gains and losses related to mark-to-market valuation adjustments for certain derivative instruments.

Accumulated Other Comprehensive Income (Loss) Activity

	Three Months Ended June 30		Nine Months Ended June 30	
	2006	2005	2006	2005
Accumulated other comprehensive income (loss) at beginning of period	$ 116	$ 44	$ 27	$ (52)
Changes in fair value				
Inflation swap	(3)	(8)	(8)	(3)
Foreign currency swaps	(1)	(32)	93	59
Accumulated other comprehensive income at end of period	$ 112	$ 4	$ 112	$ 4

3. Debt Securities

Debt Outstanding

Net debt outstanding at June 30, 2006, was $23.1 billion including net translation gain of $19 million related to the current portion of long-term debt and translation losses of $181 million related to long-term debt.

Net debt outstanding at September 30, 2005, was $22.9 billion, including a translation gain of $78 million related to the current portion of long-term debt and translation losses of $130 million related to long-term debt.

Debt Outstanding

	At June 30 2006	At September 30 2005
Short-term debt		
Discount notes (net of discount)	$ 1,575	$ 2,469
Current maturities of long-term debt	1,963	2,693
Total short-term debt, net	3,538	5,162
Long-term debt, net	19,776	17,978
Unamortized discounts, premiums, and other	(179)	(227)
Total long-term debt, net	19,597	17,751
Total outstanding debt, net	$ 23,135	$ 22,913

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 June 30, 2006.

	Date	Amount	Interest Rate
Redemptions/Maturities:			
electronotes®	First Quarter 2006	$ 152	5.88%
	Second Quarter 2006	3	4.93%
	Third Quarter 2006	4	4.68%
Total Redemptions		$ 159	
Issues:			
electronotes®	First Quarter 2006	$ 49	5.19%
	Second Quarter 2006	19	5.36%
	Third Quarter 2006	37	5.18%
		105	
2006 Series A	April 2006	1,000	5.38%
Total Issues		$ 1,105	

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

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 June 30 2006	At September 30 2005
Inflation swap	$ 21	$ 17
Interest rate swap	(79)	(158)
Currency swaps:		
Deutschemark (DM1.5 billion)	13	(68)
Sterling (GBP200 million)	56	21
Sterling (GBP250 million)	140	89
Sterling (GBP150 million)	71	36
Total currency swaps	280	78
Swaptions:		
$1 billion notional	(225)	(314)
$28 million notional	(2)	(4)
$14 million notional	(1)	(2)
Total swaptions	(228)	(320)
Coal contracts	670	791
Purchase power contracts	(22)	(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 June 30		**Other Benefits** Three Months Ended June 30		**Pension Benefits** Nine Months Ended June 30		**Other Benefits** Nine Months Ended June 30	
	2006	2005	2006	2005	2006	2005	2006	2005
Service Cost	$ 32	$ 26	$ 2	$ 1	$ 95	$ 88	$ 6	$ 4
Interest Cost	110	103	8	6	330	322	22	19
Expected return on plan assets	(123)	(114)	–	–	(368)	(343)	–	–
Amortization of prior service costs	9	9	1	1	27	27	4	4
Amortization of losses	33	24	4	3	99	89	12	8
Net periodic benefit	$ 61	$ 48	$ 15	$ 11	$ 183	$ 183	$ 44	$ 35

The Board approved $75 million in pension contributions during 2006. During the nine months ended June 30, 2006, TVA made approximately $37 million in contributions and plans to contribute another $38 million for this 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 $12 million during the nine months ended June 30, 2006, to fund other benefits costs.

6. Commitments and Contingencies

The estimated cash commitments for TVA as of June 30, 2006, are as follows:

Cash Requirements and Contractual Obligations

	2006*	2007	2008	2009	2010	Thereafter	Total
Debt	$ 2,575	$ 981	$ 91	$ 2,030	$ 63	$ 17,411	$ 23,151
Interest on debt	208	1,161	1,155	1,099	1,045	16,152	20,820
Leases	11	92	82	70	65	46	366
Lease/leaseback	21	85	89	85	89	1,209	1,578
Power purchase obligations	53	186	139	145	147	3,751	4,421
Other obligations	101	203	111	5	3	7	430
Fuel purchase obligations	638	592	536	467	397	610	3,240
Pension contribution	38	–	–	–	–	–	38
Total	$ 3,645	$ 3,300	$ 2,203	$ 3,901	$ 1,809	$ 39,186	$ 54,044

* Period July 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	$ 26	$ 106	$ 106	$ 105	$ 105	$ 823	$ 1,271

* Period July 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. A meeting was held between TVA and Areva on May 31, 2006, to discuss the issue. TVA is awaiting more information from Areva.

Bear Creek Dam Seepage. Bear Creek Dam is experiencing foundation problems as evidenced by seepage through the foundation of the dam. TVA staff held a public scoping meeting regarding the leaking Bear Creek Dam on June 20, in Red Bay, Alabama. About 150 attendees, including local public officials, provided comments and suggestions for TVA's consideration. The comments have been compiled and development of possible alternatives to be studied as a part of the Environmental Impact Statement has been initiated.

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. A trial on the issue of damages has been scheduled for January 15, 2007. TVA filed a motion with the district court seeking permission to take an interlocutory appeal of the court's ruling on summary judgment. On July 31, 2006, the district court ruled on TVA's motion, reconsidered its decision on summary judgment with respect to TVA's affirmative defenses, and held that TVA is entitled to a trial on its affirmative defenses. The court also denied TVA's motion for an interlocutory appeal.

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. Argument in this case was held on July 26, 2006.

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 was held on June 7, 2006, and TVA is currently awaiting a decision.

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 would not begin picking up SNF 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 United States has since voluntarily dismissed its appeal. On July 21, 2006, the court issued an order to that effect, ending the case. TVA recorded a receivable of $35 million as of June 30, 2006 as a result of the settlement of the case. The proceeds will partially offset the cost of construction related to

the dry cask storage facilities at Browns Ferry and Sequoyah Nuclear Plants necessitated by DOE's failure to accept spent nuclear fuel. The cost of the capitalized storage facilities totaled approximately $61 million and is included in PROPERTY, PLANT, AND EQUIPMENT on the Balance Sheet.

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. Briefing of the appeal was completed in July 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 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 was completed in May 2006. Oral argument is scheduled for September 2006.

