

U.S.\$1,000,000,000

Tennessee Valley Authority



5³/₈% Global Power Bonds 2006 Series A Due April 1, 2056

Interest Payable October 1 and April 1

The 5³/₈% Global Power Bonds 2006 Series A Due April 1, 2056 (the "Bonds") of the Tennessee Valley Authority ("TVA") will not be subject to redemption prior to maturity. The Bonds will be issued in minimum denominations of U.S.\$2,000 and integral multiples of \$1,000 in excess thereof.

The Bonds will be issued, maintained and transferred only on the book-entry system of the U.S. Federal Reserve Banks as described herein. Transactions in the Bonds will be cleared and settled in book-entry form by Euromarket participants through the facilities of Clearstream, Luxembourg (as defined herein) and Euroclear (as defined herein). See "Clearance and Settlement." The Bonds will not be exchangeable for definitive securities.

The Bonds may be separated ("stripped") into their separate Interest and Principal Components (as defined herein) and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. The components of each stripped Bond are: each future interest payment (each an "Interest Component") and the principal payment (the "Principal Component" and, together with the Interest Components, hereinafter collectively referred to as the "Strips" or "Interest and Principal Components"). See "Description of Bonds" — "Stripping" and "United States Tax Matters."

Application has been made to list the Bonds on the New York Stock Exchange. By making this application, TVA does not undertake any obligation to maintain the listing of the Bonds on the New York Stock Exchange.

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

TVA is a wholly owned corporate agency and instrumentality of the United States of America and has no subsidiaries. Principal and interest will be payable solely from TVA's Net Power Proceeds (as defined herein).

The Bonds will not be obligations of, nor will payment of the principal thereof or the interest thereon be guaranteed by, the United States of America. TVA is not required to register securities under the Securities Act of 1933 and is currently not required to make periodic reports to the U.S. Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934. As a result of legislation enacted in December 2004, TVA will be required to file annual reports, quarterly reports and current reports with the SEC under the Securities Exchange Act of 1934, beginning with its 2006 annual report.

	Price to Public(1)	Discount to Managers	Net Proceeds to TVA(1)(2)
Per Bond.....	99.432%	0.60%	98.832%
Total	U.S.\$994,320,000	U.S.\$6,000,000	U.S.\$988,320,000

- (1) Plus accrued interest from April 1, 2006 to date of delivery.
- (2) Before deducting expenses payable by TVA estimated at U.S.\$250,000.

The Bonds offered by this Offering Circular are offered by the Managers (as defined herein) subject to prior sale, withdrawal, cancellation or modification of the offer without notice, to delivery to and acceptance by the Managers and to certain further conditions. It is expected that delivery of the Bonds, in book-entry form, will be made through the book-entry system of the U.S. Federal Reserve Banks on or about April 3, 2006, against payment therefor in immediately available funds.

Joint Book-Running Managers

Merrill Lynch & Co.

Morgan Stanley

Deutsche Bank Securities

Goldman, Sachs & Co.

Lehman Brothers

The date of this Offering Circular is March 29, 2006.

CERTAIN OF THE MANAGERS MAY ENGAGE IN TRANSACTIONS THAT STABILIZE, MAINTAIN OR OTHERWISE AFFECT THE PRICE OF THE BONDS. SPECIFICALLY, THE MANAGERS MAY OVERALLOT IN CONNECTION WITH THE OFFERING AND MAY BID FOR, AND PURCHASE, BONDS IN THE OPEN MARKET AND MAY IMPOSE PENALTY BIDS. SUCH TRANSACTIONS MAY BE EFFECTED IN AN OVER-THE-COUNTER MARKET OR OTHERWISE.

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

No action has been (or will be) taken in any jurisdiction by TVA or any of the Managers or their Affiliates (other than the listing of the Bonds on the New York Stock Exchange) that would permit a public offering of the Bonds, or possession or distribution of the Offering Circular, any Term Sheet, or any other offering material, in any country or jurisdiction where action for that purpose is required (other than states of the United States in connection with securities or Blue Sky laws of such states).

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

This Offering Circular has not been registered with the Monetary Authority of Singapore. Accordingly, this Offering Circular and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Bonds may not be circulated or distributed, nor may the Bonds be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor specified in Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"), (ii) to a sophisticated investor, and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

This Offering Circular should be read in conjunction with any Term Sheet, TVA's Quarterly Report for the quarterly period ended December 31, 2005 (the "Quarterly Report") and TVA's Information Statement, dated November 18, 2005 (the "Information Statement"), which are attached hereto and incorporated herein. Any statement contained in the Information Statement shall be deemed to be modified or superseded for all purposes of the Quarterly Report, the Information Statement and this Offering Circular to the extent that a statement contained in this Offering Circular or the Quarterly Report modifies or supersedes such statement, and any statement contained in the Quarterly Report shall be deemed to be modified or superseded for all purposes of the Quarterly Report, the Information Statement and this Offering Circular to the extent that a statement contained in this Offering Circular modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified, to constitute a part of the Quarterly Report or the Information Statement. Additional copies of this Offering Circular, any Term Sheet, the Quarterly Report and the Information Statement may be obtained (free of charge) upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations, by calling 1-888-882-4975 in the United States or by calling 1-888-882-4976

internationally. The then-current Information Statement and other information concerning TVA may be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

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

In this Offering Circular, any Term Sheet, the Quarterly Report and the Information Statement, references to “U.S. dollars,” “U.S.\$,” “dollars” and “\$” are to United States dollars, references to “DM” are to deutsche marks and references to “£” are to British pound sterling.

FORWARD-LOOKING STATEMENTS

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

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

Examples of forward-looking statements include, but are not limited to, strategic objectives; estimates of costs for disposing of certain asset retirement obligations; expectations about the adequacy of TVA’s nuclear decommissioning fund; projections of future power and energy requirements; future costs related to environmental compliance; impacts of potential legislation on TVA and the likelihood of enactment of such legislation; estimates regarding the reduction of total financing obligations; anticipated availability of nuclear waste storage facilities; projections of nuclear decommissioning costs; planned construction expenditures for property, plant and equipment additions; impacts of pending litigation and various administrative orders that have been or may be issued; 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 restructuring of the electric power industry and various environmental matters; increased competition among electric utilities; changes to the Anti-Cherry-picking Provision; legal and administrative proceedings affecting TVA; the financial and economic environment; performance of TVA’s generation and transmission assets; fuel prices; demand for electricity; changes in technology; changes in the price of power; loss of any significant customers or suppliers; creditworthiness of counterparties; weather conditions and other natural phenomena; damage to power production or transmission facilities due to accidental events or terrorist activity; changes in accounting standards; and unforeseeable events. Additionally, other risks that may cause actual results to differ from the predicted results are set forth in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” - “Risk Factors and Forward-Looking Statements” in the 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 affect TVA’s business or cause results to differ from those contained in any forward-looking statement.

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

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SUMMARY OF OFFERING

The information below is qualified in its entirety by the detailed information appearing in the Quarterly Report and Information Statement (and any supplements thereto) and elsewhere in this Offering Circular. We may also prepare a Term Sheet which summarizes the particular terms of the Bonds. Any such Term Sheet is also qualified in its entirety by the detailed information appearing in the Quarterly Report and Information Statement (and any supplements thereto) and elsewhere in this Offering Circular. Capitalized terms used and not defined herein have the meanings defined in the Information Statement and elsewhere in this Offering Circular.

Issuer	TVA is a wholly owned corporate agency and instrumentality of the United States of America established by the Tennessee Valley Authority Act of 1933, as amended.
Securities Offered	U.S.\$1,000,000,000 aggregate principal amount of 5 ³ / ₈ % Global Power Bonds 2006 Series A Due April 1, 2056 (the "Bonds").
Interest	The Bonds will bear interest from April 1, 2006, at the annual rate set forth on the cover page hereof, payable semiannually in arrears on each October 1 and April 1, commencing October 1, 2006.
Redemption	The Bonds will not be subject to redemption prior to maturity.
Fiscal Agent	U.S. Federal Reserve Banks.
Ratings	The Bonds have been rated AAA by Standard & Poor's Ratings Services and Fitch Ratings, and Aaa by Moody's Investors Service, Inc.
Listing	Application has been made to list the Bonds on the New York Stock Exchange. By making this application, TVA does not undertake any obligation to maintain the listing of the Bonds on the New York Stock Exchange.
Use of Proceeds	The net proceeds received by TVA from the sale of the Bonds will be used to refinance existing debt.
Source of Payment.....	The interest and principal on the Bonds are payable solely from Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America. See "The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness" in Part I of the Information Statement.
Form and Denomination of Bonds ..	The Bonds will be issued and maintained and may be transferred by Holders (as defined herein) only on the book-entry system of the U.S. Federal Reserve Banks. See "Description of Bonds" — "Book-Entry System." The Bonds will not be exchangeable for definitive securities. The Bonds will be issued and must be maintained and transferred in minimum denominations of U.S.\$2,000 and integral multiples of \$1,000 in excess thereof.
Stripping	The Bonds may be stripped into their separate Interest and Principal Components and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. The components of each stripped Bond are: each future interest payment and the principal payment. Each Interest Component and the Principal Component will have an identifying designation and CUSIP number. See "Description of Bonds" — "Stripping" and "United States Tax Matters."
Delivery of Strips	The Managers immediately upon their acceptance of the Bonds may, but are not obligated to, strip some or all of the Bonds and deliver Strips rather than Bonds to investors purchasing Strips. Sales of any such Strips would be at negotiated prices. See "Subscription and Selling." In addition, a Holder may strip Bonds at any time prior to maturity. See "Description of Bonds" — "Stripping."

Clearance and Settlement The Bonds must be held in accounts with institutions having access in the United States to the book-entry system of the U.S. Federal Reserve Banks. Transactions in the Bonds will be cleared and settled by Euromarket participants through the facilities of Euroclear and Clearstream, Luxembourg. See “Clearance and Settlement.”

Legality of Investment in the United States Each person or entity is advised to consult with its own counsel with respect to the legality of investment in Bonds or in Strips, which could be subject to restrictions or requirements that do not apply to Power Bonds held in their fully constituted form.

The following generally describes the legality of investment in the United States in TVA Power Bonds in their fully constituted form. Power Bonds are:

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

See “Legality of Investment in the United States.”

No Acceleration Rights The Bonds will not contain any provisions permitting the Holders to accelerate the maturity thereof on the occurrence of any default or other event. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Events of Default” in Part I of the Information Statement.

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

ISIN US880591 DZ22
 CUSIP Number 880591 DZ2

If the Bonds are stripped into their separate Interest and Principal Components, the following ISIN and CUSIP numbers will apply:

<u>Interest Payment Date</u>	<u>ISIN</u>	<u>CUSIP</u>
October 1, 2006.....	US88059E YJ71	88059E YJ7
April 1, 2007	US88059E YK45	88059E YK4
October 1, 2007.....	US88059E YL28	88059E YL2
April 1, 2008	US88059E YM01	88059E YM0
October 1, 2008.....	US88059E YN83	88059E YN8
April 1, 2009	US88059E YP32	88059E YP3
October 1, 2009.....	US88059E YQ15	88059E YQ1
April 1, 2010	US88059E YR97	88059E YR9
October 1, 2010.....	US88059E YS70	88059E YS7
April 1, 2011	US88059E YT53	88059E YT5
October 1, 2011.....	US88059E YU27	88059E YU2
April 1, 2012	US88059E YV00	88059E YV0
October 1, 2012.....	US88059E YW82	88059E YW8
April 1, 2013	US88059E YX65	88059E YX6
October 1, 2013.....	US88059E YY49	88059E YY4
April 1, 2014	US88059E YZ14	88059E YZ1
October 1, 2014.....	US88059E ZA53	88059E ZA5
April 1, 2015	US88059E ZB37	88059E ZB3
October 1, 2015.....	US88059E ZC10	88059E ZC1
April 1, 2016	US88059E ZD92	88059E ZD9
October 1, 2016.....	US88059E ZE75	88059E ZE7
April 1, 2017	US88059E ZF41	88059E ZF4
October 1, 2017.....	US88059E ZG24	88059E ZG2
April 1, 2018	US88059E ZH07	88059E ZH0
October 1, 2018.....	US88059E ZJ62	88059E ZJ6
April 1, 2019	US88059E ZK36	88059E ZK3
October 1, 2019.....	US88059E ZL19	88059E ZL1
April 1, 2020	US88059E ZM91	88059E ZM9
October 1, 2020.....	US88059E ZN74	88059E ZN7
April 1, 2021	US88059E ZP23	88059E ZP2
October 1, 2021.....	US88059E ZQ06	88059E ZQ0
April 1, 2022	US88059E ZR88	88059E ZR8
October 1, 2022.....	US88059E ZS61	88059E ZS6
April 1, 2023	US88059E ZT45	88059E ZT4
October 1, 2023.....	US88059E ZU18	88059E ZU1
April 1, 2024	US88059E ZV90	88059E ZV9
October 1, 2024.....	US88059E ZW73	88059E ZW7
April 1, 2025	US88059E ZX56	88059E ZX5

<u>Interest Payment Date</u>	<u>ISIN</u>	<u>CUSIP</u>
October 1, 2025	US88059E ZY30	88059E ZY3
April 1, 2026	US88059E ZZ05	88059E ZZ0
October 1, 2026	US88059E A201	88059E A20
April 1, 2027	US88059E A383	88059E A38
October 1, 2027	US88059E A466	88059E A46
April 1, 2028	US88059E A532	88059E A53
October 1, 2028	US88059E A615	88059E A61
April 1, 2029	US88059E A797	88059E A79
October 1, 2029	US88059E A870	88059E A87
April 1, 2030	US88059E A953	88059E A95
October 1, 2030	US88059E B290	88059E B29
April 1, 2031	US88059E B373	88059E B37
October 1, 2031	US88059E B456	88059E B45
April 1, 2032	US88059E B522	88059E B52
October 1, 2032	US88059E B605	88059E B60
April 1, 2033	US88059E B787	88059E B78
October 1, 2033	US88059E B860	88059E B86
April 1, 2034	US88059E B944	88059E B94
October 1, 2034	US88059E C280	88059E C28
April 1, 2035	US88059E C363	88059E C36
October 1, 2035	US88059E C447	88059E C44
April 1, 2036	US88059E C512	88059E C51
October 1, 2036	US88059E C694	88059E C69
April 1, 2037	US88059E C777	88059E C77
October 1, 2037	US88059E C850	88059E C85
April 1, 2038	US88059E C934	88059E C93
October 1, 2038	US88059E D270	88059E D27
April 1, 2039	US88059E D353	88059E D35
October 1, 2039	US88059E D437	88059E D43
April 1, 2040	US88059E D502	88059E D50
October 1, 2040	US88059E D684	88059E D68
April 1, 2041	US88059E D767	88059E D76
October 1, 2041	US88059E D841	88059E D84
April 1, 2042	US88059E D924	88059E D92
October 1, 2042	US88059E E260	88059E E26
April 1, 2043	US88059E E344	88059E E34
October 1, 2043	US88059E E427	88059E E42
April 1, 2044	US88059E E591	88059E E59
October 1, 2044	US88059E E674	88059E E67
April 1, 2045	US88059E E757	88059E E75
October 1, 2045	US88059E E831	88059E E83

<u>Interest Payment Date</u>	<u>ISIN</u>	<u>CUSIP</u>
April 1, 2046	US88059E E914	88059E E91
October 1, 2046.....	US88059E F259	88059E F25
April 1, 2047	US88059E F333	88059E F33
October 1, 2047.....	US88059E F416	88059E F41
April 1, 2048	US88059E F580	88059E F58
October 1, 2048.....	US88059E F663	88059E F66
April 1, 2049	US88059E F747	88059E F74
October 1, 2049.....	US88059E F820	88059E F82
April 1, 2050	US88059E F903	88059E F90
October 1, 2050.....	US88059E G240	88059E G24
April 1, 2051	US88059E G323	88059E G32
October 1, 2051.....	US88059E G406	88059E G40
April 1, 2052	US88059E G570	88059E G57
October 1, 2052.....	US88059E G653	88059E G65
April 1, 2053	US88059E G737	88059E G73
October 1, 2053.....	US88059E G810	88059E G81
April 1, 2054	US88059E G992	88059E G99
October 1, 2054.....	US88059E H230	88059E H23
April 1, 2055	US88059E H313	88059E H31
October 1, 2055.....	US88059E H495	88059E H49
April 1, 2056	US88059E H560	88059E H56
Principal Component	US88059F BP53	88059F BP5

TENNESSEE VALLEY AUTHORITY

The Tennessee Valley Authority is one of the nation's largest wholesale producers of electricity in the United States of America, having produced nearly 160 billion kilowatt-hours ("kWh") of electricity in fiscal year 2005. The TVA system supplies electric power to a region containing about 8.5 million people located in parts of Tennessee, Kentucky, Mississippi, Alabama, Georgia, North Carolina and Virginia.

TVA is a wholly owned corporate agency and instrumentality of the United States of America established pursuant to the Tennessee Valley Authority Act of 1933, as amended (the "Act"), primarily to develop and manage the resources of the Tennessee Valley region. Historically, the programs of TVA have consisted of power and nonpower programs. Substantially all TVA's revenues and assets are attributable to its power program. The Act requires the power program to be self-supporting from power revenues and proceeds from power program financings, such as proceeds from the issuance of debt. Although TVA no longer receives congressional appropriations for either its power or nonpower programs, TVA is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's Appropriation Investment (as defined in the Basic Resolution) in TVA power facilities, of which \$428 million was outstanding as of September 30, 2005. See note 7 in Part II of the Information Statement. Until 2000, most of the funding for TVA's non-power programs was provided by congressional appropriations. These programs are now funded largely with power funds. Certain nonpower activities are also funded with various revenues and user fees. For a further discussion of this matter, see "Certain Provisions of the Tennessee Valley Authority Act and Related Laws" — "Public Law No. 105-62" in Part I of the Information Statement.

USE OF PROCEEDS

TVA will use the net proceeds from the sale of the Bonds of U.S.\$988,070,000 (after deducting expenses estimated to be U.S.\$250,000) to refinance existing debt.

RECENT DEVELOPMENTS

On February 13, 2006, the TVA Board approved an increase of 9.95 percent in firm wholesale electric rates to recover coal, natural gas, and purchased power costs that are significantly higher than budgeted for fiscal year 2006. The rate adjustment is effective April 1, 2006, and is expected to provide an estimated \$276 million in additional cash during fiscal year 2006. TVA is looking at additional measures to defer, save, or reduce spending or cash reserves by another \$240 million. The rate increase and these additional efforts are necessary to offset more than \$500 million in higher forecasted fuel and purchased power costs since last July. In addition, the Board directed TVA staff to proceed with testing a Fuel Cost Adjustment mechanism that could be adopted in the future and used to adjust TVA's rates up and down as fuel and purchased power costs rise and fall.

River System Operations & Environment ("RSO&E") consolidated its Resource Stewardship and Environmental Policy & Planning ("EP&P") organizations into a new group called Environmental Stewardship & Policy, headed by Senior Vice President Bridgette Ellis. Ms. Ellis has served as Vice President of Resource Stewardship for five years and as acting Vice President of EP&P. She has more than 25 years of experience in resource management with TVA. She reports to Kate Jackson, Executive Vice President, RSO&E. The new organization continues to support business units throughout TVA in the areas of environmental policy, environmental consultation, cultural and heritage consultation, realty services, land management, recreation, natural resource management, and water quality. As of February 15, 2006, most existing staff members in both organizations were consolidated into the new group. In addition, Environmental Training and its employees have transferred to Employee Technical Training & Organizational Effectiveness in Human Resources.

On February 22, 2006, the load and transmission facilities of KAMO Power ("KAMO") in Northwest Oklahoma — which include 826 miles of transmission lines and 370 megawatts of load — were transferred from the Grand River Dam Authority Balancing Authority Area to that of Associated Electric Cooperative, Inc. ("AECI"), an entity for which TVA serves as a Reliability Coordinator. As a Reliability Coordinator, TVA furthers the reliable operation of the transmission system in the area for which it is responsible, in accordance with North American Electric Reliability Council standards. KAMO also has load and transmission facilities in Southwest Missouri, which already were part of the TVA Reliability Coordinator Area. The TVA Reliability Coordinator Area now includes KAMO's Northwest Oklahoma service area, making Oklahoma the eleventh state in the TVA reliability footprint. In addition to the TVA service area, TVA provides reliability-coordination services for the electric grid of AECI, Big Rivers Electric Cooperative, East Kentucky Power Cooperative, and Electric Energy Inc. Currently, more than 140 such Reliability Coordinator areas, both large and small, exist across the United States and Canada, with TVA's being one of the five largest.

At February 28, 2006, net current liabilities were \$355 million higher than at December 31, 2005. The increase is primarily attributable to a \$373 million bond issue classified as a current maturity as of February 28, 2006.

On February 28, 2006, TVA's short-term debt owed to the U.S. Treasury was \$150 million.

On March 3, 2006, the U.S. Senate unanimously confirmed the six TVA Board nominees. The nominees are Dennis Bottorff of Nashville, TN; Don DePriest of Columbus, Miss.; Mike Duncan of Inez, Ky.; Bill Sansom of Knoxville, TN; Howard Thraikill of Huntsville, Ala.; and Susan Richardson Williams of Knoxville, TN. The new Board members are expected to be sworn in and take office on March 31, 2006. President Bush has not yet announced his nominee for the remaining seat on the Board.

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

Relations, on an interim basis reporting to John E. Long, Jr., Executive Vice President, Administrative Services.

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

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

The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated the Clean Air Act ("CAA") opacity limits applicable to TVA's Colbert Fossil Plant between July 1, 1997, and June 30, 2002. On September 14, 2004, the court found that TVA had not violated the CAA and dismissed the case in its entirety. The plaintiffs appealed the district court's decision to the Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit"). On November 22, 2005, the Eleventh Circuit issued its opinion, affirming the lower court in part and reversing in part. On January 5, 2006, TVA filed a petition seeking rehearing of the Eleventh Circuit's decision. On February 28, 2006, the Eleventh Circuit denied TVA's petition for a rehearing. The plaintiffs have filed a motion for summary judgment, which TVA is opposing. See Note 7 in the Quarterly Report for a more detailed discussion of this case.

In 2005, the State of North Carolina petitioned the Environmental Protection Agency ("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.

On March 17, 2006, the United States Court of Appeals for the District of Columbia Circuit struck down one of the Environmental Protection Agency's recently adopted rules reforming its new source review ("NSR") program under the CAA. The rule allowed power plants and other facilities to replace existing equipment with its functional equivalent without undergoing NSR review. This decision exacerbates the confusion and disarray that exists with the NSR program, but its ramification for TVA and other utilities remains uncertain.

DESCRIPTION OF BONDS

General

The Bonds are to be issued pursuant to authority vested in TVA by the Act and pursuant to the Basic Tennessee Valley Authority Power Bond Resolution adopted on October 6, 1960, as amended on September 28, 1976, October 17, 1989 and March 25, 1992 (the "Basic Resolution"), the Supplemental Resolution adopted as of March 14, 2006 (the "Supplemental Resolution" and together with the Basic Resolution, the "Resolutions"), and a concurrence as of March 29, 2006, from Tom D. Kilgore and Michael E. Rescoe authorizing the issuance of the Bonds. TVA has entered into a Fiscal Agency Agreement, dated as of October 7, 1997 (the "Fiscal Agency Agreement") with the U.S. Federal Reserve Banks, as fiscal agents

(together, the “Fiscal Agent”). The U.S. Secretary of the Treasury has approved the time of issuance of, and the maximum rate of interest to be borne by, the Bonds in compliance with Section 15d(c) of the Act. The Bonds represent obligations of TVA payable solely from TVA’s Net Power Proceeds and are not obligations of, or guaranteed by, the United States of America.

The Act authorizes TVA to issue and sell bonds, notes and other evidences of indebtedness (hereinafter collectively referred to as “Evidences of Indebtedness”) to assist in financing its power program and to refund such Evidences of Indebtedness. Evidences of Indebtedness issued pursuant to Section 2.2 of the Basic Resolution designated as Tennessee Valley Authority Power Bonds are herein referred to as “Power Bonds.” The aggregate amount of Evidences of Indebtedness at any one time outstanding is limited to U.S.\$30 billion. As of December 31, 2005, TVA had approximately U.S.\$21.3 billion, DM1.5 billion (issued in deutsche marks in September 1996 and currently payable in euros) and £600 million (£200 million issued in December 1998, £250 million issued in July 2001 and £150 million issued in June 2003) of Evidences of Indebtedness outstanding. At the time TVA issued the DM and British pound sterling Evidences of Indebtedness, TVA entered into currency swap agreements to hedge against fluctuations in such currencies. For information with respect to TVA’s Power Bonds and the Basic Resolution, see “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” in Part I of the Information Statement.

The summaries herein of certain provisions of the Act, the Resolutions and the Fiscal Agency Agreement do not purport to be complete and are qualified in their entirety by reference to all the provisions of the Act, the Resolutions and the Fiscal Agency Agreement, copies of which may be obtained upon written request directed to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations, by calling 1-888-882-4975 in the United States, or by calling 1-888-882-4976 internationally. See “General Information.”

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

The Bonds rank equally as to the application of Net Power Proceeds with all other Power Bonds and all other outstanding Evidences of Indebtedness. For a further discussion of the application of Net Power Proceeds, see “Certain Provisions of the Tennessee Valley Authority Act and Related Laws” and “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” — “Application of Net Power Proceeds” and — “Fourth Amendatory Resolution to the Basic Resolution” in Part I of the Information Statement.

There is no limit on other indebtedness or securities that may be issued by TVA and no financial or similar restrictions on TVA exist, except as provided under the Act, the Basic Resolution and the Supplemental Resolution. TVA issues its Discount Notes pursuant to Section 15d of the Act and in accordance with Section 2.5 of the Basic Resolution. TVA may also issue Other Indebtedness in addition to Power Bonds and Discount Notes. Other Indebtedness is issued pursuant to Section 15d of the Act and under appropriate authorizing resolutions. See “The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness” in Part I of the Information Statement.

In accordance with Public Law No. 105-62, enacted in 1997, TVA is required, in the absence of sufficient appropriations, to fund nonpower programs that constitute “essential stewardship activities” with revenues derived from one or more of various sources, including power program revenues, notwithstanding provisions of the Act and Resolutions to the contrary. See the discussion of Public Law No. 105-62 in “Certain Provisions of the Tennessee Valley Authority Act and Related Laws” — “Public Law No. 105-62” in Part I of the

Information Statement. Under the Supplemental Resolution, actions taken pursuant to Public Law No. 105-62 shall not be considered an event of default or breach under the Resolutions.

Possible Future Issuances

The Supplemental Resolution provides that, at the option of TVA, additional Bonds may be issued in one or more future installments pursuant to an amendment to the Supplemental Resolution not requiring the consent of Holders (as such term is defined under “Book-Entry System”) of the Bonds. Additional Bonds so issued shall be identical in all respects to the Bonds offered hereby (except for any appropriate related changes, including changes in the issue date, issue price and interest commencement date).

Payment of Principal and Interest

The Bonds will consist of U.S.\$1,000,000,000 aggregate principal amount of 5³/₈% Tennessee Valley Authority Global Power Bonds 2006 Series A Due April 1, 2056 (the maturity date being hereinafter referred to as the “Maturity Date”). The Bonds will be issued in minimum denominations of U.S.\$2,000 and integral multiples of \$1,000 in excess thereof in book-entry form only through the U.S. Federal Reserve Banks as described below under “Book-Entry System.” Interest will be payable semiannually in arrears on October 1 and April 1 (each an “Interest Payment Date”), commencing on October 1, 2006. Such interest payments will include any interest accrued from and including April 1, 2006, or the preceding Interest Payment Date, as the case may be, to but excluding the relevant Interest Payment Date. Interest shall be computed on the basis of a 360-day year of twelve 30-day months. The Bonds will be repaid at 100 percent of the principal amount thereof, together with the interest accrued and unpaid thereon, on the Maturity Date. The Bonds are not entitled to the benefit of any sinking fund. Payments of principal and interest on the Bonds will be made on the applicable payment dates to Holders of the Bonds that are Holders as of the close of business on the Business Day preceding such payment dates, by credit of the payment amount to the Holders’ accounts at the U.S. Federal Reserve Banks. The Holder and each other financial intermediary in the chain to the beneficial owner will have the responsibility of remitting payments for the accounts of their customers.

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

Certain certification requirements are applicable to payments of interest on the Bonds and Strips. The Holder or other persons otherwise required to withhold tax may require the beneficial owner of a Bond or Strip, as a condition of payment of amounts due with respect to such Bond or Strip, to present on a timely basis an appropriate United States Internal Revenue Service Form W-8BEN (or other appropriate form) to enable such person to determine its duties and liabilities with respect to any taxes or other charges that may be required to be deducted or withheld under U.S. law or any reporting or other requirements thereunder. See “United States Tax Matters.” In the event that any withholding or other tax or information reporting requirements should be imposed by any jurisdiction, TVA has no obligation to pay additional interest or other amounts as a consequence thereof or to redeem the Bonds prior to their stated maturity.

Redemption

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

Book-Entry System

The Bonds will be issued and maintained in registered form and may be transferred only on the book-entry system of the U.S. Federal Reserve Banks in minimum principal amounts of U.S.\$2,000 and integral multiples of \$1,000 in excess thereof. The U.S. Federal Reserve Banks will maintain book-entry accounts with respect to the Bonds and will make payments, on behalf of TVA, of interest on and principal of the Bonds on

the applicable payment dates by crediting Holders' accounts at the U.S. Federal Reserve Banks. The Bonds will not be exchangeable for definitive securities.

Regulations governing the use of the book-entry system for the Bonds are contained in 18 C.F.R. Part 1314. These regulations and procedures relate primarily to the registration, transfer, exchange and pledge of such obligations. The accounts of Holders on the U.S. Federal Reserve Banks book-entry system are governed by applicable operating circulars of the U.S. Federal Reserve Banks. The U.S. Federal Reserve Banks' handling of, and rights, duties and obligations with respect to, the Bonds will be governed exclusively by the applicable operating circulars of the U.S. Federal Reserve Banks, TVA's book-entry regulations and such other federal book-entry regulations as may be applicable, notwithstanding any inconsistent procedures or requirements of any depository or organized exchange.

The Bonds may be held of record only by entities eligible to maintain book-entry accounts with the U.S. Federal Reserve Banks. Such entities whose names appear on the book-entry records of a U.S. Federal Reserve Bank as the entities for whose accounts the Bonds have been deposited are herein referred to as "Holders." A Holder is not necessarily the beneficial owner of a Bond. Beneficial owners will ordinarily hold Bonds through one or more financial intermediaries, such as banks, brokerage firms and securities clearing organizations. A Holder that is not the beneficial owner of a Bond, and each other financial intermediary in the chain to the beneficial owner, will have the responsibility of establishing and maintaining accounts for their respective customers. The rights of the beneficial owner of a Bond with respect to TVA and the U.S. Federal Reserve Banks may be exercised only through the Holder thereof. TVA and the U.S. Federal Reserve Banks will have no direct obligation to a beneficial owner of a Bond that is not also the Holder of such Bond. The U.S. Federal Reserve Banks will act only upon the instructions of Holders in recording transfers of the Bonds. See "Clearance and Settlement" with respect to entities holding Bonds through the international clearance and settlement systems.

Stripping

At the request of a Holder, a Bond may be separated ("stripped") into its Interest and Principal Components and maintained as such on the book-entry records of the U.S. Federal Reserve Banks. In addition, the Managers, immediately upon their acceptance of the Bonds may, but are not obligated to, strip some or all of the Bonds. See "Summary of Offering." The components of each stripped Bond are: each future interest payment (each an "Interest Component") and the principal payment (the "Principal Component" and, together with the Interest Components, hereinafter collectively referred to as the "Interest and Principal Components"). Each Interest Component and the Principal Component will have a separate identifying designation and CUSIP number as listed in the "Summary of Offering" above.

A Bond may be separated into its Interest and Principal Components at the option of the Holder at any time prior to the maturity date. In order for a U.S. Holder to have its Bonds stripped, such Holder must submit a request for separation to the Federal Reserve Bank of New York ("FRBNY") in accordance with the applicable requirements, if any, of the FRBNY. Requests from Euromarket participants or customers for separation must be directed through Euroclear or Clearstream, Luxembourg; accordingly, Euromarket participants and customers must comply with the relevant clearing system's rules and procedures for requesting the separation of Bonds. See "Clearance and Settlement" — "The Clearing Systems." Currently, the FRBNY does not charge a fee for stripping Bonds.

For a Bond to be stripped into its Interest and Principal Components as described above, the principal amount of the Bond must be U.S.\$1,600,000 or an integral multiple thereof. This principal amount is the amount, based on the stated interest rate of the Bonds, that will produce a semiannual interest payment of U.S.\$2,000 or integral multiples of \$1,000 in excess thereof. Interest and Principal Components will be obligations of TVA payable solely from TVA's Net Power Proceeds.

Once a Bond has been stripped into its Interest and Principal Components, the Interest and Principal Components may be maintained and transferred on the book-entry system of the U.S. Federal Reserve Banks in minimum denominations of U.S.\$2,000 and integral multiples of \$1,000 in excess thereof. Payments on the Interest and Principal Components will be made on the applicable payment dates on the related Bonds by

crediting Holders' accounts at the FRBNY. At the request of a Holder and upon the Holder's payment of a fee (currently the FRBNY's fee applicable to on-line book-entry securities transfers), the FRBNY will restore ("reconstitute") the unmatured Interest and Principal Components of a stripped Bond to their fully constituted form. Holders wishing to reconstitute the unmatured Interest and Principal Components of a stripped Bond to their fully constituted form must (i) produce all outstanding Interest and Principal Components for a Bond and (ii) comply with all applicable requirements of the FRBNY governing the stripping and reconstitution of securities. Only stripped Bonds with a minimum original principal amount of U.S.\$1,600,000 or an integral multiple thereof may be reconstituted. Reconstitution requests from Euromarket participants must be directed through Euroclear or Clearstream, Luxembourg to the FRBNY; accordingly, Euromarket participants and customers must comply with the relevant clearing system's rules and procedures for requesting the reconstitution of Bonds. See "Clearance and Settlement" — "The Clearing Systems."

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

Fiscal Agent

TVA has agreed, in each case subject to applicable laws and regulations and the provisions of the Fiscal Agency Agreement, the Bonds and the Resolutions, so long as the Bonds are outstanding, to maintain a Fiscal Agent. The Fiscal Agent will be the U.S. Federal Reserve Banks. TVA and the Fiscal Agent may amend, modify or supplement, in any respect, or may terminate, substitute or replace, the Fiscal Agency Agreement without the consent of any Holder. In acting under the Fiscal Agency Agreement, the Fiscal Agent acts solely as a fiscal agent of TVA and does not assume any obligation or relationship of agency or trust for or with any Holder of the Bonds except as set forth in applicable operating circulars and letters of the U.S. Federal Reserve Banks. The address of the Fiscal Agent for the Bonds is set forth on the back cover page hereof.

Governing Law

The Fiscal Agency Agreement and the Bonds shall be governed by and construed in accordance with the laws of the State of New York, to the extent such laws are not inconsistent with U.S. federal law. Any litigation regarding the Fiscal Agency Agreement or the Bonds would have to be brought in a court with competent venue and jurisdiction.

Listing

Application has been made to list the Bonds on the New York Stock Exchange. By making this application, TVA does not undertake any obligation to maintain the listing of the Bonds on the New York Stock Exchange.

Notices

Notices and other communications will be given by transmission to a Holder through the communication system linking the U.S. Federal Reserve Banks. Notices will be deemed to have been sufficiently given or made, for all purposes, upon such transmission.

Copies of notices by TVA regarding the Bonds will also be published (a) in a leading daily newspaper in the English language and of general circulation in New York and (b) in a leading daily newspaper in the English language and of general circulation in London. It is expected that copies of such notices will normally be published in *The Wall Street Journal* in New York and *The Financial Times* in London.

Modification and Amendment

TVA may modify or amend any of the terms or provisions of the Bonds in accordance with the provisions for such modifications and amendments contained in the Basic Resolution. See "The Basic Resolution; Power

Bonds, Discount Notes and Other Indebtedness” — “Modifications of Resolutions and Outstanding Bonds” in Part I of the Information Statement.

CLEARANCE AND SETTLEMENT

The Clearing Systems

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

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

Initial Settlement

On initial issue, all Bonds will be issued and settled through the U.S. Federal Reserve Banks book-entry system and held by Holders designated by the Managers. After initial issue, all Bonds will continue to be held by such Holders in the U.S. Federal Reserve Banks book-entry system unless an investor arranges for the transfer of its Bonds to another Holder.

TVA understands that investors electing to hold their Bonds through Euroclear or Clearstream, Luxembourg accounts will follow the settlement procedures applicable to conventional Eurobonds in registered form. Bonds will be credited to the securities custody accounts of Euroclear and Clearstream, Luxembourg holders on the business day following the settlement date against payment for value on the settlement date.

Secondary Market Trading

With respect to secondary market trading in the Bonds, TVA understands the following procedures will apply. Transactions in the Bonds will be cleared and settled by Euromarket participants through the facilities of Euroclear and Clearstream, Luxembourg, the principal Euromarket securities clearance and settlement organizations. The Bonds may be held of record only by entities eligible to maintain book-entry accounts with the U.S. Federal Reserve Banks. Select entities will hold the Bonds in their book-entry accounts with the FRBNY, as the depositaries for Euroclear and Clearstream, Luxembourg. The identity of and certain information about the Euroclear or Clearstream, Luxembourg depositaries may be obtained by contacting Euroclear or Clearstream, Luxembourg. Transfers of the Bonds between Clearstream, Luxembourg customers or Euroclear participants and investors holding directly or indirectly through the U.S. Federal Reserve Banks book-entry system (“Fed Users”) will be effected through the book-entry accounts of such depositaries as Holders with the FRBNY, thereby increasing or decreasing their respective holdings of the Bonds on behalf of Euroclear or Clearstream, Luxembourg.

Transfers between Fed Users will occur in accordance with applicable Book-Entry Regulations promulgated by the U.S. Department of the Treasury. Transfers between Clearstream, Luxembourg customers and Euroclear participants will be settled using the procedures applicable to conventional Eurobonds in same-day funds in accordance with their applicable rules and operating procedures.

Cross-market transfers between Fed Users, on the one hand, and persons holding Bonds directly or indirectly through Euroclear or Clearstream, Luxembourg, on the other, will be effected on behalf of the relevant international clearing system by its U.S. depository; however, such cross-market transactions will require delivery of instructions to the relevant international clearing system by the system customer or participant in accordance with the system's rules and procedures and within its established deadlines (European time). The relevant international clearing system will, if the transaction meets its settlement requirements, deliver instructions to its U.S. depository to take action to effect final settlement on its behalf by delivering or receiving Bonds through its U.S. Federal Reserve account, and making or receiving payment in accordance with normal procedures for immediately available funds settlement. Instructions of Clearstream, Luxembourg customers and Euroclear participants with respect to such transfers must be delivered to Euroclear or Clearstream, Luxembourg, as the case may be, and not to their U.S. depositories.

Because of time-zone differences, credits of Bonds received in Euroclear or Clearstream, Luxembourg as a result of a transaction with a Fed User will be made during the securities settlement processing for the business day following the U.S. Federal Reserve Banks book-entry system settlement date. Such securities credits will be reported to the relevant Clearstream, Luxembourg customer or Euroclear participant on such following business day with the cash debt back-valued to, and the interest accruing from, the U.S. Federal Reserve Banks book-entry system settlement date. If, however, settlement is not completed on the intended value date (that is, if the trade fails), the trade would be valued as of the actual settlement date. Cash received in Euroclear or Clearstream, Luxembourg as a result of sales of Bonds by or through a Clearstream, Luxembourg customer or a Euroclear participant to a Fed User will be received with value on the U.S. Federal Reserve Banks book-entry system settlement date but will be available in the relevant Euroclear or Clearstream, Luxembourg cash account only as of the business day following settlement on the U.S. Federal Reserve Banks book-entry system.

From a Fed User's standpoint, a cross-market transaction will settle no differently from a trade between two Fed Users.

Distributions of interest and principal with respect to the Bonds held through Euroclear or Clearstream, Luxembourg will be credited to the cash accounts of Clearstream, Luxembourg customers or Euroclear participants on the same day (European time) as payment is made to Fed Users, subject to the relevant system's rules and procedures, to the extent received and applied by its U.S. depository. Such distributions will be subject to tax reporting in accordance with relevant United States tax laws and regulations. See "United States Tax Matters."

Although Euroclear and Clearstream, Luxembourg have agreed to the foregoing procedures in order to facilitate transfers of the Bonds among Fed Users, Euroclear and Clearstream, Luxembourg, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued at any time. None of TVA, the Managers or the Fiscal Agent will have any responsibility for the performance by Euroclear or Clearstream, Luxembourg or their respective participants or customers or indirect participants or customers of their obligations under the rules and procedures governing their operations.

LEGALITY OF INVESTMENT IN THE UNITED STATES

Each person or entity is advised to consult with its own counsel with respect to the legality of investment in the Bonds or in any stripped Interest and Principal Components thereof (see "Description of Bonds" — "Stripping"), which could be subject to restrictions or requirements with respect to the legality of investment that do not apply to Power Bonds held in their fully constituted form. Generally the following describes the legality of investment in the United States in Power Bonds in their fully constituted form.

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

Power Bonds are acceptable as collateral for U.S. Treasury tax and loan accounts pursuant to 31 C.F.R. § 203.24(e) and 31 C.F.R. § 380.3.

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

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

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

Power Bonds are eligible as collateral for advances by U.S. Federal Home Loan Banks to members for which Power Bonds are legal investments. 12 U.S.C. § 1430(a) and 12 C.F.R. § 950.7(a)(2).

U.S. federal credit unions may purchase Power Bonds, subject to applicable regulations. 12 U.S.C. § 1757(7)(E) and 12 C.F.R. Part 703.

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

UNITED STATES TAX MATTERS

Tax Considerations Applicable to Bonds

The following summary of certain United States federal income and estate tax and certain limited state and local tax consequences (where specifically noted) of the purchase, ownership and disposition of the Bonds has been prepared by Orrick, Herrington & Sutcliffe LLP, as special U.S. tax counsel to TVA, and is based upon laws, regulations, rulings and decisions, which are subject to change at any time, possibly with retroactive effect. The discussion in this subsection does not address the tax consequences associated with stripping a Bond into its Interest and Principal Components or of the purchase, ownership or disposition of an Interest or Principal Component. For a discussion of such tax matters, see “Tax Considerations Applicable to Strips.” The discussion does not address all aspects of United States federal income and estate taxation that may be relevant to a particular investor in light of its personal investment circumstances or to certain types of investors subject to special treatment under the United States federal income tax laws (for example, brokers, security dealers, traders in securities that elect to mark to market, banks, expatriates, life insurance companies, tax-exempt organizations and, with limited exceptions, foreign investors), and generally does not address state and local taxation. Further, the discussion is limited to persons who will hold the Bonds as capital assets and does not deal with United States federal income tax consequences applicable to persons who will hold the Bonds in the ordinary course or as an integral part of their trade or business, or as part of a hedging, straddle, integrated or conversion transaction or persons whose functional currency is not the U.S. dollar. Furthermore, it does not address alternative minimum tax consequences or the indirect effects on the holders of equity interests in a Bondholder. Each prospective owner of a Bond is urged to consult with its own tax advisor with respect to the United States federal, state and local tax consequences associated with the purchase, ownership and disposition of a Bond, as well as the tax consequences arising under the laws of any other taxing jurisdiction, and may not construe the following discussion as legal advice. In this regard, it should be noted that the Bonds are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA has no obligation to pay additional interest or other amounts if any withholding or other tax is imposed on payments on the Bonds (including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form).