In 2002, the Sierra Club and the Alabama Environmental Council 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 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 dismissed the complaint. The plaintiffs appealed the district court's decision to the Eleventh Circuit. On November 22, 2005, the Eleventh Circuit affirmed the lower court in part and reversed in part. It affirmed the lower court's dismissal of the claims for civil penalties, but held that the Alabama de minimis rule was not applicable because Alabama had not yet obtained EPA approval of that rule. The case was remanded to the district court for further proceedings. After remand the plaintiffs filed a motion for summary judgment. On May 23, 2006, the district court issued three orders in this action. The first stayed the matter until a decision is issued in a CAA case recently accepted by the Supreme Court, *United States v. Duke Energy*. The second order referred the action to mediation to be completed before the close of business on December 15, 2006, unless the court extends the deadline. The third order denied as moot the plaintiffs' pending motions to hold TVA liable for opacity violations at Colbert but indicated plaintiffs could again file such motions, if necessary, after the stay is lifted. On May 26, 2006, the plaintiffs moved the court to reconsider its orders, and in the alternative to allow an interlocutory appeal. On July 5, 2006, the district court denied plaintiffs' motion to reconsider and to appeal, and ordered the parties to select a mediator, which the parties have done.

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. On April 3, 2006, TVA moved to dismiss the case on grounds that the case is not suitable for judicial resolution because of separation of powers principles, including the fact that these matters are based on policy decisions left to TVA's discretion in its capacity as a government agency, and thus are not subject to tort liability (the "discretionary function doctrine"), as well as the Supremacy Clause. In July 2006, the court denied TVA's motion. TVA is reviewing the court's decision and considering options.

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. In June 2006, North Carolina filed a petition for review of EPA's decision with the United States Court of Appeals for the District of Columbia Circuit.

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 seven large oil companies and an oil company trade association, three large chemical companies and a chemical trade association, and thirty-one 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 has moved to dismiss the complaint on grounds that TVA's operation of its coal plants is not subject to tort liability due to the discretionary function doctrine.

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. In accordance with SFAS No. 5, *"Accounting for Contingencies,"* TVA has accrued approximately $21 million as of June 30, 2006, related to the cases described above.

8. Stewardship Responsibilities

During the third 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.

Until 2000, 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 $58 million on essential stewardship activities during the first nine months of 2006 and $61 million during the first nine months of 2005, and recognized depreciation expense on nonpower assets of $8 million in each nine month period.

9. Subsequent Events

Debt Securities
In July 2006, TVA issued $9 million of electronotes® with an interest rate of 5.63 percent which mature in 2013 and are callable beginning in 2008.

In July 2006, TVA repurchased $64 million of its 2005 Series A Power Bonds due June 15, 2035, and $28 million of its 2003 Series B Power Bonds due July 15, 2033. The $13 million gain on the transactions is considered a reacquisition cost and recorded as a regulatory asset. See note 1— *Cost-Based Regulation*.

Legal Proceeding against the Environmental Protection Agency
The Center for Biological Diversity and certain residents of Kentucky filed suit on July 31, 2006, against the Environmental Protection Agency ("EPA") in the United States District Court for the District of Columbia over the agency's alleged failure to respond to their petition objecting to the operating permit for TVA's Paradise Fossil Plant, located in Kentucky. Plaintiffs seek an order requiring EPA to respond to their petition. Any objections to EPA's response would have to be filed in a different court.

Governance
On August 3, 2006, President Bush announced his intention to nominate Bishop William Graves of Memphis, Tennessee, to fill the last vacant position on TVA's Board of Directors for a term to expire in May 2007. Bishop Graves is a former member of the board of Memphis Light, Gas and Water Division, TVA's largest distributor customer. The President's nomination first will be considered by the U.S. Senate Environment and Public Works Committee. If the committee votes to confirm Bishop Graves, its recommendation will go to the full Senate for a vote. If confirmed by the full Senate, Bishop Graves will be sworn into office, joining the other eight members of the TVA Board and giving TVA a nine-member Board for the first time in history.

Peak Electricity Demands

On July 18, 2006, TVA met a preliminary all-time TVA record peak demand for electricity in its seven-state service area. TVA met a peak demand of 32,008 megawatts at 5 p.m. CDT, when temperatures across the Tennessee Valley reached 97 degrees Fahrenheit. All five nuclear units were at full power and 58 of 59 fossil units were online to meet the expected high power demand. Management of TVA generation assets, transmission assets, and purchased power ensured that there were no "Load not Served" events on the grid, meaning all loads were served on the peak day.

On August 7, 2006, TVA met a preliminary all-time TVA record peak demand for the month of August of 31,948 megawatts. The peak occurred at 4 p.m. CDT, when temperatures across the Tennessee Valley averaged 95 degrees Fahrenheit. August is the fifth consecutive month in 2006 that TVA has met record monthly power demands.

Power Interruptions

In the first week of August 2006, extremely hot temperatures across the region placed high demands on the TVA power system due to several key TVA units being offline, the unavailability of some contracted purchased power, and extremely tight bulk-power markets. As a result of these demands, TVA curtailed power supply to some customers whose contracts allow for such interruptions.

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.

Executive Summary

Summary of Results of Operations

Net income for the third quarter of 2006 was $162 million compared to net loss of $15 million for the same period of 2005. Significant items contributing to the $177 million change in net income for the three months ended June 30, 2006, as compared to June 30, 2005, include:

- A $373 million increase in revenues from municipalities and cooperatives and industries directly served partially offset by a $17 million decrease in off-system sales; and
- A $119 million increase in net unrealized gain on derivative contracts.

These items were partially offset by:

- A $234 million increase in fuel and purchased power expense; and
- A $98 million increase in amortization related to the deferred costs of the generating units at the Bellefonte Nuclear Plant.

Net income through the first nine months of 2006 was $123 million compared to $51 million for the same period of 2005. Significant items contributing to the $72 million increase in net income for the nine months ended June 30, 2006, as compared to June 30, 2005, include:

- An $831 million increase in revenues from municipalities and cooperatives and industries directly served offset by a $74 million decrease in off-system sales;
- A $142 million increase in net unrealized gain on derivative contracts; and
- A $46 million decrease in net interest expense.

These items were partially offset by:

- A $621 million increase in fuel and purchased power expense; and
- A $290 million increase in amortization related to the deferred costs of the generating units at the Bellefonte Nuclear Plant.

The increase in revenues was primarily due to higher average rates from rate actions effective in October 2005 and April 2006 and, to a lesser extent, by increased demand. The decline in off-system sales is partially due to the high customer demand on the TVA system during the quarter ended June 30, 2006, resulting from a record peak demand for the month of June coupled with a Watts Bar Unit 1 outage. Weather degree days for heating during the nine month period ended June 30, 2006 were comparable to 2005 but cooling degree days for the same period increased nearly 17 percent. Cooling degree days were also 31 percent higher than a 30 year average weather benchmark for the nine months ended June 30, 2006. (A weather degree day is a unit of measure used to express the extent to which temperatures vary from a specific reference temperature during a given period. TVA uses 65 degrees Fahrenheit as the standard reference for both heating and cooling degree days.) This resulted in less surplus power available to sell after meeting the needs of TVA customers. See *"Significant Events"* below.