The following discussion of United States tax matters was written to support the promotion and marketing of the Bonds and was not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding United States federal income tax penalties that may be imposed. Each taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.

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

U.S. Beneficial Owners

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

Interest on a Bond will be taxable to a U.S. beneficial owner at the time that it is received or accrued, depending upon the U.S. beneficial owner’s method of accounting for United States federal income tax purposes. The Bonds are not exempt from United States federal income, estate or gift tax.

Upon a sale or exchange of a Bond, a U.S. beneficial owner generally will recognize capital gain or loss equal to the difference between the amount realized on the sale or exchange (not including any amounts attributable to accrued and unpaid interest) and the U.S. beneficial owner’s adjusted basis for the Bond for federal income tax purposes.

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

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

A U.S. beneficial owner may elect to include in gross income all interest that accrues on a debt instrument using the constant-yield method described below under the heading “Tax Considerations Applicable to Strips.” For purposes of this election, interest includes stated interest, original issue discount (“OID”), market discount, de minimis market discount and unstated interest, as adjusted by any amortizable

bond premium or acquisition premium. If this election is made with respect to a debt instrument with amortizable bond premium, the electing U.S. beneficial owner will be deemed to have elected to apply amortizable bond premium against interest with respect to all debt instruments with amortizable bond premium (other than debt instruments the interest on which is excludible from gross income) held by the electing U.S. beneficial owner as of the beginning of the taxable year in which the debt instrument with respect to which the election is made is acquired or thereafter acquired. The deemed election with respect to amortizable bond premium may not be revoked without the consent of the United States Internal Revenue Service. If this election is made with respect to a debt instrument with market discount, the electing U.S. beneficial owner will be deemed to have elected to include market discount in income currently (as discussed above) with respect to all debt instruments acquired by the electing U.S. beneficial owner during or after the first taxable year to which the election applies, which election may not be revoked without the consent of the United States Internal Revenue Service.

Non-U.S. Beneficial Owners

Generally, a Bondholder that is not a U.S. Person and that has no connection with the United States other than holding the Bond (a “non-U.S. beneficial owner”) will not be subject to United States federal withholding tax on interest paid by TVA on a Bond provided that the last U.S. Person in the chain of payment prior to payment to the non-U.S. beneficial owner has received in the year in which the payment occurs, or in either of the two preceding years, a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is not a U.S. beneficial owner and (iii) provides the name and address of the beneficial owner. The statement may be made on a United States Internal Revenue Service Form W-8BEN or, in the case of certain non-U.S. beneficial owners, Form W-8EXP (collectively, “Form W-8”) or substantially similar substitute form, and the beneficial owner must inform the withholding agent of any change in the information on the statement within 30 days of such change. In certain circumstances, the above-described certification can be provided by a securities clearing organization or by certain other financial institutions and qualified intermediaries provided that the non-U.S. beneficial owner of the Bond has provided such entity with the appropriate certification or documentation establishing its foreign status. Additionally, in the case of Bonds held by a foreign partnership (a) the certification described above must be provided by the partners rather than by the foreign partnership and (b) the partnership must provide certain information.

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

Backup Withholding

Backup withholding of United States federal income tax, currently at a rate of 28 percent, may apply to payments made in respect of the Bonds to beneficial owners who are not exempt recipients and who fail to provide certain identifying information (such as the beneficial owner’s taxpayer identification number) in the manner required. Generally, individuals are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients. Payments made in respect of the Bonds to a U.S. beneficial owner must be reported to the United States Internal Revenue Service, unless such U.S. beneficial owner is an exempt recipient or establishes an exemption. Compliance with the identification procedures (described in the preceding section) would generally establish an exemption from backup withholding for those non-U.S. beneficial owners who are not exempt recipients.

In addition, upon the sale of a Bond to (or through) a broker, the broker must withhold a percentage of the gross sales proceeds (currently 28 percent), unless either (i) the broker determines that the seller is a corporation or other exempt recipient or (ii) the seller provides, in the required manner, certain identifying information and, in the case of a non-U.S. beneficial owner, certifies that such seller is a non-U.S. beneficial owner (and certain other conditions are met). Such a sale must also be reported by the broker to the United States Internal Revenue Service, unless either (i) the broker determines that the seller is an exempt recipient

or (ii) the seller certifies its non-U.S. status (and certain other conditions are met). Certification of the beneficial owner's non-U.S. status usually would be made on Form W-8 under penalties of perjury, although in certain cases it may be possible to submit other documentary evidence. The term "broker" generally includes all persons who, in the ordinary course of a trade or business, stand ready to effect sales made by others, as well as brokers and dealers registered as such under the laws of the United States or a state. These requirements generally will apply to a United States office of a broker, and the information reporting requirements generally will apply to a foreign office of a United States broker, as well as to a foreign office of a foreign broker if the broker is (i) a controlled foreign corporation within the meaning of Section 957(a) of the Internal Revenue Code, (ii) a foreign person 50 percent or more of whose gross income from all sources for the 3-year period ending with the close of its taxable year preceding the payment (or for such part of the period that the foreign broker has been in existence) was effectively connected with the conduct of a trade or business within the United States or (iii) a foreign partnership if it is engaged in a trade or business in the United States or if 50 percent or more of its income or capital interests are held by U.S. Persons.

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

Tax Considerations Applicable to Strips

The following discussion of the United States federal income and estate tax and certain limited state and local tax consequences (where specifically noted) of the purchase, ownership and disposition of Strips has been prepared by Orrick, Herrington & Sutcliffe LLP, as special U.S. tax counsel to TVA, and is based upon laws, regulations, rulings and decisions, which are subject to change at any time, possibly with retroactive effect. The discussion does not address all aspects of United States federal income and estate taxation that may be relevant to a particular investor in light of its personal investment circumstances or to certain types of investors subject to special treatment under the United States federal income tax laws (for example, brokers, security dealers, traders in securities that elect to mark to market, banks, expatriates, life insurance companies, tax-exempt organizations and, with limited exceptions, foreign investors), and generally does not address state and local taxation. Further, the discussion is limited to persons who will hold the Strips as capital assets, and does not deal with United States federal income tax consequences applicable to persons who will hold the Strips in the ordinary course or as an integral part of their trade or business, or as part of a hedging, straddle, integrated or conversion transaction or persons whose functional currency is not the U.S. dollar. Furthermore, it does not address alternative minimum tax consequences or the indirect effects on the holders of equity interests in a holder of a Strip. Each prospective owner of a Strip is urged to consult with its own tax advisor with respect to the United States federal, state and local tax consequences associated with the purchase, ownership and disposition of a Strip, as well as tax consequences arising under the laws of any other taxing jurisdiction, and may not construe the following discussion as legal advice. In this regard, it should be noted that the Strips are not subject to redemption by reason of the imposition of withholding or other tax by any jurisdiction, and TVA has no obligation to pay additional interest or other amounts if any withholding or other tax is imposed on payments on the Strips (including any withholding tax that may be imposed as a result of a failure to provide an applicable United States Internal Revenue Service form).

The following discussion of United States tax matters was written to support the promotion and marketing of the Bonds and was not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding United States federal income tax penalties that may be imposed. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

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

is a beneficial owner of a Strip that is otherwise subject to United States federal income taxation on a net basis in respect of income attributable to a Strip.

U.S. Beneficial Owners

A U.S. beneficial owner is subject to United States federal income taxation on the income of a Strip, and there is no special exemption from United States federal income, estate or gift tax with respect to Strips. The Act provides that bonds issued by TVA are “exempt both as to principal and interest from all taxation now or hereafter imposed by any State or local taxing authority except estate, inheritance and gift taxes.” This exemption might not extend to franchise or other non-property taxes in lieu thereof imposed on corporations or to gain or loss realized upon the sale or exchange of a Bond, notwithstanding that such gain might in some cases be treated as interest income for United States federal income tax purposes. It is unclear whether this exemption applies at all to the income on a Strip. If all of the income on a Strip were to be exempt from state and local taxation, the amount of income exempted from such taxation could be in excess of the amount that would have been exempted had the Bonds not been separated into their Interest and Principal Components. It is unclear whether or not this was intended. Therefore, while it is anticipated that the income includible by a U.S. beneficial owner with respect to a Strip should qualify for the exemption provided in the Act at least to the extent of the rate of interest payable on the Bonds, there is no controlling precedential authority and, therefore, each owner of a Strip is urged to consult its own tax advisor as to whether or not the income of a Strip qualifies in whole or in part for the exemption provided in the Act.

A U.S. beneficial owner that elects to strip a Bond into its Interest and Principal Components and to dispose of one or more of such Components will be required to include in income all interest and market discount accrued on the Bond to the date of disposition (to the extent that such income has not previously been included in income), and the U.S. beneficial owner’s basis in the Bond will be increased, immediately prior to the disposition of one of the Strips, by the amount so included in income. Upon the disposition of a Strip, the U.S. beneficial owner will be required to recognize gain or loss equal to the difference between the amount realized on the disposition of the Strip and the U.S. beneficial owner’s basis in the Strip immediately prior to the disposition of one of the Strips. For purposes of determining that basis, the U.S. beneficial owner will be required to allocate its tax basis in the Bond immediately prior to the sale (as adjusted in the manner detailed above) between the Interest and Principal Components based on their respective fair market values on the date of the sale.

A U.S. beneficial owner of a Strip will accrue income on the Strip in accordance with the OID rules set forth in the United States Internal Revenue Code of 1986, as amended. In this regard, the application of the OID rules to the Strips is subject to significant uncertainty, and therefore purchasers of the Strips are urged to consult with their own tax advisors. Generally, however, it is anticipated that each U.S. beneficial owner of a Strip will be required to include in income, as OID, the difference between (1) the stated redemption price at maturity of the Interest or Principal Component owned by such person (which generally would include all payments to be made on the Component subsequent to the date that the strip was effected or, if later, the date of the U.S. beneficial owner’s purchase of the Component) and (2) the U.S. beneficial owner’s purchase price for the Component (or, in the case of a person who effects a strip and disposes of one or more of the Components, the portion of the person’s basis in the Bond which is allocable to the retained Components, as determined pursuant to the rules set forth in the preceding paragraph).

The amount of OID on a Strip (determined as set forth above) will be includible on a constant-yield basis in the income of a U.S. beneficial owner of a Strip over the life of the Strip (excluding, with respect to certain U.S. beneficial owners, Strips having a maturity of one year or less from the date of purchase — which Strips would be subject to special OID rules which are discussed below), even in years in which the owner of the Strip does not receive any actual payment. The amount of OID that must be included in income each year by the U.S. beneficial owner of a Strip will be equal to the sum of the daily portions of the OID that accrued during each day of the year during which the U.S. beneficial owner owned the Strip. The daily portions will be determined by allocating to each day of the accrual period, as defined below, a pro rata portion of an amount equal to the adjusted issue price of the Strip at the beginning of the accrual period, also as defined below, multiplied by the yield to maturity of the Strip, determined by compounding at the close of each accrual

period and properly adjusted for the length of the accrual period. For purposes of these calculations, (i) the accrual periods will, generally, be of any length and may vary in length over the term of the Strip, provided that each accrual period is no longer than a year and that each scheduled payment of principal and interest occurs either on the final day of an accrual period or on the first day of an accrual period, and (ii) the adjusted issue price of a Strip will be the U.S. beneficial owner's purchase price for the Strip (or, in the case of a person who effects a strip and disposes of one or more of the Components, the portion of the person's basis in the Bond which is allocable to the retained Components, as determined pursuant to the rules set forth above), increased by the OID accrued by the U.S. beneficial owner in previous accrual periods and decreased by any payments received by the U.S. beneficial owner in prior accrual periods. The amount of OID allocable to an initial short accrual period may be computed using any reasonable method if all other accrual periods other than a final short accrual period are of equal length. The amount of OID allocable to the final accrual period is the difference between (x) the amount payable at the maturity of the Strip and (y) the Strip's adjusted price as of the beginning of the final accrual period. The foregoing rules will generally be applied to each Strip acquired separately. In certain circumstances, Strips acquired (or retained by the person stripping a Bond) may be treated as a single instrument for tax purposes.

Upon the sale or exchange of a Strip, a U.S. beneficial owner generally will recognize capital gain or loss equal to the difference between the amount realized on the sale or exchange and the U.S. beneficial owner's adjusted tax basis in the Strip. A U.S. beneficial owner's adjusted tax basis in a Strip will generally be its cost, increased by the amount of the OID included in the U.S. beneficial owner's income with respect to the Strip.

In general, a cash basis U.S. beneficial owner who purchases a Strip the payment with respect to which is due not later than one year from the date of issuance ("short-term Strips") is not required to accrue OID for United States federal income tax purposes unless it elects to do so. Accrual basis U.S. beneficial owners and certain other U.S. beneficial owners (including certain pass-through entities and electing cash basis U.S. beneficial owners) who purchase a short-term Strip and any U.S. beneficial owners who strip a Bond into its Interest and Principal Components and who retain one or more such Components are required to accrue OID on short-term Strips on either a straight-line basis or under the constant-yield method (based on daily compounding), at the election of the U.S. beneficial owner. In the case of a U.S. beneficial owner not required and not electing to include OID on a short-term Strip in income currently, any gain realized on the sale or retirement of the short-term Strip will be ordinary income to the extent of the OID accrued on a straight-line basis (unless an election is made to accrue the OID under the constant-yield method) through the date of sale or retirement. U.S. beneficial owners who are not required and who do not elect to accrue OID on short-term Strips will be required to defer deductions for interest on borrowings allocable to short-term Strips in an amount not exceeding the deferred income until the deferred income is realized.

TVA is selling the Bonds (and not Strips) to the Managers; it is possible, however, that the Managers may elect to strip the Bonds and sell Interest and Principal Components (as well as Bonds) immediately upon their acceptance of the Bonds. Such Strips might be viewed, for United States federal income tax purposes, as OID bonds issued by TVA to the purchasers of the Strips. If the United States Internal Revenue Service were to characterize the transaction in this fashion, the rules set forth above would generally apply to the Bonds stripped by the Managers, except that (1) the amount of OID on each Strip so sold would be measured, and the adjusted issue price would be determined, by reference to the first price at which a substantial amount of each Strip was sold, rather than by reference to the price paid by the purchaser for the Strip (not only in the case of an initial purchaser of the Strip, but also in the case of any transferee thereof) and (2) the stated redemption price at maturity would be determined by reference to all payments to be made on the Strip subsequent to the date of the closing relating to the Bonds offered hereby rather than by reference to the payments to be made subsequent to the U.S. beneficial owner's acquisition of the Strip. Each U.S. beneficial owner is urged to consult with its own tax advisor as to the likelihood of such a characterization, as well as to the application of the "acquisition premium" and "market discount" rules which would apply to those Bonds stripped by the Managers if the transaction were to be so characterized.

Recombinations. The OID rules are also unclear as to the treatment of a U.S. beneficial owner who acquires a Principal Component and all the associated Interest Components; it is believed, however, that such a person would not treat the Components as a Bond, but would instead recognize income on each of the Components in the manner detailed above. However, if such a person requests the FRBNY to reconstitute the Components into a Bond and that Bond is then sold to another person, it is anticipated that the new purchaser would be treated as having acquired a Bond (rather than Interest and Principal Components) with the result that the rules set forth above, under “Tax Considerations Applicable to Bonds,” would apply. Each purchaser of a Strip is urged to consult its own tax advisor as to this issue.

Non-U.S. Beneficial Owners

A non-U.S. beneficial owner of a Strip will not be subject to United States federal withholding tax on TVA’s payment of income on a Strip provided that the last U.S. person in the chain of payment prior to payment to the non-U.S. beneficial owner has received in the year in which the payment occurs, or in either of the two preceding years, a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is a non-U.S. beneficial owner and (iii) provides the name and address of the beneficial owner. The statement may be made on an United States Internal Revenue Service Form W-8BEN or in the case of certain non-U.S. beneficial owners, Form W-8EXP (collectively, “Form W-8”) or substantially similar substitute form, and the beneficial owner must inform the withholding agent of any change in the information on the statement within 30 days of such change. In certain circumstances, the above-described certification can be provided by a securities clearing organization or by certain other financial institutions and qualified intermediaries provided that the non-U.S. beneficial owner of the Strip has provided such entity with the appropriate certification or documentation establishing its foreign status. Additionally, in the case of Strips held by a foreign partnership, (a) the certification described above must be provided by the partners rather than by the foreign partnership and (b) the partnership must provide certain information.

Generally, any amount which constitutes capital gain to a non-U.S. beneficial owner upon retirement or disposition of a Strip will not be subject to United States federal income taxation. Certain exceptions may be applicable and individual non-U.S. beneficial owners are particularly urged to consult their own tax advisors.

Generally, the Strips will not be includible in the U.S. federal estate of a non-U.S. beneficial owner.

Backup Withholding

Backup withholding of United States federal income tax, currently at a rate of 28 percent, may apply to payments made in respect of the Strips to beneficial owners who are not exempt recipients and who fail to provide certain identifying information (such as the beneficial owner’s taxpayer identification number) in the manner required. Generally, individuals are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients. Compliance with the identification procedures described in the preceding section would generally establish an exemption from backup withholding for those non-U.S. beneficial owners who are not exempt recipients.

In addition, upon the sale of a Strip to (or through) a broker, the broker must withhold a percentage of the gross sales proceeds (currently 28 percent), unless either (i) the broker determines that the seller is a corporation or other exempt recipient or (ii) the seller provides, in the required manner, certain identifying information and, in the case of a non-U.S. beneficial owner, certifies that such seller is a non-U.S. beneficial owner (and certain other conditions are met). Such a sale must also be reported by the broker to the Internal Revenue Service, unless either (i) the broker determines that the seller is an exempt recipient or (ii) the seller certifies its non-U.S. status (and certain other conditions are met). Certification of the beneficial owner’s non-U.S. status usually would be made on Form W-8 under penalties of perjury, although in certain cases it may be possible to submit other documentary evidence. The term “broker” generally includes all persons who, in the ordinary course of a trade or business, stand ready to effect sales made by others, as well as brokers and

dealers registered as such under the laws of the United States or a state. These requirements generally will apply to a United States office of a broker, and the information reporting requirements generally will apply to a foreign office of a United States broker, as well as to a foreign office of a foreign broker if the broker is (i) a controlled foreign corporation within the meaning of Section 957(a) of the Internal Revenue Code, (ii) a foreign person 50 percent or more of whose gross income from all sources for the 3-year period ending with the close of its taxable year preceding the payment (or for such part of the period that the foreign broker has been in existence) was effectively connected with the conduct of a trade or business within the United States or (iii) a foreign partnership if it is engaged in a trade or business in the United States or if 50 percent or more of its income or capital interests are held by U.S. Persons.

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

SUBSCRIPTION AND SELLING

Subject to the terms and conditions set forth in the Subscription Agreement dated March 29, 2006 (the “Subscription Agreement”) relating to the Bonds, TVA has agreed to sell to each of the Managers named below (the “Managers”), and each of the Managers has severally agreed to purchase, the principal amount of Bonds set forth opposite its name below:

<u>Manager</u>	<u>Principal Amount</u>
Merrill Lynch, Pierce, Fenner & Smith Incorporated	\$ 450,000,000.00
Morgan Stanley & Co. Incorporated	\$ 450,000,000.00
Deutsche Bank Securities Inc.	\$ 33,333,333.34
Goldman, Sachs & Co.	\$ 33,333,333.33
Lehman Brothers Inc.	\$ 33,333,333.33
Total	U.S.\$1,000,000,000.00

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

The Managers have advised TVA that they propose to offer all or part of the Bonds directly to the public initially at the offering prices set forth on the cover page of this Offering Circular and to dealers at such prices less a concession not in excess of 0.30% of the principal amount thereof. The Managers may allow and such dealers may reallow discounts not in excess of 0.15% of the principal amount of the Bonds to certain other dealers. After the initial offering, the public offering price and concession may be changed.

The Managers, immediately upon their acceptance of the Bonds, may, but are not obligated to, strip some or all of the Bonds and deliver Interest and/or Principal Components rather than Bonds to investors purchasing Strips. Sales of any such Strips would be at negotiated prices.

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (as defined herein) (each, a “Relevant Member State”), each Manager represents, warrants and agrees to and with TVA that, with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the “Relevant Implementation Date”), such Manager and its Affiliates (as defined herein) have not made and will not make an offer of Bonds to the public in that Relevant Member State, except that they may, with effect from and including the Relevant Implementation Date, make an offer of Bonds to the public in that Relevant Member State:

- (a) at any time to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (b) at any time to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000; and (3) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts; or
- (c) at any time in any other circumstances which do not require the publication by TVA of a prospectus pursuant to Article 3 of the Prospectus Directive.

The expression an “offer of Bonds to the public” in relation to any Bonds in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Bonds to be offered so as to enable an investor to decide to purchase or subscribe the Bonds, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State, and the expression “Prospectus Directive” means Directive 2003/71/EC and includes any relevant implementing measures in each Relevant Member State.

In relation to the United Kingdom, each Manager represents, warrants and agrees to and with TVA that such Manager and its Affiliates (as defined herein) (i) have not offered or sold Bonds and, during the period up to but excluding the date on which the Prospectus Directive is implemented in the United Kingdom, will not offer or sell any Bonds to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the

purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended); (ii) have complied and will comply with all applicable provisions of the Financial Services and Markets Act 2000 (the “FSMA”) and the rules and regulations thereunder with respect to anything done by them in relation to the Bonds in, from or otherwise involving the United Kingdom; and (iii) have only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by them in connection with the issue or sale of any Bonds in circumstances in which Section 21(1) of the FSMA does not apply to TVA.

The term “Affiliate” means any person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with a Manager. For purposes of this definition of Affiliate, the term “control” (including the terms “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies, including without limitation the investment or trading decisions of a person, whether through ownership of voting securities, by contract or otherwise.

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

All secondary trading in Bonds and Strips will settle in immediately available funds. See “Clearance and Settlement” — “Secondary Market Trading.”

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

The Managers and/or their Affiliates may perform services for TVA in the normal course of business.

It is expected that delivery of the Bonds will be made against payment therefor on or about the date specified in the last paragraph of the cover page of this Offering Circular, which will be the third Business Day following the date of pricing of the Bonds (such settlement cycle being herein referred to as “T + 3”). Trades in the secondary market generally are required to settle in three Business Days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade Bonds on the date of pricing or the next Business Day will be required, by virtue of the fact that the Bonds initially will settle in T + 3, to specify an alternate settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of Bonds who wish to trade Bonds on the date of pricing or the next Business Day should consult their own advisors.

GENERAL INFORMATION

1. The issuance of the Bonds was authorized pursuant to the Resolutions. At the date of issue, all necessary legal authorizations for issuance of the Bonds will have been obtained by TVA.
2. The Bonds and Strips have been accepted for clearance by Euroclear and Clearstream, Luxembourg. The identifying numbers are as set forth beginning on page C-9.
3. There has been no material adverse change in the financial position of TVA since December 31, 2005.
4. There is no litigation, actual or threatened, which relates to TVA and to which TVA is a party or of which TVA has been notified that it will be made a party which is material in the context of the issuance of the Bonds which is not described in the Offering Circular, the Quarterly Report or the Information Statement.

Tennessee Valley Authority

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

Quarterly Report

For the quarterly period ended December 31, 2005



Tennessee Valley Authority

Quarterly Report

For the quarterly period ended December 31, 2005

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

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FORWARD-LOOKING STATEMENTS

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain asset retirement obligations; expectations about the adequacy of TVA’s nuclear decommissioning fund; estimates regarding the reduction of total financing obligations; the impact of new accounting pronouncements and interpretations, including Statement of Financial Accounting Standards No. 151, *“Inventory Costs — an amendment of ARB No. 43, Chapter 4”* and 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. Additionally, other risks that may cause actual results to differ from the predicted results are set forth in *“Management’s Discussion and Analysis” — “Risk Factors and Forward-Looking Statements.”*

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-Cherry-picking Provision; 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. 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)
For the three months ended December 31
(in millions)

	<u>2005</u>	<u>2004</u>
Operating revenues		
Sales of electricity		
Municipalities and cooperatives	\$ 1,769	\$ 1,525
Industries directly served	230	215
Federal agencies and other	26	73
Other revenue	<u>27</u>	<u>21</u>
Total operating revenues	2,052	1,834
Operating expenses		
Fuel and purchased power	745	477
Operating and maintenance	600	582
Depreciation, amortization, and accretion	388	285
Tax-equivalents	<u>94</u>	<u>91</u>
Total operating expenses	<u>1,827</u>	<u>1,435</u>
Operating income	225	399
Other income, net	7	5
Unrealized gain on derivative contracts, net	14	4
Interest expense		
Interest on debt	330	339
Amortization of debt discount, issue, and reacquisition costs, net	5	5
Allowance for funds used during construction and nuclear fuel expenditures	<u>(36)</u>	<u>(26)</u>
Net interest expense	<u>299</u>	<u>318</u>
Net (loss) income	<u>\$ (53)</u>	<u>\$ 90</u>

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

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

ASSETS	December 31 2005	September 30 2005
Current assets		
Cash and cash equivalents	\$ 519	\$ 538
Restricted cash and investments (note 1)	117	107
Accounts receivable, net	1,047	1,145
Inventories and other	<u>589</u>	<u>479</u>
Total current assets	2,272	2,269
Property, plant, and equipment		
Completed plant	35,265	35,215
Less accumulated depreciation	<u>(14,653)</u>	<u>(14,407)</u>
Net completed plant	20,612	20,808
Construction in progress	2,833	2,643
Nuclear fuel and capital leases	<u>515</u>	<u>437</u>
Total property, plant, and equipment	23,960	23,888
Investment funds	886	858
Regulatory and other long-term assets (note 1)		
Deferred nuclear generating units	3,814	3,912
Other regulatory assets	<u>2,340</u>	<u>2,367</u>
Subtotal	6,154	6,279
Other long-term assets	<u>1,328</u>	<u>1,272</u>
Total regulatory and other long-term assets	<u>7,482</u>	<u>7,551</u>
Total assets	<u>\$ 34,600</u>	<u>\$ 34,566</u>
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	\$ 853	\$ 860
Accrued liabilities	211	274
Accrued interest	301	380
Current portion of lease/leaseback obligations	35	35
Current portion of energy prepayment obligations	106	106
Short-term debt	2,744	2,469
Current maturities of long-term debt, net (note 3)	<u>3,129</u>	<u>2,693</u>
Total current liabilities	7,379	6,817
Other liabilities		
Deferred liabilities	2,520	2,500
Regulatory liabilities (note 1)	975	897
Asset retirement obligations	1,883	1,857
Lease/leaseback obligations	1,107	1,108
Energy prepayment obligations	<u>1,217</u>	<u>1,244</u>
Total other liabilities	7,702	7,606
Long-term debt, net (note 3)	<u>17,172</u>	<u>17,751</u>
Total liabilities	<u>32,253</u>	<u>32,174</u>
Commitments and contingencies (note 6)		
Proprietary capital		
Appropriation investment	4,778	4,783
Retained earnings	1,190	1,244
Accumulated other comprehensive income	44	27
Accumulated net expense of nonpower programs	<u>(3,665)</u>	<u>(3,662)</u>
Total proprietary capital	<u>2,347</u>	<u>2,392</u>
Total liabilities and proprietary capital	<u>\$ 34,600</u>	<u>\$ 34,566</u>

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS (unaudited)
For the three months ended December 31
(in millions)

	2005	2004
Cash flows from operating activities		
Net (loss) income	\$ (53)	\$ 90
Items not requiring (providing) cash		
Depreciation, amortization, and accretion	416	321
Allowance for funds used during construction and nuclear fuel expenditures	(36)	(26)
Nuclear fuel amortization	35	34
Other, net	30	53
Changes in current assets and liabilities		
Accounts receivable, net	98	38
Inventories and other	(111)	(19)
Accounts payable and accrued liabilities	(72)	(234)
Accrued interest	(79)	(93)
Refueling outage costs	(3)	(28)
Other	(26)	(19)
Net cash provided by operating activities	199	117
Cash flows from investing activities		
Construction expenditures	(282)	(329)
Nuclear fuel expenditures	(116)	(84)
Allowance for funds used during construction and nuclear fuel expenditures	36	26
Investments		
Short-term investments, net	-	(114)
Change in restricted cash and investments	(10)	-
Purchases	(8)	-
Loans and other receivables		
Advances	(2)	(2)
Repayments	4	5
Proceeds from sale of loans	-	55
Other, net	(1)	(2)
Net cash used in investing activities	(379)	(445)
Cash flows from financing activities		
Long-term debt		
Issues	49	-
Redemptions and repurchases	(152)	(3)
Short-term issues, net	275	65
Payments on combustion turbine financing	(1)	(3)
Proceeds from other financing activities	-	1
Financing costs, net	(1)	-
Payments to U.S. Treasury	(9)	(9)
Net cash provided by financing activities	161	51
Net change in cash and cash equivalents	(19)	(277)
Cash and cash equivalents at beginning of period	538	519
Cash and cash equivalents at end of period	\$ 519	\$ 242

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL (unaudited)
For the three months ended December 31, 2005 and 2004
(in millions)

	Appropriation Investment	Retained Earnings - Power Program	Accumulated Net Expense of Nonpower Programs	Accumulated Other Comprehensive Income (Loss)	Total	Comprehensive Income (Loss)
Balance at September 30, 2004	\$ 4,803	\$ 1,162	\$ (3,649)	\$ (52)	\$ 2,264	
Net income (loss)	-	93	(3)	-	90	\$ 90
Return on appropriation investment	-	(4)	-	-	(4)	-
Other comprehensive income (note 2)	-	-	-	66	66	66
Return of appropriation investment	(5)	-	-	-	(5)	-
Balance at December 31, 2004	<u>\$ 4,798</u>	<u>\$ 1,251</u>	<u>\$ (3,652)</u>	<u>\$ 14</u>	<u>\$ 2,411</u>	<u>\$ 156</u>
Balance at September 30, 2005	\$ 4,783	\$ 1,244	\$ (3,662)	\$ 27	\$ 2,392	
Net (loss)	-	(50)	(3)	-	(53)	\$ (53)
Return on appropriation investment	-	(4)	-	-	(4)	-
Other comprehensive income (note 2)	-	-	-	17	17	17
Return of appropriation investment	(5)	-	-	-	(5)	-
Balance at December 31, 2005	<u>\$ 4,778</u>	<u>\$ 1,190</u>	<u>\$ (3,665)</u>	<u>\$ 44</u>	<u>\$ 2,347</u>	<u>\$ (36)</u>

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

NOTES TO FINANCIAL STATEMENTS (unaudited)

(Dollars in millions except where noted)

1. Summary of Significant Accounting Policies

Organization

TVA is a wholly owned corporate agency and instrumentality of the United States and was established by Congress through the TVA Act of 1933, as amended, 16 U.S.C. §§ 831-831ee (2000 and Supp. III 2003) (the "TVA Act"). TVA is charged with providing navigable channels on the Tennessee River system, flood damage reduction, agricultural and industrial development, and electric power to the Tennessee Valley region. TVA carries out these responsibilities in a service area that centers on Tennessee and includes parts of Alabama, Georgia, Kentucky, Mississippi, North Carolina, and Virginia.

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

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

Basis of Presentation

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

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

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

Fiscal Year

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

Reclassifications

Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation. Cash flows associated with the net activity of short-term investments were reclassified from cash used in operating activities

to cash used by investing activities. The reclassification improved operating cash flows by \$114 million and conversely was an additional use of cash in investing activities on the 2005 Statement of Cash Flows. A reclassification was made to the 2005 cash flows associated with loans and other receivables as advances of \$2 million represented amounts advanced by TVA or a use of cash and repayments of \$5 million represented amounts received by TVA or a source of cash. These reclassifications had no effect on previously reported results of operations and net cash flows.

Restricted Cash and Investments

As of December 31, 2005, TVA had \$117 million in restricted cash and investments on its balance sheet as a result of collateral posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap contract. Due to the uncertainty of the timing of the return of these funds to the counterparty, the funds are reported in RESTRICTED CASH AND INVESTMENTS and the corresponding liability is reported in ACCOUNTS PAYABLE on the December 31, 2005 Balance Sheet.

Accounts Receivables

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

	Accounts Receivable	
	At December 31 2005	At September 30 2005
Power receivables billed	\$ 259	\$ 323
Power receivables unbilled	753	787
Total power receivables	<u>1,012</u>	<u>1,110</u>
Other receivables	42	42
Allowance for uncollectible accounts	<u>(7)</u>	<u>(7)</u>
Net accounts receivable	<u>\$ 1,047</u>	<u>\$ 1,145</u>

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 December 31 2005	At September 30 2005
Regulatory Assets:		
Adjustment to accrue minimum pension liability	\$ 1,158	\$ 1,158
Nuclear decommissioning costs	721	716
Reacquisition costs	261	264
Deferred outage costs	83	103
Capital leases	83	84
Unrealized losses related to mark-to-market valuation of a purchase power contracts	<u>34</u>	<u>42</u>
Total other regulatory assets	<u>2,340</u>	<u>2,367</u>
Deferred nuclear generating units	<u>3,814</u>	<u>3,912</u>
Total regulatory assets	<u>\$ 6,154</u>	<u>\$ 6,279</u>

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 December 31, 2005, and September 30, 2005, were \$975 million and \$897 million, respectively, and are included in REGULATORY LIABILITIES on the Balance Sheets.

	Regulatory Liabilities	
	At December 31	At September 30
	<u>2005</u>	<u>2005</u>
Regulatory Liabilities:		
Unrealized gain on coal purchase contracts	\$ 873	\$ 791
Capital lease liability	<u>102</u>	<u>106</u>
Total regulatory liabilities	<u>\$ 975</u>	<u>\$ 897</u>

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.

During the first three months of 2005, TVA's total ASSET RETIREMENT OBLIGATIONS ("ARO") liability increased \$25 million due to accretion expense. The nuclear accretion expense of \$22 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of \$3 million, related to coal-fired and gas/oil plants, was expensed during 2005. During the first three months of 2006, TVA's total ARO liability increased \$26 million due to accretion expense. The nuclear accretion expense of \$23 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of \$3 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 in estimate resulted in a decrease in the total future liability of nearly \$1 million and an increase in the current net present value of the ARO asset and liability of less than \$0.1 million. 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."

	Reconciliation of Asset Retirement Obligation Liability	
	Three Months Ended December 31	
	<u>2005</u>	<u>2004</u>
Balance at beginning of period	\$ 1,857	\$ 1,782
Liabilities settled	—	—
Accretion expense	26	25
Revisions in estimated cash flows	<u>—</u>	<u>—</u>
Balance at end of period	<u>\$ 1,883</u>	<u>\$ 1,807</u>

Energy Prepayment Obligations

As of December 31, 2005, TVA had entered into sales agreements for 54.5 Discounted Energy Units totalling \$54.5 million. There have been no energy prepayment transactions during 2005 and 2006. Total credits applied to power billings on a cumulative basis during the life of the program through December 31, 2005, exceed \$16 million. Of this amount, over \$1 million was recognized as revenue for the quarterly periods ended December 31, 2005 and 2004.

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 December 31, 2005, exceed \$215 million. Of this amount, \$25 million was recognized as revenue for the quarterly periods ended December 31, 2005, and 2004. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At December 31, 2005, and September 30, 2005, obligations under these new programs were \$1,323 million and \$1,350 million, respectively. The amounts are included in ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the December 31, 2005, and September 30, 2005, Balance Sheets.

Reduction in Workforce

During 2004, organizations within TVA performed program and staffing reviews to identify surplus staffing situations. For the areas identified as having surplus staffing, TVA provided the opportunity for certain qualifying employees to apply for voluntary resignations beginning in February 2004. In conjunction with the voluntary reduction process, TVA also instituted an involuntary reduction in force ("RIF") for certain employees. As of December 31, 2005, there were 744 employees impacted by the combined RIF actions, including five during the first quarter of 2006. TVA has recognized total expense in the amount of \$41 million for termination costs incurred through December 31, 2005, of which \$1 million is for the first quarter of 2006. Payout of benefits occurs as employees retire from TVA, and substantially all affected employees had retired by the end of 2005. No further reductions are planned for 2006.

	Termination Costs Liability Activity	
	Three Months Ended	
	December 31	
	2005	2004
Termination costs liability at beginning of period	\$ 4	\$ 14
Liability incurred	1	1
Actual costs paid	(2)	(5)
Termination costs liability at end of period	<u>\$ 3</u>	<u>\$ 10</u>

Impact of New Accounting Pronouncements and Interpretations

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

In February 1997, TVA entered a purchase power agreement with Choctaw Generation, Inc. (subsequently assigned to Choctaw Generation Limited Partnership) to purchase all the power generated from its facility located in Choctaw County, Mississippi. The facility had a committed capacity of 440 megawatts and the term of the agreement was 30 years. Under the accounting guidance provided by FIN 46(R), TVA may be deemed to be the primary beneficiary under the contract; however, TVA does not have access to the financial records of Choctaw Generation Limited Partnership. As a result, TVA was unable to determine whether FIN 46(R) would require TVA to consolidate Choctaw Generation Limited Partnerships' balance sheet, results of operations and cash flows for the quarter ended December 31, 2005. Power purchases for the first quarter of 2006 under the agreement totaled \$30 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

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

Accounting Changes and Error Corrections. In May 2005, the FASB issued SFAS No. 154, "*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*," which replaces "*Accounting*

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

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

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 will become effective for TVA beginning in the second quarter of 2006. TVA is currently evaluating the potential implications of this issue which may or may not be material to its financial position or results of operations.

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 will apply this guidance beginning with the quarterly reporting period ending March 31, 2006. TVA is currently evaluating the potential implications of this staff position which may or may not be material to its financial position or results of operations.

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. The adoption of the guidance in this FSP will be applied to reporting periods beginning after December 15, 2005. TVA is currently evaluating the potential implications of this staff position which may or may not be material to its financial position or results of operations.

2. Accumulated Other Comprehensive Income

SFAS No. 130, "Reporting Comprehensive Income," requires the disclosure of comprehensive income to reflect changes in capital that result from transactions and economic events from non-owner sources. The increase for the three months ended December 31, 2005, and 2004, is due to unrealized gains related to mark-to-market valuation adjustments for certain derivative instruments.

	Accumulated Other Comprehensive Income (Loss) Activity	
	Three Months Ended December 31	
	2005	2004
Accumulated other comprehensive income (loss) at beginning of period	\$ 27	\$ (52)
Changes in fair value		
Inflation swap	(10)	-
Foreign currency swaps	27	66
Accumulated other comprehensive income at end of period	<u>\$ 44</u>	<u>\$ 14</u>

3. Debt Securities

Debt Securities Activity

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

	<u>Date</u>	<u>Amount</u>	<u>Interest Rate</u>
Redemptions/Maturities:			
electronotes®	First Quarter 2006	\$ 152	5.88%
Issues:			
electronotes®	First Quarter 2006	\$ 49	5.19%

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

Debt Outstanding

Debt outstanding at December 31, 2005, includes net translation losses of \$104 million related to long-term debt and a translation gain of \$92 million related to the current portion of long-term debt.

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 December 31	At September 30	
	<u>2005</u>	<u>2005</u>	
Inflation swap	\$ 15	\$ 17	
Interest rate swap	(144)	(158)	
Currency swaps:			
Deutschemark (DM1.5 billion)	(89)	(68)	
Sterling (GBP200 million)	20	21	
Sterling (GBP250 million)	93	89	
Sterling (GBP150 million)	<u>40</u>	<u>36</u>	
Total currency swaps	64	78	
Swaptions:			
\$1 billion notional	(321)	(314)	
\$28 million notional	(4)	(4)	
\$14 million notional	<u>(2)</u>	<u>(2)</u>	
Total swaptions	(327)	(320)	
Coal contracts	873	791	
Purchase power contracts	(34)	(42)	

5. Benefit Plans

TVA sponsors a noncontributory defined benefit pension plan for substantially all 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		Other Benefits	
	Three Months		Three Months	
	Ended December 31		Ended December 31	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Service Cost	\$ 32	\$ 31	\$ 2	\$ 2
Interest Cost	110	109	8	6
Expected return on plan assets	(123)	(114)	-	-
Amortization of prior service costs	9	9	1	1
Amortization of losses	<u>33</u>	<u>33</u>	<u>4</u>	<u>2</u>
Net periodic benefit	<u>\$ 61</u>	<u>\$ 68</u>	<u>\$ 15</u>	<u>\$ 11</u>

During the three months ended December 31, 2005, TVA did not make contributions to its pension plan. However, the Board approved \$75 million in pension contributions during 2006 with scheduled contributions of \$37 million and \$38 million to be made in March and September, respectively. 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 \$5 million during the three months ended December 31, 2005, to fund other benefits costs.

6. Commitments and Contingencies

The estimated cash commitments for TVA as of December 31, 2005 are as follows:

	Cash Requirements and Contractual Obligations						
	2006*	2007	2008	2009	2010	Thereafter	Total
Debt	\$ 5,365	\$ 977	\$ 91	\$ 2,030	\$ 42	\$ 14,762	\$ 23,267
Interest on debt	817	1,029	1,003	947	893	12,212	16,901
Leases	56	87	77	66	63	46	395
Lease/leaseback	78	85	89	85	89	1,209	1,635
Power purchase obligations	137	165	133	138	139	3,565	4,277
Other obligations	311	150	111	5	3	7	587
Fuel purchase obligations	797	322	358	243	207	476	2,403
Pension contribution	75	—	—	—	—	—	75
Total	<u>\$ 7,636</u>	<u>\$ 2,815</u>	<u>\$ 1,862</u>	<u>\$ 3,514</u>	<u>\$ 1,436</u>	<u>\$ 32,277</u>	<u>\$ 49,540</u>

* Period January 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	<u>\$ 79</u>	<u>\$ 106</u>	<u>\$ 106</u>	<u>\$ 105</u>	<u>\$ 105</u>	<u>\$ 822</u>	<u>\$ 1,323</u>

* Period January 1 – September 30, 2006

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 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 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 Manvill Corporation to represent the class. Motions for summary judgment were filed in October 2005.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of some of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory 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 Sixth Circuit. Briefing is now taking place and will be completed in February 2006. No date for oral argument has been set at this time. TVA has no further or new conclusions concerning the case.

In July 2004, two lawsuits were filed against TVA in federal court in New York City alleging that global warming is a public nuisance and that carbon dioxide ("CO₂") 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 CO₂ emissions, and, accordingly, the suits do not involve allegations of regulatory noncompliance. The theory of the cases is that global warming constitutes a nuisance and defendants' CO₂ emissions are contributing to the nuisance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO₂ emissions and then reduce these emissions by a specified percentage each year for at least a decade. In September 2005, the district court dismissed both lawsuits, concluding that they raised political questions that should not be decided by the courts. The plaintiffs have filed notices of appeal to the Court of Appeals for the Second Circuit. The parties are currently briefing the case, with briefing expected to conclude in February 2006.

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with 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 has announced that it will not begin picking up spent nuclear fuel from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools of borated water at its nuclear sites. Although TVA would have had sufficient space to continue to store spent nuclear fuel in those storage pools at its Sequoyah and Browns Ferry Nuclear Plants indefinitely had DOE begun accepting spent nuclear fuel, 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 evidentiary portion of the case was completed in Washington D.C. in July 2005. Closing arguments were made in October 2005. A decision was not issued in calendar year 2005, and the court has not indicated when to expect it.