The increases in fuel and purchased power expense are primarily a result of higher aggregate fuel cost per kilowatt-hour of net thermal generation and increased generation at the combustion turbine plants of 98.3 percent to meet electricity demands. The higher purchased power expense is attributable to increased average purchase price and higher volume necessary to accommodate decreased hydro generation and outages. See *"Significant Events"* below.

Cash flows during the first nine months of 2006 decreased $80 million from the same period of 2005. Cash flows from operations improved $255 million and cash used by financing activities decreased $125 million offset by an increase in cash used by investing activities of $460 million. See *Material Changes in Liquidity and Capital Resources.*

For further information see "Material Changes in Liquidity and Capital Resources" — "Comparative Cash Flow Analysis" and "Detailed Discussion of Results of Operations" for the three month and nine month periods ended June 30, 2006 presented later in this report.

Significant Events

Significant events for the reporting periods ended June 30, 2006 include:

- In April 2006, sharply rising fuel and purchased energy costs forced TVA to increase wholesale rates by 9.95 percent. These costs had been rising since TVA approved its fiscal year 2006 budget in July 2005, and the increase was developed to recover a portion of these costs over the remainder of the 2006 fiscal year. This rate increase resulted in additional revenue of nearly $181 million during the quarter ended June 30, 2006. The rate increases effective October 1, 2005, and April 1, 2006, resulted in additional income of over $493 million for the nine months ended June 30, 2006.
- At approximately 5 p.m. EDT, on May 30, 2006, operators at Unit 1 of Watts Bar Nuclear Plant ("Watts Bar") detected a problem involving the main turbine and took the reactor offline safely without further incident. The required event report was filed with the NRC. A piece of the turbine had broken off, resulting in additional damage within the turbine. The low-pressure turbine from Unit 2 at Watts Bar, which has never been put in service, was modified and used to repair the damaged turbine. Watts Bar Unit 1 returned to service on June 25, 2006. The current estimate is that TVA incurred $4.9 million in repair costs, and an additional $37 million in replacement power purchase costs.
- On June 22, 2006, TVA met an all-time TVA record peak demand for the month of June of 30,769 megawatts, which, at the time, was the fourth highest in TVA history. The peak occurred at 4 p.m. CDT, when temperatures across the Tennessee Valley averaged 96 degrees Fahrenheit. The previous record demand for the month of June of 30,201 megawatts was met the day before at 4 p.m. CDT, when temperatures across the Tennessee Valley averaged 91 degrees.
- Water runoff was 65 percent of the planned amount through the first three 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.

Extremely hot temperatures across the region continue to place high demands on the TVA power system. (See *"Subsequent Events" — "Peak Electricity Demands")*. TVA has further been challenged during the latter part of July and early part of August 2006 by several key units being taken offline, the unavailability of some contracted purchased power, and extremely tight bulk-power markets. In conjunction with these challenges, TVA curtailed power supply to some interruptible customers whose contracts allow for such interruptions.

- Bull Run Fossil Plant ("Bull Run") was taken offline on July 25, 2006, at 3:31 a.m. EDT due to a broken turbine stub shaft. The plant returned to service early on the morning of August 5, 2006, following replacement of the stub shaft and associated repairs and inspection. The repair and inspection of the plant is estimated to cost $0.7 million, and the replacement power purchased during the outage is estimated to have cost approximately $22 million. Bull Run has a winter net dependable capacity of approximately 883 megawatts.
- Watts Bar was automatically shut down on July 31, 2006, at 12:17 p.m. EDT, when the main generator shut down. It returned to full power operation on August 4, 2006. The required event report was filed with the NRC, and TVA's investigation into the circumstances of the outage is ongoing. The repair and inspection of the plant is estimated to cost $0.7 million, and the replacement power purchased during the outage is estimated to have cost approximately $17 million. Watts Bar has a winter net dependable capacity of approximately 1,168 megawatts.

Outlook

The TVA Board approved a budget for the 2007 fiscal year that includes a reduction in firm wholesale power rates of 4.5 percent in conjunction with a Fuel Cost Adjustment ("FCA"), to be effective October 1, 2006. See *"Other Information" — "Board Actions."* The FCA will adjust TVA's rates up and down quarterly as fuel and purchased power costs rise and fall. Implementation of the FCA will result in ultimate cost recovery equaling the actual cost of fuel burned or consumed in generating facilities and the cost of purchased energy. TVA had a monthly fuel expense adjustment in use from mid-1974 through 1978, so the concept of an FCA is not entirely new to TVA or many of its distributor customers. Many utilities across the United States – and most of TVA's neighbors – use FCA mechanisms routinely to adjust their rates for fuel and purchased energy charges.

Low rainfall and runoff during fiscal year 2006 has led to less hydro generation, which was replaced by increased fossil generation and market purchases. TVA will be experiencing 100 to 600 gigawatt-hours per month less hydro generation through the end of the year as compared to last year. Hydro production is one of TVA's most cost-effective methods of producing power.

Even though TVA's net income for the nine months ended June 30, 2006, was $72 million higher than the same period in 2005, it is still less than expected for the year primarily due to the increase in fuel costs and purchased power. TVA continues to try to mitigate the effect of some of these costs with the rate increases previously discussed and by reductions in or deferrals of other TVA expenses.

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 increased $255 million from $846 million to $1.10 billion for the nine months ending June 30, 2005, and 2006, respectively. The increase is primarily due to the following:

- An increase in net income of $72 million primarily due to increased rates;
- A decrease in cash outlays for routine and recurring operating costs of $88 million;
- A decrease in cash used for changes in working capital components of $30 million, which is discussed below; and
- A decrease of $60 million in expenditures for outages.

Cash used for changes in working capital components decreased $30 million, from net cash used of $213 million in the first nine months of 2005 to net cash used of $183 million in the first nine months of 2006. This decrease resulted from:

- An increase of $170 million in cash provided by changes in accounts payable and accrued liabilities due to higher costs for fuel and purchased power; and
- A decrease of $33 million in cash used by changes in accrued interest due to a reduction in interest expense.

These items were partially offset by:

- A larger increase in inventories and other assets of $111 million in the first nine 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's fuel oil inventories through the third quarter of 2006; and
- A net increase of $62 million in cash used by changes in accounts receivable primarily as a result of the rate adjustment and the settlement of the DOE spent fuel litigation.

Cash used in investing activities increased $460 million, from $656 million to $1.12 billion for the nine months ending June 30, 2005, and 2006, respectively, primarily due to:

- A $92 million increase in expenditures related to nuclear fuel for the Sequoyah Unit 2 and Watts Bar Unit 1 reloads scheduled to be completed in November and October of 2006, respectively, and expenditures related to uranium, conversion, and enrichment for Browns Ferry Unit 1;
- Sales of short-term investments of $335 million in 2005 not present in the current year;
- A decrease in proceeds received from the sale of certain receivables/loans of $48 million compared to the same period of 2005; and
- An increase in construction expenditures of $14 million.