The National Parks Conservation Association, Inc., and Sierra Club, Inc. filed suit in 2001 in federal district court in Birmingham, Alabama, alleging TVA violated the CAA and implementing regulations at TVA's Colbert Fossil Plant. Plaintiffs allege that TVA made major modifications to Colbert 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 granted in part TVA's motion for summary judgment, holding on sovereign immunity grounds that plaintiffs could not seek civil penalties against TVA, and dismissing on statute of limitations grounds plaintiffs' claims arising from 1982 and 1983 work projects at TVA's Colbert Unit 5 (the PSD and NNSR claims). By order dated December 8, 2005, the court clarified its November 29 ruling, stating that the only remaining PSD and NNSR claims are those, if any, that (1) fall within the five-year statute of limitations, and (2) assert that TVA's operations of Colbert Unit 5 violate the Clean Air Act. On December 21, 2005, the district court granted TVA's motion to dismiss the NSPS claim because plaintiffs failed to comply with statutory presuit notification requirements. On January 17, 2006, the district court issued a final order dismissing the action, concluding that there were no remaining issues to be decided. Plaintiffs filed a notice of appeal to the Court of Appeals for the Eleventh Circuit on January 25, 2006. If the decision is reversed on appeal, there is a reasonable possibility that TVA will be found liable, but the amount of monetary damages cannot be estimated at this time.

The National Parks Conservation Association ("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. The plaintiffs' motion for reconsideration was denied, and they have appealed to the Court of Appeals for the Sixth Circuit ("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.

The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert Fossil Plant between July 1, 1997, and June 30, 2002. The groups sought a court order that potentially could require TVA to incur substantial costs, in addition to the

costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately \$250 million. On September 14, 2004, the court found that TVA had not violated the CAA because all of the challenged emissions were within Alabama's two percent de minimis rule (which provided a safe harbor if emissions did not exceed allowable opacity limits more than two percent each quarter), and the complaint was dismissed in its entirety. The plaintiffs appealed the district court's decision to the Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit"). On November 22, 2005, the Eleventh Circuit issued its opinion, affirming the lower court in part and reversing in part. The Eleventh Circuit held that the Alabama de minimis rule was not applicable because it attempted to revise the opacity limits without going through the appropriate amendment process and receiving EPA approval. The appeals court therefore reversed summary judgment in favor of TVA and indicated that it would remand the case to the district court for further proceedings. The Eleventh Circuit affirmed the lower court's dismissal of the claims for civil penalties, holding that sovereign immunity principles preclude assessing civil penalties in citizen suits brought under the CAA against federal entities such as TVA. The lower court has indicated that it views the Eleventh Circuit's decision as a determination that TVA is in violation of opacity requirements at Colbert. On January 5, 2006, TVA filed a petition seeking rehearing of the Eleventh Circuit's decision. TVA does not have sufficient information at this time to form a reasoned opinion on the impact of the decision.

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.

8. Stewardship Responsibilities

During the first 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 include general stewardship of land, water, and wildlife resources.

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

Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. TVA primarily is using power revenues (along with user fees and other forms of nonpower revenues) to continue to fund these stewardship activities. TVA spent approximately \$20 million on essential stewardship activities during the first three months of 2006 and \$17 million during the first three months of 2005, and recognized depreciation expense on nonpower assets of \$3 million in each period.

9. Subsequent Events

Debt Securities

In January 2006, TVA issued \$5 million of electronotes[®] with an interest rate of 5.13 percent which mature in 2021 and are callable in 2009.

Legal

On January 30, 2006, North Carolina's Attorney General filed suit against TVA alleging that TVA's operation of its coal-fired power plants in Tennessee, Alabama, and Kentucky constitute public nuisances. TVA is evaluating the lawsuit and presently believes it has little merit.

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

(Dollars in millions except where noted)

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

Overview

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

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

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

Material Changes in Liquidity and Capital Resources

Comparative Cash Flow Analysis

Net cash provided by operating activities increased \$82 million from \$117 million to \$199 million for the three month periods ending December 31, 2004, and 2005, respectively. The increase is primarily due to a decrease in cash used for working capital components of \$144 million, which is discussed below, and:

- An increase in cash-related operating revenues of \$218 million due to increased rates and increased volume; offset by
- An increase of \$5 million in expenditures for fossil and hydro outages;
- An increase in cash outlays for fuel and purchased power of \$267 million primarily due to higher coal prices and higher market prices for purchased power;
- An increase in cash outlays for routine and recurring operating costs of \$14 million; and
- An increase of \$10 million during the first quarter for performance incentive compensation accrual which was not present in the prior year as the compensation program for 2005 was not approved until the second quarter of 2005.

Cash used for working capital components decreased \$144 million, from \$308 million in the first quarter of 2005 to \$164 million in the first quarter of 2006. This decrease resulted from:

- A larger source from the collections of accounts receivable of \$60 million due to higher late summer power sales in 2005;
- A smaller decrease in accounts payable and accrued liabilities of \$162 million due to timing of accruals made for fuel and purchased power during the first quarter of 2006 that will be paid in the second quarter of 2006, combined with one time payments made during the first quarter of 2005 (\$40 million for the Browns Ferry Unit 1 restart and \$9 million for a breach of contract settlement); and
- A smaller reduction in accrued interest of \$14 million due to a lower level of long-term debt outstanding and lower interest payments.

This decrease was partially offset by:

- A larger increase in inventories and other assets of \$92 million in the first quarter of 2006 as compared to 2005, primarily due to higher fuel inventory prices and the rebuilding of combustion turbine plant inventories in the first quarter of 2006.

Cash used in investing activities decreased \$66 million, from \$445 million to \$379 million for the three month periods ending December 31, 2004, and 2005, respectively, primarily due to:

- A decrease in expenditures for capital projects of \$47 million, primarily due to decreases in nuclear projects and Browns Ferry Unit 1 restart expenditures; and
- Purchases of short-term investments of \$114 million in 2005 not present in the current year; offset by
- Proceeds received from the sale of certain power distributor loans receivable of \$55 million in the prior year; and
- An increase in the fabrication of nuclear fuel of \$32 million in preparation for the upcoming reloads during 2006.

Net cash provided by financing activities was \$161 million for the three months ended December 31, 2005, compared with \$51 million for the same period of 2004. The change is related primarily to:

- An increase in net short-term debt issues of \$210 million in the first quarter of 2006 compared to the same period in the prior year; offset by
- A net increase of \$100 million in long-term debt redemptions for the first quarter of 2006 as compared to the first quarter of 2005.

Working Capital

At December 31, 2005, TVA had negative working capital of \$5,107 million, largely attributable to current maturities of long-term debt of \$3,129 million and short-term indebtedness of \$2,744 million. The table below summarizes the components of working capital and discount notes with maturities of less than 90 days. It is TVA's cash management policy to use short-term notes to meet current obligations, and TVA plans to continue to use such financing instruments as long as short-term interest rates remain favorable.

	Working Capital and Short-Term Debt	
	December 31 2005	September 30 2005
Current assets	\$ 2,272	\$ 2,269
Current liabilities	(7,379)	(6,817)
Working capital	<u>\$ (5,107)</u>	<u>\$ (4,548)</u>
Discount notes <90 days	\$ 2,744	\$ 2,469
Current maturities of long-term debt	3,129	2,693
Total short-term debt	<u>\$ 5,873</u>	<u>\$ 5,162</u>

On November 9, 2005, TVA and a national bank extended the term of an existing revolving credit facility agreement until May 22, 2006. The facility provides TVA with an unsecured revolving line of credit of up to \$2.5 billion. The interest rate on any borrowing under this agreement is variable and based on market factors and the rating of TVA's senior unsecured long-term non-credit enhanced debt at the time TVA draws on the facility. TVA is required to pay an unused facility fee on the portion of the \$2.5 billion against which TVA has not borrowed. This fee is similar to fees charged in the banking industry to similar customers for similar products and may fluctuate depending upon the rating of TVA's senior unsecured long-term non-credit enhanced debt. There were no outstanding borrowings under the facility at December 31, 2005.

Capital Resources

Debt Securities Activity. From October 1, 2005, to December 31, 2005, TVA redeemed at par \$152 million of electronotes® carrying an average interest rate of 5.88 percent. During the same period, TVA issued \$49 million of electronotes® with an average interest rate of 5.19 percent.

Sale of Loans. On December 2, 2004, TVA sold a portfolio of 51 power distributor loans receivable. The portfolio was sold for \$55 million without recourse and contained loans with maturities ranging from less than one year to over 34

years. The principal amount due on the loans at the time of the sale was \$57 million. The \$2 million loss is reported in OTHER INCOME, NET on the Income Statement for the quarter ended December 31, 2004.

Energy Prepayment Obligations. As of December 31, 2005, TVA had entered into sales agreements for 54.5 Discounted Energy Units totalling \$54.5 million. There have been no energy prepayment transactions during 2005 or 2006. Total credits applied to power billings on a cumulative basis during the life of the program through December 31, 2005, exceed \$16 million. Of this amount, over \$1 million was recognized as revenue for the quarterly periods ended December 31, 2005, and 2004.

In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment will be applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was \$1.5 billion. Total credits applied to power billings on a cumulative basis during the life of the program through December 31, 2005, exceed \$215 million. Of this amount, \$25 million was recognized as revenue for the quarterly periods ended December 31, 2005, and 2004. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At December 31, 2005, and September 30, 2005, obligations under these programs were \$1,323 million and \$1,350 million, respectively. These amounts are included in ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the December 31, 2005, and September 30, 2005, Balance Sheets.

Cash Requirements and Contractual Obligations

The estimated cash requirements and contractual obligations for TVA as of December 31, 2005, are as follows:

Cash Requirements and Contractual Obligations							
	<u>2006*</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Debt	\$ 5,365	\$ 977	\$ 91	\$ 2,030	\$ 42	\$ 14,762	\$ 23,267
Interest on debt	817	1,029	1,003	947	893	12,212	16,901
Leases	56	87	77	66	63	46	395
Lease/leaseback	78	85	89	85	89	1,209	1,635
Power purchase obligations	137	165	133	138	139	3,565	4,277
Other obligations	311	150	111	5	3	7	587
Fuel purchase obligations	797	322	358	243	207	476	2,403
Pension contribution	75	-	-	-	-	-	75
Total	<u>\$ 7,636</u>	<u>\$ 2,815</u>	<u>\$ 1,862</u>	<u>\$ 3,514</u>	<u>\$ 1,436</u>	<u>\$ 32,277</u>	<u>\$ 49,540</u>

* Period January 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							
	<u>2006*</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Energy prepayment obligations	<u>\$ 79</u>	<u>\$ 106</u>	<u>\$ 106</u>	<u>\$ 105</u>	<u>\$ 105</u>	<u>\$ 822</u>	<u>\$ 1,323</u>

* Period January 1 – September 30, 2006

As of December 31, 2005, TVA's decommissioning trust funds totaled approximately \$856 million, which is less than the present value of the estimated future decommissioning costs calculated in accordance with Nuclear Regulatory Commission ("NRC") requirements. In March 2003, TVA submitted its biennial letter to the NRC on the funding status of the Nuclear Decommissioning Trust versus its liabilities. In the letter, TVA stated that it is considering several alternatives to provide additional funding assurance methods and is assessing the need for future action on an ongoing basis. The current status of the fund has been primarily influenced by declines in market value as well as increases in the projected decommissioning costs. TVA is monitoring the monetary value of its nuclear decommissioning trust fund in light of recent market performance and believes that, over the long term and before cessation of nuclear plant operations and commencement of decommissioning activities, adequate funds from investments will be available to support decommissioning. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Critical Accounting Policies and Estimates" — "Nuclear Decommissioning" in the 2005 Information Statement.

Results of Operations

Net loss for the first quarter of 2006 was \$53 million compared to net income of \$90 million for the same period of 2005. Significant items contributing to the \$143 million change in net income for the three months ended December 31, 2005, as compared to December 31, 2004, include decreased operating income of \$174 million, partially offset by increased unrealized gains on derivative contracts of \$10 million and lower net interest expense of \$19 million.

Operating Revenues

A detailed table of operating revenue for the three month periods is as follows:

	Operating Revenues		
	Three months ended December 31		
	2005	2004	Percent Change
Operating revenues			
Sales of electricity			
Municipalities and cooperatives	\$ 1,769	\$ 1,525	16.0%
Industries directly served	230	215	7.0%
Federal agencies and other	26	73	(64.4%)
Other revenue	27	21	28.6%
Total operating revenues	<u>\$ 2,052</u>	<u>\$ 1,834</u>	11.9%

Significant items contributing to the \$218 million increase in operating revenue for the three months ended December 31, 2005, as compared to December 31, 2004, include:

- A \$244 million increase in revenues from municipalities and cooperatives due to increased rates and a higher power demand, and
- A \$15 million increase in revenues from industries directly served reflecting increased rates.

The rate increase, effective the first quarter of 2006, contributed about \$75 million to the increase in revenues over the same period in 2005.

These items were partially offset by a \$51 million decrease in off-system sales (included in FEDERAL AGENCIES AND OTHER) attributable to a decreased generation available for sale and unfavorable market conditions.

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

	Electricity Sales		
	Three months ended December 31		
(millions of kWh)	2005	2004	Percent Change
Sales of electricity			
Municipalities and cooperatives	33,104	31,485	5.1%
Industries directly served	7,912	8,241	(4.0%)
Federal agencies and other	459	1,768	(74.0%)
Total sales of electricity	<u>41,475</u>	<u>41,494</u>	(0.0%)

Significant items contributing to the 19 million kilowatt-hour decrease in electricity sales include:

- A 329 million kilowatt-hour decrease in sales to directly served industries due primarily to decreased demand by a large volume customer, and
- A 1,346 million kilowatt-hour decrease in off-system electricity sales (included in FEDERAL AGENCIES AND OTHER) attributable to decreased generation available for sale and increased market prices.

These items were partially offset by a 1,619 million kilowatt-hour increase in sales to municipalities and cooperatives as a result of more extreme weather this year versus last.

Operating Expenses

A detailed table of operating expenses for the three month periods is as follows:

	Operating Expenses		Percent Change
	Three months ended December 31		
	2005	2004	
Operating expenses			
Fuel and purchased power	\$ 745	\$ 477	56.2%
Operating and maintenance	600	582	3.1%
Depreciation, amortization, and accretion	388	285	36.1%
Tax-equivalents	94	91	3.3%
Total operating expenses	<u>\$ 1,827</u>	<u>\$ 1,435</u>	27.3%

Significant items contributing to the \$392 million increase in operating expenses include:

- A \$94 million increase in fossil fuel cost attributable to higher market prices and increased generation at the combustion turbine plants,
- A \$173 million increase in purchased power cost due to an increase in the amount of power purchased and increased market prices; and
- A \$99 million increase in amortization attributable mainly to the amortization of deferred cost of nuclear generating units at Bellefonte Nuclear Plant.

Other Income, Net

Net other income was \$2 million higher for the three months ended December 31, 2005, as compared to the three months ended December 31, 2004, due to an increase in non-electric business activity.

Unrealized Gain on Derivative Contracts, Net

Significant items contributing to the \$10 million increase in net unrealized gain on derivative contracts for the three months ended December 31, 2005, as compared to the same period in 2004 include a \$4 million net gain on the mark-to-market ("MTM") valuation adjustment of derivative contracts during the first quarter of 2005 reflecting changes in interest rates from the first quarter of 2005 to the first quarter of 2006 and a \$6 million unrealized net loss related to the MTM valuation of SO₂ emissions allowance call options during the first quarter of 2005.

Interest Expense

A detailed table of interest expense for the three month periods is as follows:

	Interest Expense		Percent Change
	Three months ended December 31		
	2005	2004	
Interest expense			
Interest on debt	\$ 330	\$ 339	(2.7%)
Amortization of debt discount, issue, and reacquisition costs, net	5	5	0.0%
Allowance for funds used during construction	(36)	(26)	38.5%
Net interest expense	<u>\$ 299</u>	<u>\$ 318</u>	(6.0%)

Significant items contributing to the \$19 million decrease in net interest expense include:

- A decrease in the average long-term interest rate from 6.30 percent to 6.06 percent,
- A reduction of \$755 million in the average balance of long-term outstanding debt, and
- A \$10 million increase in ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION ("AFUDC") due to a higher level of construction work-in-progress in 2005.

These items were partially offset by:

- An increase in the average short-term interest rate from 1.93 percent to 3.61 percent, and
- An increase of approximately \$1.1 billion in the average balance of short-term outstanding debt.

Impact of New Accounting Pronouncements and Interpretations

Variable Interest Entities

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

In February 1997, TVA entered a purchase power agreement with Choctaw Generation, Inc. (subsequently assigned to Choctaw Generation Limited Partnership) to purchase all the power generated from its facility located in Choctaw County, Mississippi. The facility had a committed capacity of 440 megawatts and the term of the agreement was 30 years. Under the accounting guidance provided by FIN 46(R), TVA may be deemed to be the primary beneficiary under the contract; however, TVA does not have access to the financial records of Choctaw Generation Limited Partnership. As a result, TVA was unable to determine whether FIN 46R would require TVA to consolidate Choctaw Generation Limited Partnerships' balance sheet, results of operations and cash flows for the quarter ended December 31, 2005. Power purchases for the first quarter of 2006 under the agreement totaled \$30 million. TVA has no additional financial obligations beyond the purchase power agreement with respect to the facility.

Conditional Asset Retirement Obligations

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

Accounting Changes and Error Corrections

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

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 will adopt EITF Issue No. 04-13 beginning in the second quarter of 2006 and is currently evaluating the potential implications of this issue which may or may not be material to its financial position or results of operations.

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 will become effective for TVA beginning in the second quarter of 2006. TVA is currently evaluating the potential implications of this issue which may or may not be material to its financial position or results of operations.

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 will apply this guidance beginning with the quarterly reporting period ending March 31, 2006. TVA is currently evaluating the potential implications of this staff position which may or may not be material to its financial position or results of operations.

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. The adoption of the guidance in this FSP will be applied to reporting periods beginning after December 15, 2005. TVA is currently evaluating the potential implications of this staff position which may or may not be material to its financial position or results of operations.

Risk Factors and Forward-Looking Statements

Weather Risk

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

Operational Risk

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

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

Additionally, during the quarter ended December 31, 2005, a supplier with whom TVA has contracts for purchased power filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. There is a possibility that the company may reject, or fail to perform, under an existing power purchase agreement. TVA currently has an agreement with the supplier for power through August 2007. See "*Quantitative and Qualitative Disclosures about Market Risk*"—"Credit Risk."

Rate Setting

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

TVA continues to monitor the cost of fuel and purchased power. Current projections have these costs increasing significantly above the amount upon which the October 1, 2005, rate increase was based. This will place upward pressure on rates and could possibly result in further rate actions in the near term.

Risk of Loss of Customers

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

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

The Anti-Cherry-picking Provision minimizes the financial exposure of TVA to loss of distributor customers due to their limited access to transmission resources.

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

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.

During the quarter ended December 31, 2005, a directly-served customer filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. TVA did not experience any losses as a result of the customer bankruptcy. Sales to the customer generated approximately 0.1 percent of TVA's total operating revenues in 2005.

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 is spending \$1.3 billion more on additional environmental projects. TVA continues to consider better, more cost-effective ways to further reduce emissions in light of evolving emission reduction requirements. TVA's objective is to optimize its coal-fired assets and strategy for compliance with clean air regulations by maintaining the flexibility to respond to changing market conditions and allowing an adequate timeline to mitigate uncertainties. In light of the continuing progress in reducing its emissions, TVA expects to have a several-year window available before deciding on significant additional investments beyond those already announced. TVA's plan will manage uncertainties and risks, provide flexibility to match predicted loads, and allow time to evaluate market conditions and make changes to other strategies as business conditions dictate without requiring major additional financial commitments.

Forward-Looking Statements

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain asset retirement obligations; expectations about the adequacy of TVA's nuclear decommissioning fund; estimates regarding the reduction of total financing obligations; the impact of new accounting pronouncements and interpretations, including Statement of Financial Accounting Standards No. 151, *"Inventory Costs — an amendment of ARB No. 43, Chapter 4"* and 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-Cherry-picking Provision; 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. 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.

Legislative Activity

TVA Governance

President Bush has nominated people for six of the seven open positions on the restructured TVA Board. The nominees are Dennis Bottorff of Nashville, Tennessee; Donald R. DePriest of Columbus, Mississippi; Robert Mike Duncan of Inez, Kentucky; William B. Sansom of Knoxville, Tennessee; Howard A. Thrailkill of Huntsville, Alabama; and Susan Richardson Williams of Knoxville, Tennessee. Hearings on all six nominations began on February 8, 2006. Once three new directors take office, the new Board structure will become effective. 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

Senator Mitch McConnell of Kentucky is continuing to look for support for S. 1499, a bill that would effectively remove any area within Kentucky from the coverage of the Anti-Cherry-picking Provision. If the bill were to become law, FERC could 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. 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.

Other

Fossil Fuels Inventories

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

TVA has been notified of problems with three of its coal suppliers. This will result in a shortfall of coal to the fossil plants. Replacement coal and transportation for these shortfalls have been located and contracted for; however, these replacement coals are originating in places not normally utilized by TVA and present disruption risks. While inventories are improving slightly, negative inventory impacts may still occur. TVA continues to assess the impact and make plans to secure the necessary tonnage to compensate for the shortfalls.

Bellefonte Nuclear Plant

In September 2005, NuStart Development LLC (“NuStart”), selected Bellefonte as one of the two sites in the country for a new advanced design nuclear plant. Although neither TVA nor NuStart have decided to build an advanced nuclear reactor at this time, NuStart does intend to seek a combined construction and operating license for the site for the new Advanced Passive 1000 reactor design by Westinghouse Electric Co. TVA also led a team which prepared a cost and schedule study in August 2005 on building an Advanced Boiling Water Reactor (“ABWR”) on the Bellefonte site and submitted the results to DOE. Other members of the team, operating under the DOE’s Nuclear Power 2010 program, include Toshiba Corp., General Electric Corp., Bechtel Corp., United States Enrichment Corporation, and Global Nuclear Fuels–Americas. The ABWR has been design-certified in the United States by the Nuclear Regulatory Commission (“NRC”). The study was designed to verify the costs of building a new ABWR plant, which could provide another option for utilities interested in preserving the nuclear option for the future.

In December 2005, TVA notified the NRC that it has placed Bellefonte Nuclear Plant Units 1 and 2 in terminated status and that it intends to submit for NRC approval a request for withdrawal of construction permits for these units. Canceling the construction status of the existing plant facilities and withdrawal of the related construction permits are necessary in order to facilitate other future uses of the Bellefonte site. The placement of the partially constructed Bellefonte units in terminated status does not prevent the future use of the Bellefonte site for other uses, including the construction of any new nuclear or non-nuclear power facilities.

Bear Creek Dam Seepage

Bear Creek Dam is experiencing foundation problems as evidenced by seepage through the foundation of the dam. Continued monitoring indicates that remedial work such as grouting and sinkhole repair have reduced but not eliminated the problem. With the concurrence of third party independent reviewers, TVA will begin the environmental, economic, and engineering study to determine and evaluate potential options and identify a recommendation on how to proceed.

Fuel Fabrication Claims

On November 9, 2005, TVA received two invoices totaling \$76 million from Areva ("Areva") and Framatome ANP, Inc., the predecessor of Babcock and Wilcox Company ("B&W"). In 1970, TVA and B&W entered into a contract for fuel fabrication services for the Bellefonte Nuclear Plant. 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 did. TVA is reviewing Areva's claim.

President's 2007 Budget, TFO Reductions

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

TVA estimates it will reduce TFOs by a total of \$7.8 billion for 2004 through 2016. This estimate is based on the assumptions that TVA will recover fuel and purchased-power cost increases through revenues and that TVA will be able to keep growth in other operating and maintenance costs at ½ of one percent below the rate of inflation. As with any type of long term planning, business model uncertainties and assumptions, most of which are out of TVA's control, may negatively impact TVA's ability to meet the reductions in TFO targets. See "*Forward-Looking Statements.*"

Through 2005, TVA has reduced its TFOs by \$2.1 billion since the beginning of 1997. As of December 31, 2005, TVA had \$25.7 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 reduce the drug portion of participant premiums.

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.

As of December 31, 2005, closing prices, the MTM value of TVA's electricity portfolio for the next 12 months was \$3.0 billion. The fair value calculation determines a profit or loss for each source of fair value (e.g. load revenue) based on market prices. Market prices for electricity have a small impact on TVA margins because only a small portion of TVA's energy needs are bought or sold in the market.

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 December 31, 2005, include the following:

	Accumulated Other Comprehensive Income (Loss)	
	December 31, 2005	September 30, 2005
Inflation swaps	\$ (8)	\$ 2
Foreign currency swaps	<u>52</u>	<u>25</u>
Total	<u>\$ 44</u>	<u>\$ 27</u>

Other derivative contracts include swaption agreements, an interest rate swap, various purchased power option contracts, coal contracts that contain volume options, and options on futures contracts. One of TVA's swaption agreements qualifies for fair value hedge accounting under SFAS No. 133, as amended, and the gains and losses on the hedged item and the hedging item are recognized immediately in the determination of earnings. TVA elected to forego hedge

accounting treatment for two other swaption agreements, and the gains and losses on these swaption agreements, as well as the gains and losses on an interest rate swap that does not qualify for hedge accounting treatment under SFAS No. 133, as amended, are recognized immediately in the determination of earnings.

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

Credit Risk

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

Emission Allowances

In October 2004, the Board expanded the existing delegation that allows TVA to enter into agreements for the sale, purchase and loan of SO₂ emission allowances to include NO_x emission allowances. This provides TVA the same ability to transact in the new and evolving NO_x emissions allowance market as the SO₂ emissions allowance market.

Financial Trading Program

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

At December 31, 2005, TVA had 328 derivative contracts outstanding under the program with an approximate net market value of \$33.2 million. The program has enabled TVA to effectively hedge the price risk associated with a portion of its natural gas and power purchases. During the three-month period ended December 31, 2005, TVA recognized unrealized losses of approximately \$1.2 million which offset previously accumulated gains of about \$0.5 million and included all such losses in purchased power expense for the period ended December 31, 2005.

Financial Trading Program Activity

Three Months Ended December 31

	2005	Contract	2004	Contract
	Notional Amount	Value	Notional Amount	Value
	(in mmBtu)		(in mmBtu)	
Futures contracts				
Financial positions at beginning of period, net	880,000	\$ 9.6	-	\$ -
Purchased	2,420,000	26.1	600,000	4.0
Sold	(140,000)	(1.8)	(50,000)	(0.3)
Realized gains (losses)	-	-	-	-
Net positions-long	<u>3,160,000</u>	<u>33.9</u>	<u>550,000</u>	<u>3.7</u>
Options Contracts				
Financial positions at beginning of period, net	240,000	-	-	-
Calls purchased	-	-	150,000	0.1
Puts sold	-	-	(300,000)	(0.1)
Positions closed or expired	(120,000)	-	-	-
Net positions	<u>120,000</u>	<u>-</u>	<u>(150,000)</u>	<u>-</u>
Holding gains (losses)				
Unrealized gains at the beginning of period, net	-	0.5	-	-
Unrealized (losses) for the period	-	(1.2)	-	(0.3)
Unrealized (losses) at end of period, net	-	(0.7)	-	(0.3)
Financial positions at end of period, net	<u>3,280,000</u>	<u>\$ 33.2</u>	<u>400,000</u>	<u>\$ 3.4</u>

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 members of the Board, the Disclosure Control Committee, and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation has been performed under the supervision of TVA management, including members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) of the effectiveness of TVA's disclosure controls and procedures as of December 31, 2005. Based on that evaluation, the members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) concluded that, as a result of internal control deficiencies (described below), TVA's disclosure controls and procedures were not effective as of December 31, 2005. 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 members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) have determined that there is reasonable assurance that the financial statements included in this report fairly present, in all material respects, TVA's financial condition, results of operations and cash flows as of, and for, the periods presented. However, these identified internal control deficiencies, if not remediated, could individually or in the aggregate result in a material weakness.

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

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

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. As of June 30, 2005, a significant internal control deficiency was identified related to TVA's general computer controls as follows:

- Program development and program changes including (1) documentation of change authorization and (2) restricting programmer access to the production environment, and
- Unrestricted access to programs and data including (1) user administration, (2) application and system security configurations, and (3) periodic user access validation.

TVA is taking corrective actions to address this deficiency by implementing stronger controls over data and program changes, stricter logging and monitoring processes of data and program 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 developed and communicated a plan to obtain annual Statement on Auditing Standards ("SAS") 70 internal control reports on 12 specific control objectives from customers and their third party billing processors. The first SAS 70 reports will be due to TVA on August 31, 2006.

Also during the fourth quarter of 2004, TVA management identified a significant deficiency related to the mark-to-market valuation of coal contracts that contain volumetric optionality. Although key controls have been designed to facilitate the complete and accurate capture and processing of coal contract activities, many control activities were not stan-

standardized. To improve controls in this area, personnel have performed independent reviews of all new contracts and supplements to be included, and changes made to the valuation model during the quarter ended December 31, 2005. TVA has also implemented standard control procedures to address this internal control deficiency which include independent reviews of the input of contract terms into the valuation model and proper segregation of duties.

Except for the efforts taken and currently underway as described above, no changes occurred during the quarter ended December 31, 2005, in TVA's 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

BOARD ACTIONS

As of November 22, 2005, the Board approved tax-equivalent payments for 2005 in the amount of \$365 million and estimated tax-equivalent payments for 2006 in the amount of \$373 million.

ADDITIONAL INFORMATION

Management

In November 2005, Jon Rupert, Vice President of Browns Ferry Unit 1 Restart, announced his retirement, effective January 6, 2006. Masoud Bajestani, Senior Vice President of Maintenance Scheduling and Outage Coordination, has assumed responsibility for the restart project on an interim basis until a final selection is made and approved.

In December 2005, LeAnne Stribley, Executive Vice President of Administration, announced her resignation from TVA, effective January 31, 2006. John E. Long, Executive Vice President of Administrative Services, assumed responsibility for many of the former Administration organizations (including Facilities, Procurement, Information Services, TVA Police, and Enterprise Performance and Analysis) as part of the September 20, 2005, reorganization.

Operations

Browns Ferry Unit 1

In May 2002, the TVA Board initiated activities for the return of Browns Ferry Unit 1 to service in order to meet long-term energy needs in the Tennessee Valley. It is anticipated the Browns Ferry Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately \$1.8 billion. Unit 1 is expected to return to service in 2007, and the additional generating capacity is expected to lower the average cost of power and provide additional cash flow. As of December 31, 2005, TVA had incurred approximately \$1.4 billion of costs (including AFUDC of \$120 million) on the Browns Ferry Unit 1 restart project, the planned amount for this period. The restart project was about 75 percent complete at that date and on schedule for completion.

Other

In November 2005, the President of the United States sent to the Senate nominations of five people to serve on the TVA Board. In December 2005, President Bush sent to the Senate the name of a sixth nominee to the TVA Board. The nominees are Dennis Bottorff of Nashville, Tennessee; Donald R. DePriest of Columbus, Mississippi; Robert Mike Duncan of Inez, Kentucky; William B. Sansom of Knoxville, Tennessee; Howard A. Thraikill of Huntsville, Alabama; and Susan Richardson Williams of Knoxville, Tennessee. Hearings on all six nominations began February 8, 2006. As soon as three new Board members take office, the restructured Board provided for in the Consolidated Appropriations Act, 2005 will take effect. With seven new positions on the restructured Board, one position remains for which a nominee has not been designated. See *"Management's Discussion and Analysis of Financial Condition and Results of Operation"* — *"Subsequent Events"* — *"Management"* in the 2005 Information Statement.

Spent Nuclear Fuel

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with 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 receiving SNF from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools 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 those 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.) The Sequoyah and Browns Ferry facilities have been constructed and approved by the NRC and are now in use. 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.

President's 2007 Budget, TFO Reductions

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

TVA estimates it will reduce TFOs by a total of \$7.8 billion for 2004 through 2016. This estimate is based on the assumptions that TVA will recover fuel and purchased-power cost increases through revenues and that TVA will be able to keep growth in other operating and maintenance costs at ½ of one percent below the rate of inflation. As with any type of long-term planning, business model uncertainties and assumptions, most of which are out of TVA's control, may negatively impact TVA's ability to meet the reductions in TFO targets. See *"Forward-Looking Statements."*

Through 2005, TVA has reduced its TFOs by \$2.1 billion since the beginning of 1997. As of December 31, 2005, TVA had \$25.7 billion of TFOs outstanding.

CERTIFICATIONS OF THE INDIVIDUAL MEMBERS OF THE TVA BOARD OF DIRECTORS

Bill Baxter and Skila Harris individually certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended December 31, 2005;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this Report;
3. Based on my knowledge, the financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Report is being prepared;
 - b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and
 - c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended December 31, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and
5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: February 10, 2006



Bill Baxter
Chairman



Skila Harris
Director

CERTIFICATION OF THE CHIEF FINANCIAL OFFICER

I, Michael E. Rescoe, certify that:

1. I have reviewed the Tennessee Valley Authority Quarterly Report ("Report") for the quarterly period ended December 31, 2005;
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this Report;
3. Based on my knowledge, the financial statements and other financial information included in this Report fairly present in all material respects the financial condition, results of operations, and cash flows of the Tennessee Valley Authority as of, and for, the periods presented in this Report;
4. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Report is being prepared;
 - b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and
 - c) disclosed in this Report any change in internal control over financial reporting that occurred during the quarter ended December 31, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and
5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: February 10, 2006



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

CONTACT INFORMATION

GENERAL INQUIRIES

Ellen Robinson
Executive Vice President, Communications
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902

Phone: 865-632-6263
Fax: 865-632-4760
E-mail: tvainfo@tva.com
Web site: www.tva.com

INVESTOR INQUIRIES

John M. Hoskins
Senior Vice President, Treasurer/Investor Relations
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902

Phone: 888-882-4975 (toll-free inside the U.S.)
Phone: 888-882-4967 (toll-free outside the U.S.)
E-mail: investor@tva.com
Web site: www.tva.com/finance

E-mail Alert

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

TVA OFFICE OF THE INSPECTOR GENERAL

Richard W. Moore
Inspector General
Tennessee Valley Authority
400 West Summit Hill Drive
Knoxville, TN 37902

Phone: 865-632-4120
Empowerline (formerly, the Hotline); 1-877-866-7840 (toll free) or www.OIGempowerline.com
Fax: 865-632-4130
E-mail: richard.moore@tva.gov
Web site: oig.tva.gov

2005 INFORMATION STATEMENT

TENNESSEE VALLEY AUTHORITY

A Wholly Owned Corporate Agency and Instrumentality of the United States of America

The Tennessee Valley Authority ("TVA" or the "Corporation") presents this Information Statement (this "Statement") for the information of interested individuals and potential purchasers of (1) its Power Bonds ("Power Bonds"), (2) its Discount Notes ("Discount Notes"), and (3) any other evidences of indebtedness ("Other Indebtedness") it may issue pursuant to the Tennessee Valley Authority Act of 1933, as amended, 16 U.S.C. §§ 831-831ee (2000 and Supp. II 2002) (the "Act" or the "TVA Act"). TVA issues Power Bonds pursuant to the Act and the Basic Tennessee Valley Authority Power Bond Resolution adopted by the Board of Directors of TVA (the "Board" or the "TVA Board") on October 6, 1960, as amended on September 28, 1976, October 17, 1989, and March 25, 1992, (the "Basic Resolution"). TVA issues Discount Notes and Other Indebtedness pursuant to the Act and their authorizing resolutions. Power Bonds, Discount Notes, and Other Indebtedness are collectively referred to in this Statement as "Evidences of Indebtedness."

Evidences of Indebtedness are not obligations of the United States of America, and the United States of America does not guarantee the payment of the principal of or interest on any Evidences of Indebtedness. TVA is not required to register Evidences of Indebtedness with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933 or to make periodic reports under the Securities Exchange Act of 1934. Beginning with TVA's 2006 annual report, however, TVA will be required to file annual reports, quarterly reports, and current reports with the SEC under section 37 of the Securities Exchange Act of 1934. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Legislative and Regulatory Matters" in Part II.)

TVA may offer Evidences of Indebtedness from time to time or on a continuous basis either by direct placement or through selected investment dealers, dealer banks, underwriters, or underwriting syndicates.

- For Power Bonds offered from time to time, TVA typically prepares an offering circular describing the specific terms and conditions of the Power Bonds.
- For Power Bonds offered under a program on a continuous basis, TVA typically prepares a single offering circular that describes the general terms and conditions common to all securities issued under the program.
- For offerings of Discount Notes, TVA typically prepares a single offering circular describing the general terms and conditions common to all offerings of Discount Notes.
- For offerings of Other Indebtedness, TVA typically prepares either an offering circular describing the specific terms and conditions of the particular offering or a more general offering circular, as TVA deems appropriate.

For any offerings made through a program under which Evidences of Indebtedness are offered on a continuous basis, the offering circular typically describes how, if at all, the offering circular will be supplemented in order to reflect, among other things, the specific terms and conditions of the securities being offered. You should read this Statement, as it may be supplemented or amended, together with the appropriate offering circular, as it may be supplemented or amended, for each offering.

For each offering of an Evidence of Indebtedness, you should rely only on the information contained in (1) this Statement, (2) the relevant offering circular, and (3) any supplements or amendments to these documents approved by TVA. TVA has not authorized anyone to provide you with any information that is different from that found in this Statement and each relevant offering circular and any supplements or amendments to such documents. This Statement does not constitute an offer to sell or a solicitation of an offer to buy any Evidences of Indebtedness in any jurisdiction to any person to whom it is unlawful to make an offer or solicitation.

This Statement is accurate only as of its date. TVA may supplement, amend, or replace this Statement from time to time, generally no more often than annually, to reflect its annual financial results or otherwise as TVA deems appropriate. However, TVA assumes no duty to update this Statement. If TVA does supplement, amend, or replace this Statement, you should rely on the most recent supplements or amendments to or replacement of this Statement over different information in this Statement.

Any statements in this Statement involving matters of opinion, regardless of whether expressly so identified, are opinions only and not factual representations. This Statement is not a contract with the purchaser of any Evidences of Indebtedness.

You may obtain additional copies of this Statement by writing to Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1401, Attention: Investor Relations, by calling 1-888-882-4975, or on the TVA website: www.tva.com.

The date of this Information Statement is November 18, 2005.

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PART I

BUSINESS

General

Forward-Looking Information

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain tangible long-lived assets; expectations about the adequacy of TVA’s nuclear decommissioning fund; the impact of new accounting pronouncements and interpretations, including Financial Accounting Standards Board (“FASB”) Interpretation No. 46, “*Consolidation of Variable Interest Entities – an interpretation of ARB No. 51,*” which was amended by FASB Interpretation No. 46R, and Statement of Financial Accounting Standards No. 151, “*Inventory Costs — an amendment of ARB No. 43, Chapter 4,*” and 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-Cherry-picking Provision; 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. 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 after the statement is made.

Fiscal Year

Unless otherwise indicated, years (2005, 2004, etc.) in this Statement refer to TVA’s fiscal years ended September 30.

Notes

References to “notes” are to the Notes to Financial Statements contained in Part II.

The Corporation

TVA is a wholly-owned corporate agency and instrumentality of the United States government created in 1933 by the TVA Act and charged with providing improvement for navigation, flood damage reduction, agricultural and industrial development, and electric power to the Tennessee Valley region. TVA has developed and operates one of the largest electric power systems in the United States, having produced nearly 160 billion kilowatt-hours (“kWh”) of electricity in 2005.

TVA is currently administered by a board of three persons appointed by the President and confirmed by the Senate, although only two Board members are currently in office. Appointments are currently for nine-year staggered terms, with one term expiring each three-year interval.

The Consolidated Appropriations Act, 2005, among other things, included provisions which will result in the restructuring of the Board and the establishment of the position of a Chief Executive Officer. The legislation restructures the Board by increasing the number of directors from three full-time members to nine part-time members, at least seven of whom must be legal residents of the TVA service area. As with the current Board, future Board members will be appointed by the President and confirmed by the Senate, but will serve, after a transition period, five-year terms rather than the current nine-year terms. The Board's role will continue to be, among other things, to develop long-term plans and strategies for TVA, approve annual budgets and an employee compensation plan for TVA, and have general responsibility for TVA policies. The Board will also create an audit committee consisting of members of the Board "independent of the management" to review reports from TVA's external auditors and Inspector General and make recommendations to the full Board. Congress also reaffirmed the authority of the Board to set electric rates charged by TVA. These provisions will go into effect on the date when three new members of the Board take office. The members of the Board will select a member to serve as Chairman.

Historically, the programs at TVA have consisted of power and nonpower programs. Revenues and expenses of the power program are segregated from other revenues and expenses. Substantially all of TVA's revenues and assets are attributable to its power program. For a discussion of the funding of TVA's nonpower programs, see note 13 in Part II. The financial statements included in this Statement include the combined results of all TVA programs.

The Act requires the power program to be self-supporting from power system revenues and capital TVA raises through its power program financings. The Act authorizes TVA to issue Evidences of Indebtedness in an amount not exceeding \$30 billion outstanding at any one time. See "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*" — "*Public Law No. 105-62*" and "*The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness*" in Part I.

Under certain circumstances, the Act permits TVA to borrow up to \$150 million for a period of one year or less from the United States Treasury ("Treasury"). The Act requires TVA to obtain the approval of the Secretary of the Treasury of the issue date and maximum interest rate for any issuance of an Evidence of Indebtedness with a term of one year or longer. The Office of Management and Budget ("OMB") includes TVA's finances as part of the budget of the United States.

The Act requires TVA to annually file a financial statement and complete report as to its business with the President and Congress. The Government Corporation Control Act authorizes the Comptroller General of the United States to periodically audit the transactions of TVA.

Regulation of TVA

Congress

TVA exists pursuant to legislation enacted by Congress and operates within the bounds set by this legislation. Congress has the authority to control TVA's activities, reduce such activities, change TVA's structure, or even eliminate TVA through legislation. In order to allow TVA more freedom to operate than a traditional agency, however, Congress, in passing the TVA Act in 1933, exempted TVA from many general federal laws that govern other agencies, such as laws related to the hiring of employees, the procurement of supplies and services, and the acquisition of land. Since 1933, Congress has exempted TVA from certain federal laws applicable to other agencies in recognition of TVA's unique status. Other federal laws enacted since the creation of TVA have been made applicable to TVA including those related to the protection of the environment and cultural resources and civil rights laws.

Federal Energy Regulatory Commission

TVA is not a "public utility" as defined in the Federal Power Act ("FPA"). Therefore, TVA is not subject to the plenary jurisdiction of the Federal Energy Regulatory Commission ("FERC") under the FPA. TVA is, however, an "electric utility" as defined in the FPA and, thus, is subject to certain aspects of FERC's jurisdiction under Sections 210 to 212 of the FPA. TVA has elected to implement various FERC orders and regulations on a voluntary basis to the extent consistent with TVA's obligations under the TVA Act.

The Energy Bill signed by the President on August 8, 2005, gave FERC additional authority over TVA in limited areas:

- TVA is subject to FERC review of transmission rates and terms and conditions of service to ensure comparability of treatment of its and others regarding the same transmission service. The bill also reaffirms the Anti-Cherry-picking Provision in providing that TVA distributors will be afforded native load preference regarding firm transmission rights on the TVA transmission system, but in a way that (i) will not affect the requirements of the Anti-Cherry-picking Provision and (ii) will not itself provide a new basis for any FERC order that would be contrary to the purposes of the Anti-Cherry-picking Provision. (Native load refers to the customers on whose behalf a company, by statute, franchise, regulatory requirement, or contract, has undertaken an obligation to serve. The Anti-Cherry-picking Provision provides that FERC cannot order TVA to deliver power from a non-TVA source to a customer if the power would be consumed within TVA's defined service territory.)
- FERC's authority to order refunds of excessive prices on short-term sales (transactions lasting 31 days or less) in market manipulation and price gouging situations is expanded to include authority over TVA if TVA makes such sales under a FERC approved tariff.
- TVA is subject to new prohibitions on (i) using manipulative or deceptive devices or contrivances in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to jurisdiction and (ii) willfully and knowingly reporting false information on the price of electricity sold at wholesale or the availability of transmission capacity to a federal agency with intent to fraudulently affect the data being compiled by the agency. This includes becoming subject to FERC's investigative and enforcement authority in these two areas.
- FERC is authorized to issue regulations requiring the reporting, on a timely basis, of information about the availability and prices of wholesale electric energy and transmission service by all market participants, including TVA.

States

The Supremacy Clause of the United States Constitution prohibits states, without congressional consent, from regulating the manner in which the federal government conducts its activities. As a federal agency, TVA is exempt from regulation, control, and taxation by states except in certain areas such as air and water quality where Congress has given the states limited powers to regulate federal activities.

Governmental Entities

TVA's activities and records are also subject to review by various governmental entities including TVA's Office of Inspector General, the Government Accountability Office, the Congressional Budget Office, the Nuclear Regulatory Commission, the Environmental Protection Agency, and OMB.

The Area Supplied by the Tennessee Valley Authority

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

Rates and Customers

TVA is primarily a wholesaler of power. Its customers consist of three major groups: (1) distributors, consisting of municipalities and cooperatives; (2) industries that have large or unusual loads; and (3) federal agencies. Additionally, TVA has entered into exchange power arrangements with most of the electric systems that border its service territory as allowed by the TVA Act.

The Act gives the Board sole responsibility for establishing the rates TVA charges for power and authorizes the Board to include in power contracts terms and conditions that it judges necessary or desirable for carrying out the purposes of the Act. The Act requires TVA to charge rates for power which, among other things, will produce gross revenues sufficient to provide funds for (1) operation, maintenance, and administration of its power system; (2) payments to states and counties in lieu of taxes; (3) debt service on outstanding Evidences of Indebtedness; and (4) annual payments to the Treasury in repayment of and as a return on the government's appropriation investment in TVA power facilities. See "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*" and "*The Basic Resolution; Power Bonds, Discount Notes and Other Indebtedness*" — "Rate Covenant" in Part I. 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 (discussed in "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "TVA and Competition" in Part II), 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.

A summary of operating revenues by customer type for each of the last five years ended September 30 is shown in "*Selected Financial Data*" in Part II.

Municipal and Cooperative Distributors

Sales to municipal and cooperative distributors customers ("distributors") accounted for approximately 84 percent of TVA's total operating revenues in 2005. TVA has wholesale power contracts with 158 municipal and cooperative distributors. All of these contracts require distributors to purchase substantially all of their electric power and energy requirements from TVA.

All distributors purchase power under one of three basic arrangements. Forty-eight distributors purchase power under contracts that require ten years' notice to terminate. These contracts provide that on each anniversary beginning on the tenth anniversary, one additional year is automatically added to the term. Five distributors have contracts that require 15 years' notice to terminate the contract. On each anniversary of these contracts, beginning on the fifth anniversary, one additional year is automatically added to the term. TVA has also offered distributors the option of moving from ten-year or 15-year termination notice periods to a five-year termination notice period. Ninety-eight distributors, including two of the largest, have entered into contractual arrangements of this type. Sales to these two distributors generated approximately 12 percent of TVA's total operating revenues in 2005. Nine of the 158 distributors have given TVA notice to terminate their power contracts, and seven of these notices remain in effect. As a result, these seven distributors effectively have contracts with durations of less than five years. See "*Termination Notices*" below.

The number of distributors with the contract arrangements described above, the revenues derived from such arrangements in 2005, and the percentage of TVA's 2005 total operating revenues represented by these revenues are summarized in the table below.

Contract Arrangement	Number of Distributors	Sales to Distributors in 2005	Percentage of Total Operating Revenues in 2005
		(in millions)	
15-Year Termination Notice	5	\$ 75	1.0%
10-Year Termination Notice	48	2,174	27.9%
5-Year Termination Notice	98	4,062	52.1%
5-Year Termination Notice *	7	250	3.2%

* (Scheduled to terminate due to distributor notice)

TVA's wholesale power contracts contain standard provisions specifying the wholesale rate and terms and conditions under which power is sold to distributors. Under these contracts, TVA, on a quarterly basis, may determine and make adjustments in the wholesale rate schedules necessary to enable TVA to meet all the requirements of the Act and the financial requirements, covenants, and provisions of its bond resolutions. The contracts provide for agreement between the parties on general or major changes in the wholesale schedules. If, however, agreement is not reached, the contracts permit TVA to make changes in these schedules to carry out the objectives of the Act, to meet financial requirements and covenants, and to comply with the provisions of its bond resolutions.

Most of the power contracts between TVA and the distributors specify the resale rates that distributors charge the ultimate power customers. These rates are revised from time to time to reflect changes in costs, including changes in the wholesale cost of power. They are designed to promote the Act's objective of providing an adequate supply of power at the lowest feasible rates.

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 terms 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 ("TVPPA"), an association that represents all distributors of TVA power, to develop future wholesale pricing options and new long-term contract options.

TVA has also entered into agreements with four distributors that significantly reduce TVA's involvement with their resale rates and with five distributors that provide for TVA's termination notice period to generally be ten years even if the distributor has chosen the five-year option described above. Contracts with two distributors contain both of these features.

For a discussion of the effects of competition in a restructured electric power market, see "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "TVA and Competition" in Part II.

During October 2002, TVA introduced the Discounted Energy Units ("DEU") program. Under this program, TVA customers purchase DEUs, generally in \$1 million increments, which entitle them to a 0.025 dollar/kilowatt-hour discount on a specified quantity of firm load over a period of years (five, ten, 15, or 20) for each kilowatt-hour in the prepaid block. The remainder of the price of the kilowatt-hours delivered is due upon billing. Upon termination of the power contract, the DEU agreement terminates unless TVA and the distributor agree to other supply arrangements. Absent such agreement, the remaining net present value of the balance of the unearned revenue will be returned to the distributor upon termination.

TVA did not offer the DEU program in 2005. However, as of September 30, 2005, TVA had entered into sales agreements for 54.5 DEUs totaling \$54.5 million. TVA is accounting for the prepaid power as unearned revenue. (See "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "Energy Prepayment Obligations" in Part II.)

In November 2003, TVA, Memphis Light, Gas and Water Division ("MLGW"), and the City of Memphis entered into an arrangement whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The prepayment will be applied to MLGW's monthly power bill on a straight-line basis over the same 15-year period. The amount of the prepayment was \$1.5 billion. TVA is accounting for the prepaid power as unearned revenue (see "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "Energy Prepayment Obligations" in Part II).

Other Sources of Revenues

Revenues from directly served industries and federal agencies, exchange power arrangements with other power systems, and other revenue sources accounted for approximately 16 percent of TVA's total operating revenues in 2005. Contracts with industries and federal agencies directly served by TVA are normally for ten-year terms. These contracts are subject to termination by TVA or the customer upon a minimum notice period that varies according to the customer's contract demand and the period of time service has been provided to the location where service would be terminated. TVA establishes the rates it charges to industrial customers it directly serves. These rates normally are the same as those charged by the distributors of TVA power to large customers (those with demand greater than 25,000 kilowatts).

TVA also has exchange power arrangements with 12 neighboring power systems. As part of the TVA self-financing legislation enacted by Congress in 1959, TVA was restricted to selling power outside of the TVA service area to what were then 14 power generating companies. Due to mergers and acquisitions over the years, there are now 12 of these grandfathered organizations remaining. The agreements are open-ended but do have termination provisions.

Termination Notices

During 2005, TVA received notices from three distributors in Kentucky terminating their power contracts with TVA. In December 2004, TVA received notice from Paducah Power System ("PPS") that terminates its power contract

with TVA effective December 2009. In January 2005, TVA received notice from Princeton Electric Plant Board (“PEPB”) that terminates its power contract with TVA effective January 2010. In August 2005, TVA received notice from Hopkinsville Electric System (“HES”) that terminates its power contract with TVA effective August 2010. In 2005, 0.4 percent of TVA’s total operating revenues were from sales to PPS; less than 0.1 percent of TVA’s total operating revenues were from sales to PEPB; and less than 0.3 percent of TVA’s total operating revenues were from sales to HES.

Since October 2002, nine of TVA’s distributors have given notice to terminate their power contracts with TVA. Notices from two of these distributors — Bowling Green Municipal Utilities and Meriwether Lewis Electric Cooperative — have since been withdrawn and deemed to be of no force and effect by the mutual agreement of the distributor and TVA. In addition, Duck River Electric Membership Corporation (“DREMC”) and TVA have agreed in principle to a contract amendment that, if executed, would extend DREMC’s termination date from August 2008 until August 2010.

The table below lists the names and locations of the seven distributors whose termination notices are still in effect, their contract termination dates, the amount of revenues that TVA generated by selling power to these distributors in 2005, and the percentage of TVA’s total 2005 operating revenues represented by these revenues.

<u>Distributor</u>	<u>Location</u>	<u>Date of Termination of Power Contract</u>	<u>Sales to Distributor in 2005</u> (in millions)	<u>Percentage of Operating Revenues in 2005</u>
Warren Rural Electric Cooperative Corporation	Kentucky	April 2008	\$ 82	1.0%
Duck River Electric Membership Corporation	Tennessee	August 2008	85	1.1%
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%
Hopkinsville Electric System	Kentucky	August 2010	21	0.3%
Total			<u>\$ 250</u>	<u>3.2%</u>

In addition to the six Kentucky distributors listed above, TVA has 11 other distributors located in Kentucky. Sales to these 11 distributors generated approximately three percent of TVA’s total operating revenues in 2005. See “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” — “*Legislative and Regulatory Matters*” — “*Other Matters*” in Part II of this Statement for discussion of a bill that would effectively remove any area within Kentucky from coverage of the Anti-Cherry-picking Provision.

In January 2004, the United States Enrichment Corporation (“USEC”) announced it will begin constructing its new commercial centrifuge facility in Piketon, Ohio. While it is unclear how much electricity USEC will need to acquire from TVA for its Paducah, Kentucky, facility (“Paducah Facility”) once this new facility is opened, it is expected to be substantially less. Under the current contract with TVA, USEC is required to purchase a fixed amount of electricity for its Paducah Facility through May 2006. In 2005, sales to USEC for its Paducah Facility generated approximately 4.4 percent of TVA’s total operating revenues. TVA does not expect any loss of revenues from sales to USEC to have a material effect on TVA’s financial condition.

Power and Energy Requirements

TVA prepares annual forecasts of future power and energy requirements as part of its planning and budgeting process. TVA’s forecast procedure involves producing a range of load forecasts for the explicit purpose of bounding the range of uncertainty associated with load growth. TVA produces the load forecasts probabilistically. TVA believes that there is a 90 percent probability that the actual load will be less than the high load forecast, a 50 percent probability that the actual load will be less than medium load forecast, and a ten percent probability that the actual load will be less than the low load forecast. TVA’s current load forecast through 2007 reflects an average annual energy growth rate of 1.4 percent with 2.8 percent for the high and (0.4) percent for the low load forecasts. Numerous factors could cause actual results to differ materially from TVA’s forecasts. See “*Business*” — “*General*” — “*Forward Looking Information*” in Part I.

Fuel

Management believes the sources and availability of fuel materials essential to its business should be adequate for the foreseeable future.

Fossil Fuel

Coal consumption at TVA generating facilities during 2005 was 45 million tons. Coal is purchased under contracts ranging from a single delivery to multiple deliveries over several years. TVA coal inventory targets vary from plant to plant based upon a probabilistic inventory model. As of September 30, 2005, TVA had 16 days' system-wide coal supply in inventory at full burn. Coal inventories have been impacted by recent shortfalls in deliveries of mid and low sulfur coals from the Powder River Basin (Wyoming) ("PRB"), Uinta Basin (Colorado and Utah), and Illinois Basin. Problems with rail transportation from the PRB and mine production problems in the Uinta and Illinois Basin regions are the primary causes for the shortfalls in deliveries. Evaluation of alternative fuel supplies indicates that obtaining low cost replacement coals that meet plant and regulatory requirements will be more difficult than past experience. Total fossil fuel inventory at September 30, 2005, and 2004, amounted to \$185 million and \$193 million, respectively, of which \$149 million and \$158 million, respectively, related to coal inventory.

TVA has in place term coal contracts which supplied 89 percent of TVA's total coal requirements for 2005. The remaining 11 percent was purchased in the spot coal market under contracts with terms of one year or less. Thirty-nine percent of TVA's coal supply comes from the Illinois Basin; 23 percent from the PRB of Wyoming; 22 percent from the Uinta Basin of Utah; and 16 percent from the Appalachian Basin of Kentucky, Pennsylvania, Tennessee, Virginia, and West Virginia. Thirty-seven percent of TVA's coal supply was delivered by train, 19 percent was delivered by barge, and 36 percent was delivered by a combination of barges and trains. The remainder was delivered by truck.

During 2005, TVA purchased substantially all of its natural gas requirements under contracts with terms of one year or less. TVA purchases substantially all of its natural gas to operate combustion turbine peaking units and to supply fuel under power purchase agreements in which TVA is the fuel supplier. As a result of hurricanes Katrina and Rita during the summer of 2005, the Energy Information Agency ("EIA") has estimated that 76 percent of Gulf Coast gas supplies were "shut-in" as of September 30, 2005, meaning that the gas wells were not able to produce. The EIA expects a significant amount of Gulf Coast gas supplies to remain shut-in through December 2005 with recovery to continue well into 2006. This may result in tight supplies or shortages and higher prices during the 2005-2006 winter season. TVA has natural gas supply in storage and intends to make forward purchases of natural gas for future delivery in order to meet TVA's expected demand. All of TVA's combustion turbines are dual fuel capable, and TVA has fuel oil stored on each site as a backup to natural gas. The combustion turbine units produced less than 0.4 percent of the electricity that TVA generated during 2005. See note 8 — *Financial Trading Program*.

Nuclear Fuel

TVA owns all nuclear fuel held for its nuclear units. The net book value of this fuel was \$340 million as of September 30, 2005. TVA plans to meet future uranium requirements through a combination of term and spot purchase contracts while maintaining diversity of supply sources. TVA currently has approximately 61 percent of its forward five-year (2006 through 2010) uranium requirements either in inventory or under contract for its boiling water reactor units at its Browns Ferry Nuclear Plant and has 29 percent of its forward five-year (2006 through 2010) uranium requirements under contract for its pressurized water reactor ("PWR") units at its Sequoyah and Watts Bar Nuclear Plants. At its July 2005 Board Meeting, the Board approved the purchase of uranium concentrates (refined raw uranium) and uranium conversion services (chemical process readying the concentrates for the enrichment process). The converted material will be fabricated into fuel for use in the Sequoyah and Watts Bar Units. Negotiations of contracts for these purchases were in progress at the end of 2005.

TVA also has agreements with the Department of Energy ("DOE") and Framatome ANP to use blended low enriched fuel at its reactors. This fuel was successfully loaded in Browns Ferry Unit 2 in April 2005 and will provide approximately 11 to 12 more reloads for the Browns Ferry reactors (see note 1 — *Blended Low Enriched Uranium Program*).

PROPERTIES

The Tennessee River system provides multiple benefits for people of the Tennessee Valley. TVA manages the use of resources among its multiple river-system responsibilities: navigation, flood damage reduction, power generation, environmental stewardship, shoreline use, and water supply for power plant operations, consumer use, recreation, and industry.

TVA's power system is one of the largest in the United States in capacity and in energy production. Its size permitted the construction of large facilities which has resulted in lower unit costs. TVA's dams were completed decades ago when construction costs were far below present-day levels. In accordance with the Act, all real estate acquired by TVA is acquired in the name of the United States. See "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*" in Part I.

Generating Resources

TVA's power generating facilities at September 30, 2005, included 29 conventional hydroelectric plants, one pumped storage hydroelectric plant, 11 coal-fired plants, three nuclear plants, six combustion turbine plants, one wind energy site, and 16 solar photovoltaic sites. Energy is delivered to TVA customers over a transmission system which interconnects with neighboring power systems at numerous points.

The following table summarizes TVA's net generation in millions of kilowatt-hours by generating source for the years indicated:

	GENERATION BY FUEL SOURCE (millions of kWh)				
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Hydroelectric	15,723	13,916	16,103	10,205	9,508
Coal Fired	98,404	94,648	90,975	94,930	100,118
Nuclear	45,156	46,003	43,167	45,179	45,615
Combustion Turbine and Diesel Generators	595	278	817	1,190	1,073
Other	18	18	15	18	5
Total	<u>159,896</u>	<u>154,863</u>	<u>151,077</u>	<u>151,522</u>	<u>156,319</u>

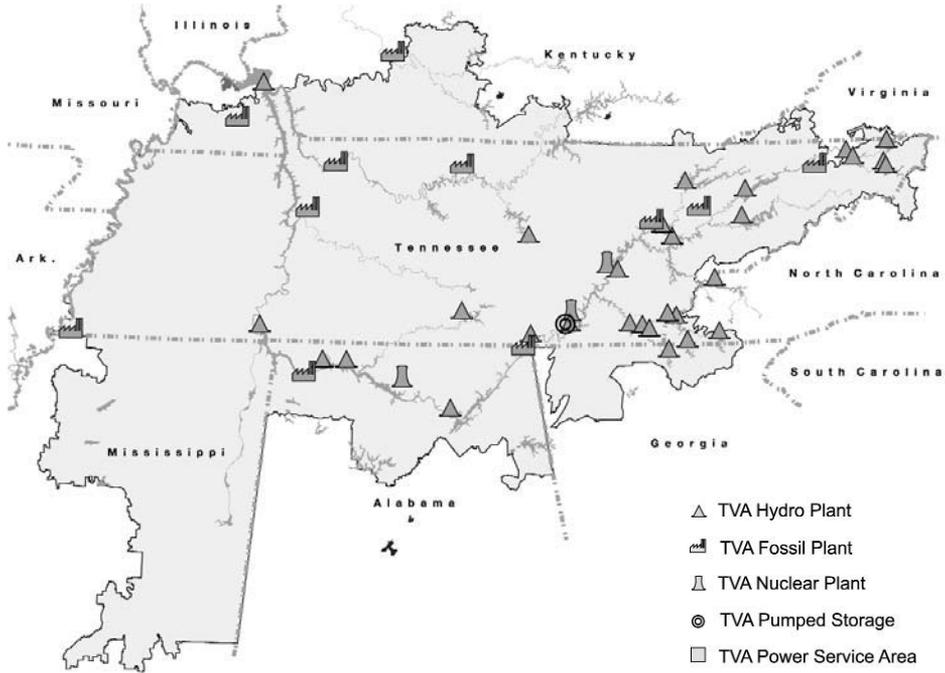
Hydroelectric power plays a vital role in the TVA power system because it is economical and reliable, and it can be brought online quickly when the demand for electricity is high or when energy is needed due to system problems or lost generation. TVA maintains 29 conventional hydroelectric dams and one pumped storage plant for the production of electricity. Nine of these hydroelectric dams are on the main channel of the Tennessee River, and 20 are on tributary rivers. The hydroelectric system typically generates between six and 11 percent of TVA's electricity supply each year.

TVA's fossil plants include coal-fired plants and combustion turbines that are fueled by natural gas and fuel oil. The 59 units at TVA's 11 coal-fired plants typically provide nearly two-thirds of the power produced by TVA. The 72 combustion turbine units at six sites are quick-start facilities that, at times of peak demand, bolster TVA's ability to supply its customers with power. The combustion turbines typically generate less than one percent of TVA's power annually.

TVA began building nuclear power plants in the 1960s and currently has five operating units at three sites. These plants typically supply approximately 29 percent of TVA's power. A sixth unit is currently in recovery and is expected to be online in 2007. (See "*Nuclear Power Program*" below.)

During 2005, 62 percent of the power generated by the TVA coordinated system was by coal-fired plants and combustion turbines, 28 percent by nuclear units, and nearly ten percent by hydroelectric units.

TVA SERVICE AREA



The following table summarizes the winter net dependable capacity ("NDC") in megawatts ("MW") on this coordinated system as of September 30, 2005:

TVA WINTER NET DEPENDABLE CAPACITY

TVA-OWNED/LEASED FACILITIES	Location	Number of Units	Winter Net Dependable Capacity (MW) ⁽¹⁾	Date Last Unit Placed in Service
Hydroelectric				
Conventional Plants	North Carolina, Tennessee, Georgia, Alabama, and Kentucky	109	3,507	1914-1972
Pumped Storage	Tennessee	<u>4</u>	<u>1,597</u>	1979
Total Hydro		113	5,104	
Coal-Fired				
Allen	Tennessee	3	750	1959
Bull Run	Tennessee	1	883	1967
Colbert	Alabama	5	1,201	1965
Cumberland	Tennessee	2	2,524	1973
Gallatin	Tennessee	4	988	1959
John Sevier	Tennessee	4	712	1957
Johnsonville	Tennessee	10	1,254	1959
Kingston	Tennessee	9	1,448	1955
Paradise	Kentucky	3	2,318	1970
Shawnee	Kentucky	10	1,369	1956
Widows Creek	Alabama	<u>8</u>	<u>1,628</u>	1965
Total Coal-Fired		59	15,075	
Nuclear				
Browns Ferry	Alabama	2	2,286	1977
Sequoyah	Tennessee	2	2,336	1982
Watts Bar	Tennessee	<u>1</u>	<u>1,168</u>	1996
Total Nuclear		5	5,790	
Combustion Turbine				
Allen	Tennessee	20	575	1972
Colbert	Alabama	8	486	1972
Gallatin	Tennessee	8	730	2000
Johnsonville	Tennessee	20	1,372	2000
Kemper	Mississippi	4	374	2002
Lagoon Creek	Tennessee	<u>12</u>	<u>1,125</u>	2002
Total Combustion Turbine		72	4,662 ⁽²⁾	
Diesel Generator				
Meridian	Mississippi	5	9	1998
Albertville	Alabama	<u>4</u>	<u>4</u>	1999
Total Diesel Generators		9	13 ⁽²⁾	
Total TVA-Owned /Leased Facilities			<u>30,644</u>	
OTHER FACILITIES (NON-TVA OWNED) ⁽³⁾				
TAPOCO, Inc.			348 ⁽⁴⁾	
U.S. Army Corps of Engineers			405 ⁽⁵⁾	
Purchased Power Agreements			<u>2,578 ⁽⁶⁾</u>	
Total Other Facilities			<u>3,331</u>	
RENEWABLE ASSETS (PPAs and non-TVA owned)			<u>6</u>	
TOTAL LONG-TERM AVAILABLE CAPACITY			<u>33,981</u>	

Notes

- (1) NDC is the net power output which can be obtained for a period adequate to satisfy the daily load patterns under expected conditions of operation with equipment in an average state of maintenance excluding any fluctuations in capacity that may occur due to planned outages, unplanned outages, and deratings. For planning purposes, TVA currently estimates summer dependable total hydro capacity of approximately 5,439 megawatts, coal-fired capacity of approximately 14,698 megawatts, nuclear power capacity of approximately 5,643 megawatts, combustion turbine capacity (on gas at 95 degrees Fahrenheit) of approximately 3,838 megawatts, diesel generator capacity of approximately 13 megawatts, and capacity at other facilities of approximately 2,628 megawatts for a total summer NDC of approximately 32,259 megawatts.
- (2) Combustion turbine and diesel generator capacities include 4,662 megawatts for turbines (on gas at 25 degrees Fahrenheit) and 13 megawatts for generators. As of September 30, 2005, 24 of TVA's combustion turbine units were leased to private entities and leased back to TVA under long-term leases.
- (3) Other facilities (non-TVA owned) include generation that TVA has purchased or acquired to meet the peak load and energy requirements of its customers.
- (4) Four hydro plants owned by TAPOCO, Inc., a subsidiary of Alcoa, Inc., are operated in coordination with the TVA power system. Under contractual arrangements with TAPOCO, Inc., electric power generated at these facilities is used to partially supply Alcoa's energy needs.
- (5) Under arrangements among TVA, the U.S. Army Corps of Engineers (the "CORPS"), and the Southeastern Power Administration ("SEPA"), eight hydro plants of the CORPS on the Cumberland River system are operated in coordination with the TVA system. These arrangements further provide for capacity (405 megawatts) and all surplus energy from the Cumberland River system to be supplied to TVA by SEPA at the points of generation at a price based on the operating and maintenance expenses and amortization of the power facilities. A portion of the output of the Cumberland River system is also made available to SEPA's customers outside the TVA region. The agreement with SEPA covering these arrangements for power from the Cumberland River system can be terminated upon three years' notice. This notice may be given beginning June 30, 2017.
- (6) TVA has contracted with various independent power producers and power distributors for additional capacity to be provided by their facilities. In total, these agreements constitute 2,578 megawatts of winter net dependable capacity. See note 12 — *Commitments — Power Purchase Obligations*.

TVA has also supplemented its existing generation portfolio with additional renewable resource assets (wind, solar, methane gas, and wood waste/digester gas cofiring technologies). Due to the nature of these sources, TVA includes only a portion of them in net winter dependable capacity. Six megawatts of solar and landfill gas are included. An additional 32 megawatts of wind and cofire capacity exist for a total of 38 megawatts of renewable generating capacity. Cofiring is a near-term, low-cost option for efficiently and cleanly converting biomass to electricity by adding biomass as a partial substitute fuel in coal boilers.

Transmission Operations

The TVA transmission system is one of the largest in North America, delivering nearly 172 billion kilowatt-hours of electricity in 2005 and maintaining 99.999 percent reliability over the last six years in delivering electricity to customers. This system is comprised of about 17,000 circuit miles of transmission lines and includes 2,400 miles of extra-high-voltage (500,000 volt) transmission lines, and 536 substations, power switchyards, and switching stations. There are 258,000 right-of-way acres and 1,025 individual interchange and customer connection points. During 2005, TVA constructed 92 miles of transmission lines.

TVA executed an agreement with the Midwest Independent Transmission System Operator, Inc. ("MISO") in August 2003 to become a "market participant" and executed an agreement with the PJM Interconnection, L.L.C. ("PJM") in July 2004 as an "other supplier." These arrangements facilitate the purchase and sale of electric energy when beneficial to TVA and in accordance with TVA's statutory limitations on the sale of surplus generation.

Changes in the fundamental business model for bulk transmission system operations, including the emergence of large markets in many areas of the eastern United States, have created new reliability risks and exposure for the TVA system as well as other systems. This has manifested itself in actual blackouts (August 14, 2003, in the mid-west and northeast United States) and in more frequent interconnection excursions such as frequency deviations.

To promote grid reliability, TVA continues to work closely with independent generators to enhance compatibility with the transmission system, develop and implement consistent operating procedures, and minimize practices that can result in interrupted service.

Nuclear Power Program

Overview

TVA has five operating nuclear units, three deferred nuclear units, and one nuclear unit in recovery that is scheduled to be returned to service in 2007. Selected statistics of each of these units are included in the chart below.

Nuclear Unit	Status	Installed Capacity (MW)	Net Capacity Factor for 2005	Date of Expiration of Operating License	Date of Expiration of Construction License
Sequoyah Unit 1	Operating	1,221 ⁽¹⁾	90.9	2020	—
Sequoyah Unit 2	Operating	1,221 ⁽¹⁾	89.0	2021	—
Browns Ferry Unit 2	Operating	1,190	88.7	2014	—
Browns Ferry Unit 3	Operating	1,190	94.8	2016	—
Watts Bar Unit 1	Operating	1,270 ⁽¹⁾	87.8	2035	—
Watts Bar Unit 2	Deferred ⁽²⁾	—	—	—	2010
Bellefonte Unit 1	Deferred ⁽²⁾	—	—	—	2011
Bellefonte Unit 2	Deferred ⁽²⁾	—	—	—	2014
Browns Ferry Unit 1	Recovery	—	—	2013	—

Notes

(1) While the nameplate ratings of the units have not changed, the net electrical output of these units has been increased slightly through license amendments issued by the Nuclear Regulatory Commission ("NRC").

(2) Per NRC's definition of deferred nuclear plant units.

Status of Certain Nuclear Units

Browns Ferry Unit 1 was taken offline in 1985 for plant modifications and regulatory improvements. The undepreciated cost of Browns Ferry Unit 1 of \$24 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period. In May 2002, the Board determined the operation of all three units at Browns Ferry over an extended license period could reduce TVA's delivered cost of power relative to the market giving TVA more financial flexibility for the future. Accordingly, the Board initiated activities for the return of Browns Ferry Unit 1 to service. It is anticipated that the Browns Ferry Unit 1 recovery project will cost approximately \$1.8 billion, excluding allowance for funds used during construction ("AFUDC") and estimated asset retirement obligation. Browns Ferry Unit 1 is expected to return to service in 2007 and is expected to provide additional generating capacity of approximately 1,280 megawatts. In 2005, TVA incurred approximately \$474 million of costs on the restart project, including \$57 million of AFUDC, which is in line with the total planned costs for the project. Planned expenditures for 2006 and 2007 are \$420 million and \$81 million, respectively.

TVA has three units in deferred status. In 1988, TVA suspended construction activities on Watts Bar Unit 2. Bellefonte Unit 1 and Unit 2 were deferred in 1988 and 1985, respectively.

In December 1994, TVA determined that it would not, by itself, complete Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 as nuclear plants. The TVA Board determined as of the end of 2001 that the values of some of its existing assets were not appropriate in a competitive marketplace. Certain nuclear assets — portions of Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 in its entirety — were identified as assets for which the estimated cash flows expected to be provided through future rates were less than recorded book values. Consequently, in 2001 TVA revalued these assets downward by \$2.2 billion and recognized an impairment loss. In 2004, it was determined that certain assets at the Bellefonte site, such as the diesel generators, training facilities, transmission structures, and other assets, had achieved a usable state. Consequently, during 2004, the Board approved the reclassification of approximately \$203 million of Bellefonte assets from DEFERRED NUCLEAR GENERATING UNITS to COMPLETED PLANT.

In July 2005, the Board approved the amortization of TVA's remaining investment in the deferred generating units at Bellefonte Nuclear Plant over a ten-year period beginning in 2006 (see note 1 — *Cost-Based Regulation* and note 5). The Board action to begin amortizing the investment of the \$3.9 billion of deferred nuclear generating units at

Bellefonte Nuclear Plant will not limit TVA's ability to use the Bellefonte site in the future. Estimated 2006 expenditures for the three deferred units are limited to costs incurred to ensure that options for the future use of the units remain viable.

In September 2005, NuStart Development LLC ("NuStart"), of which TVA is a member, selected Bellefonte as one of the two potential sites in the country for a new advanced design nuclear plant. Although neither TVA nor NuStart has decided to build an advanced nuclear reactor at this time, NuStart does intend to seek combined construction and operating licenses for the site for the new Advanced Passive 1000 reactor design by Westinghouse Electric Co. The combined operating license-approach allows the applicant to seek both a construction permit and an operating license at the front end to help provide greater certainty of the outcome, so long as the applicant closely builds what is described in the application. TVA also recently led a team which prepared a cost and schedule study on building an Advanced Boiling Water Reactor ("ABWR") on the Bellefonte site. Other members of the team, operating under the DOE's Nuclear Power 2010 program, include Toshiba Corp., General Electric Corp., Bechtel Corp., USEC, and Global Nuclear Fuels--Americas. The ABWR has been design-certified in the United States by the Nuclear Regulatory Commission ("NRC"). The study was designed to verify the costs of building a new ABWR plant, which could provide another option for utilities interested in preserving the nuclear option for the future.

Blended Low Enriched Uranium Program

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

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

Under the terms of the interagency agreement, DOE supplies off-specification, highly enriched uranium materials to the appropriate Third Party Fuel Processors for processing into usable fuel for TVA. In exchange, DOE will participate to a degree in the savings generated by TVA's use of this blended nuclear fuel product. As of September 30, 2005, TVA projects that DOE's share of savings generated by TVA's use of this blended nuclear fuel product could result in future payments to DOE of as much as \$212 million. TVA anticipates these future payments could begin in 2010. However, due to the uncertainty of the ultimate fuel cost savings and related payments to DOE under the program, TVA has not accrued an obligation related to such future potential payments. TVA will re-assess the estimated amount and probability of these future potential payments each time a BLEU fuel assembly is loaded into one of TVA's nuclear reactors. The next BLEU fuel reload is currently scheduled for March 2006.

The Third Party Fuel Processors own the conversion and processing facilities and will retain title to all land, property, plant, and equipment used in the BLEU fuel program. There is no provision for TVA to own or otherwise take title to the facilities, materials, or equipment now or at any time in the future. See note 1 — *Blended Low Enriched Uranium Program*.

Spent Nuclear Fuel

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with DOE for the disposal of spent nuclear fuel ("SNF"). Payments to DOE are based upon TVA's nuclear generation and charged to nuclear fuel expense. Although the contracts called for DOE to begin accepting SNF from the utilities by January 31, 1998, DOE announced that it will not begin receiving 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.) The Sequoyah and Browns Ferry facilities have been constructed and approved by the NRC and are now in use. 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 court's decision is expected by the end of calendar year 2005. See "*Legal Proceedings*."

Low-Level Radioactive Waste

Low-level radioactive waste (“radwaste”) resulting from the normal operation of nuclear units includes such materials as disposable protective clothing, mops, and filters. Disposal costs for radwaste have increased significantly in recent years. Pursuant to the Low-Level Radioactive Waste Policy Act, each state is responsible for disposal of radwaste generated in that state. States may form regional compacts to jointly fulfill their disposal responsibilities. The states of Tennessee and Alabama (where TVA’s nuclear plants are located) have joined with other southeastern states to form the Southeast Compact Commission for Low-Level Radioactive Waste Management. This commission regulates the siting of new disposal facilities and the disposal of radwaste within the southeastern states.

Until July 1995, the radwaste generators located in the southeastern states were required to dispose of their radwaste at the Barnwell, South Carolina, disposal facility. South Carolina is no longer a member of the interstate compact serving the southeastern states and is now a member of the Atlantic Interstate Low-Level Radioactive Waste Compact. South Carolina has volume caps that cannot be exceeded for radwaste generated in states that are not members of the Atlantic Interstate Low-Level Radioactive Waste Compact. After June 2008, no waste will be accepted from such states, which include Tennessee and Alabama.

After reviewing its storage and disposal options for radwaste management, TVA, in 1999, began temporary self-storage of the type of radwaste that had previously been sent to Barnwell at the storage facilities located at two of TVA’s plant sites. These facilities are sized to handle the anticipated storage needs for the foreseeable life of TVA’s operating plants. A liability was recognized for this undisposed waste. In 2003, TVA resumed shipping the stored waste to Barnwell for disposal, and TVA has contracted to dispose of radwaste at Barnwell through June 2008.

Nuclear Decommissioning Costs

TVA’s current accounting policy for nuclear decommissioning costs recognizes all obligations related to closure and removal of its nuclear units as incurred (see note 5). TVA measures and records such liabilities, at their fair values, in the period in which they are incurred along with an accompanying addition to the recorded cost of the long-lived assets. The fair values of these liabilities represent the present value of the estimated future cash outflows to decommission the assets. The present value of the liabilities is determined by discounting the future cash outflows using a credit-adjusted rate of interest. The recorded amounts for the liabilities and assets may be subsequently modified to comply with the prevailing accounting provisions. Earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 71, “*Accounting for the Effects of Certain Types of Regulation*” (see note 12—*Contingencies—Decommissioning Costs*).

Nuclear Insurance

The Price-Anderson Act establishes a framework for providing coverage for the general public in the event of a nuclear accident. This act, which was established in 1957 by Congress, was renewed for an additional 20 years by the Energy Policy Act of 2005.

The Price-Anderson Act provides a layered framework of protection to compensate for losses arising from a nuclear event. For the first layer, all NRC nuclear plant licensees, including TVA, purchase \$300 million of nuclear liability insurance from American Nuclear Insurers (“ANI”) for each plant with an operating license. The second layer, the Secondary Financial Program (“SFP”), would come from an assessment of up to \$100.6 million from the licensees of each of the 104 NRC licensed reactors in the United States. The assessment for any nuclear accident would be limited to \$15 million per year per reactor. ANI, under a contract with the NRC, administers the SFP. With its six licensed units, TVA could be required to pay a maximum of \$603.5 million per nuclear incident, but it would have to pay no more than \$90 million per incident in any one year. When the contributions of the nuclear plant licensees are added to the insurance proceeds of \$300 million, over \$10.7 billion would be available. Under the Price-Anderson Act, if the first two layers are exhausted, Congress is required to take action to provide additional funds to cover the additional losses.

Nuclear Decontamination and Property Insurance

TVA carries property, decommissioning, and decontamination insurance of \$2.1 billion for its licensed nuclear plants to cover the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums up to a maximum of approximately \$62 million.

Accidental Outage Insurance

TVA purchases accidental outage (business interruption) insurance for TVA's nuclear sites from Nuclear Electric Insurance Limited ("NEIL"). In the event that an accident covered by this policy takes a nuclear unit offline or keeps a nuclear unit offline, NEIL will pay TVA, after a deductible waiting period, an indemnity (a set dollar amount per week) up to a maximum indemnity of \$490 million per unit. This insurance policy may require the payment of retrospective premiums up to a maximum of approximately \$24 million.

Operating License Extensions

In December 2003, TVA submitted an application to the NRC for a 20-year extension of the operating licenses for three reactors at Browns Ferry Nuclear Plant. Current expiration dates of the operating licenses for the Browns Ferry units are:

Browns Ferry Unit 1	2013
Browns Ferry Unit 2	2014
Browns Ferry Unit 3	2016

The original 40-year term on licenses issued pursuant to the Atomic Energy Act and the NRC regulations was based on economic and antitrust considerations and not on limitations of technology. If the NRC approves the application, it will allow TVA to continue production of power from the facilities until 2033, 2034, and 2036 for Units 1, 2, and 3, respectively. The NRC has set a 28-month schedule to review TVA's application. This review is a few months longer than a more standard review due to the complexity and uniqueness of the application, since it involves Browns Ferry Unit 1, which has been shut down for 19 years. The license renewal proceeding is uncontested.

Tritium-Related Services

In September 2002, the NRC issued an amendment to the Watts Bar Nuclear Plant operating license, allowing TVA to irradiate tritium-producing burnable absorber rods ("TPBARS") at the plant to assist DOE in producing tritium. TVA's license amendment currently allows operation with a maximum of 240 TPBARS in the Watts Bar reactor. A planned future license amendment will permit installation of up to 2,304 TPBARS. In general, the TPBARS will be irradiated for a full cycle, which lasts about 18 months. TVA then removes the irradiated TPBARS for shipment to DOE's tritium-extraction facility and loads a fresh set of TPBARS into the reactor. TVA began irradiating TPBARS at Watts Bar in the fall of 2003 with the first removal of TPBARS occurring in the spring of 2005. The first batch of irradiated TPBARS has been successfully shipped to the DOE facility. Also in September 2002, the NRC issued a similar amendment to the Sequoyah Nuclear Plant operating license allowing TVA to provide tritium-related irradiation services. At this time, no tritium-related services have been scheduled at the Sequoyah Nuclear Plant. While irradiating TPBARS, TVA is able to operate the reactors for its program mission of producing electricity. Income related to these services is included in OTHER REVENUE.

TVA has a long-term interagency agreement with DOE to utilize TVA's Sequoyah and Watts Bar Nuclear Plants to irradiate TPBARS. This agreement, ending in 2035, requires DOE to reimburse TVA for costs incurred plus a fee per TPBAR produced for irradiation services.

Stewardship Activities

TVA has federal jurisdiction for managing the United States' fifth largest river system — the Tennessee River and its tributaries — to deliver multiple benefits, including year-round navigation, flood damage reduction, affordable and reliable electricity, and, consistent with these primary purposes, recreational opportunities, adequate water supply, and improved water quality. TVA owns and operates 49 dams which comprise its integrated reservoir system. Twenty-nine of these dams produce conventional hydroelectric power, and one additional project is solely a pumped storage hydroelectric project. The reservoir system provides 800 miles of commercially navigable waterways and also provides significant flood reduction benefits both within the Valley and downstream on the lower Ohio and Mississippi Rivers. Total flood damage averted since the development of the TVA reservoir system is estimated to be over \$5.8 billion. The reservoir system also provides a water supply for residential and industrial customers, including cooling water for TVA thermal power projects.

TVA's responsibilities for managing public resources began with its creation in 1933. It has direct stewardship responsibility for 293,000 acres of public land, 11,000 miles of shoreline, and 650,000 acres of reservoir water surface available for recreation and other purposes. TVA reservoirs and public lands provide outdoor recreation

opportunities for millions of visitors each year. TVA has over 100 recreation facilities including campgrounds, boat ramps, fishing piers, and picnic areas. More than 239,000 acres of the public land managed by TVA have been designated for resource management and recreation, including the enhancement of wildlife habitat, protection of sensitive resources, and development of public recreation facilities.

As of September 30, 2005, TVA's stewardship program manages assets of \$672 million representing multi-purpose dams and reservoirs used for navigation, flood control, recreation, and economic development (see Part I and note 13).

LEGAL PROCEEDINGS

TVA is involved in various claims amounting to approximately \$89 million incidental to the conduct of its business for which it has assessed the likelihood of gain or loss. The claims, grouped by likelihood of loss, include (1) claims recorded by TVA in the amount of \$13 million representing probable losses of \$12 million and losses deemed reasonably possible of \$1 million, and (2) claims of about \$76 million for which a determination of loss cannot be made at this time. (See note 17 — *Legal*.)

In the fall of 1999, the Environmental Protection Agency ("EPA") commenced judicial or administrative actions against a number of utilities in the eastern United States, including TVA, alleging that they modified their coal-fired units without complying with the new source review ("NSR") requirements under the Clean Air Act ("CAA"). Although no decision was rendered on the merits, TVA eventually prevailed in this litigation.

The National Parks Conservation Association ("NPCA") and the Sierra Club filed cases in two federal district courts in 2001 alleging that TVA modified its Bull Run Fossil Plant ("Bull Run") and Colbert Fossil Plant Unit 5 ("Colbert Unit 5") without complying with the NSR requirements of the CAA. In March 2005, the district court granted TVA's motion to dismiss the lawsuit in the Bull Run case. The plaintiffs' motion for reconsideration was denied, and they have appealed to the Court of Appeals for the Sixth Circuit ("Sixth Circuit"). In the Colbert Unit 5 case, the parties have filed motions for summary judgment. The judge has ruled on some but not all of these motions, and dispositive motions remain to be considered. In similar lawsuits filed by EPA and others against other utility companies, the rulings by the respective courts differ widely.