These items were partially offset by an increase in funds from Allowance for Funds Used during Construction ("AFUDC") of $33 million.

Net cash used in financing activities was $22 million for the first nine months of 2006, compared with $147 million for the same period of 2005. The $125 million change is related primarily to a decrease of $2.21 billion in long-term debt redemptions for the first nine months of 2006 as compared to the same period of 2005.

This was partially offset by:

- A decrease of $525 million in long-term debt issues; and
- An increase of $1.55 billion in net short-term debt redemptions from $658 million of cash provided in the first nine months of 2005 to $894 million of cash used 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 June 30, 2006, TVA had negative working capital of $2.75 billion, largely attributable to current maturities of long-term debt of $1.96 billion and short-term indebtedness of $1.58 billion. 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 debt to take advantage of more favorable interest rates.

Working Capital and Short-Term Debt

	June 30 2006	September 30 2005
Current assets	$ 2,495	$ 2,269
Current liabilities	(5,245)	(6,817)
Working capital	$ (2,750)	$ (4,548)
Discount notes <90 days	$ 1,575	$ 2,469
Current maturities of long-term debt	1,963	2,693
Total short-term debt	$ 3,538	$ 5,162

In May 2006, TVA converted its $2.5 billion short-term revolving credit facility agreement with a national bank into two $1.25 billion short-term revolving credit facilities with the same national bank. In order to provide greater flexibility going forward, TVA staggered the maturities of the two credit facilities to November 12, 2006, and May 16, 2007, respectively. The two facilities provide TVA with unsecured revolving lines of credit of up to $2.5 billion. The interest rate on any borrowing under either of these agreements 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 either facility. TVA is required to pay an unused facility fee on the portion of the total $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 facilities at June 30, 2006. TVA anticipates renewing each facility for a period not to exceed one year.

Capital Resources

Debt Securities Activity. From October 1, 2005, to June 30, 2006, TVA redeemed at par $159 million of electronotes® carrying an average interest rate of 5.83 percent. During the same period, TVA issued $105 million of electronotes® with an average interest rate of 5.22 percent. In April 2006, TVA also issued $1 billion in global power bonds which mature April 1, 2056, and have a coupon rate of 5.375 percent. The proceeds of the global issue were used to redeem existing debt.

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 nine months ended June 30, 2005.

Energy Prepayment Obligations. As of June 30, 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 June 30, 2006, exceed $18 million. Of this amount, over $1 million was recognized as revenue for the quarterly periods ended June 30, 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 June 30, 2006, exceed $265 million. Of this amount, $25 million was recognized as revenue for the quarterly periods ended June 30, 2006, and 2005. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At June 30, 2006, and September 30, 2005, obligations under these prepayment programs were $1,271 million and $1,350 million, respectively. The amounts are included in ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the June 30, 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 June 30, 2006 are as follows:

Cash Requirements and Contractual Obligations

	2006*	2007	2008	2009	2010	Thereafter	Total
Debt	$ 2,575	$ 981	$ 91	$ 2,030	$ 63	$ 17,411	$ 23,151
Interest on debt	208	1,161	1,155	1,099	1,045	16,152	20,820
Leases	11	92	82	70	65	46	366
Lease/leaseback	21	85	89	85	89	1,209	1,578
Power purchase obligations	53	186	139	145	147	3,751	4,421
Other obligations	101	203	111	5	3	7	430
Fuel purchase obligations	638	592	536	467	397	610	3,240
Pension contribution	38	–	–	–	–	–	38
Total	$ 3,645	$ 3,300	$ 2,203	$ 3,901	$ 1,809	$ 39,186	$ 54,044

* Period July 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	$ 26	$ 106	$ 106	$ 105	$ 105	$ 823	$ 1,271

* Period July 1 – September 30, 2006

As of June 30, 2006, TVA's decommissioning funds totaled approximately $902 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. The funding target at the end of calendar year 2005 was $790 million at which time the NDT balance was $856 million.

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.

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 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 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. At June 30, 2006, the NDT balance of approximately $902 million is greater than the present value of the estimated future decommissioning costs calculated in accordance with a formula provided by the NRC.

Detailed Discussion of Results of Operations

Operating Revenues

A detailed table of operating revenue for the three and nine month periods ended June 30, 2006, and 2005 is as follows:

Operating Revenues

	Three Months Ended June 30			Nine Months Ended June 30		
	2006	2005	Percent Change	2006	2005	Percent Change
Operating revenues						
Sales of electricity						
Municipalities and cooperatives	$ 1,903	$ 1,558	22.1%	$ 5,422	$ 4,644	16.8%
Industries directly served	275	247	11.3%	751	698	7.6%
Federal agencies and other	27	40	(32.5)%	85	145	(41.4%)
Other revenue	45	36	25.0%	92	67	37.3%
Total operating revenues	$ 2,250	$ 1,881	19.6%	$ 6,350	$ 5,554	14.3%

Significant items contributing to the $369 million increase in operating revenue for the three months ended June 30, 2006, as compared to June 30, 2005, include:

- A $345 million increase in revenues from municipalities and cooperatives as a result of increased sales of 2.6 percent and increased rates of which $111 million and $170 million relate to the increases effective October 1, 2005, and April 1, 2006, respectively;
- A $28 million increase in revenues from directly served industries reflecting increased sales of 0.1 percent and increased rates of which $4 million and $9 million relate to the increases effective October 1, 2005, and April 1, 2006, respectively; and
- A $9 million increase in other revenue attributable to increased nonutility services and wheeling activity. (In the electricity market "wheeling" refers to the interstate sale of electricity or transmission of power from one system to another.)

The rate increases, effective the first quarter and third quarter of 2006, contributed about $297 million to the increase in revenues on firm-based products in the third quarter of 2006 over the same three-month period in 2005. Firm-based products carry higher rates since they offer the most reliable power supply. As a result, customers purchasing these products are the last to have their supply interrupted during a system emergency. An additional $40 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 $17 million decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) as a result of decreased sales of 96.0 percent and reduced generation with a 39.5 percent decrease in hydro generation resulting from dry conditions.

Significant items contributing to the $796 million increase in operating revenue for the nine months ended June 30, 2006, as compared to June 30, 2005, include:

- A $778 million increase in revenues from municipalities and cooperatives reflecting increased sales of 2.7 percent and increased rates of which $466 million relates to the increases effective October 1, 2005, and April 1, 2006;
- A net $53 million increase in revenues from directly served industries attributable to increased rates of which $21 million relates to the increases effective October 1, 2005, and April 1, 2006, partially offset by decreased sales of 2.2 percent; and
- A $25 million increase in other revenue as a result of increased nonutility services and wheeling activity.

The rate increases, effective the first quarter and third quarter of 2006, contributed about $493 million to the increase in revenues on firm-based products during the first nine months of 2006 over the same nine month period in 2005. An additional $232 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 $74 million decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) reflecting decreased sales of 91.7 percent and reduced generation with a 37.5 percent decrease in hydro generation resulting from dry conditions.

A detailed table of electricity sales for the three and nine month periods ended June 30, 2006, and 2005 is as follows:

Electricity Sales

	Three Months Ended June 30			Nine Months Ended June 30		
(millions of kWh)	2006	2005	Percent Change	2006	2005	Percent Change
Sales of electricity						
Municipalities and cooperatives	32,962	32,129	2.6%	98,894	96,265	2.7%
Industries directly served	7,683	7,676	0.1%	23,761	24,291	(2.2%)
Federal agencies and other	456	1,064	(57.1%)	1,506	3,530	(57.3%)
Total sales of electricity	41,101	40,869	0.6%	124,161	124,086	0.1%

Significant items contributing to the 232 million kilowatt-hour increase in electricity sales for the three months ended June 30, 2006, as compared to June 30, 2005, include:

- An 833 million kilowatt-hour increase in sales to municipalities and cooperatives as a result of increased power demand of 2.1 percent and 3.9 percent from residents and firm commercial and industrial sales, respectively;

- A seven million kilowatt-hour increase in sales to directly served industries due to a slight increase in volume demanded; and
- A 12 million kilowatt-hour increase in sales to federal agencies (included in FEDERAL AGENCIES AND OTHER) attributable to increased power demand as a result of favorable economic conditions.

These items were partially offset by a 620 million kilowatt-hour decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) reflecting decreased generation available for sale and unfavorable market conditions.

Significant items contributing to the 75 million kilowatt-hour increase in electricity sales for the nine months ended June 30, 2006, as compared to June 30, 2005, include:

- A 2,629 million kilowatt-hour increase in sales to municipalities and cooperatives as a result of increased power demand of 7.9 percent from residents; and
- A 99 million kilowatt-hour increase in sales to federal agencies (included in FEDERAL AGENCIES AND OTHER) attributable to increased power demand reflecting favorable economic conditions.

These items were partially offset by:

- A 530 million kilowatt-hour decrease in sales to directly served industries as a result of decreased demand by some large volume customers; and
- A 2,123 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.

Operating Expenses

A detailed table of operating expenses for the three and nine month periods ended June 30, 2006, and 2005 is as follows:

Operating Expense

	Three Months Ended June 30			Nine Months Ended June 30		
	2006	2005	Percent Change	2006	2005	Percent Change
Operating expenses						
Fuel and purchased power	$ 833	$ 599	39.1%	$ 2,295	$ 1,674	37.1%
Operating and maintenance	585	575	1.7%	1,752	1,741	0.6%
Depreciation, amortization, and accretion	363	288	26.0%	1,140	863	32.1%
Tax-equivalents	93	91	2.2%	280	272	2.9%
Total operating expenses	$ 1,874	$ 1,553	20.7%	$ 5,467	$ 4,550	20.2%

A significant driver contributing to the $321 million increase in total operating expenses for the three months ended June 30, 2006, as compared to June 30, 2005, was lower hydro generation which contributed in part to:

- A $101 million increase in fuel cost attributable to higher aggregate fuel cost per kilowatt-hour of net thermal generation of 22.7 percent and increased generation at the combustion turbine plants of 98.3 percent; and
- A $133 million increase in purchased power expense reflecting an increased average purchase price of 25.4 percent and higher volume acquired of 56.4 percent to accommodate decreased generation.

Additionally, amortization expense increased $98 million mainly as a result of the amortization of the deferred cost of nuclear generating units at Bellefonte Nuclear Plant for the three month period ended June 30, 2006. These items were partially offset by a $25 million decrease in depreciation primarily due to the depreciation rate reduction for Browns Ferry Nuclear Plant reflecting the 20-year license extension.

A significant driver contributing to the $917 million increase in total operating expenses for the nine months ended June 30, 2006, as compared to June 30, 2005, was lower hydro generation which contributed in part to:

- A $303 million increase in fuel cost attributable to higher aggregate fuel cost per kilowatt-hour of net thermal generation of 21.1 percent and increased generation of 1.3 percent, 2.5 percent, and 76.5 percent at the fossil, nuclear, and combustion turbine plants, respectively; and
- A $318 million increase in purchased power expense reflecting increased average purchase price of 50.2 percent and higher volume acquired of 23.6 percent to accommodate decreased generation.

Additionally, amortization expense for the nine months ended June 30, 2006, increased $290 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 $21 million decrease in depreciation mainly due to the depreciation rate reduction for Browns Ferry Nuclear Plant reflecting the 20-year license extension.

Other Income
Other income decreased $1 million for the three months ended June 30, 2006, as compared to the same period of 2005, attributable to a $2 million decrease in non-electric business activity partially offset by a $1 million increase in interest earnings on the collateral deposit funds held by TVA. See note 1—*Restricted Cash and Investments.*

Other income increased $3 million for the nine months periods ended June 30, 2006, as compared to the same period 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 nine months ended June 30, 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 $119 million increase in net unrealized gain on derivative contracts for the three months ended June 30, 2006, as compared to the same period in 2005 include:

- A $90 million net gain on the mark-to-market ("MTM") valuation adjustment of an interest rate swap contract; and
- A $154 million net gain on the MTM valuation adjustment of swaption contracts, which includes $36 million of gain related to the discontinuance of hedge accounting; offset by
- A $125 million net loss on the MTM valuation of an embedded call option.

Significant items contributing to the $142 million increase in net unrealized gain on derivative contracts for the nine months ended June 30, 2006, as compared to the same period in 2005, include:

- A $128 million net gain on the MTM valuation adjustment of an interest rate swap contract;
- A $235 million net gain on the MTM valuation adjustment of swaption contracts, which includes $36 million of gain related to the discontinuance of hedge accounting; and
- A $6 million unrealized net loss related to the MTM valuation of sulfur dioxide ("SO_2") emissions allowance call options during the first quarter of 2005 not present in 2006; offset by
- A $227 million net loss on the MTM valuation of an embedded call option.

Interest Expense
A detailed table of interest expense for the three and nine month periods ended June 30, 2006, and 2005 is as follows:

Interest Expense

	Three Months Ended June 30			Nine Months Ended June 30		
	2006	2005	Percent Change	2006	2005	Percent Change
Interest expense						
Interest on debt	$ 336	$ 334	0.6%	$ 999	$ 1,011	(1.2%)
Amortization of debt discount, issue and reacquisition costs	5	6	(16.7%)	15	16	(6.3%)
Allowance for funds used during construction	(42)	(30)	40.0%	(117)	(84)	39.3%
Net interest expenses	$ 299	$ 310	(3.5%)	$ 897	$ 943	(4.9%)

Significant items contributing to the $11 million decrease in net interest expense for the three months ended June 30, 2006, as compared to June 30, 2005, include:

- A decrease in the average long-term interest rate from 6.27 percent to 6.17 percent;
- A reduction of $580 million in the average balance of discount notes outstanding; and
- A $12 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 2.89 percent to 4.82 percent; and
- An increase of $169 million in the average balance of long-term outstanding debt.