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

- The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert Fossil Plant between July 1, 1997, and June 30, 2002. The groups sought a court order that could require TVA to incur substantial costs, in addition to the costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately \$250 million. On September 14, 2004, the court found that TVA had not violated the CAA, and the complaint was dismissed in its entirety. The plaintiffs have appealed the district court's decision to the Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit"), which held oral argument on the case on August 17, 2005. The parties are awaiting the Eleventh Circuit's decision.
- On July 25, 2003, TVA received a notice of intent to sue from Our Children's Earth Foundation ("OCE"). OCE contends that TVA violated the NSR requirements of the CAA by undertaking major modifications of TVA's Allen Unit 3, Bull Run, Cumberland Units 1 and 2, Kingston Units 6 and 8, John Sevier Unit 3, Paradise Units 1, 2, and 3, Shawnee Units 1 and 4, Colbert Unit 5, and Widows Creek Unit 5 without installing additional pollution control equipment. OCE also contends the CAA new source performance standards at Colbert Unit 5 and the operations at TVA's Johnsonville Fossil Plant have not met the applicable opacity requirements. This notice does not specify a monetary amount of TVA's claimed liability. OCE's allegations about Bull Run and Colbert Unit 5 are already the subject of litigation in federal district courts initiated by the NPCA and the Sierra Club. In 2004, OCE obtained the district court's permission to join as a plaintiff in the Bull Run NSR suit. It made a similar request in the Colbert NSR suit which the court denied as untimely.
- The Sierra Club gave notice in a September 26, 2002, letter that it intends to sue TVA for violating CAA opacity limits applicable to the John Sevier and Kingston Fossil Plants. The notice claims that TVA violated opacity standards at the two plants from July 1, 1997. The alleged opacity violations substantially overlap those that were challenged in a lawsuit filed by the NPCA four years ago in federal court in Knoxville, Tennessee. TVA ultimately prevailed in that lawsuit. The Sierra Club has not filed suit.

For a discussion of TVA's CAA activities, see "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" — "*Environmental Matters*" in Part II.

On December 28, 2001, Bowater Incorporated and Bowater Newsprint South, Inc. (together, "Bowater") filed a lawsuit against TVA in federal court in Knoxville challenging TVA's charges for Economy Surplus Power ("ESP") and Testing and Restart Power ("TRP") for two Bowater plants. The lawsuit sought, among other things, compensatory damages in excess of \$45 million, plus interest. TVA and Bowater settled the lawsuit by entering into revised and extended power supply arrangements at the two plants. The settlement agreement does not require TVA to pay Bowater the damages sought. On March 8, 2005, the court dismissed this case with prejudice.

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the U.S. District Court for the Northern District of Alabama alleging that TVA overcharged for ESP during the summer of 1998. The lawsuit was filed as a class action on behalf of industrial customers who participated in TVA's ESP program. Under ESP contracts, the hourly ESP energy price is calculated using TVA's actual incremental cost of supplying the ESP load in each hour. The plaintiff alleges that TVA overcharged for ESP during the summer of 1998 by including in the price of ESP some costs that were added to TVA's incremental cost. The complaint seeks over \$100 million in damages on behalf of Birmingham Steel and the other class members. In September 2002, the district court decertified the class and then dismissed Birmingham Steel's individual claim without prejudice on a jurisdictional issue. The class lawyers appealed the ruling on class decertification, and in December 2003, the Eleventh Circuit reversed that ruling and sent the case back to the district court to allow the class lawyers a reasonable time to find a new class representative. The district court allowed the substitution of Johns Manville Corporation to represent the class. Motions for summary judgment were filed in October 2005.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of some of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory period. As to the plaintiffs' allegations of federal law violations, the court found that Congress had specifically authorized TVA to set the rates charged by distributors via its contracts. In the face of such express Congressional authorization, the plaintiffs' federal law claims failed as a matter of law and were dismissed with prejudice, precluding them from being brought again. The plaintiffs moved for reconsideration of the dismissal, and the judge denied the plaintiffs' motion. The plaintiffs subsequently appealed to the Sixth Circuit.

In July 2004, two lawsuits were filed against TVA in federal court in New York City alleging that global warming is a public nuisance and that carbon dioxide ("CO₂") 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 CAA requirements limiting CO₂ emissions, and, accordingly, the suits do not involve allegations of regulatory noncompliance. The theory of the cases is that global warming constitutes a nuisance and defendants' CO₂ emissions are contributing to the nuisance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO₂ emissions and then reduce these emissions by a specified percentage each year for at least a decade. The defendants filed motions to dismiss on September 30, 2004. Oral argument was held on the motions on August 12, 2005. 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 Court of Appeals for the Second Circuit.

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with DOE for the disposal of 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 spent nuclear fuel from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools of borated water at its nuclear sites. Although TVA would have had sufficient space to continue to store SNF in those storage pools at its Sequoyah and Browns Ferry Nuclear Plants indefinitely had DOE begun accepting SNF, DOE's failure to do so required TVA to construct dry cask storage facilities at its Browns Ferry and Sequoyah Nuclear Plants and to purchase special storage containers for the SNF. (Watts Bar Nuclear Plant currently has sufficient storage capacity in its spent fuel pool to last until 2018.) Both

Sequoyah's and Browns Ferry's dry cask storage facilities are operational. To recover the cost of providing long-term, on-site storage for SNF, TVA filed a breach of contract suit against the United States in the Court of Federal Claims in 2001. The evidentiary portion of the case for damages through 2004 was completed in Washington D.C. in July 2005. Closing arguments were made in October 2005. A decision is expected before the end of the calendar year 2005.

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 legal proceedings described above except as specifically noted.

CERTAIN PROVISIONS OF THE TENNESSEE VALLEY AUTHORITY ACT AND RELATED LAWS

The following summaries of certain provisions of the Act and related laws are not complete and are qualified in their entireties by reference to the full text of the Act and related laws.

Payments in Lieu of Taxes

TVA is not subject to federal income taxes, and it, its property, franchises, and income are not subject to taxation by states or their subdivisions. However, the Act requires TVA to make payments in lieu of taxes to states and counties in which the Corporation conducts power operations and in which the Corporation has acquired properties previously subject to state and local taxation. The basic amount of these payments is five percent of gross revenues from the sale of power during the preceding year excluding sales or deliveries to other federal agencies and off-system sales to other utilities, with a provision for minimum payments under certain circumstances. During 2005 and 2004, TVA made payments totaling \$365 million and \$338 million, respectively, to the states of Alabama, Georgia, Illinois, Kentucky, Mississippi, North Carolina, Tennessee, and Virginia.

Payments to the Treasury

Initially, TVA's power program was financed with Congressional appropriations (the "Appropriation Investment"). Prior to 1961, TVA paid the Treasury \$185 million in repayment of and as a return on the Appropriation Investment. In 1959, Congress amended the Act to require TVA to make certain payments to the Treasury each year, beginning in 1961, from Net Power Proceeds in excess of those required for debt service as a return on and reduction of the Appropriation Investment. Under the 1959 amendment, TVA is required to repay an additional \$1 billion of the Appropriation Investment, after which TVA would have no further requirement to repay further the Appropriation Investment. Payments under the 1959 amendment began in 1961 (see note 7). The balance of the Appropriation Investment totaled \$428 million as of September 30, 2005, and the remaining amount to be repaid under the 1959 amendment totaled \$170 million as of September 30, 2005. Once TVA fulfills its requirement to repay the \$1 billion portion of the Appropriation Investment under the 1959 amendment, the remaining balance of the Appropriation Investment will be \$258 million (assuming TVA does not receive additional appropriations for its power program). TVA will continue to pay a return to the Treasury on this remaining balance each year.

Net Power Proceeds are defined as the remainder of gross power revenues from TVA's power program

after deducting

- the costs of operating, maintaining, and administering its power properties (including multiple-purpose properties in the proportion that multiple-purpose costs are allocated to power) and
- payments to states and counties in lieu of taxes,

but before deducting

- depreciation accruals or other charges representing the amortization of capital expenditures,

plus

- the net proceeds of the sale or other disposition of any interest in TVA's power properties that constitute an operating unit or system.

Acquisition of Real Estate

The Act empowers TVA to acquire real estate in the name of the United States of America by purchase or by exercise of the right of eminent domain, "and thereupon all such real estate shall be entrusted to the Corporation as the agent of the United States to accomplish the purposes of [the] Act." Thus, all references in this Statement to TVA properties, and to the amounts invested in TVA properties, should be read and construed in the light of this provision of the Act.

Public Law No. 105-62

In October 1997, Congress enacted the Energy and Water Development Appropriations Act, 1998, Pub. L. No. 105-62, 111 Stat. 1320, 1338 (1997). The paragraph captioned "TENNESSEE VALLEY AUTHORITY" in Title IV of this act (the "Appropriations Act Paragraph") requires TVA, beginning with 1999, to fund nonpower programs that constitute "essential stewardship activities" with revenues derived from one or more of various sources, including power revenues, notwithstanding provisions of the Act and power bond covenants to the contrary. These programs historically had been funded primarily with appropriated funds rather than power revenues.

In compliance with the Appropriations Act Paragraph, TVA is and plans to continue funding its essential stewardship activities with funds primarily from its power program (and other funds to the extent available) so long as Congress does not make appropriations available for these activities.

In 1999, the last year TVA received appropriated funds, it spent a total of approximately \$75 million on essential stewardship activities, \$30 million of which was power funds. In 2005 and 2004, TVA spent a total of approximately \$93 million and \$87 million, respectively, on essential stewardship activities.

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

TVA issues Power Bonds pursuant to section 15d of the Act and pursuant to the Basic Resolution. At September 30, 2005, TVA had \$18.7 billion, DM1.5 billion (issued in September 1996), and £600 million (£200 million issued in December 1998, £250 million issued in July 2001, and £150 million issued in June 2003) principal amount of Power Bonds outstanding. TVA may issue Power Bonds only to provide capital for TVA's power program (including refunding any Evidences of Indebtedness issued for like purposes) and only as authorized by law at the time of issuance. However, see also "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*"— "*Public Law No. 105-62*." Power Bonds are payable as to both principal and interest solely from Net Power Proceeds, but TVA may, at its option, pay Power Bonds from the proceeds of refunding obligations or other funds legally available for such payment. Net Power Proceeds (as defined in "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*"— "*Payments to the Treasury*" on page 20) for 2005, 2004, and 2003 were \$2.9 billion, \$3.1 billion, and \$2.8 billion, respectively. Power Bonds of each series must be further authorized by Supplemental Resolution. Power Bonds are not obligations of, or guaranteed by, the United States of America.

TVA intends from time to time to issue new Power Bonds with maturities and terms determined in light of market conditions at the time of sale. TVA may sell new Power Bonds to dealers or underwriters, who may resell the new Power Bonds in public offerings or otherwise. Additionally, TVA may sell new Power Bonds directly or through other entities.

The offering circular, and any appropriate amendment or supplement to the offering circular, for each offering of new Power Bonds, except for new Power Bonds offered under a program on a continuous basis, typically sets forth the following information: (1) the aggregate principal amount, (2) maturity, (3) interest rate or method for determining such rate, (4) interest payment dates, if any, (5) purchase price to be paid to TVA, (6) any terms for redemption or other special terms, (7) form and denomination of new Power Bonds, (8) if applicable, information as to any stock exchange listing, (9) the names of any dealers, underwriters, or agents, (10) a description of any amendments or supplements to the Basic Resolution in connection with the sale of the new Power Bonds, and (11) other terms of the new Power Bonds.

For Power Bonds offered under a program on a continuous basis, TVA typically prepares a single offering circular that describes the general terms and conditions common to all Power Bonds issued under the program. The offering circular typically describes how, if at all, the offering circular will be supplemented in order to reflect, among other things, the specific terms and conditions of the Power Bonds being offered. At the time of each sale, TVA typically determines if the Power Bonds being sold will be subject to redemption prior to the

maturity date and will establish the purchase price, principal amount, interest rate or interest rate formula, maturity date, and certain other terms of such sale.

TVA also issues Discount Notes pursuant to section 15d of the Act and in accordance with section 2.5 of the Basic Resolution. As of September 30, 2005, TVA had approximately \$2.5 billion in Discount Notes outstanding. Discount Notes are payable solely from Net Power Proceeds, but TVA may, at its option, pay Discount Notes from the proceeds of refunding obligations or other funds legally available for such payment. TVA intends to offer Discount Notes for sale on a continuous basis to a group of securities dealers selected by TVA, who will resell the notes. TVA will issue Discount Notes in a form and upon terms and conditions as it deems appropriate. Certain information about Discount Notes is typically set forth in a Discount Notes offering circular and any appropriate supplement to the offering circular. Discount Notes are not obligations of, or guaranteed by, the United States of America.

TVA may issue Other Indebtedness pursuant to section 15d of the Act and in accordance with section 2.5 of the Basic Resolution. An offering circular, and any appropriate amendment or supplement to the offering circular, for each offering of Other Indebtedness typically sets forth the following information: (1) the aggregate principal amount, (2) maturity, (3) interest rate or method for determining such rate, (4) interest payment date(s), (5) purchase price to be paid to TVA, (6) any terms for redemption or other special terms, (7) form and denomination of Other Indebtedness, (8) if applicable, information as to any stock exchange listing, (9) the names of any dealers, underwriters or agents, and (10) other terms of Other Indebtedness. Other Indebtedness will not be obligations of, or guaranteed by, the United States of America.

Income on Evidences of Indebtedness issued by TVA is subject to United States federal income taxation and various other federal tax consequences. There is no special exemption for Evidences of Indebtedness from federal estate and gift taxes. Under the Act, Evidences of Indebtedness are exempt both as to principal and interest from all taxation now or hereafter imposed by any state or local taxing authority except estate, inheritance, and gift taxes. This exemption might not extend to franchise or other nonproperty taxes imposed on corporations or to gain or loss realized upon the sale or exchange of an Evidence of Indebtedness even though such gain might in some cases be treated as interest income for federal income tax purposes.

The following summary of certain provisions of the Basic Resolution is not complete and is qualified in its entirety by reference to the full text of the Basic Resolution. See also "*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*" — "*Public Law No. 105-62.*"

Application of Net Power Proceeds

Section 2.3 of the Basic Resolution provides as follows:

Net Power Proceeds shall be applied, and the Corporation hereby specifically pledges them for application, first to payments due as interest on Bonds, on Bond Anticipation Obligations, and on any Evidences of Indebtedness issued pursuant to section 2.5 which rank on a parity with Bonds as to interest; to payments of the principal due on Bonds for the payment of which other provisions have not been made and on any Evidences of Indebtedness issued pursuant to section 2.5 which rank on a parity with Bonds as to principal and for the payment of which other provisions have not been made; and to meeting requirements of sinking funds or other analogous funds under any Supplemental Resolutions. The remaining Net Power Proceeds shall be used only for:

- (a) Required interest payments on any Evidences of Indebtedness issued pursuant to section 2.5 which do not rank on a parity with Bonds as to interest.
- (b) Required payments of or on account of principal of any Evidences of Indebtedness which do not rank on a parity with Bonds as to principal.
- (c) Minimum payments into the United States Treasury required by the Act in repayment of and as a return on the Appropriation Investment.
- (d) Investment in Power Assets, additional reductions of the Corporation's capital obligations, and other lawful purposes related to the Power Program; provided, however, that payments into the United States Treasury in any fiscal year in reduction of the Appropriation Investment in addition to the minimum amounts required for such purpose by the Act may be made only if there is a net reduction during such year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes, and only

to such extent that the percentage of aggregate reduction in the Appropriation Investment during such year does not exceed the percentage of net reduction during the year in the dollar amount of outstanding Evidences of Indebtedness issued for capital purposes.

Section 2.4 of the Basic Resolution provides as follows:

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

Section 2.5 of the Basic Resolution provides as follows:

To assist in financing its Power Program the Corporation may issue Evidences of Indebtedness other than Bonds and Bond Anticipation Obligations, which may be payable out of Net Power Proceeds subject to the provisions of section 2.3 hereof. Such other Evidences of Indebtedness may rank on parity with but shall not rank ahead of the Bonds as to payments on account of the principal thereof or the interest thereon.

See “*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*” — “*Public Law No. 105-62*” and note 4 in Part II for a discussion of legislation relating to appropriations for TVA’s nonpower programs and the funding of such programs, including the use of power revenues.

Rate Covenant

Section 3.2 of the Basic Resolution provides as follows:

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

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

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

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

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 (discussed in “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” — “*TVA and Competition*” in Part II), it is possible, however, that the ability of TVA’s Board to set TVA’s rates as specified in the TVA Act and the Basic Resolution could be adversely affected by legislative changes or by competitive pressures.

Covenant for Protection of Bondholders’ Investment

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

TVA made the calculation under section 3.3 of the Basic Resolution at the end of 2005 and passed the section 3.3 test as of September 30, 2005. Before TVA calculated the Section 3.3 Amount, it had concluded and previously disclosed that write-downs are generally not included in the Section 3.3 Amount because write-downs do not constitute depreciation or amortization under generally accepted accounting principles. Accordingly, when it calculated the Section 3.3 Amount at the end of 2005, TVA excluded most of the write-down that occurred in 2001. In 2001, TVA identified assets that would not be recovered in future rates and reduced the value of these assets by a total of \$3.4 billion. Of this amount \$2.2 billion was attributable to deferred nuclear generating units, \$789 million was attributable to deferred debt refinancing costs, and \$410 million was attributable to plant held for future use. Of these amounts, only the \$789 million of deferred debt refinancing costs was included in the section 3.3 test calculation in 2005 because this amount was being amortized at the time it was written down.

Issuance of Additional Bonds and Other Evidences of Indebtedness

The Act limits the issuance of Evidences of Indebtedness by TVA to a total of \$30 billion outstanding at any one time. At September 30, 2005, TVA had approximately U.S. \$21.2 billion, DM1.5 billion (issued in September 1996), £600 million (£200 million issued in December 1998, £250 million issued in July 2001, and £150 million issued in June 2003) of Evidences of Indebtedness outstanding. The Basic Resolution and the Act permit the issuance of Power Bonds only to finance TVA’s power program, including the refunding of any Evidences of Indebtedness issued for that purpose. However, see also “*Certain Provisions of the Tennessee Valley Authority Act and Related Laws*” — “*Public Law No. 105-62.*”

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

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

TVA may also issue Evidences of Indebtedness other than Power Bonds and Bond Anticipation Obligations, such as Discount Notes, to assist in financing TVA’s power program. They may be payable out of Net Power Proceeds subject to the provisions of section 2.3 of the Basic Resolution. They may not rank ahead of the Power Bonds as to principal or interest.

Mortgaging and Disposal of Power Properties

TVA may not mortgage any part of its power properties and may not dispose of all or any substantial portion of these properties unless it provides for a continuance of the interest, principal, and sinking fund payments due and to become due on all outstanding Evidences of Indebtedness, or for the retirement of such Evidences of Indebtedness. Conditions for disposal of property are outlined in sections 4(k) and 31 of the Act. Section 31 of the Act provides that no real estate shall be held except what is necessary in the opinion of the Board to carry out TVA’s plans and projects. This finding is made by the Board in its approval of the disposal. TVA may also dispose of property in certain circumstances in connection with the construction of power facilities under section 15d(g).

Modifications of Resolutions and Outstanding Bonds

The Basic Resolution provides for amendments to it, to any Supplemental Resolution, and to any outstanding Power Bonds. Generally, TVA may make amendments to the respective rights and obligations of TVA and the bondholders with the written consent of the holders of at least 66 $\frac{2}{3}$ percent in principal amount of the outstanding Power Bonds to which the amendment applies. However, TVA may not make changes in the maturity of the principal of any Power Bond or any interest installment thereon or reduction in the principal amount, redemption premium, or rate of interest with respect to any Power Bond, or in the above percentage for any such consent, without the consent of the holder of such Power Bond.

Additionally, TVA may amend the Basic Resolution or any Supplemental Resolution without the consent of the bondholders in order (1) to close the Basic Resolution against the issuance of additional Power Bonds or to restrict such issuance by imposing additional conditions or restrictions; (2) to add other covenants and agreements to be observed by TVA or to eliminate any right, power, or privilege conferred upon TVA by the Basic Resolution; (3) to modify any provisions to release TVA from any of its obligations, covenants, agreements, limitations, conditions, or restrictions, provided that such modification or release shall not become effective with respect to any Power Bonds issued prior to the adoption of such amendment; (4) to correct any defect, ambiguity, or inconsistency in, or to make provisions in regard to matters or questions arising under, the Basic Resolution or any Supplemental Resolution, so long as such amendments are not contrary to, or inconsistent with, the Basic Resolution or such Supplemental Resolution; or (5) to make any other modification or amendment which the Board by resolution determines will not materially and adversely affect the interests of holders of the Power Bonds; provided, however, that no such amendatory resolution shall be deemed to waive or modify any restriction or obligation imposed by the Basic Resolution or any Supplemental Resolution upon TVA in respect of, or for the benefit of, any of the then outstanding Power Bonds.

Events of Default

Any of the following shall be deemed an Event of Default under the Basic Resolution: (1) default in the payment of the principal or redemption price of any Power Bond when due and payable at maturity, by call for redemption or otherwise; (2) default in the payment of any installment of interest on any Power Bond when due and payable for more than 30 days; or (3) failure of TVA to duly perform any other covenant, condition, or agreement contained in the Power Bonds or in the Basic Resolution or any Supplemental Resolution for 90 days after written notice specifying such failure has been given to TVA by the holders of at least five percent in aggregate principal amount of the then-outstanding Power Bonds.

Upon any such Event of Default, the holders of the Power Bonds may proceed to protect and enforce their respective rights, subject to the restrictions described below. The holders of at least five percent in aggregate principal amount of Power Bonds then outstanding shall, subject to certain restrictions, have the right and power to institute a proceeding (1) to enforce TVA's covenants and agreements, (2) to enjoin any acts in violation of the rights of holders of Power Bonds, and (3) to protect and enforce the rights of holders of Power Bonds. Such holders have no right to bring any such action or proceeding against TVA unless they have given TVA written notice of an Event of Default and TVA has had a reasonable opportunity to take appropriate corrective action with respect thereto and has failed or refused to do so. Power Bonds do not provide for acceleration upon an Event of Default.

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

Fourth Amendatory Resolution to the Basic Resolution

On March 25, 1992, TVA adopted a resolution amending the Basic Resolution, entitled "Fourth Amendatory Resolution to Basic Tennessee Valley Authority Power Bond Resolution," that (1) deleted from the Basic Resolution limitations on issuance of Power Bonds formerly set forth as section 3.4 thereof and (2) amended the Basic Resolution to permit issuance of other Evidences of Indebtedness under section 2.5 thereof that rank on a parity with Power Bonds as to principal and interest. With the deletion of section 3.4 of the Basic Resolution, sections 3.5 through 3.10 were renumbered as appropriate. This amendatory resolution became effective December 16, 1999, with retroactive application to all Power Bonds issued after March 25, 1992.

PART II

SELECTED FINANCIAL DATA

The following selected financial data for the years 2001 through 2005 should be read in conjunction with the audited financial statements and notes thereto (collectively, the "Financial Statements") presented in "Financial Statements and Supplementary Data." Certain reclassifications have been made to the 2003, 2002, and 2001 financial statements to conform to the 2004 and 2005 presentation.

STATEMENTS OF INCOME DATA (in millions)

For the years ended September 30

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Operating revenues	\$ 7,794	\$ 7,533	\$ 6,953	\$ 6,798	\$ 6,896
Operating expenses	<u>(6,503)</u> ⁽¹⁾	<u>(5,873)</u> ⁽²⁾	<u>(5,398)</u>	<u>(5,323)</u> ⁽³⁾	<u>(5,445)</u>
Operating income	1,291	1,660	1,555	1,475	1,451
Other income, net	33	37	29	17	258
Unrealized gains (losses) on derivative contracts, net	3	(7)	(7)	—	—
Loss on asset impairment	—	—	—	—	(3,419) ⁽⁴⁾
Interest expense, net	(1,242)	(1,304)	(1,350)	(1,429)	(1,633)
Cumulative effect of accounting changes	<u>—</u>	<u>—</u>	<u>217</u> ⁽⁵⁾	<u>—</u>	<u>—</u>
NET INCOME (LOSS)	<u>\$ 85</u>	<u>\$ 386</u>	<u>\$ 444</u>	<u>\$ 63</u>	<u>\$ (3,343)</u>

Notes:

- (1) During 2005, TVA recognized a total of \$24 million in impairment losses related to its property, plant and equipment. The losses included a \$16 million write-down of certain CONSTRUCTION IN PROGRESS assets related to new pollution-control and other technologies that had not been proven effective, and an \$8 million write-down on one of two buildings in TVA's Knoxville Office Complex ("KOC") based on TVA's desire, intent, and plans to sell or lease the East Tower of the KOC. See note 6.
- (2) During 2004, TVA was notified by a supplier that it would not proceed with manufacturing of fuel cells to be installed in the partially completed Regenesys energy storage plant in Columbus, Mississippi. Accordingly, TVA recognized a net \$20 million loss on the cancellation of the Regenesys project. See note 1 — *Project Cancellation*.
- (3) Due to changes in the market forecast, TVA elected not to complete a gas-fired combine cycle plant in 2002. TVA recognized a \$154 million loss related to the cancellation of this project.
- (4) During 2001, TVA identified certain assets for which the estimated cash flows provided through future rates were likely to be less than recorded book values. Accordingly, a \$3,419 million impairment loss was recognized.
- (5) The cumulative effects of \$217 million are due to two accounting changes. Effective October 1, 2002, the Board approved a change in the methodology for estimating unbilled revenue from electricity sales. The impact of this change resulted in an increase in accounts receivable of \$412 million with a corresponding cumulative effect gain for the change in accounting for unbilled revenue. In addition, TVA adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," which resulted in a cumulative effect charge to income of \$195 million and an increase in accumulated depreciation of \$206 million. See note 1 — *Accounting Changes*.

BALANCE SHEETS DATA
(in millions)

At September 30

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Assets					
Current assets	\$ 2,269	\$ 2,386	\$ 2,321	\$ 1,682	\$ 1,624
Property, plant, and equipment, net.	23,888	23,699	23,125	22,175	22,152
Investment funds	858	744	638	510	606
Regulatory and other long-term assets	<u>7,551</u>	<u>7,451</u>	<u>7,027</u>	<u>6,522</u>	<u>6,061</u>
TOTAL ASSETS	<u>\$ 34,566</u>	<u>\$ 34,280</u>	<u>\$ 33,111</u>	<u>\$ 30,889</u>	<u>\$ 30,443</u>
Liabilities and proprietary capital					
Current liabilities	\$ 6,817	\$ 5,511	\$ 5,902	\$ 4,811	\$ 6,339
Regulatory and other liabilities.	7,606	7,168	5,114	3,304	2,806
Long-term debt, net of discount.	<u>17,751</u>	<u>19,337</u>	<u>20,201</u>	<u>21,358</u>	<u>19,851</u>
Total liabilities	<u>32,174</u>	<u>32,016</u>	<u>31,217</u>	<u>29,473</u>	<u>28,996</u>
Retained earnings	1,244	1,162	783	349	306
Other proprietary capital	<u>1,148</u>	<u>1,102</u>	<u>1,111</u>	<u>1,067</u>	<u>1,141</u>
Total proprietary capital	<u>2,392</u>	<u>2,264</u>	<u>1,894</u>	<u>1,416</u>	<u>1,447</u>
TOTAL LIABILITIES AND PROPRIETARY CAPITAL	<u>\$ 34,566</u>	<u>\$ 34,280</u>	<u>\$ 33,111</u>	<u>\$ 30,889</u>	<u>\$ 30,443</u>

FINANCIAL OBLIGATIONS
(in millions)

At September 30

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Long-term debt, including current maturities *	\$ 20,671	\$ 21,439	\$ 22,760	\$ 21,543	\$ 22,038
Other financial obligations					
Capital leases	150	138	151	162	172
Lease/leaseback commitments	1,143	1,178	1,238	561	271
Energy prepayment obligations	<u>1,350</u>	<u>1,455</u>	<u>47</u>	<u>—</u>	<u>—</u>
Total other financial obligations	<u>2,643</u>	<u>2,771</u>	<u>1,436</u>	<u>723</u>	<u>443</u>
Total long-term obligations	<u>23,314</u>	<u>24,210</u>	<u>24,196</u>	<u>22,266</u>	<u>22,481</u>
DISCOUNT NOTES	<u>2,469</u>	<u>1,924</u>	<u>2,080</u>	<u>3,492</u>	<u>3,016</u>
FINANCIAL OBLIGATIONS	<u>\$ 25,783</u>	<u>\$ 26,134</u>	<u>\$ 26,276</u>	<u>\$ 25,758</u>	<u>\$ 25,497</u>

For additional discussion on long-term obligations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Liquidity and Capital Resources" — "Cash Requirements and Contractual Obligations."

* Includes foreign currency transaction (losses) gains of (\$52) million, (\$113) million, \$35 million, \$220 million, and \$321 million for 2005, 2004, 2003, 2002, and 2001, respectively.

**COMPARATIVE FIVE-YEAR DATA
STATISTICAL AND FINANCIAL SUMMARIES**

	For the years ended September 30				
	2005	2004	2003	2002	2001
Sales (millions of kWh) ^(a)					
Municipalities and cooperatives	136,640	133,161	130,769	128,600	129,760
Industries directly served	30,872	29,344	27,756	26,478	23,306
Federal agencies and other	3,986	3,353	3,009	3,579	5,967
Total sales	<u>171,498</u>	<u>165,858</u>	<u>161,534</u>	<u>158,657</u>	<u>159,033</u>
Operating revenues (millions of dollars) ^(a)					
Electric					
Municipalities and cooperatives	\$ 6,561	\$ 6,457	\$ 5,974	\$ 5,856	\$ 5,908
Industries directly served	962	842	781	732	659
Federal agencies and other	181	140	120	120	226
Other	90	94	78	90	103
Total revenues	<u>\$ 7,794</u>	<u>\$ 7,533</u>	<u>\$ 6,953</u>	<u>\$ 6,798</u>	<u>\$ 6,896</u>
Electric revenue per kWh (cents)	4.48	4.49	4.26	4.23	4.27
Winter net dependable generating capacity (megawatts) ^(b)					
Hydro	5,104	4,981	5,022	4,924	4,941
Fossil	15,075	15,076	15,029	15,023	15,050
Nuclear units in service	5,790	5,777	5,776	5,751	5,715
Combustion turbine and diesel generators ^(c)	4,675	4,685	4,655	4,643	3,923
TVA facilities	30,644	30,519	30,482	30,341	29,629
Other facilities	3,337	2,670	1,176	1,176	736
Total long term available capacity ^(d)	<u>33,981</u>	<u>33,189</u>	<u>31,658</u>	<u>31,517</u>	<u>30,365</u>
System peak load (megawatt)—summer	31,924	29,966	28,530	29,052	27,368
System peak load (megawatt)—winter	29,278	27,997	29,866	26,061	27,163
Percent gross generation by fuel source					
Fossil	62%	61%	60%	63%	64%
Hydro	10%	9%	11%	6%	6%
Nuclear	28%	30%	29%	30%	29%
Combustion turbine	<1%	<1%	<1%	1%	1%
Fuel cost per kWh (cents)					
Fossil	1.65	1.48	1.43	1.39	1.32
Combustion turbine	11.44	9.01	7.61	4.65	6.07
Nuclear	0.39	0.39	0.39	0.41	0.44
Aggregate fuel cost per kWh net thermal generation	1.30	1.14	1.14	1.11	1.08

Notes:

- (a) Sales and revenues have been adjusted to include sales to other utilities and to exclude interdivisional sales.
- (b) See "Properties" — "Generating Resources" in Part I.
- (c) As of September 30, 2005, includes twenty-four 85-megawatt units subject to lease/leaseback arrangements.
- (d) Total summer NDC for 2005, 2004, 2003, 2002, and 2001 was approximately 32,259 megawatts, 32,059 megawatts, 30,743 megawatts, 30,477 megawatts, and 29,405 megawatts, respectively.

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

(Dollars in million except where noted)

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") explains the results of operations and general financial condition of TVA. In this MD&A, TVA's future outlook is discussed as well as its regulatory environment and liquidity and capital resources. The MD&A then discusses the results of operations, both operational and financial, critical accounting policies and estimates, risk management activities, accounting changes, and new accounting pronouncements. Finally, TVA's competitive and regulatory environment and business strategy are discussed as well as environmental matters, subsequent events, and various uncertainties that could affect future results of operations. The MD&A should be read in conjunction with the Financial Statements.

Overview

The power industry is changing, and it is anticipated that TVA's customers could eventually have a choice of suppliers. Potential changes in the market could affect TVA, its stakeholders, and the way it fulfills its obligations. TVA's financial health in the future will depend on what changes may come and how well it is able to adapt to those changes. Over the next several years, TVA plans to concentrate on four specific areas:

- Developing new, more highly differentiated prices, services, and contract terms that more closely tie the cost and the risk of the product to its terms and pricing. During the past year, work has focused on developing long-term contract terms and conditions that would provide value to distributors and help strengthen TVA's financial viability under competition, assessing how different wholesale rate structures would impact TVA's ability to compete in wholesale markets, and developing a new industrial portfolio to better align the cost and risk of production with the prices that customers pay.
- Addressing the range of issues related to wholesale market design and transmission pricing, including how TVA will interface with the markets that are expected to surround it, as well as how TVA will price transmission services within its service area when distributors can choose other suppliers.
- Increasing cash flow through cost reductions and rate increases in order to accelerate reduction in total financing obligations and to provide the financial flexibility needed to tolerate the higher levels of revenue and cost volatility associated with a more competitive market.
- Maintaining and operating its generation and transmission assets so that it can continue to fulfill its supply obligations in a safe and reliable manner.

Customers

In October 2003, TVA implemented a multi-part rate action, which included a rate adjustment and a rate change.

On July 22, 2005, the Board approved a 7.52 percent increase in firm wholesale electric rates effective on October 1, 2005. The rate increase is expected to provide additional revenues of approximately \$524 million in fiscal year 2006. See "*Liquidity and Capital Resources*" — "*Rate Actions*" below.

Notwithstanding the rate increases, the total average retail rates in the TVA service area remain competitive with other areas of the region and below the national average.

In addition to rates charged to customers, TVA is developing new, more differentiated prices, services, and customer contracts that more closely tie risk, cost, and product differences to pricing (see "*Business*" — "*Rates and Customers*" in Part I).

Wholesale Market Design and Transmission Pricing

By the late 1990s, the nation appeared to be well on its way to restructuring both wholesale and retail electricity markets. Recently, however, market and regulatory events have increased the uncertainty about the ultimate outcome and timing of electricity market restructuring in the United States. Despite the current uncertainty, TVA believes that wholesale customer choice is likely to continue to evolve in its service territory.

While TVA is generally not subject to Federal Energy Regulatory Commission (“FERC”) jurisdiction, TVA complies with FERC transmission regulations where consistent with the provisions of the TVA Act and other provisions of federal law. Several fully integrated utilities, as well as regional transmission organizations, now border TVA, and all operate under FERC regulations. TVA will continue to operate within the bounds of applicable laws and regulations and will adapt as they may change in the future. In addition, TVA is voluntarily seeking ways to meet FERC’s objective to improve regional transmission operations in a manner consistent with TVA’s responsibilities under the TVA Act.

Reduction of Total Financing Obligations

In 2004, TVA redoubled its efforts to reduce debt and certain debt-like instruments in its capitalization, collectively called “total financing obligations,” which include debt, lease/leaseback obligations, and energy prepayments. Due to the uneven nature of TVA’s expenditures both for expense and capital cost, the amount of total financing obligations that TVA can retire will vary in each year as a function of its margin on power sales, its ability to control its operating costs, and requirements for capital. Capital requirements generally can be broken down into base capital needed to sustain existing plant, environmental capital such as the funds required to build facilities that reduce emissions on TVA’s fossil fleet, and growth capital such as that needed for increasing the capacity of TVA’s generating plants and transmission grid.

The reduction in total financing obligations is being considered under several options, and in combination with and in the context of, setting multi-year annual performance plans and budgets, including:

- Continued emphasis on cost reduction through process improvements,
- Asset improvements to increase performance,
- Capital rationing:
 - Deferring and/or canceling capital projects when necessary and appropriate,
 - Synchronizing investment criteria with the changing portfolio of customer contracts and commitments, and
- Rate adjustments and rate changes consistent with changes in market and power supply conditions.

Principal threats to TVA’s ability to reduce total financing obligations are loss of load, increased operating expenses (including fuel), need for new base load generation, and unforeseen capital costs due to changing environmental standards that are not made up through rate increases. TVA evaluates business conditions, regulations, and costs to identify ways to improve financial flexibility.

Maintain Assets

While it is unclear how competitive markets will affect TVA in the future, even indirect competitive pressure will mean that TVA’s financial health will be more dependent on its ability to control expenses, while keeping power rates competitive.

TVA is working to reduce its total financing obligations, improve efficiency, and maintain the viability of its generating fleet so that it will continue to be the provider of choice for its customers in a competitive environment. TVA’s generating fleet, supplemented by purchased power, as appropriate, is expected to be adequate to meet demand in TVA’s service area for the next ten years, especially as Browns Ferry Nuclear Plant Unit 1 is brought on line. This unit is expected to begin operations in 2007 and is expected to add 1,280 megawatts of energy to TVA’s system and have the effect of reducing TVA’s cost of power.

Part of maintaining the viability of TVA’s generating fleet involves investment of capital in the maintenance of fleet assets. TVA, along with other electric utilities, is challenged by an aging fleet of coal-fired generating units. Eight of TVA’s 11 coal plants are more than 40 years old and require capital investment to maintain performance and availability. TVA’s nuclear plants require ongoing capital investment to maintain plant reliability and performance. In addition, nuclear plants occasionally require investment to address new regulatory requirements or design-specific plant aging and degradation, such as the replacement of steam generators in certain reactors. TVA’s hydro plants are also aging – the average actual age of TVA’s hydro units is more than 65 years. TVA is in the midst of a long-term capital improvement program that will modernize the power production equipment at major hydro facilities.

TVA expects to have adequate cash flow in coming years to be able to complete its current clean air commitments and currently planned investments in its power system. This includes currently planned expenditures for maintenance of existing power system assets. However, new environmental mandates, other required expenditures, or a decline in power demand, among other things, could threaten expected cash flows.

Economic Outlook

TVA's current load forecast through 2007 reflects an average annual energy growth rate of 1.4 percent. Numerous factors, such as weather conditions and the health of the regional economy, could cause actual results to differ materially from TVA's forecasts. TVA's regional economic outlook is a major driver of its sales forecast. The health of the regional economy can be measured in three ways. Generally, population is most important for residential sales, employment for commercial sales, and regional gross domestic product for manufacturing sales. The estimated growth rates through 2007 from TVA's economic outlook are:

	Range of Forecast		
	High	Medium	Low
Regional Gross Domestic Product	5.1%	3.4%	1.3%
Total Nonfarm Payroll Employment	2.9%	1.5%	-0.4%
Total Population	1.6%	1.0%	0.4%

For additional information on TVA's longer-term future outlook, see *"TVA and Competition"* and *"Business Strategy"* — *"Strategic Plan"* below.

Legislative and Regulatory Matters

TVA Governance

In December 2004, the Consolidated Appropriations Act, 2005, was signed by the President as Public Law No. 108-447. This legislation restructures the Board by increasing the number of directors from three full-time members to nine part-time members, at least seven of whom must be legal residents of the TVA service area. As with the current Board, future Board members will be appointed by the President and confirmed by the Senate, but will serve, after a transition period, five-year terms rather than the current nine-year terms. The Board's role will continue to be, among other things, to develop long-term plans and strategies for TVA, approve annual budgets and an employee compensation plan for TVA, and have general responsibility for TVA policies. The Board will also create an audit committee consisting of members of the Board "independent of the management" to review reports from TVA's external auditors and Inspector General and make recommendations to the full Board. Congress also reaffirmed the authority of the Board to set electric rates charged by TVA. These provisions will go into effect on the date when at least three new Board members take office.

The legislation also creates the position of Chief Executive Officer ("CEO") for TVA. The CEO will be appointed by the Board and will be responsible for development and implementation of TVA's strategic direction. The CEO will serve at the pleasure of the Board.

The legislation also amends the Securities Exchange Act of 1934 to provide that beginning with its annual report for fiscal year 2006, TVA will be required to file annual reports (10-Ks), quarterly reports (10-Qs), and current reports (8-Ks) with the SEC. Also, TVA will be deemed an issuer for some of the audit-related provisions of section 10A of the Securities Exchange Act of 1934 but not for those provisions of section 10A that are inconsistent with TVA's structure under the TVA Act. The legislation does not require TVA to register securities under either the Securities Act of 1933 or the Securities Exchange Act of 1934. The legislation provides that TVA securities are "government securities" under the Securities Exchange Act of 1934, and that nothing in the amendment interferes with or affects the Board's authority to carry out its statutory functions under the TVA Act.

The American Jobs Creation Act of 2004, H.R. 4520, was signed by the President in October 2004 as Public Law No. 108-357. It contains provisions designed to limit the use of sale/leaseback and lease/leaseback financings by tax-exempt entities, such as TVA. TVA has used lease/leaseback financings in the last several years and obtained a more favorable financing rate than it would have obtained by issuing bonds. These provisions of H.R. 4520 will reduce or eliminate the attractiveness of using lease/leaseback transactions as a financing alternative for TVA in the future.

Energy Bill

On August 8, 2005, President Bush signed H.R. 6, the wide-ranging energy bill, as Public Law No. 109-58. Among other things, the legislation provides incentives to energy companies, including tax breaks and loan guarantees for new nuclear power plants, clean coal technology and wind energy. Provisions in the bill relevant to TVA include:

- TVA is subject to FERC review of transmission rates and terms and conditions of service to ensure comparability of treatment of its and others regarding the same transmission service. The bill also reaffirms the Anti-Cherry-picking Provision in providing that TVA distributors will be afforded native load preference regarding firm transmission rights on the TVA transmission system, but in a way that (i) will not affect the requirements of the Anti-Cherry-picking Provision and (ii) will not itself provide a new basis for any FERC order that would be contrary to the purposes of the Anti-Cherry-picking Provision. (Native load refers to the customers on whose behalf a company, by statute, franchise, regulatory requirement, or contract, has undertaken an obligation to serve. The Anti-Cherry-picking Provision provides that FERC cannot order TVA to deliver power from a non-TVA source to a customer if the power would be consumed within TVA's defined service territory. See "*Risk of Loss of Customers*" below.)
- FERC's authority to order refunds of excessive prices on short-term sales (transactions lasting 31 days or less) in market manipulation and price gouging situations is expanded to include authority over TVA if TVA makes such sales under a FERC approved tariff.
- TVA is subject to new prohibitions on (i) using manipulative or deceptive devices or contrivances in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to jurisdiction and (ii) willfully and knowingly reporting false information on the price of electricity sold at wholesale or the availability of transmission capacity to a federal agency with intent to fraudulently affect the data being compiled by the agency. TVA is also subject to FERC's investigative and enforcement authority in these two areas.
- FERC is authorized to issue regulations requiring the reporting, on a timely basis, of information about the availability and prices of wholesale electric energy and transmission service by all market participants, including TVA.
- FERC is also directed to help transform the current national and regional, contractually-based, electric reliability councils into regulatory agencies. As such, the resulting electric reliability organizations, with FERC oversight, will exercise federal regulatory authority over utilities, including TVA, rather than rely on contractually-based reliability standards. The exact nature of these new regulatory bodies has not yet been fully determined.
- Three new standards are added to the Public Utility Regulatory Policies Act ("PURPA"), requiring TVA, as a "state" regulatory authority, to consider its suitability for application to distributors and itself. The new standards to be considered are (i) net metering, (ii) smart metering, and (iii) interconnection.
- TVA is authorized to participate in regional transmission organizations ("RTOs"), but only under contractual relationships that (i) do not impair the requirements of federal laws and contracts, (ii) set performance standards to assure that the federal transmission assets in question are managed in ways consistent with federal laws and contracts, and (iii) enable withdrawal from the RTO if those performance standards are not met.

In summary, the impacts of this energy bill on TVA directly will primarily be in regulatory process and administrative cost. TVA has not joined a RTO, but currently has a Joint Reliability Coordination Agreement with the Midwest Independent Transmission System Operator, Inc. ("Midwest ISO") and PJM Interconnection that provides for cooperation in the management and operation of the electric transmission grid over a major portion of the eastern United States and for the coordination of planning and congestion management to ensure reliability and market liquidity in the Eastern Interconnection.