Significant items contributing to the $46 million decrease in net interest expense for the nine months ended June 30, 2006, as compared to June 30, 2005, include:

- A decrease in the average long-term interest rate from 6.35 percent to 5.99 percent; and
- A $33 million increase in AFUDC due to a higher level of construction work-in-progress in 2006.

These items were partially offset by:

- An increase of $133 million in the average balance of long-term outstanding debt;
- An increase in the average discount note interest rate from 2.40 percent to 4.29 percent; and
- An increase of $233 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 46R 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 46R provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial interests rather than from voting interests. FIN 46R 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 46R 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 46R, 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 nine months ended June 30, 2006. Power purchases for the first nine months of 2006 under the agreement totaled $91 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

On April 13, 2006, the FASB issued FASB Staff Position FIN 46R-6, *"Determining the Variability to Be Considered in Applying FASB Interpretation No. 46R,"* which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46. FIN 46R-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 46R when a reconsideration event has occurred pursuant to paragraph 7 of FIN 46R 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. Additionally, TVA is evaluating the potential impacts of FIN No. 47. TVA is currently reviewing areas potentially giving rise to conditional AROs including costs associated with the removal and disposal of asbestos in assets such as fossil plants, hydro plants, and certain transmission facilities. Costs related to polychlorinated biphenyls ("PCBs") contained in transformers and substations are also currently under review. This interpretation is effective not 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. The potential impacts of this interpretation on its AROs may or may not be material to TVA's 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.

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 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.

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.

Accounting for Defined Benefit Pension and Other Postretirement Plans

On July 26, 2006, FASB affirmed its previous decision to make the recognition provisions of its proposed standard, *"Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No 87, 88, 106 and 132(R)*," effective for public companies (as defined in FASB Statement No. 123 (revised 2004), *"Share-Based Payment")* for fiscal years ending after December 15, 2006. This means TVA will be required to apply the new standard for its 2007 year-end financial statements and recognize on its 2007 balance sheets the funded status of their pension and other postretirement benefit plans. TVA is evaluating the implications of this standard which may or may not be material to its financial position or results of operations. However, had TVA been required to adopt the standard as of its last actuarial valuation date (September 30, 2005), TVA would have recorded the following amounts on its balance sheet for the year then ended: a regulatory asset of $1.0 billion, additional pension and postretirement obligations of $400 million and $300 million, respectively, and the elimination of a $300 million intangible asset representing unamortized prior service cost. The net effect of recognizing such amounts would have increased total assets and liabilities $700 million at that date.

In August 2006, Congress passed the Pension Protection Act of 2006 (the "Pension Act"), which is awaiting signature by the President. TVA is currently assessing the applicability of the Pension Act's provisions to the TVA Retirement System ("TVARS"), and the effect of the Pension Act on TVARS is unknown at this time.

The Pension Act incorporates the provisions agreed to by the House-Senate conference on the separate pension reform bills passed earlier by the House and Senate. Those bills amended the Employee Retirement Income Security Act ("ERISA") and Section 412 of the Internal Revenue Code to provide new minimum funding rules for defined benefit plans. The TVARS defined benefit plan, as a governmental plan, is not subject to the minimum funding rules under ERISA and Section 412 of the Internal Revenue Code, and it is unclear the extent to which the Pension Act would have any effect on the TVARS defined benefit plan.

Balance Sheet Changes

On May 4, 2006, the NRC approved TVA's application for license extension at each of TVA's three Browns Ferry nuclear units. The license extension has the effect of changing the estimated lives of the units for depreciation purposes from a recovery period of 40 years to a recovery period of 60 years.

Further, due to the extended operating lives of the units, the estimated ARO related to the three Browns Ferry units was reduced by $153 million, the regulatory asset related to nuclear decommissioning costs was reduced by $166 million, the capitalized portion of the ARO related to Browns Ferry was reduced by $31 million and corresponding accumulated depreciation on the ARO was reduced by $44 million on the June 30, 2006 Balance Sheet. (See "*Other" — "Browns Ferry Nuclear Plant"* and *note 1 — Asset Retirement Obligations.)*

Risk Factors

<u>Operational Risk</u>
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 covered 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 June 30, 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*."

<u>Rate Setting</u>
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 April 1, 2006, the Board-approved 9.95 percent increase in firm wholesale electric rates became effective. 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, the Board approved a budget for the 2007 fiscal year that includes a reduction in firm wholesale power rates of 4.5 percent in conjunction with a proposed Fuel Cost Adjustment ("FCA"), to be effective October 1, 2006. See *"Other Information" — "Board Actions."* The rate reduction and other budget parameters will require improvements in productivity across TVA and implementation of a FCA that adjusts TVA's rates up and down quarterly as fuel and purchased power costs rise and fall.

<u>Risk of Loss of Customers</u>
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. The agreement rescinding the notice has been executed by both parties. 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. The table below lists the names and locations of the six distributor customers whose termination notices are still in effect, their

contract termination dates, the amount of revenues that TVA generated by selling power to these distributor customers in 2005, and the percentage of TVA's total 2005 operating revenues represented by these revenues.

	Distributor Termination Notices			
Distributor Customer	Location	Date Termination of Contract	Sales to Distributor Customers in 2005	Percentage of Total Operating Revenues in 2005
Warren Rural Electric Cooperative Corporation	Kentucky	April 2008	$ 82	1.0%
Monticello Electric Plant Board	Kentucky	November 2008	5	0.1%
Glasgow Electric Plant Board	Kentucky	December 2008	18	0.2%
Paducah Power System	Kentucky	December 2009	33	0.4%
Princeton Electric Plant Board	Kentucky	January 2010	6	0.1%
Duck River Electric Membership Corporation	Tennessee	August 2010	85	1.1%
Total			$ 229	2.9%

On June 20, 2006, FERC issued an order that rejects TVA's request that FERC reconsider its January 19, 2006, decision to grant East Kentucky Power Cooperative ("EKPC") three interconnections with the TVA transmission system. EKPC had asked FERC to order TVA to interconnect EKPC with TVA's transmission system. TVA responded that if FERC granted EKPC's request, the actual effect would be to require TVA to provide free transmission service across TVA's transmission system. TVA believes such a scenario would be contrary to provisions of the Federal Power Act, which restricts FERC from ordering TVA to permit other power providers from using TVA's transmission system to serve load within the TVA service area. In accordance with FERC's January 19, 2006, decision, TVA provided EKPC with a proposed interconnection agreement. On July 20, 2006, however, FERC determined that the interconnection agreement was not consistent with its January 19, 2006 order and issued an order directing TVA to submit a revised interconnection agreement within 30 days. Although FERC stated TVA could be subject to civil penalties if it does not submit a revised agreement complying with FERC's directions, FERC has not issued any civil penalties or initiated the process required before issuing such penalties. TVA will file the revised agreement in accordance with FERC's directions. Under the Federal Power Act, TVA may seek judicial review of the June 20, 2006 order in the United States Court of Appeals within 60 days of its issuance. It also has a right to seek rehearing of the July 20, 2006 order, and thereafter, judicial review of that order.

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 NO_x 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 fossil 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.

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 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
Nationally, natural gas production has returned to pre-Katrina levels and storage levels are at an all-time high.

The rail and mine problems that plagued TVA early in the year have been resolved with the exception of one mine that supplies coal to the six small units at Widows Creek. That mine is experiencing equipment problems which they expect to have resolved by the end of July. Coal inventories are adequate to meet the demands of the summer.

Browns Ferry Nuclear Plant
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, excluding AFUDC. Unit 1 is expected to return to service in May 2007, and the additional generating capacity is expected to lower the average cost of power and provide additional cash flow. As of June 30, 2006, TVA had incurred approximately $1.5 billion of costs (excluding AFUDC of $160 million) on the Browns Ferry Unit 1 restart project, the planned amount for this period. The restart project was over 88 percent complete at that date and on schedule for completion.

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 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.

Watts Bar Nuclear Plant Unit 2
TVA is planning to perform a detailed scoping, estimating, and planning ("DSEP") study at Watts Bar Nuclear Plant Unit 2 ("WBN2") during 2007 and 2008 at an estimated cost of $30 million. WBN2 is a partially completed nuclear plant identical in design to the operating Watts Bar Unit 1. The purpose of the DSEP study is to provide accurate cost, schedule, and risk information to enable a more informed future decision to be made on new base load generation. No decision has been made to actually complete WBN2.

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 consortium comprised of nine 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. TVA has been a participant in NuStart since its inception and is engaged in discussions to become a full member of NuStart. No decision has been made to actually build an advanced reactor at the site.

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. Costs for repairs from both storms are nearly $5 million, which is covered through operating and maintenance funds and storm contingency funds.

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. A meeting was held between TVA and Areva on May 31, 2006 to discuss the issue. TVA is awaiting more information from Areva.

Bear Creek Dam Seepage
TVA staff held a public scoping meeting regarding the leaking Bear Creek Dam on June 20, in Red Bay, Alabama. About 150 attendees, including local public officials, provided comments and suggestions for TVA's consideration. The comments have been compiled and development of possible alternatives to be studied as a part of the Environmental Impact Statement has been initiated.

President's 2007 Budget, Total Financing Obligations Reductions
On February 6, 2006, the Office of Management and 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.

Through 2005, TVA has reduced its TFOs by $2.1 billion since the beginning of 1997. As of June 30, 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 July 2006, TVA issued $9 million of electronotes® with an interest rate of 5.63 percent which mature in 2013 and are callable beginning in 2008.

In July 2006, TVA repurchased $64 million of its 2005 Series A Power Bonds due June 15, 2035, and $28 million of its 2003 Series B Power Bonds due July 15, 2033. The $13 million gain on the transactions is considered a reacquisition cost and recorded as a regulatory asset. See note 1— *Cost-Based Regulation*.

Legal Proceeding against the Environmental Protection Agency
The Center for Biological Diversity and certain residents of Kentucky filed suit on July 31, 2006, against the Environmental Protection Agency ("EPA") in the United States District Court for the District of Columbia over the agency's alleged failure to respond to their petition objecting to the operating permit for TVA's Paradise Fossil Plant, located in Kentucky. Plaintiffs seek an order requiring EPA to respond to their petition. Any objections to EPA's response would have to be filed in a different court.

Governance
On August 3, 2006, President Bush announced his intention to nominate Bishop William Graves of Memphis, Tennessee, to fill the last vacant position on TVA's Board of Directors for a term to expire in May 2007. Bishop Graves is a former member of the board of Memphis Light, Gas and Water Division, TVA's largest distributor customer. The President's nomination first will be considered by the U.S. Senate Environment and Public Works Committee. If the committee votes to confirm Bishop Graves, its recommendation will go to the full Senate for a vote. If confirmed by the full Senate, Bishop Graves will be sworn into office, joining the other eight members of the TVA Board and giving TVA a nine-member Board for the first time in history.

Peak Electricity Demands
On July 18, 2006, TVA met a preliminary all-time TVA record peak demand for electricity in its seven-state service area. TVA met a peak demand of 32,008 megawatts at 5 p.m. CDT, when temperatures across the Tennessee Valley reached 97 degrees. All five nuclear units were at full power and 58 of 59 fossil units were online to meet the expected high power demand. Management of TVA generation assets, transmission assets, and purchased power ensured that there were no "Load not Served" events on the grid, meaning all loads were served on the peak day.

On August 7, 2006, TVA met a preliminary all-time TVA record peak demand for the month of August of 31,948 megawatts. The peak occurred at 4 p.m. CDT, when temperatures across the Tennessee Valley averaged 95 degrees Fahrenheit. August is the fifth consecutive month in 2006 that TVA has met record monthly power demands.

Power Interruptions
In the first week of August 2006, extremely hot temperatures across the region placed high demands on the TVA power system due to several key TVA units being offline, the unavailability of some contracted purchased power, and extremely tight bulk-power markets. As a result of these demands, TVA curtailed power supply to some customers whose contracts allow for such interruptions.

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 June 30, 2006, include the following:

Accumulated Other Comprehensive Income (Loss)

	June 30, 2006	September 30, 2005
Inflation swaps	$ (6)	$ 2
Foreign currency swaps	118	25
Total	$ 112	$ 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 counterparty 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 June 30, 2006, the supplier has continued to perform under the contractual arrangements.

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, swaps, 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. Trading is not authorized for speculative purposes.

At June 30, 2006, TVA had 929 derivative contracts outstanding under the program with an approximate net market value of $58 million. During the three-month period ended June 30, 2006, TVA recognized unrealized losses of approximately $8 million. For the nine months ended June 30, 2006, the program's unrealized loss is over $15 million. The cumulative unrealized losses are included in purchased power expense.