Environmental

In March 2005, the EPA issued its final Clean Air Interstate Rule ("CAIR") that requires certain states to reduce sulfur dioxide ("SO₂") and nitrogen oxide ("NO_x") emissions from fossil-fuel fired power plants to eliminate interstate pollutant transport in significant amounts. All states served by TVA would be subject to CAIR. CAIR allows the trading of credits to satisfy its requirements.

In March 2005, the EPA also released its final Clean Air Mercury Rule that would limit annual mercury emissions collectively from power plants to 38 tons in 2010 and 15 tons in 2018. The final rule also allows the trading of credits to satisfy requirements.

A number of existing environmental regulatory programs have been and are being made more stringent in their application to fossil-fuel units, and additional regulatory programs potentially affecting fossil-fuel units have been proposed. The total cost of future compliance with NO_x, SO₂, and mercury reduction requirements and other environmental-related requirements cannot reasonably be determined at this time because of the uncertainties, among other things, surrounding emerging regulations, resultant compliance strategies, potential for the development of new emission control technologies, litigation, and future amendments to the Clean Air Act (see note 12 — *Environmental Matters*). Litigation over emissions from coal-fired generating units is growing, including litigation against TVA (see *Legal Proceedings* in Part I). It is not possible to predict with any precision how these developments will impact the operation of existing and new fossil-fuel generating units. It is virtually certain that environmental requirements placed on the operation of fossil-fuel generating units will become more restrictive.

Other Matters

In July 2005, Senator Jim Bunning (R-KY) and Senator Mitch McConnell (R-KY) introduced S.1499, a bill that would effectively remove any area within Kentucky from coverage by the Anti-Cherry-picking Provision. See *Management's Discussion and Analysis of Financial Condition and Results of Operations* — *Risk of Loss of Customers* for further discussion of the Anti-Cherry-picking Provision. If the bill were to become law, FERC could 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 bill was referred to and remains in the Senate Energy and Natural Resources Committee.

In June 2005, OMB transmitted draft legislation to Congress that would expand the type of evidences of indebtedness that count toward TVA's \$30 billion debt ceiling. Under this legislation, long-term obligations that finance capital assets would count toward the debt ceiling, including lease-leaseback arrangements and power prepayment agreements whose original term exceeded one year. This legislation, which would be effective for transactions into which TVA entered after December 31, 1999, has not yet been introduced in Congress.

It is difficult to predict whether the initiatives discussed above will become law in the future and what their impact would be on TVA.

Liquidity and Capital Resources

Capital Structure

TVA is very different from investor-owned utilities ("IOUs") in its capital structure. Primarily during the first 25 years of TVA's existence, the U.S. Government made appropriation investments in TVA power facilities. In 1959, TVA was authorized by statute to issue bonds in order to finance its growing power program. Since that time, TVA's power program has been required to be self-supporting. As a result, TVA funds its capital requirements through internal cash generation, through borrowings (subject to a congressionally-mandated \$30 billion limit on the amount of Evidences of Indebtedness outstanding), and through other financing arrangements including customer prepayments and lease/leaseback transactions.

TVA's Power Bonds are currently rated "Aaa" by Moody's Investors Service and "AAA" by Standard and Poor's and Fitch Ratings (the "rating agencies"). TVA's capital structure is composed primarily of debt and reflects a strong credit rating and investor confidence, both of which are important to TVA's financial health. TVA's current ratings are based to a large extent upon the body of legislation that defines TVA's business structure, including the Board's ratemaking authority and TVA's status as a corporate agency and instrumentality of the U.S. Government. TVA's current debt, including its short-term debt, is either retired or refinanced as it matures. A reduction in TVA's credit rating could impact its currently expected cash flows, which could result in some combination of the need to increase borrowings, the need to reduce other expenses or capital expenditures, and the need to increase rates. Other factors that could potentially create volatility for TVA's cash flows include, among other things, changes in legislation, load changes or shifts, and weather extremes.

TVA is required to pay the U.S. Government a return on the appropriation investment in TVA power facilities ("Appropriation Investment"), plus a repayment of the investment as specified by law. The combined payment for 2005 was \$36 million. Cumulative repayments and return on investment paid by TVA to the U.S. Treasury ("Treasury")

approximate \$3.6 billion. Approximately \$1.0 billion of the \$1.4 billion Appropriation Investment has been repaid. See note 7 — *Appropriation Investment*.

**Appropriation Investment in Power Program
as of September 30, 2005**

Appropriations from Congress	\$ 1,419
Transfers of Property to TVA	24
Transfers of Property from TVA	—
Program Expenditures	—
Repayments to U.S. Treasury	(1,015)
	\$ 428

When monitoring its financial condition, TVA considers its ability to generate adequate cash flow from operations, the extent to which cash flow covers interest expense, and the proportion of interest expense to the amount of revenue generated. TVA has recently improved these measures and is committed to improving its financial flexibility in the future. Nonetheless, TVA is very dependent upon liquidity provided by the capital markets in order to run its business and refinance its debt. Loss of its current ratings, loss of access to the capital markets, or an inability to recover its costs, among other things, could lead to potentially severe financial distress.

Cash Flow

Because TVA's business is highly influenced by seasonal and economic factors, it is helpful to look at average cash flow over a multi-year period.

TVA's summary cash flows for the years ended September 30 are:

	Years ended September 30		
	2005	2004	2003
Cash provided by (used in):			
Operating activities	\$ 1,346	\$ 3,191	\$ 1,629
Investing activities	(1,072)	(1,619)	(1,942)
Financing activities	(255)	(1,586)	446
Net increase (decrease) in cash and cash equivalents	\$ 19	\$ (14)	\$ 133

Excluding the \$1.5 billion energy prepayment transaction in 2004 (see "*Energy Prepayment Obligations*" — "*Prepayment of Energy Services*" below), TVA's cash from operations was \$1.3, \$1.7 and \$1.6 billion for 2005, 2004, and 2003, respectively. This positive trend is a continuation of increases in cash generated from operations since the mid 1990's. With the upward trend in cash from its power operations coupled with a downward trend in investing activities, primarily due to a reduction in capital spending, TVA has been able to use funds to reduce its financing obligations as shown in the table above. TVA continues to assess other factors that could create volatility for its cash flows including, among other things, changes in legislation, volatility of fuel and purchased power costs, load changes or shifts, and weather extremes.

2005 Compared to 2004

Net cash provided by operating activities decreased \$1.9 billion from \$3.2 billion in 2004 to \$1.3 billion in 2005. This decrease resulted from:

- Proceeds of \$1.5 billion received in 2004 for energy prepayments not present in the current year;
- Decreased cash provided from net income components of \$218 million;
- An increase in expenditures for nuclear refueling outages of \$36 million due to the number and timing of outages; and
- An increase in other deferred items of \$28 million primarily due to increased contributions to the TVA Retirement System.

Net cash used by changes in working capital components increased \$59 million from \$10 million in 2004 to \$69 million in 2005. The unfavorable working capital fluctuation primarily resulted from:

- A larger increase of \$71 million in accounts receivable due to increased sales volume during the summer months;
- An increase in inventories and prepaid expenses of \$12 million in 2005, compared to a decrease in inventories and other of \$10 million in 2004 due to purchases of emission allowances and prepayment of insurance premiums for new programs in 2005; and
- A larger decrease in accrued interest of \$17 million due to a lower level of total outstanding debt during 2005 as compared to 2004.

These items were partially offset by:

- A larger increase of \$51 million in accounts payable and accrued liabilities primarily due to the receipt of a \$107 million collateral deposit and higher fuel and purchased power expense of \$71 million offset by the timing and payment of other accruals, including a \$41 million payment related to Browns Ferry Nuclear Unit 1 accrued in 2004 and paid in 2005, a \$10 million settlement for litigation accrued in 2004 and paid in 2005, a \$19 million rate settlement accrued in 2004 and paid in 2005, \$6 million in lump sum leave accrued in 2004 and paid in 2005, and an additional \$18 million of performance incentives paid in 2005 over 2004.

Net cash provided by net income components decreased \$218 million from \$1.8 billion in 2004 to \$1.6 billion in 2005. This decrease was the result of:

- Increased cash paid for fuel and purchased power of \$521 million which was driven by both higher volume and increased market prices; and
- An increase in tax equivalent payments of \$27 million.

These items were partially offset by:

- An increase in cash provided by operating revenues of \$251 million resulting primarily from increased sales volume;
- A decrease in cash outlays for interest of \$42 million; and
- A decrease in cash outlays for operating and maintenance costs of \$36 million primarily due to \$33 million in severance and restructuring costs that were recognized in 2004.

Cash used in investing activities decreased \$547 million from \$1.6 billion to \$1.1 billion for the years ended September 30, 2004, and 2005, respectively. The change is primarily due to:

- A decrease in expenditures for capital projects of \$214 million primarily due to decreases in clean air expenditures of \$210 million partially offset by increases in expenditures for the Browns Ferry Unit 1 restart;
- A corresponding increase in funds from AFUDC of \$17 million;
- Proceeds received in 2005 from the sale of certain power distributor loans receivable of \$55 million (see note 1—*Sale of Loans*);
- Cash provided by net collections on loans and long-term receivables of \$6 million as opposed to \$5 million in the prior year, and net proceeds from investment activity of \$1 million; and
- Maturity of short-term investments in 2005 of \$335 million compared to an increase in short-term investments of \$68 million in 2004.

These items are partially offset by:

- An increase in expenditures for the enrichment and fabrication of nuclear fuel of \$22 million as four nuclear units completed refueling outages in 2005;
- Proceeds of \$15 million provided in 2004 by the cancellation of the Regenesys project; and
- Restrictions on cash of \$107 million resulting from the collateral deposits (see note 1—*Restricted Cash and Investments*).

Net cash used in financing activities was \$255 million for the year ended September 30, 2005, compared with net cash used in financing activities of \$1.6 billion in the prior year. The net decrease of \$1.3 billion in funds used is primarily due to:

- An increase in issuances of long-term debt of \$878 million;
- Net issuances of short-term debt of \$546 million in 2005 compared to net redemptions of short-term debt of \$157 million in 2004;
- A decrease in payments to the Treasury of \$2 million due to lower interest rates; and
- A decrease in lease payments of \$26 million.

These items were partially offset by:

- An increase in redemptions of long-term debt of \$117 million primarily due to the refinancing of callable debt at lower interest rates;
- Decreased proceeds from bond premium received of \$97 million;
- Decreased proceeds from swap receivable monetization of \$55 million; and
- An increase in net financing costs of \$14 million related to bond transactions.

2004 Compared to 2003

Net cash provided by operating activities increased \$1.6 billion from \$1.6 billion in 2003 to \$3.2 billion in 2004. This increase resulted from:

- Proceeds of \$1.5 billion received in 2004 for energy prepayments;
- Higher operating revenues of \$580 million driven primarily by the 2004 rate increase coupled with increased sales volume offset by \$92 million of prepaid energy services;
- A decrease in cash outlays for interest of \$17 million; and
- A decrease in expenditures for nuclear refueling outages of \$7 million due to the number and timing of outages.

These items were partially offset by:

- Increased cash paid for fuel and purchased power of \$121 million; and
- Increased cash outlays for operating and maintenance costs of \$92 million.

Additionally, these items were partially offset by a change in net cash used in working capital components of \$174 million, from net cash provided of \$164 million in 2003 to net cash used of \$10 million in 2004. The unfavorable working capital fluctuation is primarily a result of:

- An increase in accounts receivable of \$41 million in 2004, resulting from the rate increase and an increase in sales volume, as opposed to a \$78 million reduction in the prior year;
- A smaller increase in accounts payable and accrued liabilities of \$123 million due to the timing of accruals made in 2003 and paid in 2004; and
- A decrease in accrued interest of \$5 million, due to a lower level of total outstanding debt during 2004 as compared to 2003, as opposed to an increase of \$2 million in the previous year.

These items were partially offset by a \$10 million reduction in inventory in 2004, partially due to a reduction in the number of days of inventory supply on hand, as opposed to a \$65 million increase in the previous year.

Net cash used in investing activities decreased \$323 million from \$1.9 billion in 2003 to \$1.6 billion in 2004. This change resulted primarily from:

- A decrease in expenditures for capital projects of \$141 million;
- An increase in AFUDC of \$25 million;
- A decrease in nuclear fuel expenditures of \$68 million due to the completion of nuclear plant refueling outages between September 2003 and September 2004 and use of certain nuclear fuel inventory that built up during the prior year in preparation for the reloads;
- Proceeds received in 2004 from the Regenesys project cancellation settlement of \$15 million;

- Net cash provided by loans and long-term receivables of \$5 million as opposed to net cash used by the same items of \$9 million in the prior year; and
- A smaller increase in short-term investments of \$50 million.

Net cash used in financing activities was \$1.6 billion for the year ended September 30, 2004, compared to net cash provided by financing activities of \$446 million in the prior year. This \$2.0 billion change resulted primarily from:

- A decrease in long-term debt issues of \$1.5 billion primarily due to the receipt of \$1.5 billion in proceeds from MLGW for energy prepayments;
- An increase in redemptions of long-term debt of \$966 million due to the refinancing of callable debt at lower interest rates;
- Proceeds of \$256 million from bond call monetizations not present in 2004;
- Proceeds of \$389 million from qualified technological equipment leasing not present in 2004;
- Proceeds of \$325 million from combustion turbine leasing not present in 2004; and
- Equipment lease payments of \$29 million in 2004.

These items were partially offset by:

- A decrease in redemptions net of issuances of short-term debt of \$1.3 billion compared to the prior year due to lower outstanding short-term debt balances during the year;
- Proceeds of \$97 million of bond reopening premium not present in 2003;
- Proceeds of \$55 million from payment on a swap receivable monetization (see note 8) not present in the prior year;
- A decrease in payments to the Treasury of \$4 million; and
- A decrease in net financing costs of \$55 million.

Working Capital

The table below summarizes the components of working capital and short-term debt. At September 30, 2005, TVA had negative working capital of \$4.6 billion, largely attributable to \$5.2 billion in short-term indebtedness. TVA's cash management policy is to use cash provided by operations as well as Discount Notes to fund current cash requirements, and TVA plans to continue to use such financing instruments as long as short-term interest rates remain favorable.

	Years ended September 30		
	2005	2004	2003
Current assets	\$ 2,269	\$ 2,386	\$ 2,321
Current liabilities	<u>(6,817)</u>	<u>(5,511)</u>	<u>(5,902)</u>
Working capital (deficit)	<u>\$ (4,548)</u>	<u>\$ (3,125)</u>	<u>\$ (3,581)</u>
Discount notes <90 days	\$ 2,469	\$ 1,924	\$ 2,080
Current portion of long-term debt	<u>2,693</u>	<u>2,000</u>	<u>2,336</u>
Total short-term debt	<u>\$ 5,162</u>	<u>\$ 3,924</u>	<u>\$ 4,416</u>

Capital Resources

IOUs typically raise capital through the issuance of a combination of common stock, preferred stock, and short and long-term debt. By contrast, the Act limits TVA's financing methods which results in a capital structure that is very different from that of an IOU and is part of the reason why TVA's debt levels are generally higher than an IOU of comparable size. Power bonds and notes comprise about 90 percent of TVA's total financing obligations. Though interest rates may increase, the overall average interest rates on TVA bonds and notes should be somewhat insulated, reflecting the 16-year average life of TVA's long-term bond and note portfolio.

From October 1, 2004, to September 30, 2005, TVA redeemed at par \$182 million of electronotes® with an average interest rate of 6.18 percent, the 2000 Series E QUINTS with a \$100 million par amount and an interest rate

of 7.75 percent, and the 1995 Series A Global Power Bonds with \$2 billion par amount and an interest rate of 6.38 percent. In addition, on June 1, 2005, the interest rate on the TVA 1998 Series D Putable Automatic Rate Reset Securities ("PARRS") reset from 5.95 percent to 5.49 percent. The rate may be reset again under certain circumstances on June 1, 2006, and annually thereafter, until maturity. In conjunction with the reset, \$86 million of the \$552 million of 1998 Series D PARRS outstanding was redeemed by bondholders. The remaining bonds mature on June 1, 2028 but may be put back to TVA at par any time the interest rate is reset.

TVA issued \$1.7 billion of long-term debt during the year ended September 30, 2005, including \$150 million par amount of electronotes[®] with maturity dates ranging from 2010 to 2025 and an average interest rate of 4.74 percent, Global Power Bonds 2005 Series A maturing on June 15, 2035, with a par amount of \$500 million and an interest rate of 4.65 percent, and Global Power Bonds 2005 Series B maturing on June 15, 2015, with a par amount of \$1 billion and an interest rate of 4.38 percent. TVA also has access to financing arrangements with the Treasury, whereby the Treasury is authorized to accept a short-term note with the maturity of one year in an amount not to exceed \$150 million. TVA may draw any portion of the authorized \$150 million during the year. Interest is accrued daily and paid quarterly at a rate determined by the Secretary of the Treasury each month based on the average of outstanding obligations of the United States with maturities of one year or less. During 2005, 2004, and 2003, the daily average amounts outstanding were approximately \$103, \$35, and \$12 million, respectively. The outstanding balances were repaid quarterly. See note 9— *Short-Term Debt*.

Revolving Credit Facility Agreement

On May 26, 2005, TVA and a national bank entered into a revolving credit facility agreement with an initial term of 180 days. On November 9, 2005, the term was extended until May 22, 2006. The facility provides TVA with an unsecured revolving line of credit of up to \$2.5 billion. The interest rate on any borrowing under this agreement is variable and based on market factors and the rating of TVA's senior unsecured long-term non-credit enhanced debt at the time TVA draws on the facility. TVA is required to pay an unused facility fee on the portion of the \$2.5 billion against which TVA has not borrowed. This fee is similar to fees charged in the banking industry to similar customers for similar products and may fluctuate depending upon the rating of TVA's senior unsecured long-term non-credit enhanced debt. There were no outstanding borrowings under the facility at September 30, 2005.

Sale of Loans

On December 2, 2004, TVA sold a portfolio of 51 power distributor loans receivable. The portfolio was sold for \$55 million without recourse and contained loans with maturities ranging from less than one year to over 34 years. The principal amount due on the loans at the time of sale was \$57 million. The \$2 million loss is reported on OTHER INCOME, NET on the Income Statement for the year ended September 30, 2005.

Energy Prepayment Obligations

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

TVA did not offer the DEU program in 2005. Sales for the 2004 program included 5.5 DEUs totaling \$5.5 million over a ten-year period and 1.75 DEUs totaling \$1.75 million over a five-year period. Total sales for the program since inception are \$54.5 million. TVA is accounting for the prepayment proceeds as unearned revenue and is reporting the obligations to deliver power as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the September 30, 2005 and 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers, based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of September 30, 2005, over \$14.6 million had been applied against power billings on a cumulative basis during the life of the program, \$5.6 million of which was recognized as noncash revenue during 2005 and over \$5.5 million of which was recognized as noncash revenue during 2004.

Prepayment of Energy Services. During 2004, TVA and its largest customer, MLGW, entered into an energy prepayment agreement under which MLGW prepaid TVA \$1.5 billion for the future costs of electricity to be delivered by TVA to MLGW over a period of 180 months. In exchange for this prepayment, MLGW receives a credit on its monthly bills during this period. TVA received the \$1.5 billion prepayment in December 2003, accounted for the prepayment

as unearned revenue, and is reporting the obligation to deliver power under this arrangement as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the September 30, 2005 and 2004 Balance Sheets. TVA expects to recognize approximately \$100 million of noncash revenue in each year of the arrangement as electricity is delivered to MLGW based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of September 30, 2005, over \$190.3 million has been recognized as noncash revenue on a cumulative basis during the life of the agreement, \$100 million of which was recognized as noncash revenue during 2005 and over \$90.3 million of which was recognized as noncash revenue during 2004.

Rate Actions

On July 22, 2005, the Board approved a 7.52 percent increase in firm wholesale electric rates effective on October 1, 2005. The rate increase is expected to provide additional revenues of approximately \$524 million in fiscal year 2006. TVA approved the rate adjustment to fund increases in fuel and purchased power costs as well as increased transportation costs. Utilities surrounding the Tennessee Valley are also increasing rates, and 12 of the 14 surrounding utilities have fuel-adjustment clauses that allow them to pass fuel increases along to their customers. TVA's relative competitive position is not expected to change as a result of the rate increase. In the coming year, TVA will continue to monitor the cost of fuel and purchased power. Current projections have these costs increasing significantly above the amount upon which the October 1, 2005, rate increase was based. This will place an upward pressure on rates and could possibly result in further rate actions in the near term.

Monetization of Call Options

During 2002, TVA monetized the call provisions on a \$1 billion public bond issue by entering into a swaption agreement with a third party in exchange for \$175 million. In 2003, TVA monetized the call provisions on a second public bond issue of \$476 million by entering into a swaption agreement with a third party in exchange for \$81 million. In the third quarter of 2005, TVA monetized the call provisions on two electronotes[®] issues (\$42 million total par value) by entering into swaption agreements with a third party in exchange for \$5 million. A swaption essentially grants a third party the right to exercise the embedded call provision of the applicable bond while TVA continues to pay the holders of the swaption pursuant to the original bond issuance. In February 2004, the counterparty to the 2003 swaption transaction exercised its option to enter into a swap with TVA, effective April 10, 2004, requiring TVA to make fixed rate payments to the counterparty of 6.875 percent and the counterparty to make floating payments to TVA based on London Interbank Offered Rate ("LIBOR"). These payments are based on a notional principal amount of \$476 million, and the parties began making these payments on June 15, 2004. The 2002 swaption is recorded in OTHER LIABILITIES on the September 30, 2005 Balance Sheet and is designated as a hedge of future changes in the fair value of the original call provision. Under SFAS No. 133, as amended, TVA records the changes in market value of both the swaption and the embedded call. These values historically have been highly correlated; however, to the extent that the values do not perfectly offset, any differences will be recognized currently through earnings. These differences (including those for the 2003 swaption prior to its being exercised in February 2004) amounted to a nearly \$10 million noncash gain for the year ended September 30, 2004, and a \$27 million noncash gain for the year ended September 30, 2005. The swap entered into pursuant to the 2003 swaption and the two electronotes[®] swaptions are also recorded in OTHER LIABILITIES on the September 30, 2005 Balance Sheet, and the changes in market value are recognized currently in earnings. These changes amounted to a \$23 million noncash loss for the year ended September 30, 2004, and a \$19 million noncash loss for the year ended September 30, 2005.

Lease/Leaseback Transactions

During the summer of 2002, TVA completed construction of two sets of four combustion turbine ("CT") units which were part of a series of new peaking CT units. Of the financing options available to TVA for these units, long-term lease and leaseback arrangements provided outcomes that were the most economically favorable to TVA. The lease/leaseback for the first set of four units was finalized during the first quarter of 2003 and provided about \$163 million in lease proceeds. The cost of the first lease agreement approximated a full-term implicit rate of just above four percent. The lease/leaseback of the second set of four units was finalized during the third quarter of 2003 and provided about \$162 million in lease proceeds. The cost of the second lease agreement approximated a full-term implicit rate of slightly more than three and one half percent.

In addition to the financing activity for the CTs described above, TVA entered into another financing arrangement late in 2003 related to various Qualified Technological Equipment ("QTE") consisting of certain transmission equipment and related software. Such QTE was leased to a group of investors and subsequently leased back by TVA under terms and conditions which substantially mirrored those contained in the CT lease/leaseback arrangements.

The transaction resulted in financing proceeds of approximately \$389 million. The cost of the QTE lease agreement approximated a full-term implicit rate of slightly less than four percent.

TVA accounted for the respective CT and QTE lease proceeds as financing obligations in accordance with SFAS No. 66, "Accounting for Sales of Real Estate," and SFAS No. 98, "Accounting for Leases." As of September 30, 2004, the outstanding financing obligations of \$1.2 billion were included in LEASE/LEASEBACK OBLIGATIONS (\$1.1 billion) and CURRENT PORTION OF LEASE/LEASEBACK OBLIGATIONS (\$35 million), respectively, on TVA's 2004 year-end Balance Sheet. The outstanding financing obligations of \$1.1 billion at September 30, 2005, are included in LEASE/LEASEBACK OBLIGATIONS (\$1.1 billion) and CURRENT PORTION OF LEASE/LEASEBACK OBLIGATIONS (\$35 million), respectively, on TVA's 2005 year-end Balance Sheet.

Cash Requirements and Contractual Obligations

Due to the nature of the power industry, which requires large multi-year capital investments, using trends and multi-year forecasts are important in assessing the effectiveness of management's decisions related to capital expenditures, pricing and accessing capital markets.

The future planned construction expenditures for property, plant, and equipment additions, including clean air projects and new generation, are expected to be internally funded and are estimated to be as follows:

	Actual 2005	Estimated Construction Expenditures				
		2006	2007	2008	2009	2010
Browns Ferry Unit 1 Restart	\$ 417	\$ 420	\$ 81	\$ —	\$ —	\$ —
Clean Air Expenditures	201	201	305	335	306	290
Transmission Expenditures ⁽¹⁾	173	245	211	313	319	312
Other Capital Expenditures ⁽²⁾	431	467	492	596	510	560
Total Capital Projects Requirements	<u>\$ 1,222</u>	<u>\$ 1,333</u>	<u>\$ 1,089</u>	<u>\$ 1,244</u>	<u>\$ 1,135</u>	<u>\$ 1,162</u>

Notes:

- (1) Transmission Expenditures includes reimbursable projects.
- (2) Other Capital Expenditures are primarily associated with short lead time construction expenditure projects aimed at the continued safe and reliable operation of generating assets.

TVA conducts a continuing review of its construction expenditures and financing programs. The amounts shown in the table above are forward-looking amounts based on a number of assumptions and are subject to various uncertainties. Actual amounts may differ materially based upon a number of factors, including changes in assumptions about system load growth, environmental regulation, rates of inflation, total cost of major projects, and availability and cost of external sources of capital, as well as the outcome of the ongoing restructuring of the electric industry.

TVA does not anticipate receiving a financial return on its clean air expenditures because these expenditures neither generate revenues nor reduce costs. In fact, clean air equipment will reduce the operating efficiency and increase the operating costs of TVA's fossil units. In the near term, TVA will be negatively impacted by investments in new generation (i.e., Browns Ferry Unit 1) that are not expected to return a cash contribution until 2007. TVA also has contractual cash obligations, including minimum payments on operating leases, purchase obligations, power purchase contracts, and fuel purchase contracts (see note 12 — *Commitments*). For reporting purposes, TVA defines "contractual cash obligations" as written agreements to purchase goods and services that may or may not be legal commitments but which TVA intends to exercise. TVA expects that cash provided by operating activities and new financing activities will be adequate to meet these estimated cash requirements, as well as capital expenditures. In the coming year, TVA will continue to monitor the cost of fuel and purchased power. If these costs continue to increase, there will be upward pressure on TVA's rates. As of September 30, 2005, the amounts of contractual cash obligations for each of the next five years and thereafter are shown below:

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Debt	\$ 5,240	\$ 970	\$ 91	\$ 2,031	\$ 42	\$ 14,714	\$ 23,088
Interest on debt	1,220	1,027	1,001	945	891	12,196	17,280
Leases	84	82	72	66	63	46	413
Lease/leaseback transactions	85	85	89	85	89	1,209	1,642
Power purchase obligations	184	165	133	138	139	3,565	4,324
Other obligations	420	146	111	5	2	7	691
Fuel purchase obligations	958	333	299	208	166	363	2,327
Decommissioning	25	—	—	—	—	—	25
Retirement system*	75	—	—	—	—	—	75
Total	<u>\$ 8,291</u>	<u>\$ 2,808</u>	<u>\$ 1,796</u>	<u>\$ 3,478</u>	<u>\$ 1,392</u>	<u>\$ 32,100</u>	<u>\$ 49,865</u>

Note:

*Contributions/payments beyond 2006 to be determined based on funding requirements.

In addition to the cash requirements above, TVA has contractual obligations in the form of revenue discounts related to energy prepayments discussed above.

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Energy Prepayment Obligations	<u>\$ 106</u>	<u>\$ 106</u>	<u>\$ 105</u>	<u>\$ 105</u>	<u>\$ 105</u>	<u>\$ 823</u>	<u>\$ 1,350</u>

Debt

At September 30, 2005, TVA had outstanding short-term debt of \$2.5 billion and long-term debt (including current maturities) at varying maturities and interest rates of \$20.6 billion for total outstanding indebtedness of \$23.1 billion (see note 9).

Interest on Debt

At September 30, 2005, TVA's interest obligation related to its short- and long-term debt, if held to maturity, was \$17.3 billion.

Leases

TVA leases certain property, plant, and equipment under agreements with terms ranging from one to 30 years. Obligations under capital lease agreements in effect at September 30, 2005, total \$60 million for 2006, \$63 million for 2007, \$59 million for 2008, \$57 million for 2009, \$57 million for 2010, and an aggregate of \$36 million thereafter, for a total commitment of \$332 million. Of this amount, \$76 million represents the cost of financing. Obligations under non-cancelable operating lease agreements in effect at September 30, 2005, total \$24 million for 2006, \$19 million for 2007, \$13 million for 2008, \$9 million for 2009, \$6 million for 2010, and \$10 million thereafter for a total commitment of \$81 million.

Lease/Leaseback Transactions

Obligations under the lease/leaseback transactions in effect at September 30, 2005, total \$85 million annually for 2006 and 2007, \$89 million for 2008, \$85 million for 2009, \$89 million for 2010, and an aggregate of \$1.2 billion thereafter, for a total commitment of \$1.6 billion. Of this amount, \$499 million represents the cost of financing (see notes 10 and 12).

Power Purchase Obligations

TVA has contracted with various independent power producers and power distributors for additional capacity to be made available to TVA. In total, these agreements constitute 2,578 megawatts of winter net dependable capacity. Approximately 80 percent of this total capacity is made available to TVA under power purchase agreements that will expire within two years. The total financial obligation of these contracts is approximately \$4.2 billion. Additionally, TVA has contracted with various other counterparties for the purchase of power from renewable sources (wind and

methane gas technologies). These arrangements constitute about 33 megawatts of capacity. Of this total, 27 megawatts are attributable to wind generation, and due to the nature of this energy source, they are not included in the determination of net winter dependable capacity. TVA's financial obligation related to these renewable resource power purchase agreements is \$100 million. In total, TVA's financial obligation for all of its power purchase agreements is approximately \$4.3 billion. Costs under these contracts are included in the Statements of Income for the years ended September 30, 2005, 2004, and 2003 as FUEL AND PURCHASED POWER expense and are expensed as incurred in accordance with the normal purchases and sales exemption described in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

Under the Public Utility Regulatory Policies Act of 1978, TVA is obligated to purchase power from qualifying facilities. There are currently two independent power producers, with a combined capacity of 1,600 megawatts, that qualify under this program. However, the potential for TVA being required to take substantial amounts of power from these facilities under these circumstances has been mitigated by certain contractual arrangements entered into in 2005. Costs associated with these purchases are based on rates as specified in "Attachment A" of the Dispersed Power Production Guidelines for TVA and the Distributors of TVA Power as approved annually by the Board.

TVA also has an agreement with the Southeastern Power Administration to receive 405 megawatts of net dependable capacity from the Cumberland River Basin Projects for use in the TVA system. TVA receives a yearly energy allocation of 607,500 megawatt hours which is based on the reserved capacity. Once this allocation is exceeded, TVA is assessed an additional energy charge for the excess generation received based on rates as specified in the *Federal Register*.

Other Obligations

Other obligations of \$691 million consist of contracts negotiated as of September 30, 2005, for goods and services primarily related to capital projects as well as other major recurring operating costs. TVA has approximately \$587 million in long-term construction commitments consisting primarily of the construction of generating assets (including Browns Ferry Unit 1), and emission control equipment. In addition to construction commitments, TVA is committed under various other contracts for recurring goods and services of \$104 million with terms extending into 2010.

Fuel Purchase Obligations

TVA has approximately \$1.2 billion in long-term fuel purchase commitments ranging in terms of up to four years for the purchase and transportation of coal and approximately \$1.1 billion of long-term commitments ranging in terms of up to ten years for the purchase of enriched uranium and fabrication of nuclear fuel assemblies.

Pension Contribution

TVA's Board approved a pension contribution of \$75 million for 2006.

Decommissioning Fund Contribution

TVA's Board approved a decommissioning fund contribution of \$25 million for 2006.

Results of Operations

Operational Results

Generation. TVA prepares a power supply plan, semi-annually, to help generation assets meet projected loads and to enhance system reliability. This plan considers historical seasonal weather and water availability information, projected load growth, expected generation asset performance, and market price forecasts. This plan is also a key element in the planning of generation asset outages. The plan is updated monthly to reflect factors such as near term weather forecasts, actual runoff which affects availability of water for hydroelectric power, and generation asset availability, including outage schedule revisions.

During 2005, there was an increase in hydro generation due to the availability of water in storage even though rainfall and runoff were below normal. The dry weather in the later part of 2005 may impact 2006 generation unless the situation changes.

Asset Availability. During 2005, asset availability exceeded plan due to better performance by TVA's fossil and nuclear generating units. Fossil's favorable performance was primarily due to favorable equivalent forced outage rates ("EFOR"). The EFOR calculation compares the number of hours a facility was out of service during the year, including outage hours incurred because of a forced curtailment, such as an equipment malfunction, to the total number of hours in that same period. Fossil's increased availability was due to the improved material condition of the plants, increased focus on human performance issues and stricter adherence to operating procedures. Favorable nuclear performance was primarily due to better refueling outage execution. While some fossil, hydro and nuclear generating units did not meet targets, the overall system performance was not adversely affected. See "*Business Strategy*" — "*TVA's Six Strategic Objectives*" below.

Transmission. In 2005, TVA's Transmission/Power Supply organization set another record in reducing the duration of customer outages. Load-not-served decreased from 9.45 system minutes in 1999 to 3.34 system minutes in 2005 (a 65 percent improvement). A key indicator of reliability, that is, measuring the average number of interruptions per year at customer connection points, has declined from 1.40 in 2000 to 0.785 in 2005 — a 44 percent improvement. Additionally, power was delivered with 99.999 percent reliability for the sixth straight year. Also during the year, TVA built 92 miles of new transmission lines. Continuing its response to the investigation which found that improper right-of-way maintenance was a major cause of the 2003 midwest/northwest blackout, TVA remained focused on removing vegetation in its own service area that could come into contact with power lines. TVA removed over 760,000 trees during 2005 that could have jeopardized reliability.

Hurricane Katrina entered the TVA service area in August 2005 near Meridian, Mississippi, and passed through to the north and east fairly quickly, causing a relatively small amount of transmission damage compared to the systems to TVA's south. Transmission service to all of TVA's customers was restored by the following day.

In addition to providing reliable electric service to its own seven-state region, TVA, under separate agreements, provides system reliability coordinator services for several neighboring systems, including Associated Electric Cooperative, Inc., Big Rivers Electric Corporation, East Kentucky Power Cooperative, and Electric Energy Inc. These agreements enhance compliance with the North American Electric Reliability Council ("NERC") reliability standards for the entire service territory. On October 7, 2005, LG&E Energy asked the Federal Energy Regulatory Commission ("FERC") for permission to pull its two Kentucky utilities from the Midwest Independent Transmission System ("MISO") and hire TVA to serve as their reliability coordinator. LG&E Energy filed the request on behalf of its Kentucky Utilities and Louisville Gas & Electric subsidiaries. A Kentucky Public Service Commission hearing on the costs of the MISO concluded recently and a ruling is pending. Under the proposal filed with FERC, the LG&E energy subsidiaries would continue to control transmission under normal circumstances, but during times of constraints, TVA would direct them.

TVA has load served off the Kentucky Utilities transmission system in several remote areas. Typically serving that load has cost TVA approximately \$50,000 to \$60,000 per month. With the loads located in MISO, TVA may now incur congestion charges that may result in a significant increase in costs for a service that is not any better than the service TVA obtained before Kentucky Utilities joined MISO.

Changes in the fundamental business model for bulk transmission system operations, including the emergence of large markets in many areas of the eastern United States, have created new reliability risks and exposure for the TVA system, as well as other systems. This has manifested itself in actual blackouts (August 14, 2003, in the midwest and northeast United States) and in more frequent interconnection excursions, such as frequency deviations.

To further grid reliability, TVA works closely with independent generators to enhance compatibility with the transmission system, develop and implement consistent operating procedures, and minimize practices that can result in interrupted service.

Rates and Customers. On July 22, 2005, the Board approved a 7.52 percent increase in firm wholesale electric rates effective on October 1, 2005. The rate increase is expected to provide additional revenues of approximately \$524 million in fiscal year 2006. TVA's relative competitive position is not expected to change as a result of the rate increase. In the coming year, TVA will continue to monitor the cost of fuel and purchased power. Based upon a current forecast, these costs could increase significantly. Current projections have these costs increasing significantly above the amount upon which the October 1, 2005, rate increase was based. This will place upward pressure on rates and could possibly result in further rate actions in the near term.

Rates for customers in the TVA service territory continue to compare favorably to regional and national averages, despite recent TVA rate increases. TVA estimates that the average retail rate for electricity consumers in the

TVA service area for the 12 months ending June 30, 2005, was 5.75 cents per kilowatt-hour, comprised of 6.99 cents, 6.85 cents, and 3.55 cents per kilowatt-hour for residential, commercial, and industrial customers, respectively. According to information filed with the Energy Information Administration ("EIA") for the 12 months ending June 30, 2005, the average rate in areas served by 14 neighboring utilities for this same period was estimated to be 6.14 cents per kilowatt-hour, which includes 7.45 cents, 6.47 cents, and 4.45 cents per kilowatt-hour for residential, commercial, and industrial customers, respectively. The average rate for a sample of 328 companies, statistically chosen by EIA, that sell power in the U.S., was 7.79 cents for this same time period, comprised of 9.16 cents, 8.34 cents, and 5.32 cents per kilowatt-hour for residential, commercial, and industrial customers, respectively. In total, the average retail rate in the TVA service territory was six and 26 percent lower than these regional and national averages, respectively.

In addition, TVA's system has been designed and built over the years to optimize serving major power "load centers" in the Valley, such as major cities. This means that power is generated close to where it is consumed, which increases reliability and reduces cost. TVA's power system operates across two time zones and possesses geographic weather diversity, which helps diversify peak power demands, and because of the region's natural seasonality, the TVA system peaks in both the summer and winter.

Financial Results

The following table compares operating results and selected statistics for the years ended September 30:

Summary Statements of Income

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating revenues	\$ 7,794	\$ 7,533	\$ 6,953
Operating expenses	<u>(6,503)</u>	<u>(5,873)</u>	<u>(5,398)</u>
Operating income	1,291	1,660	1,555
Other income, net	33	37	29
Unrealized gains (losses) on derivative contracts, net	3	(7)	(7)
Interest expense, net	<u>(1,242)</u>	<u>(1,304)</u>	<u>(1,350)</u>
Income before cumulative effects of accounting changes	85	386	227
Cumulative effects of accounting changes, net	—	—	217
Net income	<u>\$ 85</u>	<u>\$ 386</u>	<u>\$ 444</u>

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Sales (millions of kWh)	171,498	165,858	161,534
Heating degree days (normal 3,459)	2,973	3,266	3,505
Cooling degree days (normal 1,777)	2,022	1,702	1,602

2005 Compared to 2004

Net income for 2005 was \$85 million compared with net income of \$386 million for 2004. Significant items contributing to the \$301 million decrease in net income include a \$630 million increase in operating expenses, partially offset by an increase in operating revenues of \$261 million, lower net interest expense of \$62 million, and a \$3 million unrealized gain on derivative contracts in 2005 as compared to a \$7 million unrealized loss on derivative contracts in 2004.

Operating Revenues. A detailed table of electricity sales and operating revenue is as follows:

	<u>Sales of Electricity</u>			<u>Operating Revenues</u>		
	<u>Years ended September 30</u>			<u>Years ended September 30</u>		
	(millions of kWh)			(millions of dollars)		
	<u>2005</u>	<u>2004</u>	<u>Percent Change</u>	<u>2005</u>	<u>2004</u>	<u>Percent Change</u>
Sales of electricity and operating revenue						
Municipalities and cooperatives	136,640	133,161	2.6%	\$ 6,561	\$ 6,457	1.6%
Industries directly served	30,872	29,344	5.2%	962	842	14.3%
Federal agencies and other utilities	3,986	3,353	18.9%	181	140	29.3%
Other revenue	—	—	—	90	94	(4.3%)
Total sales of electricity and operating revenue	<u>171,498</u>	<u>165,858</u>	<u>3.4%</u>	<u>\$ 7,794</u>	<u>\$ 7,533</u>	<u>3.5%</u>

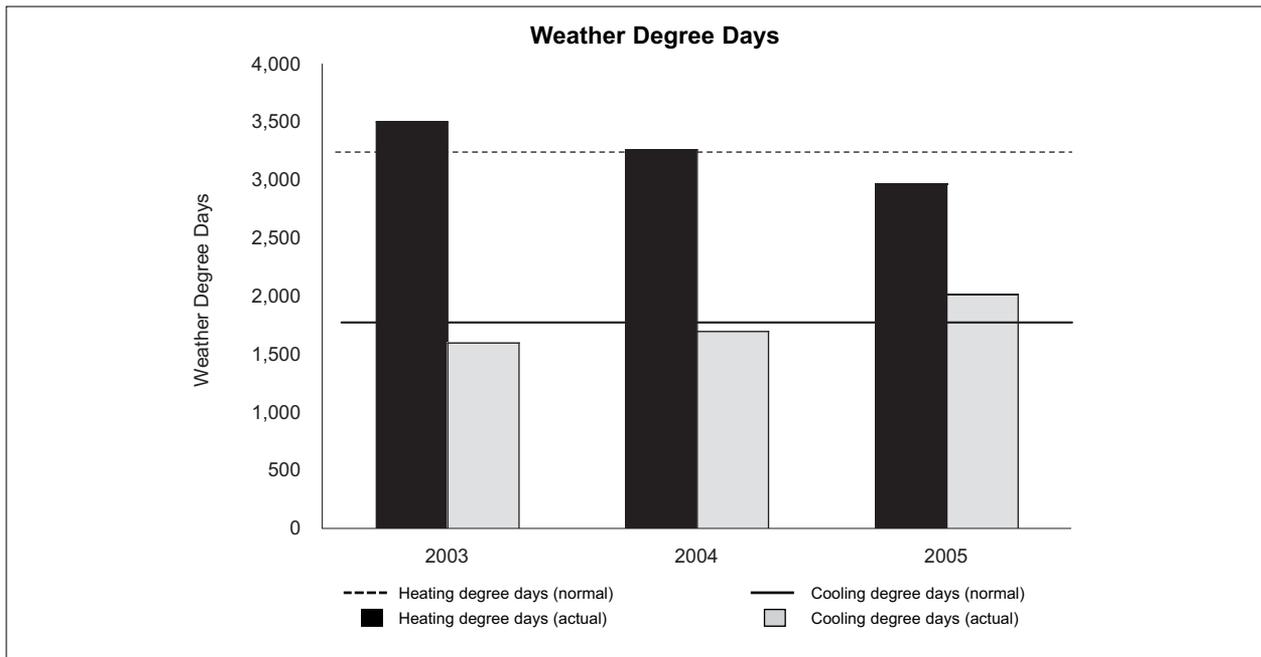
Significant items contributing to the \$261 million increase in operating revenues include:

- A \$104 million increase in revenues from municipalities and cooperatives primarily due to increases in volume. Sales to municipalities and cooperatives are more sensitive to weather than the other categories of sales since they service the more volatile residential markets. During 2005, there were 320, or 19 percent, more cooling degree days offset by 293, or nine percent, less heating degree days.
- A \$120 million increase in revenues from industries directly served primarily due to increased rates and volume. Also, operating revenues and sales of electricity to one of TVA's largest consumers of industrial power increased 35 percent and 19 percent, respectively, over the prior year.
- A \$36 million increase in revenues from off-system sales (included in FEDERAL AGENCIES AND OTHER) due to increased generation available for sale as a result of favorable market conditions.