Financial Trading Program Activity
Nine Months Ended June 30

	2006 Notional Amount (in mmBtu)	2006 Contract Value	2005 Notional Amount (in mmBtu)	2005 Contract Value
Futures contracts				
Financial positions at beginning of period, net	880,000	$ 9.6	–	$ –
Purchased	10,647,500	92.9	3,230,000	21.4
Sold	(2,470,000)	(24.8)	(1,110,000)	(7.4)
Realized (losses)	–	(3.9)	–	–
Net positions–long	9,057,500	73.8	2,120,000	14.0
Options Contracts				
Financial positions at beginning of period, net	240,000	–	–	–
Calls purchased	–	–	520,000	0.3
Puts sold	–	–	800,000	(0.3)
Positions closed or expired	(240,000)	–	(930,000)	–
Net positions	–	–	390,000	–
Holding gains (losses)				
Unrealized gains at the beginning of period, net	–	0.5	–	–
Unrealized (losses) for the period	–	(16.0)	–	0.8
Unrealized (losses) at end of period, net	–	(15.5)	–	0.8
Financial positions at end of period, net	9,057,500	$ 58.3	2,510,000	$ 14.8

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 ("Acting CEO"); the Disclosure Control Committee; and the Chief Financial Officer ("CFO"), as appropriate, to allow timely decisions regarding required disclosure.

An evaluation has been performed under the supervision of TVA management, including the Acting CEO and members of the Disclosure Control Committee (including the CFO and the Controller) of the effectiveness of TVA's disclosure controls and procedures as of June 30, 2006. Based on that evaluation, the Acting CEO and members of the Disclosure Control Committee (including the CFO 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 June 30, 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 CEO and members of the Disclosure Control Committee (including the CFO 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 by 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 report 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.

Except for the efforts taken and currently underway as described above, no changes occurred during the quarter ended June 30, 2006 in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, TVA's internal control over financial reporting.

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

OTHER INFORMATION

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. A trial on the issue of damages has been scheduled for January 15, 2007. TVA filed a motion with the district court seeking permission to take an interlocutory appeal of the court's ruling on summary judgment. On July 31, 2006, the district court ruled on TVA's motion, reconsidered its decision on summary judgment with respect to TVA's affirmative defenses, and held that TVA is entitled to a trial on its affirmative defenses. The court also denied TVA's motion for an interlocutory appeal.

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. Argument in this case was held on July 26, 2006.

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 was held on June 7, 2006, and TVA is currently awaiting a decision.

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 would not begin picking up SNF 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 United States has since voluntarily dismissed its appeal. On July 21, 2006, the court issued an order to that effect, ending the case. TVA recorded a receivable of $35 million as of June 30, 2006 as a result of the settlement of the case. The proceeds will partially offset the cost of construction related to the dry cask storage facilities at Browns Ferry and Sequoyah Nuclear Plants necessitated by DOE's failure to accept spent nuclear fuel. Cost of the capitalized storage facilities totaled approximately $61 million and is included in PROPERTY, PLANT, AND EQUIPMENT on the Balance Sheet.

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. Briefing of the appeal was completed in July 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 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. Oral argument date is scheduled for September 2006.

In 2002, the Sierra Club and the Alabama Environmental Council 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 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 dismissed the complaint. The plaintiffs appealed the district court's decision to the Eleventh Circuit. On November 22, 2005, the Eleventh Circuit affirmed the lower court in part and reversed in part. It affirmed the lower court's dismissal of the claims for civil penalties, but held that the Alabama de minimis rule was not applicable because Alabama had not yet obtained EPA approval of that rule. The case was remanded to the district court for further proceedings. After remand the plaintiffs filed a motion for summary judgment. On May 23, 2006, the district court issued three orders in this action. The first stayed the matter until a decision is issued in a CAA case recently accepted by the Supreme Court, *United States v. Duke Energy*. The second order referred the action to mediation to be completed before the close of business on December 15, 2006, unless the court extends the deadline. The third order denied as moot the plaintiffs' pending motions to hold TVA liable for opacity violations at Colbert but indicated plaintiffs could again file such motions, if necessary, after the stay is lifted. On May 26, 2006, the plaintiffs moved the court to reconsider its orders, and in the alternative to allow an interlocutory appeal. On July 5, 2006, the district court denied plaintiffs' motion to reconsider and to appeal, and ordered the parties to select a mediator, which the parties have done.

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. On April 3, 2006, TVA moved to dismiss the case on grounds that the case is not suitable for judicial resolution because of separation of powers principles, including the fact that these matters are based on policy decisions left to TVA's discretion in its capacity as a government agency, and thus are not subject to tort liability (the "discretionary function doctrine"), as well as the Supremacy Clause. In July 2006, the court denied TVA's motion. TVA is reviewing the court's decision and considering options.

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. In June 2006, North Carolina filed a petition for review of EPA's decision with the United States Court of Appeals for the District of Columbia Circuit.

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 seven large oil companies and an oil company trade association, three large chemical companies and a chemical trade association, and thirty-one 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 has moved to dismiss the complaint on grounds that TVA's operation of its coal plants is not subject to tort liability due to the discretionary function doctrine.

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. In accordance with SFAS No. 5, *"Accounting for Contingencies,"* TVA has accrued approximately $21 million as of June 30, 2006, related to the cases described above.

BOARD ACTIONS

May 18, 2006, Hearing and Board Meeting

On May 18, 2006, the TVA Board of Directors (the "Board") conducted a hearing in Hopkinsville, Kentucky. This hearing, the first of its kind, was conducted to provide the Board with an opportunity to receive input on the issue of transmission access from representatives of TVA's various distributor customers, the Tennessee Valley Public Power Association, the Tennessee Valley Industrial Committee, and the Kentucky Public Service Commission.

Immediately following the May 18, 2006, hearing, the newly expanded Board held its second meeting. During the meeting, the Board adopted bylaws. The bylaws establish the operational policies and rules for the Board itself, as well as define the general authorities and duties of TVA's Chief Executive Officer.

On May 18, the Board also approved the establishment of the following committees:

- Corporate Governance Committee
- Finance, Strategy and Rates Committee
- Audit and Ethics Committee
- Operations, Environment and Safety Committee
- Human Resources Committee
- Community Relations Committee

Each committee will draft a charter to govern its operations consistent with its responsibilities. The committee charters will be presented to the Board for approval at a future meeting.

June 28, 2006, Board Meeting

On June 28, 2006, the Board held a meeting in Knoxville, Tennessee, during which it approved a recommendation by the Finance, Strategy and Rates Committee to direct TVA staff to develop a budget for the 2007 fiscal year using parameters set forth during the meeting.

July 28, 2006, Board Meeting

On July 28, 2006, the Board approved a budget for the 2007 fiscal year that, among other things, targets (1) reducing TVA's total financing obligations by $529 million, (2) holding, subject to certain exceptions, the rate of increase in non-fuel cash operating costs at or below the expected rate of growth in power sales, and (3) maintaining a cash balance of $500 million. In connection with approving the budget, the Board also approved a reduction in firm wholesale power rates of 4.5 percent and a fuel cost adjustment ("FCA") mechanism. The FCA, similar to those used by many utilities, will adjust TVA's rates up or down as fuel and purchased power costs rise and fall. Both the FCA and the decrease in firm rates will take effect on October 1, 2006.

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 June 30, 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 June 30, 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: August 11, 2006

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 June 30, 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 June 30, 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: August 11, 2006

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

CONTACT INFORMATION

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