Favorable market conditions relate to electricity demands both inside and outside the TVA service area in addition to advantageous market rates.

Significant items contributing to the 5,640 million kilowatt-hour increase in electricity sales include:

- A 3,479 million kilowatt-hour, or three percent, increase in sales to municipalities and cooperatives primarily due to increased volume as a result of warmer summer weather.
- A 1,528 million kilowatt-hour, or five percent, increase in sales to industries directly served due in large part to increases in volume due to economic growth.
- A 419 million kilowatt-hour, or 22 percent, increase in off-system sales (included in FEDERAL AGENCIES AND OTHER) due to increased generation available for sale and favorable market conditions.



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.

Operating Expenses. A detailed table of operating expenses is as follows:

	Years ended September 30		
	2005	2004	Percent Change
Operating expenses			
Fuel and purchased power	\$ 2,601	\$ 2,081	25.0%
Operating and maintenance	2,359	2,319	1.7%
Depreciation and accretion	1,154	1,115	3.5%
Tax-equivalents	365	338	8.0%
Loss on asset impairment/project cancellation	24	20	20.0%
Total operating expenses	<u>\$ 6,503</u>	<u>\$ 5,873</u>	<u>10.7%</u>

Significant items contributing to the \$630 million increase in total operating expenses for 2005 include:

- A \$269 million increase in fuel expense attributable primarily to higher coal prices and increased generation at coal fired plants;
- A \$251 million increase in purchased power expense which is attributable to higher market prices for off-system power;
- A \$77 million increase in pension and post retirement expense due primarily to increased interest cost coupled with increased amortization of actuarial loss (see note 5);
- A \$29 million increase in depreciation expense attributable to capital projects placed in service;
- An \$9 million increase in amortization expense related to the amortization of the capital lease recognized for the blended low enriched uranium program (see note 1 — *Blended Low Enriched Uranium Program*); and
- A \$24 million impairment loss related to the \$16 million write-down of certain assets related to a new technology that had not been proven effective and a \$8 million loss equal to the difference in the book value and market price of the East Tower of the Knoxville Office Complex (see note 1 — *Impairment of Assets* and note 6).

These items were partially offset by a \$33 million reduction in severance expense due to recognition of termination benefit costs in the prior period.

Other Income. TVA had net other income of \$33 million in 2005 compared with net other income of \$37 million in 2004. The decrease in net other income relates to a decrease in non-electric business activity.

Unrealized Gain on Derivative Contracts, Net. Significant items contributing to the \$3 million unrealized gain on derivative contracts include a \$116 million unrealized net gain related to the mark-to-market valuation adjustment of an embedded call option contract.

This items were partially offset by:

- A \$17 million unrealized net loss related to the mark-to-market valuation adjustment of an interest rate swap contract;
- A \$6 million unrealized net loss related to the mark-to-market valuation of SO₂ emissions allowance call options; and
- A \$90 million unrealized net loss related to the mark-to-market valuation of three swaption contracts.

Interest Expense. A detailed table of interest expense, outstanding debt and interest rates is as follows:

	Years ended September 30		
	2005	2004	Percent Change
Interest expense			
Interest on debt	\$ 1,337	\$ 1,379	(3.0%)
Amortization of debt discount, issue, and reacquisition costs, net	21	24	(12.5%)
Allowance for funds used during construction	(116)	(99)	17.2%
Net interest expense	<u>\$ 1,242</u>	<u>\$ 1,304</u>	<u>(4.8%)</u>
Outstanding bonds and notes	<u>\$ 23,088</u>	<u>\$ 23,250</u>	<u>(0.7%)</u>

	Years ended September 30		
	2005	(percent) 2004	Percent Change
Interest rates (average)			
Long-term	6.25	6.36	(1.7%)
Short-term	2.72	1.15	136.5%
Blended	5.99	6.16	(2.8%)

Significant items contributing to the \$62 million decrease in net interest expense include:

- A reduction of approximately \$1,089 million in the average balance of long-term debt outstanding; and
- A \$17 million increase in AFUDC due to a higher level of construction work-in-progress in 2005.

These items were partially offset by an increase of approximately \$822 million in the average balance of short-term debt outstanding coupled with an increase in average short-term interest rates from 1.15 percent to 2.72 percent.

2004 Compared to 2003

Net income for 2004 was \$386 million, compared with net income of \$444 million for 2003. The decrease was primarily due to two non-cash accounting changes implemented in the first quarter of 2003. These accounting changes included a \$412 million gain related to a change in accounting for unbilled revenue and a \$195 million charge related to a change in accounting for asset retirement obligations. Income before cumulative effects of accounting changes for 2004 increased \$159 million compared to 2003. This increase was primarily due to the rate adjustment implemented in October of 2003.

Operating Revenues. A detailed table of electricity sales and operating revenue is as follows:

	Sales of Electricity			Operating Revenue		
	Years ended September 30 (millions of kWh)			Years ended September 30 (millions of dollars)		
	2004	2003	Percent Change	2004	2003	Percent Change
Sales of electricity and operating revenue						
Municipalities and cooperatives	133,161	130,769	1.8%	\$ 6,457	\$ 5,974	8.1%
Industries directly served	29,344	27,756	5.7%	842	781	7.8%
Federal agencies and other	3,353	3,009	11.4%	140	120	16.7%
Other revenue	—	—	—	94	78	20.5%
Total sales of electricity and operating revenue	<u>165,858</u>	<u>161,534</u>	<u>2.7%</u>	<u>\$ 7,533</u>	<u>\$ 6,953</u>	<u>8.3%</u>

Significant items contributing to the \$580 million, or eight percent, increase in revenue for 2004 compared to 2003 include:

- An increase in sales to municipalities and cooperatives of \$483 million related to a higher average rate due to the rate adjustment implemented in October of 2003, partially offset by \$42 million in prepaid revenue discounts;
- An increase of \$61 million in revenue from industries directly served due to a six percent increase in sales

volume to directly served industrial customers, partially offset by decreased rates to large manufacturing customers due to the October 2003 rate action; and

- An increase in other revenue of \$16 million primarily attributable to increased external business activity.

The TVA service territory experienced six percent more cooling degree days and seven percent fewer heating degree days in 2004 compared to 2003. Although the net effect should have been minimal to sales to TVA's customers, total kilowatt-hour sales to customers increased four billion kilowatt-hours, or three percent, from 162 billion in 2003 to 166 billion in 2004. This increase can be attributed to population growth, increased demand in the industrial sector, and increased demand for electricity across the Valley.

Operating Expenses. A detailed table of operating expenses is as follows:

	Years ended September 30		
	2004	2003	Percent Change
Operating expenses			
Fuel and purchased power	\$ 2,081	\$ 1,957	6.3%
Operating and maintenance	2,319	2,039	13.7%
Depreciation and accretion	1,115	1,073	3.9%
Tax-equivalents	338	329	2.7%
Loss on asset impairment/project cancellation	20	—	—
Total operating expenses	<u>\$ 5,873</u>	<u>\$ 5,398</u>	<u>8.8%</u>

Significant items contributing to the increase of \$475 million, or approximately nine percent, in operating expenses in 2004 over 2003 include:

- An \$81 million, or five percent, increase in fuel costs driven by reduced hydro generation and an increase in the price of coal and natural gas;
- A 2.7 percent increase in electricity sales in 2004 as compared to 2003;
- An increase of \$43 million in purchased power costs primarily due to higher off-system prices partially offset by lower volume;
- A \$280 million increase in OPERATING AND MAINTENANCE ("O&M") primarily due to pension financing expense which changed from a \$49 million credit in 2003 to a \$66 million charge in 2004. This \$115 million change is due primarily to the increased amortization of certain unrecognized pension costs, in the form of actuarial losses, which resulted from the end-of-year valuation of TVA's pension plan. The additional amortizable actuarial losses were a result of TVA's lowering the plan valuation discount rate from 7.05 percent to 6.00 percent;
- A \$68 million increase in scheduled outage costs attributable to increased amortization of refueling outages at nuclear plants and increases in outages at fossil plants to install emission control equipment;
- A recognition of severance expense of \$36 million in 2004 compared to no severance expense in 2003 (see note 1—*Reduction in Workforce*) due to attrition of 690 employees to voluntary and involuntary reductions in force;
- A \$22 million increase in pension service costs due to decreasing the discount rate used to calculate the PBO; and
- A \$42 million increase in depreciation and accretion due primarily to capital projects placed in service during the year.

In December 2003, TVA was notified that Regenesys Technologies Limited ("RTL") would not proceed with manufacturing of the fuel cells to be installed in the partially completed Regenesys energy storage plant in Columbus, Mississippi. TVA had invested approximately \$35 million in the Regenesys project. RTL reimbursed TVA for early termination of the contract in the amount of \$15 million, which reduced the net loss to \$20 million on the cancellation of the Regenesys project (see note 1 — *Project Cancellation*).

Unrealized Loss on Derivative Contracts, Net. Unrealized losses on derivative contracts were \$7 million in 2004 and 2003 due primarily to losses on mark-to-market adjustments on swaption and swap contracts (see note 8).

Other Income. TVA had net other income of \$37 million in 2004 compared with net other income of \$29 million in 2003. The increase in net other income relates to an increase in non-electric business activity.

Interest Expense. A detailed table of interest expense, outstanding debt and interest rates is as follows:

	Years ended September 30		
	2004	2003	Percent Change
Interest expense			
Interest on debt	\$ 1,379	\$ 1,396	(1.2%)
Amortization of debt discount, issue, and reacquisition costs, net	24	28	(14.3%)
Allowance for funds used during construction	(99)	(74)	(33.8%)
Net interest expense	<u>\$ 1,304</u>	<u>\$ 1,350</u>	<u>(3.4%)</u>
Outstanding bonds and notes	<u>\$ 23,250</u>	<u>\$ 24,875</u>	<u>(6.5%)</u>

	Years ended September 30 (percent)		
	2004	2003	Percent Change
Interest rates (average)			
Long-term	6.36	6.22	2.3%
Short-term	1.15	1.28	(10.2%)
Blended	6.16	5.66	8.8%

Net interest expense was \$1,304 million for the year ended September 30, 2004, compared to \$1,350 million for the year ended September 30, 2003. This decrease resulted from:

- A lower level of total outstanding debt during 2004 as compared to 2003; and
- An increase in allowance for funds used during construction ("AFUDC") due to increased construction work in progress.

Total outstanding indebtedness, excluding discounts and premiums, as of September 30, 2004, was \$23.3 billion with a blended average interest rate (of long-term and short-term debt) of 6.16 percent; as of September 30, 2003, total debt outstanding, excluding discounts and premiums, was \$24.9 billion with a blended average interest rate of 5.66 percent. The average long-term and short-term interest rates for the year ended September 30, 2004, were 6.36 percent and 1.15 percent, respectively, as compared with 6.22 percent and 1.28 percent for 2003. Net interest expense is one of TVA's largest single expenses. Interest expense as a percentage of revenue declined from 34 cents of every revenue dollar in 1997 to 17 cents in 2004.

Critical Accounting Policies and Estimates

The preparation of financial statements requires TVA to estimate the effects of various matters that are inherently uncertain as of the date of the financial statements. Although the statements are prepared in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the amounts of revenues and expenses reported during the reporting period. Each of these estimates varies in regards to the level of judgment involved and its potential impact on TVA's financial results. Estimates are deemed critical either when a different estimate could have reasonably been used, or where changes in the estimate are reasonably likely to occur from period to period, and such use or change would materially impact TVA's financial condition, changes in financial position, or results of operations. TVA's critical accounting policies are also discussed in note 1.

Regulatory Assets and Liabilities

Although TVA's power rates are not subject to regulation through a public service commission or other similar agency, its Board of Directors is authorized by the TVA Act to maintain and operate the property of TVA and to set binding rates for power sold to its customers in accordance with the provisions of the TVA Act. The rate-setting authority vested in the TVA Board by the TVA Act meets the "self-regulated" provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," and TVA meets the remaining criteria of SFAS No. 71. Accordingly, TVA records certain assets and liabilities that result from the regulated ratemaking process that would not be recorded under generally accepted accounting principles ("GAAP") for non-regulated entities. Regulatory assets generally represent incurred costs that have been deferred because such costs are probable of future recovery in customer rates. Regulatory liabilities generally represent obligations to make refunds to customers for previous collections for costs that are not likely to be incurred. Management assesses whether the regulatory assets are probable of

future recovery by considering factors such as applicable regulatory changes, potential legislation, and changes in technology. Based on this assessment, management believes the existing regulatory assets are probable of recovery. This determination reflects the current regulatory and political environment and is subject to change in the future. If future recovery of regulatory assets ceases to be probable, TVA could be required to write-off these costs under the provisions of SFAS No. 101, "Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71." Any asset write-offs would be required to be recognized in earnings in the period in which regulatory accounting under SFAS No. 71 ceased to apply.

Regulatory assets capitalized under the provisions of SFAS No. 71 are included in DEFERRED NUCLEAR GENERATING UNITS and OTHER REGULATORY ASSETS on the September 30, 2005 and 2004 Balance Sheets. Components of OTHER REGULATORY ASSETS include certain charges related to the closure and removal from service of nuclear generating units, unrealized losses related to mark-to-market valuations of a purchased power contract, deferred capital lease asset costs, deferred outage costs, reacquisition costs, and an adjustment to accrue the minimum pension liability. See note 1 — *Cost-Based Regulation*, note 2, and note 5.

The year-end balances of TVA's regulatory assets and liabilities are as follows:

	<u>At September 30</u>	
	<u>2005</u>	<u>2004</u>
Regulatory Assets:		
Adjustment to accrue minimum pension liability	\$ 1,158	\$ 1,243
Nuclear decommissioning costs	716	755
Reacquisition costs	264	277
Deferred outage costs	103	86
Capital leases	84	90
Unrealized losses on purchase power contract	42	59
Subtotal	<u>2,367</u>	<u>2,510</u>
Deferred nuclear generating units	<u>3,912</u>	<u>3,909</u>
Total	<u>\$ 6,279</u>	<u>\$ 6,419</u>
Regulatory Liabilities:		
Unrealized gain on coal purchase contracts	\$ 791	\$ 478
Capital lease liability	<u>106</u>	<u>122</u>
Total	<u>\$ 897</u>	<u>\$ 600</u>

Reacquisition expenses, call premiums, and other related costs, such as unamortized debt issue costs associated with redeemed bond issues, are deferred under the provisions of the FERC Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act. These costs are deferred and amortized (accrued) on a pooled straight-line basis over the weighted average life of TVA's debt portfolio. (Even though TVA is not a public utility subject generally to FERC jurisdiction, the TVA Act requires TVA to keep accounts in accordance with the requirements established by FERC.)

Deferred capital lease asset costs, representing the difference between the FERC Uniform System of Accounts model balances and the SFAS No. 13, "Accounting for Leases," model balances are also included in OTHER REGULATORY ASSETS. Under FERC accounting model, TVA recognized the initial capital lease asset and liability at inception of the lease in accordance with SFAS No. 13; however, the annual expense is equal to the annual lease payments, which differs from SFAS No. 13 accounting treatment. This practice results in TVA's capital lease asset balances being higher than they otherwise would have been under the SFAS No. 13 model, with the difference representing a regulatory asset related to each capital lease. These costs are being amortized over the respective lease terms as lease payments are made.

Nuclear decommissioning costs include certain charges related to the future closure and decommissioning of TVA's nuclear generating units under NRC requirements. These future costs will be funded through a combination of investment funds already set aside by TVA, future earnings on those investment funds, and if necessary under TVA's funding requirements, additional TVA cash contributions to the investment funds. See note 1 — *Investment Funds* and note 4.

Due to negative pension plan asset returns from 2002 and 2001, TVA's accumulated benefit obligation at September 30, 2005 and 2004 exceeded plan assets. As a result, TVA was required to recognize an additional minimum pension liability as prescribed by SFAS No. 87, "Employers' Accounting for Pensions." These future pension costs will be funded through a combination of the pension investment funds already set aside by TVA, future earnings on those pension investment funds, and, if necessary under TVA's funding requirements, future TVA cash contributions to the pension plan.

Unrealized loss on a purchase power contract represents the estimated unrealized loss related to the mark-to-market valuation of the contract. Under the accounting rules contained in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, this contract qualifies as a derivative contract but does not qualify for cash flow hedge accounting treatment. As a result, TVA recognizes the changes in the market value of this derivative contract as a regulatory asset. This treatment reflects TVA's ability and intent to recover the cost of this commodity contract on a settlement basis for ratemaking purposes. TVA has historically recognized the actual cost of purchased power received under this contract in purchased power expense at the time of settlement. The contract expires in 2007. See note 8.

TVA's investment in the fuel used in the Sequoyah, Watts Bar, and Browns Ferry nuclear units is being amortized and accounted for as a component of fuel expense (see note 2). Nuclear refueling outage and maintenance costs are deferred and amortized on a straight-line basis over the estimated period until the next refueling outage. The amounts of deferred outage costs for the years ended September 30, 2005, 2004, and 2003 were \$103 million, \$86 million, and \$100 million, respectively.

At September 30, 2005, construction of the Bellefonte Nuclear Plant ("Bellefonte") remains in a deferred status (see note 2). In July 2005, the Board approved the amortization of, and inclusion into rates, TVA's investment in the deferred nuclear generating units at Bellefonte over a ten-year period beginning in 2006.

Regulatory liabilities accounted for under the provisions of SFAS No. 71 consist of mark-to-market valuation gains on certain derivative contracts and capital leases.

Unrealized gain on coal purchase contracts represents the estimated unrealized gains related to the mark-to-market valuation of coal purchase contracts. Under the accounting rules contained in SFAS No. 133, as amended, these contracts qualify as derivative contracts but do not qualify for cash flow hedge accounting treatment. As a result, TVA recognizes the changes in the market value of these derivative contracts as a regulatory liability. This treatment reflects TVA's ability and intent to recover the cost of these commodity contracts on a settlement basis for ratemaking purposes. TVA has historically recognized the actual cost of fuel received under these contracts in fuel expense at the time the fuel is used to generate electricity. These contracts expire at various times through 2017. See note 8.

As a result of a capital lease payment stream requiring larger cash payments during the latter years of the lease term than during the early years of the lease term, TVA leveled the annual lease expense recognition related to this lease in order to promote the fair and equitable cost recovery from ratepayers. These costs are being amortized over the lease term.

Long-Lived Assets

TVA capitalizes long-lived assets such as property, plant, and equipment at historical cost, which includes direct and indirect costs and an allowance for funds used during construction. TVA recovers the costs of these long-lived assets through depreciation of the physical assets as they are consumed in the process of providing products or services. Depreciation is generally computed on a straight-line basis over the estimated productive lives of the various classes of assets. When TVA retires its regulated long-lived assets, it charges the original asset cost plus removal costs, less salvage value, to accumulated depreciation in accordance with utility industry practice.

Long-Lived Asset Impairments

TVA evaluates the carrying value of long-lived assets when circumstances indicate the carrying value of those assets may not be recoverable. Under the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," an asset impairment exists for a long-lived asset to be held and used when the carrying value exceeds the sum of estimates of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. If the asset is impaired, the asset's carrying value is adjusted downward to its estimated fair value with a corresponding impairment loss recognized in earnings.

TVA is marketing the East Tower of the Knoxville Office Complex (“KOC”) to local, national and international real estate investors. TVA intends to complete a sale or lease of the facility as soon as practical, but it is not probable the sale or lease will be completed in the next year. In September 2005, based on TVA’s desire, intent, and plans to sell or lease the East Tower of the KOC, TVA recognized an impairment loss of \$8 million on the asset equal to the difference between the book value of \$20 million and current market value of \$12 million. The loss has been charged to the Income Statement for the year ended September 30, 2005.

If TVA ceased to qualify as a regulated entity as a result of future legislation, competitive pressures, or other factors, TVA would be required to evaluate all of its long-lived assets, including generating plants and transmission facilities, to determine whether they were impaired under the provisions of SFAS No. 144. This evaluation could result in asset impairment losses due to a lower expected level of cash flows associated with certain assets in a competitive environment. Other assets, however, might produce future cash flows in a competitive environment which are greater than the current carrying values of those assets. In such circumstances the asset carrying values would remain unchanged instead of being adjusted upward to reflect the increase in expected cash flows.

Revenue Recognition

Revenues from power sales are recorded as power is delivered to customers. TVA accrues estimated unbilled revenues for power sales provided to customers for the period of time from the end of the billing cycle to the end of the month. The methodology for estimating unbilled revenue from electricity sales uses generation for the current billing period. (See note 1 — *Accounting Changes*.)

Off-system sales are presented in the Statements of Income as a component of SALES OF ELECTRICITY — FEDERAL AGENCIES AND OTHER. Off-system sales are sales of excess power after meeting TVA native load and direct served requirements.

Normal Purchases and Normal Sales Special Exemption

A unique characteristic of the electric utility industry is that electricity cannot readily be stored in significant quantities and, as a result, some contracts to buy and sell electricity afford the buyer some flexibility in determining when to take electricity, and in what quantity, to meet fluctuating demands. These contracts would normally qualify as derivatives, but because electricity cannot be readily stored and an entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customers, an option contract for the purchase of electricity qualifies for the normal purchases and sales exemption described in paragraph ten of SFAS No. 133, as amended by SFAS No. 149, “*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*,” and Derivative Implementation Group (“DIG”) Issue No. C15, “*Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts in Electricity*,” also as amended by SFAS No. 149. Contracts for the sale or purchase of power in future periods that meet the criteria of DIG Issue C15 have been categorized as “normal purchase, normal sales” contracts and are exempted from recognition in the financial statements until power is delivered to customers.

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 (see note 4). TVA records estimates of such disposal costs at the time the legal obligation arises or costs are actually incurred. Based on new engineering studies performed annually in accordance with NRC requirements, revisions to the amount and timing of certain cash flow estimates of nuclear asset retirement obligations may be made.

Nuclear Decommissioning

At September 30, 2005, the present value of the estimated future nuclear decommissioning cost of \$1.6 billion was included in ASSET RETIREMENT OBLIGATIONS, and the unamortized regulatory asset of \$716 million was included in OTHER REGULATORY ASSETS. Under the NRC’s regulations, the present value of the estimated future nuclear decommissioning cost amounts to \$1.1 billion. This decommissioning cost estimate is based on NRC’s requirements for removing a plant from service, releasing the property for unrestricted use, and terminating the operating license. The actual decommissioning costs may vary from the derived estimates because of changes in current assumptions, such as the assumed dates of decommissioning, changes in regulatory requirements, changes in technology, and changes in the cost of labor, materials, and equipment. Utilities that own and operate nuclear plants are required to use different procedures in estimating nuclear decommissioning costs under SFAS No. 143 than those that are used

in estimating nuclear decommissioning costs that are reported to the NRC. Accordingly, the two sets of procedures produce different estimates for the costs of decommissioning.

TVA maintains a nuclear decommissioning trust fund to provide money for the ultimate decommissioning of its nuclear power plants. The fund is invested in securities generally designed to achieve a return in line with overall equity market performance. The nature of these investments comprises physical securities and certain derivative instruments. The derivative instruments that are used include options, futures, forwards, and swaps. These instruments are used across various asset classes to achieve a desired investment structure. The derivative instruments in the fund are comprised of 919 contracts. These contracts include futures, options on futures, and swap agreements. Investments held in the decommissioning fund are stated at fair value, which is determined by the Trustee of the fund. Futures and options on futures positions are marked to market on a daily basis. The swap agreements are marked to market on a monthly basis. The assets of the fund as of September 30, 2005, totaled \$835 million including total gains of \$115 million of which \$48 million was unrealized. The assets of the fund as of September 30, 2004, totaled \$720 million including total gains of \$88 million of which \$29 million was unrealized. The assets of the fund as of September 30, 2003, totaled \$632 million including total gains of \$133 million of which \$132 million was unrealized. The balance as of September 30, 2005 is less than the present value of the estimated future nuclear decommissioning costs. In October 2003, TVA provided a schedule of annual funding targets to the NRC and stated its commitment to make contributions to the decommissioning trust fund or provide other methods of decommissioning funding assurance necessary to match projected decommissioning fund balances. TVA is monitoring the monetary value of its nuclear decommissioning trust fund in light of recent market performance and believes that, over the long term and before cessation of nuclear plant operations and commencement of decommissioning activities, adequate funds from investments will be available to support decommissioning. TVA's nuclear power units are currently authorized to operate until 2013-2035, depending on the unit, with an additional 20 years of operation for each unit in the event the NRC approves the renewal of each unit's license (see "*Properties*" — "*Nuclear Power Program*" — "*Operating License Extensions*" in Part I).

The following key assumptions can have a significant effect on estimates related to the nuclear decommissioning costs:

- **Timing** – In projecting decommissioning costs, two assumptions must be made to estimate the timing of plant decommissioning. First, the date of the plant's retirement must be estimated. At a multiple unit site, the expiration of the unit with the operating license with the latest expiration date is typically used for this purpose, or an assumption could be made that the plant will be relicensed and operate for some time beyond the original license term. Second, an assumption must be made whether decommissioning will begin immediately upon plant retirement, or whether the plant will be held in "safestor" status for later decommissioning, as permitted by applicable regulations. While the impact of these assumptions cannot be determined with precision, assuming either license extension or use of "safestor" status can significantly decrease the present value of these obligations.
- **Technology and Regulation** – Because of the age of the nuclear plants in the United States, there is limited experience with actual decommissioning of large nuclear facilities. Changes in technology and experience as well as changes in regulations regarding nuclear decommissioning could cause cost estimates to change significantly. The impact of these potential changes is not presently determinable. TVA's cost studies assume current technology and regulations.
- **Discount Rate** – TVA's decommissioning fund uses a blended rate of 5.65 percent to calculate the present value of the weighted estimated cash flows required to satisfy TVA's decommissioning obligation.
- **Investment Rate of Return** – TVA assumes that its decommissioning fund will achieve a five percent real rate of return.
- **Cost Escalation Factors** – TVA's decommissioning estimates include an assumption that decommissioning costs will escalate over present cost levels by four percent annually.

Actuarial Assumptions

TVA utilizes professional actuaries to perform valuation services related to the areas of pension, postretirement, and postemployment benefits. Net periodic pension, postretirement, and postemployment benefit costs are determined using assumptions as of the beginning of each year. Funded status for each plan is determined using

assumptions as of the end of each year. The valuations performed at the end of 2005 were based on actuarial assumptions that were consistent for all of TVA's benefit plans (see note 11).

Pension and Other Postretirement Benefits. TVA sponsors defined benefit pension plans which cover substantially all employees. Additionally, TVA provides postretirement health care benefits for substantially all employees who reach retirement age while still working for TVA. TVA's reported costs of providing these benefits, as described in note 11 to the financial statements, are impacted by numerous factors including the provisions of the plans, changing employee demographics, and various actuarial calculations, assumptions, and accounting mechanisms. Because of the complexity of these calculations, the long-term nature of these obligations, and the importance of the assumptions utilized, the costs as reported represent critical accounting estimates for TVA and its stakeholders.

Key actuarial assumptions utilized in determining these costs include:

- Discount rates used in determining the future benefit obligations;
- Projected health care cost trend rates;
- Expected long-term rate of return on plan assets; and
- Rate of increase in future compensation levels.

TVA reviews these assumptions on an annual basis and adjusts them as necessary. The falling interest rate environment and poor performance of the financial equity markets over the past several years have impacted TVA's funding and reported costs for these benefits. In addition, these trends have caused TVA to make a number of adjustments to its assumptions.

In selecting an assumed discount rate, TVA reviews market yields on high-quality corporate debt and long-term obligations of the U.S. Treasury. Based on recent market trends, TVA reduced its discount rate from 6.00 percent and 5.81 percent at the end of 2003 and 2004 respectively, to 5.375 percent at the end of 2005. TVA reviews actual recent cost trends and projected future trends in establishing health care cost trend rates. Based on this review process, TVA reset its health care cost trend rate assumption used in calculating the 2005 accumulated postretirement benefit obligation. The assumed health care cost trend rate has been reset to 9.0 percent at the end of 2005 and mirrors the 9.0 percent trend rate used during 2004. TVA has reset its health care cost trend rate at the end of each of the last four years. The health care cost trend rate of nine percent is assumed to gradually decrease each successive year until it reaches a five percent annual increase in health care costs in 2013 and beyond.

In determining its expected long-term rate of return on pension plan assets, TVA reviews past long-term performance, asset allocations, and long-term inflation assumptions. TVA targets an asset allocation for its pension plan assets of approximately 60 percent equity securities and 40 percent fixed income securities. Pursuant to its allocation policy, the asset allocations are to be comprised of approximately 45 percent United State equities, of which five percent may be private equity or other similar investments, but not to include holding title to real property; 40 percent fixed income, of which ten percent may be high yield securities; and 15 percent non-United States equities. TVA's policy includes a permissible three percent deviation, plus or minus, from these target allocations. The TVA Retirement System Board (see note 11 Pension Plans and Other Retirement Benefits — paragraph one) can take action, as appropriate, to rebalance the system's assets consistent with the asset allocation policy. TVA decreased its expected long-term rate of return on pension plan assets from 8.50 percent at the end of 2003 to 8.25 percent at the end of 2004 and will continue to use a similar asset return assumption for 2005. TVA utilized a rate of return of 8.00 percent during 2003 in the aftermath of the market declines of 2002 and 2001.

TVA does not presently set aside assets dedicated solely to fund its postretirement benefits. Instead, TVA pays the costs of its postretirement benefit plan through premiums collected from participating retirees and TVA contributions.

The following chart reflects the sensitivity of pension cost to changes in certain actuarial assumptions:

<u>Actuarial Assumption</u>	<u>Change in Assumption</u>	<u>Impact on 2005 Pension Cost</u>	<u>Impact on 2006 Projected Benefit Obligation</u>
		(Increase in millions)	
Discount Rate	(0.25%)	\$ 12	\$ 224
Rate of Return on plan assets	(0.25%)	\$ 14	NA

The following chart reflects the sensitivity of postretirement benefit cost to changes in certain actuarial assumptions:

<u>Actuarial Assumption</u>	<u>Change in Assumption</u>	<u>Impact on 2005 Postretirement Benefit Cost</u>	<u>Impact on 2006 Projected Postretirement Benefit Obligation</u>
		(Increase in millions)	
Discount Rate	(0.25%)	\$ 1	\$ 15
Health care cost trend	0.25%	\$ 2	\$ 16

Each fluctuation above assumes that the other components of the calculation are held constant.

Accounting Mechanisms. In accordance with SFAS No. 87, "Employers' Accounting for Pensions," TVA utilizes a number of accounting mechanisms that reduce the volatility of reported pension costs. Differences between actuarial assumptions and actual plan results are deferred and are amortized into cost only when the accumulated differences exceed ten percent of the greater of the projected benefit obligation or the market-related value of plan assets. If necessary, the excess is amortized over the average remaining service period of active employees.

Additionally, TVA smoothes the impact of asset performance on pension expense over a three-year phase-in period through a "market-related" value of assets calculation. Since the market-related value of assets recognizes investment gains and losses over a three year period, the future value of assets will be impacted as previously deferred gains or losses are recognized. As a result, the losses that the pension plan assets experienced in 2002 and 2001 may have an adverse impact on pension cost in future years depending on whether the actuarial losses at each measurement date exceed the ten percent corridor in accordance with SFAS No. 87.

Costs and Funding. In 2005, TVA's total pension cost was \$243 million. TVA expects 2006 pension cost to increase to \$244 million due to a decrease in the discount rate from 5.81 percent to 5.375 percent. However, the impact of the lower discount rate was primarily offset by the recognition of certain actuarial gains. Pension funding amounted to \$53 million for 2005 and is projected to be \$75 million for 2006.

Due to negative pension plan asset returns from 2002 and 2001, TVA's accumulated benefit obligation at September 30, 2005 and 2004 exceeded plan assets. As a result, TVA was required to recognize an additional minimum pension liability as prescribed in SFAS No. 87. The charge to establish the minimum liability and the subsequent increases and decreases thereto were entered to OTHER COMPREHENSIVE INCOME, again in accordance with the requirements of SFAS No. 87. However, TVA reclassified all such minimum pension liability changes to a regulatory asset in accordance with SFAS No. 71. The regulatory treatment of the original changes was deemed necessary from the perspective that it would be improper to presume a level of future earnings on pension assets sufficient to fully recover, within a period of one year, all such costs included in OTHER COMPREHENSIVE INCOME.

Total postretirement health care costs for TVA in 2005 were \$46 million. The set of assumptions used for the end-of-year actuarial valuation process had no effect on postretirement benefit costs for 2005, 2004, or 2003 but, when coupled with further experience adjustments related to claims and contributions, will increase postretirement benefits expense for 2006 by approximately \$12 million compared to 2005. TVA expects 2006 postretirement health care cost to approximate \$58 million which represents an increase of \$12 million over 2005 costs, excluding special termination benefits.

In December 2003, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" became law. The act introduces a prescription drug benefit under Medicare (Part D) as well as a federal subsidy to employers who provide a retiree prescription drug benefit that is at least actuarially equivalent to Medicare Part D. TVA has determined that it does not directly qualify for the subsidy; however, TVA continues to investigate alternatives that could produce similar subsidy benefits for its retirees.

Tennessee Valley Authority Retirement System

As previously stated, TVA provides retirement benefits through its sponsorship of defined benefit pension plans which cover substantially all employees. The Tennessee Valley Authority Retirement System (“TVARS”) is a separate legal entity comprised of and controlled by an independent, seven-member Board of Directors that not only administers TVA’s defined benefit plan, but administers TVA’s defined contribution plan as well. The System is comprised of assets placed in two investment funds within the plan: the Fixed Benefit Fund and the Variable Annuity Fund. As the Plan sponsor, TVA contributes to the Fixed Benefit Fund such amounts as are necessary on an actuarial basis to provide the System with assets sufficient to meet benefit obligations of the plan. Benefits are provided in the form of a pension funded by TVA contributions and, if eligible, an annuity derived from member contributions.

TVARS prepares proprietary audited financial statements in accordance with SFAS No. 35, *“Accounting and Reporting by Defined Pension Plans,”* which provides the accounting basis underlying the presentation of the actuarially determined plan benefit obligations and assets. The primary objective of the plan’s financial statements is to provide financial information that is useful in assessing the plan’s present and future ability to pay benefits when due. In accordance with the guidance contained within SFAS No. 35, current plan benefit obligations are determined by applying discount rates of interest to future obligations consistent with the assumed rate of return on the assets of the plan. Thus assets of the plan of \$6.4 billion, as reported in the TVARS annual report for the year ended September 30, 2004, when compared to corresponding plan benefit obligations of about \$6.6 billion indicated a plan funding ratio of approximately 97 percent for the period so ended. Calculations under SFAS No. 35 may differ from calculations for other purposes, such as determining TVA’s benefit obligations under SFAS No. 87, *“Employers’ Accounting for Pensions,”* and, in fact, the TVARS Board of Directors’ determination of the valuation (and therefore the funded status) of the TVARS plan under SFAS No. 35 differs from TVA’s determination under SFAS No. 87. See *“Management’s Discussion and Analysis of Financial Condition and Results of Operations” — “Critical Accounting Policies and Estimates” — “Regulatory Assets and Liabilities”* and notes 5 and 11.

Risk Management Activities

Risk Governance

In August 2005, the TVA Board approved further changes to the structure of risk management at TVA. The Board dissolved the existing Portfolio Risk Management Committee (“PRMC”) and created a new Enterprise Risk Council (“ERC”) to strengthen and formalize TVA’s effort to manage enterprise-wide risk. The ERC is responsible for the highest level of risk oversight at TVA. The ERC is also responsible for communicating any enterprise-wide risks with policy implications to the Board or a designated Board committee. The ERC’s current members are the President and Chief Operating Officer (chair), the Chief Financial Officer, the Executive Vice President and General Counsel, the Chief Risk Officer (“CRO”), and a designated representative from the Office of the Inspector General (“OIG”) (advisory). Risk Management & Economic Analysis is responsible for providing the tools and analytical support necessary to ensure that all significant enterprise-wide risk issues are effectively communicated to the ERC.

In addition to the ERC, subordinate risk committees were created to segregate risks into natural groupings. There are currently three subordinate risk committees: the Financial Risk Committee, the Operational Risk Committee, and the Strategic Risk Committee. Each of the subordinate committees reports directly to the ERC. Membership in the subordinate committees includes senior management from organizations that “own” the applicable risks, the CRO, and advisory representatives from the OIG and from the Office of the General Counsel. See *“Qualitative and Quantitative Disclosures About Market Risk.”*

Derivatives

To manage the volatility attributable to its various risk exposures, TVA has entered into various nontrading derivative transactions. TVA risk management policies provide for the use of derivative financial instruments to manage financial exposures but prohibit the use of these instruments for speculative 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.”*

Certain derivative contracts utilized by TVA — the inflation swap and the currency swaps — 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 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, as are the gains and losses of an interest rate swap that does not qualify for hedge accounting treatment under SFAS No. 133, as amended and the 2005 swaptions, for which TVA elected to forego hedge accounting treatment. The 2002 swaption agreement qualifies for fair value hedge accounting under SFAS Nos. 133 and 138 with gains and losses on the hedged items and the hedging item recognized immediately in the determination of earnings. TVA also holds purchased options related to futures contracts with changes in fair value 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 recorded as regulatory assets or liabilities in accordance with SFAS No. 71 until settlement, at which time they are recognized in fuel and purchased power expense. Such treatment reflects TVA's ability and intent to account for these derivative instruments on a settlement basis for rate-making purposes. (See note 8 for a more detailed discussion of TVA's derivative activities.)

**Summary of Derivative Instruments that Receive Hedge Accounting Treatment
As of September 30, 2005**

<u>Derivative Hedging Instrument</u>	<u>Hedged Item</u>	<u>Purpose of Hedge Transaction</u>	<u>Type of Hedge— Fair Value (FV) or Cash Flow (CF)</u>	<u>Accounting for Derivative Hedging Instrument</u>	<u>Accounting for the Hedged Item</u>
Inflation Swap	Variable-principal debt	To fix the debt's variable cash flows to a fixed flow	CF	Cumulative gains and losses are recorded in other comprehensive income to the extent they are offset by cumulative gains and losses on the hedged transaction.	No adjustment is made to the basis of the hedged item.
Currency Swaps	Anticipated payment denominated in a foreign currency	To protect against changes in cash flows caused by changes in foreign-currency exchange rates	CF	Cumulative gains and losses are recorded in other comprehensive income to the extent they are offset by cumulative gains and losses on the hedged transaction.	No adjustment is made to the basis of the hedged item.
Swaption (2002)	Embedded call	To protect against a decrease in value of the embedded call	FV	All gains and losses on the derivative are recorded in earnings as unrealized gain/loss on derivative contracts.	All gains and losses on the hedged item are recorded in earnings as unrealized gain/loss on derivative contracts.

**Summary of Derivative Instruments that Do Not Receive Hedge Accounting Treatment
As of September 30, 2005**

<u>Derivative Type</u>	<u>Purpose of Derivative</u>	<u>Accounting for Derivative Instrument</u>
Coal Contracts—Volume Options	To protect against fluctuations in market prices of the item to be purchased	Gains and losses are recorded as regulatory assets or liabilities until settlement at which time they are recognized in fuel and purchased power expense.
Purchase Power Option Contracts	To protect against fluctuations in market prices of the item to be purchased	Gains and losses are recorded as regulatory assets or liabilities until settlement, at which time they are recognized in fuel and purchased power expense.
Interest Rate Swap	To fix short-term debt variable rate to a fixed rate	Fixed and variable interest cash flows are recorded in earnings as interest expense. MTM gains and losses are recorded in earnings as unrealized gains/losses on derivative contracts.
Swaptions (2005)	To protect against decreases in value of the embedded call	Gains and losses are recorded in earnings as unrealized gains/losses on derivative contracts.

Weather Risk

The weather affects TVA's ability to both generate and sell electricity. Hot water temperatures in the summer can limit TVA's ability to use water from the Tennessee River for cooling at generating facilities. Extreme peaks in either the summer or winter may require TVA to purchase electricity in the more expensive short-term market to meet demands from customers.

Historically, the weather risk has created short-term variability only. Over periods of one year or longer, the financial risks associated with weather have historically been modest, for reasons including averaging of effects over a large service territory, averaging of effects over different times of the year (which is particularly helpful to TVA since it is a "double-peaking utility"), and minor changes in hydroelectric generation during high-value periods.

Operational Risk

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

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

Corporate Insurance

Although TVA uses private companies to administer its health-care plans for eligible active and retired employees not covered by Medicare, TVA does not purchase health insurance. Consulting actuaries assist TVA in determining certain liabilities for self-assumed claims. TVA recovers the costs of losses through power rates and through adjustments to the participants' contributions to their benefit plans.

TVA purchases nuclear liability insurance, nuclear property, decommissioning, and decontamination insurance, and nuclear accidental outage insurance. (See note 12 — *Contingencies — Nuclear Insurance*.)

TVA does not currently purchase commercial general liability, auto liability, or workers' compensation insurance. TVA recovers the costs of losses through power rates. The Federal Employees' Compensation Act governs liability to employees for service-connected injuries.

On March 31, 2005, the TVA Board approved the purchase of property and business interruption/outage insurance for its non-nuclear assets. TVA implemented the property insurance program on October 1, 2005, and the outage insurance program on November 7, 2005.

On April 25, 2005, the TVA Board approved the purchase of Directors and Officers Liability insurance. This type of insurance provides coverage, subject to the terms and conditions of the policy, for claims against corporate directors and officers for alleged breach of duty while acting in their capacity as a director or officer of TVA. The insurance program went into effect on May 20, 2005.

Additional information on risk management activities and the financial impact of these activities is provided in notes 8 and 12.

Rate Setting

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. TVA continues to monitor the cost of fuel and purchased power. Current projections have these costs increasing significantly above the amount upon which the October 1, 2005, rate increase was based. This will place upward pressure on rates and could possibly result in further rate actions in the near term.

Risk of Loss of Customers

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

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

The Anti-Cherry-picking Provision minimizes the financial exposure of TVA to loss of distributors due to their limited access to transmission resources. However, senators from Kentucky have questioned the appropriateness of applying the Anti-Cherry-picking Provision to a distributor whose notice of termination of its TVA power contract has become effective. In addition, due to the uncertainties in rulings related to the nation's transmission systems, TVA's financial exposure to customer losses may increase in the future. See "*Legislative and Regulatory Matters*" — "*Other Matters*" for discussion of a bill that would effectively remove any area within Kentucky from coverage of the Anti-Cherry-picking Provision.

Termination Notices. During 2005, TVA received notices from three distributors in Kentucky terminating their power contracts with TVA. In December 2004, TVA received notice from Paducah Power System ("PPS") that terminates its power contract with TVA effective December 2009. In January 2005, TVA received notice from Princeton Electric Plant Board ("PEPB") that terminates its power contract with TVA effective January 2010. In August 2005, TVA received notice from Hopkinsville Electric System ("HES") that terminates its power contract with TVA effective August 2010. In 2005, 0.4 percent of TVA's total operating revenues were from sales to PPS; less than 0.1 percent of TVA's total operating revenues were from sales to PEPB; and less than 0.3 percent of TVA's total operating revenues were from sales to HES.

Since October 2002, nine of TVA's distributors have given notice to terminate their power contracts with TVA. Notices from two of these distributors — Bowling Green Municipal Utilities and Meriwether Lewis Electric Cooperative — have since been withdrawn and deemed to be of no force and effect by the mutual agreement of the distributors

and TVA. In addition, Duck River Electric Membership Corporation (“DREMC”) and TVA have agreed in principle to a contract amendment that, if executed, will extend DREMC’s termination date from August 2008 until August 2010.

The following table lists the names and locations of the seven distributors whose termination notices are still in effect, their contract termination dates, the amount of revenues that TVA generated by selling power to these distributors in 2005, and the percentage of TVA’s total 2005 operating revenues represented by these revenues.

Distributor	Location	Date of Termination of Power Contract	Sales to Distributor in 2005	Percentage of Operating Revenues in 2005
Warren Rural Electric Cooperative Corporation	Kentucky	April 2008	\$ 82	1.0%
Duck River Electric Membership Corporation	Tennessee	August 2008	85	1.1%
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%
Hopkinsville Electric System	Kentucky	August 2010	21	0.3%
Total			<u>\$ 250</u>	<u>3.2%</u>

In addition to the six Kentucky distributors listed above, TVA has 11 other distributors located in Kentucky. Sales to these 11 distributors generated approximately three percent of TVA’s total operating revenues in 2005.

On October 1, 2004, East Kentucky Power Cooperative (“EKPC”) filed an application with the Federal Energy Regulatory Commission (“FERC”) ostensibly seeking an order requiring EKPC to be interconnected with TVA’s transmission system. If this interconnection is granted, EKPC would be able to use TVA’s transmission system to provide power to Warren Rural Electric Cooperative Corporation (“WRECC”) when WRECC’s contract with TVA terminates in April 2008. TVA submitted a response to FERC stating that if FERC grants the requested relief, the actual effect would be to require TVA to provide free transmission service across TVA’s transmission system in violation of the Anti-Cherry-picking Provision of the Federal Power Act. On April 13, 2005, FERC issued a proposed order granting EKPC’s application. The parties tried without success to resolve their differences.

On August 3, 2005, FERC issued an order for TVA to interconnect with EKPC and to provide EKPC with coordination services necessary to deliver energy to WRECC. The order recognized that TVA is entitled to be compensated for the use of the TVA system caused by the interconnections and asked TVA to file a new agreement within 30 days, covering the terms, conditions and rates TVA believes it should receive for this use. TVA filed a proposed agreement as requested by FERC. FERC has not issued a final order. After FERC issues a final order, TVA can request a rehearing and ultimately appeal to the Court of Appeals.

In January 2004, the United States Enrichment Corporation (“USEC”) announced it will begin constructing its new commercial centrifuge facility in Piketon, Ohio. While it is unclear how much electricity USEC will need to acquire from TVA for its Paducah, Kentucky facility (“Paducah Facility”) once this new facility is opened it is expected to be substantially less. Under the current contract with TVA, USEC is required to purchase a fixed amount of electricity for its Paducah Facility through May 2006. In 2005, sales to USEC for its Paducah Facility generated approximately 4.4 percent of TVA’s total operating revenues. TVA does not expect any loss of revenues from sales to USEC to have a material effect on TVA’s financial condition.

Long-Term Contracts. A number of TVA distributors, including some with large loads, have expressed interest in further revising their wholesale power contracts to allow them more options with respect to contract term and other matters, such as purchasing a portion of their power requirements from suppliers other than TVA. Representatives of TVA and distributors have been meeting to discuss various potential long-term contract structures that could provide more certainty to both TVA and distributors. While these discussions have not yet resulted in any agreed upon structure, TVA and the distributors plan to continue with the process.

Accounting Changes

Effective October 1, 2002, the Board approved a change in the methodology for estimating unbilled revenue from electricity sales. The change in calculating unbilled revenue was from a method using cumulative generation to a method that uses only generation for the current billing period. TVA was able to make this change based on improved metering technology that allows TVA to more accurately capture the number of days power has been generated and transferred to its customers but not yet billed to those customers. Changing to this more accurate estimating methodology resulted in an increase in accounts receivable of \$412 million.

On October 1, 2002, TVA adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," which requires the recognition of a liability and capitalization of the associated asset retirement cost as part of the carrying amount of the long-lived asset for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or normal operation of long-lived assets. The effect of the adoption of SFAS No. 143 during 2003 included a cumulative effect charge to income of \$195 million, a recognition of a corresponding additional long-term liability of \$734 million, a recognition of an increase in assets of \$745 million, and related accumulated depreciation of \$206 million.

New Accounting Standards and Interpretations

Variable Interest Entities

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

TVA considered the provisions of FIN 46(R) for application to its lease/leaseback transactions. Under FIN 46(R), TVA would be deemed the primary beneficiary of the variable interest entities created in connection with these transactions and would therefore be required to consolidate the assets and liabilities of these VIEs. TVA has already effectively consolidated these assets and liabilities under the accounting guidance provided by SFAS No. 66 and SFAS No. 98 as described in "Management's Discussion and Analysis of Financial Condition and Results of Operations" — "Liquidity and Capital Resources" — "Lease/Leaseback Transactions" and note 10.

TVA has not identified any material VIEs created, or interest in VIEs obtained, after December 31, 2003, which require consolidation or disclosure under FIN 46(R). TVA continues to assess the existence of any interests in VIEs created on or prior to December 31, 2003, which may or may not be material to its results of operations or financial position as it determines whether it can obtain the financial information necessary to make the assessment.

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

Medicare Prescription Drug, Improvement and Modernization Act of 2003

In December 2003, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" became law. The act introduces a prescription drug benefit under Medicare (Part D) as well as a federal subsidy to employers who provide a retiree prescription drug benefit that is a least actuarially equivalent to Medicare Part D. TVA decided that its retiree drug plan is not actuarially equivalent as described by the Act of 2003, and accordingly, has not included or utilized any manner of subsidy in the determination of APBO or postretirement benefit cost (see note 11 *Benefit*

Plans), for the current or prior periods, in accordance with the requirements contained within the FASB Staff Position (“FSP”), FSP FAS 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003.” Beginning in 2006, Medicare will provide prescription drug coverage under Medicare Part D. After analyzing a number of options available to plan sponsors for integration with the new Medicare Part D, TVA elected to provide an employer-sponsored Part D prescription drug plan (“PDP”), with alternative coverage over and above Medicare standard Part D coverage, for Medicare-eligible retirees who participate in TVA’s Medicare supplement. By providing an employer-sponsored PDP, any Medicare subsidies will be passed through to retirees in the form of lower participant premiums and should not affect TVA’s cost of providing prescription drug coverage.

Inventory Costs

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

Exchanges of Nonmonetary Asset

In December 2004, the FASB published SFAS No. 153, “*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29,*” which eliminates the exception to fair value for exchanges of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance—that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. This statement is intended to produce financial reporting that more faithfully represents the economics of the transactions. This guidance is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on TVA’s results of operations or financial condition.

Conditional Asset Retirement Obligations

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

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 SFAS 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 the date the statement is issued.

Accounting for Purchases and Sales of Inventory with the Same Counterparty

On September 28, 2005, the EITF ratified Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty." This issue relates to companies that sell inventory to another entity in the same line of business from which it also purchases inventory. The staff believes that the transition guidance in Issue 04-13 should apply to all contracts entered into after March 15, 2006. The adoption of EITF Issue No. 04-13 beginning in the second quarter of 2006 is not expected to have a material effect on TVA's results of operations or financial position.

Put and Call Options

In September 2005 the Derivatives Implementation Group of the FASB ("DIG") 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. DIG Implementation Issue No. B-39, "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 does not apply 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. TVA is evaluating the potential implications of these Issues on its transactions related to future call and put options which may or may not be material to its financial position or results of operations.

TVA and Competition

By the late 1990s, the nation appeared to be well on its way to restructuring both wholesale and retail electricity markets. Recently, however, market and regulatory events have increased the uncertainty about the ultimate outcome and timing of electricity market restructuring in the United States. Despite the current uncertainty, however, TVA believes that wholesale competitive electricity markets are likely to continue to evolve.

Among the early initiatives that have begun to promote industry competition is the Energy Policy Act of 1992 (the "Energy Act"). The Energy Act and related FERC orders already allow competitors of a utility to access that utility's transmission system to sell electricity to other electric power suppliers and wholesale customers. In TVA's case, some special provisions apply.

Under the TVA Act, subject to certain minor exceptions, TVA may not currently enter into contracts that would have the effect of making it or the distributors of its power a source of power supply outside a statutorily specified area. Inside that same area, under the Anti-Cherry-picking Provision, TVA is not required to provide its competitors access to its transmission system to transmit power for consumption within the area that TVA or the distributors of its power may serve. Thus, while TVA may not freely sell power outside its current service area, TVA cannot be compelled to permit its competitors to use its transmission system to sell power within TVA's service area.

In the future, it appears possible that the current law that serves to limit competition between TVA and its competitors may change. In the past six years, numerous bills have been introduced in Congress, designed to restructure the electric utility industry and mandate or promote competition in the industry. Within the context of restructuring legislation, some of the key issues for TVA are (1) whether TVA rates and transmission system will be regulated by FERC, (2) whether TVA and the distributors of TVA power will be able to sell power outside the TVA service area and whether TVA will be required to provide its competitors access to its transmission system to transmit power for consumption within the TVA service area, and (3) whether Congress will attempt to shorten the terms of TVA's current wholesale power contracts with the distributors of its power. Whether TVA's existing customers will be expressly entitled by statute to "native load preference" under an unbundled transmission scenario is uncertain.

In the spring of calendar year 2000, TVA, the Tennessee Valley Public Power Association ("TVPPA"), an association representing the distributors of TVA power, and the Tennessee Valley Industrial Committee ("TVIC"), an organization representing industries that TVA directly serves, reached consensus on draft legislation on the relationships between TVA and its customers in a restructured electric power industry. The draft legislation, as revised by

TVA, TVPPA, and TVIC in 2003, provides for (1) simultaneous repeal on the effective date of the restructuring legislation of the Anti-Cherry-picking Provision and the provision that limits the area in which TVA and the distributors of TVA power can be a source of power supply, (2) a distributor option to gradually take up to a maximum of 30-percent partial requirements from other suppliers with advance notice to TVA, (3) new limitations on TVA retail sales in TVA's current service area, (4) stranded cost recovery through 2007, (5) FERC regulation of TVA's transmission service rates and terms and conditions of service to ensure that those TVA charges and imposes on other users of its system are comparable to those TVA charges and imposes on itself, (6) TVA's subjection to antitrust laws (with the exception of monetary damages and attorney's fees), (7) as elected by individual distributors, reduction in TVA's existing regulatory role with respect to distributors, and (8) an express statutory limitation on new TVA generation to that needed to meet demand within the current TVA service area.

During the past year, work has focused on developing long-term contract terms and conditions that would provide value to distributors and help strengthen TVA's financial viability under competition, assessing how different wholesale rate structures would impact TVA's ability to compete in wholesale markets, and developing a new industrial portfolio to better align the cost and risk of production with the prices that customers pay.

Regional Transmission Organizations

While not generally subject to FERC jurisdiction, TVA is voluntarily seeking ways to meet FERC's objective to improve regional transmission operations in a manner consistent with TVA's responsibilities under the TVA Act. TVA is moving forward on following initiatives:

- TVA supports the need for regional solutions to resolve transmission issues faced by the industry.
- TVA has been working with federal and state authorities, public power entities, investor-owned utilities, and emerging regional transmission organizations ("RTOs") to address today's critical concerns.
- TVA has been developing regional transmission partnerships that meet FERC's intent for regional transmission. This effort includes entering into coordinating agreements (Memorandums of Understanding ("MOUs")) with neighboring utilities, public power providers and RTOs.

The initial step of this coordination effort was to establish a joint transmission reliability area with TVA's public power partners. In 2002, TVA entered into Reliability Coordination Agreements with Associated Electric Membership Cooperative, Big Rivers Electric Corp, and East Kentucky Power Cooperative. In 2004 Electric Energy, Inc. joined this reliability partnership.

TVA has been designated by the North American Electric Reliability Council ("NERC") to serve as the reliability coordinator for parts of eleven states covering 192,000 square miles with a population of nearly ten million people. As the reliability coordinator for this region, TVA is responsible for monitoring and ensuring the reliable operation of the bulk transmission system in an eleven state region that includes Tennessee and portions of Alabama, Georgia, Illinois, Iowa, Kentucky, Mississippi, Missouri, North Carolina, Oklahoma, and Virginia. TVA is one of four reliability coordination offices in the Southeastern Electric Reliability Council ("SERC").

Through its MOU coordination, TVA continues to develop analysis and operational processes with Southern Company and Entergy for transmission reliability and interchange activities in support of regional transmission.

TVA has initiated a joint effort with MISO and PJM to create broad, seamless transmission services and facilitate working energy markets across a large region while implementing solutions to improve the reliability and adequacy of the transmission infrastructure. A joint reliability coordination agreement has been executed that provides a coordinated approach to transmission capacity availability, system outage approval, congestion management, and transmission planning.

Our continuing efforts with public power partners, Southern and Entergy, and jointly with the Midwest Independent Transmission System Operator ("MISO") and PJM Interconnection, L.L.C. ("PJM"), provide a mechanism for TVA to pursue regional transmission solutions in a manner consistent with our public service mission obligations.

Changes in the fundamental business model for bulk transmission system operations, including the emergence of large markets in many areas of the eastern United States, have created new reliability risks and exposure for the TVA system as well as other systems. This has manifested itself in actual blackouts (August 14, 2003, in the mid-west and northeast United States) and in more frequent interconnection excursions such as frequency deviations.

Business Strategy

TVA's Six Strategic Objectives

TVA's strategic objectives encompass excellence in operating performance, leadership in economic development, and sensitivity to its stakeholders' needs. Critical success factors have been developed and targets established to reach performance goals. TVA's Strategic Objectives are:

Improve life in the Tennessee Valley through integrated management of the river system and environmental stewardship. TVA is committed to environmental stewardship. TVA will improve the quality of life in the Valley by managing the Tennessee River system in accordance with a strategy that manages the diverse benefits of navigation, flood control, power production, water quality, and recreation for the greatest public good.

Meet customers' needs with affordable, reliable electric power. Electric power is the fuel of TVA's regional economy, and TVA's power system is growing and improving to keep pace with the ever-increasing demand. In step with America's energy policy for the 21st century, TVA is prepared to play a vital role as a public power provider, dedicated to public service and providing competitively priced electricity in an increasingly open energy marketplace.

Demonstrate leadership in sustainable economic development in the Valley. TVA will continue to work with the communities it serves in order to help attract and retain new and better jobs for the people of the Valley.

Continue the trend of debt reduction. TVA is committed to reducing its level of total financing obligations in order to create more financial flexibility for the future business environment.

Reduce TVA's delivered cost of power relative to the market. The bottom line for TVA is the creation of value for the public. TVA will be responsive to the marketplace through its initiatives for promoting innovation and continuous improvement. TVA will generate more for less for the good of many.

Strengthen working relationships with all of TVA's stakeholders. TVA will strengthen its relationships with Valley residents, communities, and businesses; with customers and suppliers; and with leaders at all levels of government.

Key Indicators and Objectives

↑ = Better than target

→ = On target

↓ = Worse than target

Measure	Strategic Objective	Indicator	Status as of September 30, 2005	2005 Actual	2005 Target
Customer	Meet customers' needs with affordable, reliable electric power	Customer satisfaction on power reliability, billing reliability, product timeliness, competitive price (percent)	↑	107	100
	Demonstrate leadership in sustainable economic development in the Valley	Jobs added or retained in the Valley, capital investment leveraged, and quality-job measure (index)	↑	123	100
Operations	Meet customers' needs with affordable, reliable electric power	Asset availability (percent of actual to plan)	↑	102	98
	Improve life in the Valley through integrated management of the river system and environmental stewardship	Environmental impact on air quality, water quality, land, waste production, energy consumption (index of environmental factors)	↑	55	78
Financial	Reduce TVA's delivered cost of power relative to the market	Operating costs including O&M, depreciation, tax equivalents, and external business (millions of \$)	↑	3,493	3,584
	Continue trend of improving financial flexibility	Financial Strength (net reduction in total financing obligations in millions of \$)	↑	301	225
	Meet customers' needs with affordable, reliable electric power	Productivity (kWh/\$)	↑	160.9	153.7
People	Strengthen working relationship with all of TVA's stakeholders	All injury rate (injuries/hours worked)	↓	1.82	2.12

Strategic Plan

To prepare for a more competitive electricity market, TVA has implemented a strategic planning process that analyzes how the new market may function, what competitive pressures TVA will face, and how TVA must prepare now for success in the future. More specifically, the process focuses on what TVA needs to do in order to preserve TVA's core mission of providing low-cost power, promoting economic prosperity in the Tennessee Valley, and exercising stewardship while remaining financially viable in a competitive market.

These challenges are not unique to TVA. Fiscally and strategically, the federal government, corporations, and the utility industry are dealing with cost pressures, competition for customers, the need to develop new technologies, and the need to efficiently manage all resources.

TVA's strategic plan is based on an analysis of possible market conditions and gives a qualitative basis for better decision-making as TVA moves into a world where laws restricting competition will be modified. The plan is based on the most thorough analysis of possible future market conditions that TVA has ever done.

TVA believes that wholesale competitive markets are going to continue to evolve and bring four fundamental changes to the business environment:

First, the wholesale electricity markets that border TVA to the North either already have or are expected to include the following core features:

- Independent, real-time operation of the regional transmission system, integrated with
- Voluntary day-ahead and real-time energy markets,
- Locational marginal pricing to reflect locational differences in generation costs caused by transmission constraints, and
- Financial congestion revenue rights to allow buyers and sellers to hedge the cost of energy delivered to a particular location.

Efforts to develop independently administered, structured spot markets in the South are stalled for the time being. Thus, markets in the South are expected to remain bilateral in nature for the foreseeable future.

Second, current law restricts TVA's ability to sell outside the TVA region and restricts the ability of other suppliers to sell power inside the TVA region. TVA must begin to prepare for a future where the laws restricting competition are modified, allowing distributors to choose other suppliers for all or part of their energy needs and allowing TVA to sell surplus power outside the region.

Third, TVA's historic monopoly on power sales in its service area appears likely to change, although market share is protected for the near term by existing contracts requiring at least five-years notice of termination. If other suppliers can provide services to distributors, TVA's planning, pricing, and financial structure must adapt to the potential reality that investments in long-lived facilities will face market risk.

Fourth, in the past TVA has relied almost entirely on debt to fund power system investments and support all activities related to its broad mission. This financing approach was very successful in the past, but will be risky in a world where distributors can select other suppliers. Under competition, TVA's effective monopoly position in the Valley will erode and will bring more cost and revenue volatility. TVA will need to reduce its debt and develop a more flexible financial structure so that it can weather the greater volatility of revenues that will come with competition.

TVA's Strategic Plan was adopted by the Board in January 2004. The plan identifies a number of steps that TVA needs to take to begin to prepare for a more competitive future. Specifically, over the next several years, TVA needs to concentrate on four major areas:

- (1) Developing new, more highly differentiated prices, services, and contract terms that more closely tie the cost and the risk of the product to its terms and pricing. During the past year, work has focused on developing long-term contract terms and conditions that would provide value to distributors and help strengthen TVA's financial viability under competition, assessing how different wholesale rate structures would impact TVA's ability to compete in wholesale markets, and developing a new industrial portfolio to better align the cost and risk of production with the prices that customers pay.
- (2) Addressing the range of issues related to wholesale market design and transmission pricing, including how TVA will interface with the markets that are expected to surround TVA, as well as how TVA will price transmission services within the TVA's power service area when distributors can choose other suppliers.
- (3) Increasing cash flow through cost reductions or rate increases in order to accelerate reduction in total financing obligations and to provide the financial flexibility needed to tolerate the higher levels of revenue and cost volatility associated with a more competitive market.
- (4) Maintaining and operating its generation and transmission assets so that it continues to fulfill its supply obligations in a safe and reliable manner.

According to the plan, preparing for a more competitive market requires TVA to begin working with

distributors to develop new, more highly differentiated prices for power, unbundled services, and new contract terms. TVA also will assess the way it provides and prices transmission service to its customers and decide whether to integrate its transmission system into a larger regional market.

The plan recommends a reduction target of at least \$3 billion to \$5 billion in debt over the next ten to 12 years but notes that debt-reduction targets will be updated annually depending on TVA priorities and changing market conditions. TVA anticipates that accelerated debt reduction can be achieved through continued emphasis on cost reduction, increased productivity, asset improvements to increase performance, further limiting capital projects where appropriate, and rate adjustments and rate changes consistent with market and power-supply conditions.

Because the plan is a "living" document, it will continue to evolve, providing a framework for TVA to respond to future market challenges.

Environmental Matters

As is the case across the utility industry and in other industrial sectors, TVA's activities are subjected to certain federal, state, and local environmental statutes and regulations. Major areas of regulation affecting TVA's activities include air quality control, water quality control, and management and disposal of solid and hazardous wastes.

TVA has incurred and continues to incur substantial capital and operating/maintenance costs in order to comply with evolving environmental requirements. Many of these costs are associated with the operation of TVA's 59 coal-fired generating units. While it is not possible to predict with any precision how these evolving requirements will impact the operation of existing and new coal-fired and other fossil-fuel generating units, it is virtually certain that environmental requirements placed on the operation of these generating units will continue to become more restrictive. Litigation over emissions from coal-fired generating units is also growing, including litigation against TVA (see "*Legal Proceedings*" in Part I).

Several existing regulatory programs have been and are being made more stringent in their application to fossil-fuel units and additional regulatory programs affecting fossil-fuel units have been promulgated in the past year. The total cost of future compliance with nitrogen oxide ("NO_x"), sulfur dioxide ("SO₂"), and mercury emission reduction requirements cannot reasonably be determined with precision at this time because of the uncertainties surrounding emerging EPA regulations, resultant compliance strategies, the potential for the development of new emission control technologies, court litigation, and future amendments to the Clean Air Act ("CAA"). However, additional costs for future regulation could be \$3.0 to \$3.5 billion through 2020, in addition to the costs to install SCRs and scrubbers as described below. In addition to these costs, there could be other substantial costs if reductions of carbon dioxide ("CO₂") are mandated (discussed in more detail below). Predicting how and when CO₂ may be regulated is very uncertain, even more so than the future regulation of other substances. TVA will continue to monitor this issue and will assess and respond to potential financial impacts as they become more certain.

Expenditures related to the clean air projects during 2005 and 2004 were approximately \$202 million and \$400 million, respectively. During 2005, TVA spent \$51 million on its publicly announced SCR program and \$146 million on its publicly announced scrubber programs.

Clean Air Developments

Air quality in the United States has significantly improved since the enactment of the modern CAA in 1970. These air quality improvements are expected to continue as the CAA and its implementing programs evolve through legislative and regulatory changes. Three substances emitted from coal-fired units have historically been the focus of emission reduction regulatory programs: SO₂, NO_x, and particulates. TVA's total cost through 2010 is expected to reach \$5.7 billion to reduce these emissions, \$4.4 billion of which TVA had already spent as of September 30, 2005. This figure includes the publicly announced SCR and scrubber programs outlined above, but not the \$3.0 to \$3.5 billion in potential future costs for additional reductions. Recently, attention has been given to two other substances emitted by coal fired units: mercury and CO₂. Increasingly stringent regulation of some or all of these substances will continue to result in significant capital and operating costs for coal-fired generating units, including those operated by TVA.

Sulfur Dioxide

Coal-fired utilities have historically emitted large amounts of SO₂. Utility SO₂ emissions are extensively regulated and will be regulated further under state programs to achieve and maintain EPA's National Ambient Air Quality

Standard for SO₂, the acid rain control program, and - depending on when units commenced operation and their effect on sensitive areas - the regional haze program. EPA's new, stringent fine particle national ambient air quality standard is expected to result in additional significant reductions of utility SO₂ emissions because SO₂ can transform into sulfates, and sulfates are a major component of fine particles in the eastern United States. Since 1977, TVA has reduced its SO₂ emissions by approximately 78 percent by switching to lower-sulfur coals, re-powering a unit at its Shawnee Fossil Plant with the advanced Atmospheric Fluidized Bed Combustion Technology, and installing flue gas desulphurization technology ("scrubbers") on six of its larger units. A seventh scrubber at unit 3 of its Paradise Fossil Plant is under construction. In 2005, TVA broke ground on its eighth scrubber at its Bull Run Fossil Plant in East Tennessee, as part of its previously announced plans to install additional scrubbers to achieve a total SO₂ emission reduction of 80 to 85 percent. TVA also has switched, or plans to switch to lower sulfur coal on several additional units in the next few years. These plans may change depending on the timing and severity of new SO₂ emission reductions that have been promulgated but not yet fully implemented under the Clean Air Interstate Rule ("CAIR"). The State of North Carolina also petitioned EPA under Section 126 of the CAA to impose additional emission reductions requirements for SO₂ and NO_x emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama where TVA's coal-fired power plants are located. The EPA proposes to deny the North Carolina petition primarily on the basis that CAIR remedies the problem.

Nitrogen Oxide

Utility NO_x emissions are extensively regulated and will be regulated further under state programs to achieve and maintain EPA's national ambient air quality standard for ozone (NO_x combines with volatile organic compounds in the presence of sunlight to produce ozone under certain meteorological conditions), the acid rain control program, and — depending on when units commenced operation and their effect on sensitive areas — the regional haze program. EPA's new, more stringent eight-hour ozone and fine particle national ambient air quality standards could result in requirements to further reduce NO_x emissions from coal-fired power plants and other fossil-fuel generation such as combustion turbines. (NO_x emissions can transform into nitrates, another component of fine particles.) Since 1995, TVA has reduced its NO_x emissions during the summer (when ozone levels increase) by approximately 80 percent by installing various combustion controls on all 59 coal fired units. TVA has also installed selective catalytic reduction technology ("SCRs") on 20 of its units and is in the process of installing an SCR on one additional unit. Also in 2005, TVA began evaluations of Selective Non-Catalytic Reduction ("SNCR") systems at two units. TVA's NO_x emission reduction program will continue to depend primarily on SCRs, but will also likely incorporate SNCRs if the evaluations are favorable. These plans may change depending on the timing and severity of new NO_x emission requirements that have been promulgated under CAIR but not yet finally implemented. The State of North Carolina has petitioned EPA to establish additional emission reductions requirements for SO₂ and NO_x emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama where TVA's coal-fired power plants are located. The EPA proposes to deny the North Carolina petition primarily on the basis that CAIR remedies the problem.

Particulates/Opacity

Larger particulates (fly ash), as opposed to fine particles discussed above, have long been regulated by states to meet EPA's national ambient air quality standard for particulate matter (this has evolved into the new fine particle standard). TVA's coal-fired units have been equipped with mechanical collectors, electrostatic precipitators, scrubbers, or baghouses, which have reduced particulate emissions from the TVA system by more than 99 percent. As part of the periodic review of the national ambient air quality standards, EPA is evaluating additional, more stringent options for setting the standard. Issues about utility compliance with state opacity requirements are also increasing. Opacity measures the denseness (or color) of power plant plumes and has traditionally been used by states as a means of monitoring good maintenance and operation of particulate control equipment. Under some conditions, retrofitting a unit with additional equipment to better control SO₂ and NO_x emissions can adversely affect opacity performance, and TVA and other utilities are now addressing this issue. There are also disputes with special interest groups over the role of continuous opacity monitors in determining compliance with opacity limitations.

Mercury

The EPA has issued a rule to regulate mercury emissions from coal-fired generating units under the CAA. TVA supports a cap and trade program for mercury due to the resounding success of the same program when it was used to reduce SO₂ emissions. TVA endorses EPA's approach to setting the first phase of mercury reductions at a level consistent with the co-benefits received from the reduction of SO₂ and NO_x under CAIR. The billions of dollars TVA has spent and will continue to spend in response to CAIR and other rules to further reduce SO₂ and NO_x emissions will help TVA satisfy the additional requirements of EPA's mercury rule.

Carbon Dioxide

The existence, cause, and importance of climate change continue to be widely debated. CO₂ is a greenhouse gas and is believed by some to contribute to climate change. Legislation has been introduced in Congress to require reductions of CO₂, and if enacted, could result in significant additional costs for TVA and other coal-fired utilities. The Bush Administration has proposed a voluntary initiative that established a goal of reducing the greenhouse gas intensity of the U.S. economy by 18 percent and has asked the electric utility sector and other industry sectors to support this initiative. TVA is supporting this effort in cooperation with electric utility industry trade associations and the Department of Energy. The last administration also asked utilities to voluntarily participate in an effort to reduce, sequester, or avoid greenhouse gases. Under that program, TVA reduced, sequestered, or avoided more than 275 million tons of CO₂ from 1994 through 2004, as reported under Section 1605b of the Energy Policy Act. TVA has also brought on line about 3,850 megawatts of non CO₂-emitting generation since 1990, and is in the process of adding another 1,800 megawatts of non CO₂-emitting generation.

Clean Water Developments

In the second phase of a three-part rulemaking to minimize the adverse impacts from cooling water intake structures on fish and shellfish, as required under section 316(b) of the Clean Water Act, EPA promulgated a final rule for existing power producing facilities that became effective on September 7, 2004. The new rule requires existing facilities to select one of the following compliance options for reducing the number of organisms pinned against and/or drawn into the cooling systems; (1) have specific designated features, (2) install specific technologies, (3) meet performance standards or (4) seek a site-specific compliance option based on application of cost/cost or cost/benefit tests. The site specific tests are designed to ensure that a facility's costs are not significantly greater than cost projections in the rule, or than benefits derived from taking mitigation actions. Actions taken to compensate for any impacts by restoring habitat, or pursuing other options such as building hatcheries for fish/shellfish production, count toward compliance. Some northeastern states and environmental groups have challenged the new regulation, and especially the compliance flexibility it offers, in federal court.

All of TVA's existing coal-fired and nuclear generating facilities will be regulated by this rule. Compliance will involve some level of new assessments at all generating plants, and will likely require some capital and/or operating expenditures at some or all facilities. The assessments, however, are complicated somewhat by the uncertainty created by pending legal action challenging EPA's rule.

As is the case across the utility industry and in other industrial sectors, TVA is facing more stringent requirements related to protection of wetlands, reductions in storm water impacts from construction activities, water quality degradation and criteria, and laboratory analytical methods. TVA is also following litigation related to the use of herbicides, water transfers, and releases from dams. TVA has a good compliance record and is not facing any substantive requirements related to non-compliance with existing Clean Water Act regulations.

Hazardous Substances

Liability for releases and cleanup of hazardous substances is regulated by the federal Comprehensive Environmental Response, Compensation, and Liability Act, among others, and similar state statutes. In a manner similar to many other industries and power systems, TVA has generated or used hazardous substances over the years. TVA is aware of hazardous-substance releases at eleven offsite areas for which it may have some liability. TVA's potential liabilities for its share of cleanup costs at these sites are uncertain. In addition, TVA operations at some TVA-owned facilities have resulted in releases of oil and/or hazardous substances which require cleanup and/or remediation.

At September 30, 2005, and 2004, TVA's estimated liability for environmental cleanup for those sites for which sufficient information is available to develop an estimate was \$28 million and \$29 million, respectively, and was included in OTHER LIABILITIES on the Balance Sheet. However, TVA has insufficient information to develop an estimate for some of the sites.

Legal Proceedings

For a discussion of TVA's current legal proceedings and anticipated outcomes, see "*Legal Proceedings*" in Part I.

Other Matters

Cash Balance Benefit Plans

In 2005, pension plan reform bills applicable to qualified defined benefit plans were introduced in the House and Senate. The reform bills would amend ERISA and Section 412 of the Internal Revenue Code to provide new minimum funding rules for defined benefit plans. The Senate's version of the bill has also included several versions of a provision that would approve either prospectively or retroactively hybrid plans, such as cash balance plans, provided that certain conditions and conversion requirements have been met.

The outcome of any pension plan reform legislation cannot be predicted at this time. The TVARS defined benefit plans, as other governmental plans, are not subject to the minimum funding rules under ERISA and Section 412 of the Internal Revenue Code, and it is unclear whether such legislation would have any effect on the TVARS defined benefit plans, generally, or the TVARS cash balance benefit plan, specifically.

FERC Interconnect Order

On October 1, 2004, East Kentucky Power Cooperative ("EKPC") filed an application with the Federal Energy Regulatory Commission ("FERC") ostensibly seeking an order requiring EKPC to be interconnected with TVA's transmission system at several locations. If these interconnections are granted, EKPC would be able to use TVA's transmission system to provide power to Warren Rural Electric Cooperative Corporation ("WRECC") when WRECC's contract with TVA terminates in April 2008. TVA submitted a response to FERC stating that if FERC grants the requested relief, the actual effect would be to require TVA to provide free transmission service across TVA's transmission system in violation of the Anti-Cherry-picking Provision of the Federal Power Act. On April 13, 2005, FERC issued a proposed order granting EKPC's application. The parties tried without success to resolve their differences.

On August 3, 2005, FERC issued an order for TVA to interconnect with EKPC and to provide EKPC with coordination services necessary to deliver energy to WRECC. The order recognized that TVA is entitled to be compensated for the use of the TVA system caused by the interconnections and asked TVA to file a new agreement within 30 days, covering the terms, conditions and rates TVA believes it should receive for this use. TVA filed a proposed agreement as requested by FERC. FERC has not issued a final order. After FERC issues a final order, TVA can request a rehearing and ultimately appeal to the Court of Appeals.

Organizational Structure Changes

On September 20, 2005, TVA announced changes in its organizational structure to prepare for the transition to a new governance structure at TVA and to assist in adapting to a changing legislative environment while working to improve its competitive position. The changes are as follows:

- Effective as of September 20, 2005, all Board Services functions and the Government Affairs office based in Washington, D.C., began reporting to Maureen H. Dunn, Executive Vice President and General Counsel.
- Also effective as of September 20, 2005, the Administrative Services organization was created, which reports to John E. Long, Jr., Executive Vice President, Administrative Services. Administrative Services consolidates Facilities Management, Information Services, Procurement, Administration Business Services, TVA Police, Enterprise Performance and Analysis, Employee Relations and Diversity, and Human Resources.
- Effective as of October 31, 2005, Bulk Power Trading will report to W. Terry Boston, Executive Vice President, Power System Operations.

Also during 2005, TVA made additional organizational changes:

- Theresa Flaim, Senior Vice President, Strategic Planning and Analysis, was named Senior Vice President, Pricing and Strategic Planning. In the new role, Ms. Flaim will continue to direct TVA's strategic planning efforts reporting in this regard directly to TVA's President and Chief Operating Officer, and she will lead the Contracts and Pricing organization in Customer Service and Marketing, reporting in this regard to Kenneth R. Breeden, TVA's Executive Vice President, Customer Service and Marketing.

- TVA's Power Resources and Operations Planning organization was restructured and the functions reassigned to existing TVA organizations. The Senior Vice President, Power Resources and Operations Planning, Jack A. Bailey, was selected to lead TVA's Nuclear Asset Recovery and Strategic Projects organization in TVA Nuclear.

Subsequent Events

Debt Securities

In October 2005, TVA issued \$27 million of electronotes[®] with an interest rate of 5.00 percent which mature in 2015.

In November 2005, TVA issued \$11 million of electronotes[®] with an interest rate of 5.5 percent which mature in 2020 and are callable in 2008.

On October 2, 2005, TVA redeemed at par five bonds in the TVA electronotes[®] series. The bonds TVA redeemed are all of its 2001 6.35 percent electronotes[®] due June 15, 2021, with a par amount of \$28 million, all of its 2001 6.10 percent electronotes[®] due August 15, 2021, with a par amount of \$23 million, all of its 2002 6.00 percent electronotes[®] due May 15, 2017, with a par amount of \$40 million, all of its 2003 5.50 percent electronotes[®] due August 15, 2018, with a par amount of \$43 million, and all of its 2003 5.625 percent electronotes[®] due October 15, 2023, with a par amount of \$14 million.

Legal

On November 9, 2005, TVA received two invoices totalling \$76 million from Areva for Framatome ANP, Inc, the predecessor of Babcock and Wilcox Company ("B&W"). In 1970, TVA and B&W entered into a contract for fuel fabrication services for the Bellefonte Nuclear Plant. 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 did. TVA is reviewing Areva's claim.

Management

In November 2005, the President of the United States sent to the Senate nominations of five people to serve on the TVA Board. The Senate has not announced when it will consider the nominations. As soon as three new Board members take office, the restructured Board provided for in the Consolidated Appropriations Act, 2005, will take effect.

Forward-Looking Information

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

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

Some examples of forward-looking statements include statements regarding strategic objectives; estimates of costs for disposing of certain tangible long-lived assets; expectations about the adequacy of TVA's decommissioning fund; the impact of new accounting pronouncements and interpretations, including Financial Accounting Standards Board ("FASB") Interpretation No. 46, "*Consolidation of Variable Interest Entities – an amendment of ARB No. 51*," which was amended by FASB Interpretation No. 46R, Statement of Financial Accounting Standards No. 151, "*Inventory Costs – an amendment of ARB No. 43, Chapter 4*," and 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-Cherry-picking Provision; 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. 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 after the statement is made.

QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

The Enterprise Risk Council ("ERC") was created in August 2005 to strengthen and formalize TVA's enterprise-wide risk management efforts. The ERC is responsible for the highest level of risk oversight at TVA and is also responsible for communicating enterprise-wide risks with policy implications to the Board or a designated Board committee. Three subordinate risk committees, Financial, Operation, and Strategic, have also been created to manage risks in these areas and report to the ERC.

Through the normal course of its business, TVA does not engage in wholesale trading operations for the purposes of speculation. Rather, when necessary in order to balance TVA's load obligation, TVA will engage in some aspects of physical trading. Further, TVA employs commodity-based instruments which include forwards, futures, and option contracts to manage risks associated with market fluctuations in the price and transportation costs of certain commodities and fuels including, but not limited to, coal, natural gas, and electricity.

TVA is exposed to market risks, including changes in interest rates, inflation rates, foreign currency exchange rates in association with TVA bonds, the prices of energy related commodities (electricity, natural gas, and coal), and equity market prices, and losses in the event of counterparties' nonperformance. To manage the volatility attributed to certain of these exposures, TVA has entered into various nontrading derivative transactions, principally an interest rate swap agreement, an inflation swap agreement, foreign currency swap contracts, swaptions, coal contracts, power purchase contracts, and natural gas contracts. Additionally, to manage volatility in the emission allowance markets, TVA has obtained options related to SO₂ and NO_x allowances (see note 8 — *Commodity Contracts*). These options expired in 2005. The exposure to losses in the event of the counterparties' nonperformance has been mitigated through controls to determine the creditworthiness of counterparties before transactions take place.

Cash Flow at Risk

Cash Flow at Risk ("CFaR") is the probability that a company will meet its cash flow targets. At TVA, CFaR is evaluated using a computer model for short-term and a separate model for the medium term. The short-term framework forecasts one week to reflect operating margins only. A one-year projection is developed to examine enterprise-wide free cash flow.

CFaR is calculated based on the simulation of future financial statements, taking as its input the projected values of the financial prices relevant to TVA. Its purpose is to build a probabilistic picture of the impact of various risks on the cash flow in much the same way as Value at Risk ("VaR") is used to find the probability of losses on a portfolio of assets. TVA measures the operating margin portion of CFaR on a weekly basis.

At the beginning of 2006, TVA estimated its expected annual 2006 free cash flow available to pay down its financing obligations. This value includes not only short-term operating margins but also costs associated with capital investments and financing agreements. Based on data available at the end of September 2005, TVA expects that its 2006 total enterprise free cash flow could range between \$(188) million and \$598 million. This range reflects modeling results for the tenth percentile and ninetieth percentile in free cash flow. Estimated enterprise Cash Flow at Risk for 2006 is \$545 million.

TVA manages its daily cash needs through issuance of Discount Notes and other short-term borrowings. These borrowings expose TVA to fluctuations in short-term interest rates. A near-term one percentage point change in interest rates would not have a material impact on TVA's financial position or results of operations.

Value at Risk

The commodity market risk exposure is measured through TVA’s VaR calculation. VaR is a single summary statistic of possible portfolio losses due to normal market movements for a given confidence level over a selected period of time. TVA measures VaR on a daily basis. TVA’s VaR exposure for the electricity, natural gas, and other commodities in which TVA has market positions, assuming a ten-day holding period and a one-day holding period, is described below:

Electricity

**Electricity Value at Risk
Associated with Energy Trading Contracts and Related Energy Derivative Contracts
For the Year Ended September 30, 2005**

	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 57.83
Average for the period.....	39.44
High	68.00
Low	20.25
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 23.59
Average for the period.....	16.09
High	27.74
Low	8.26

Notes: _____

The VaR calculations are for the TVA 5x16 electricity portfolio for 2005. The calculations are for the rolling forward 12-month portfolio.

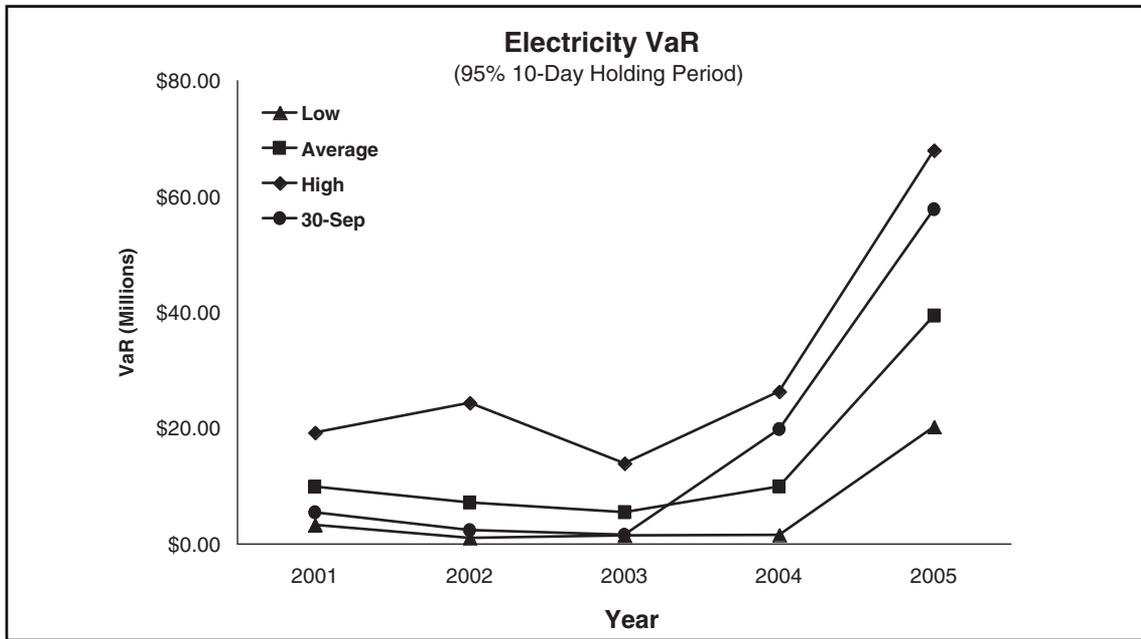
The VaR method used is the parametric variance/covariance method accepted as an industry standard.

From the table above, given a 95 percent confidence level at September 30, 2005, there is a 2.5 percent probability TVA’s electricity portfolio could lose more than \$57.83 million over the next ten days. The average VaR for the entire year for the ten-day holding period is \$39.44 million. Further, given a 99 percent confidence level at September 30, 2005, there is a 0.5 percent probability that TVA’s electricity portfolio could lose more than \$23.59 million over the next day. The average VaR for the entire year for the one-day holding period is \$16.09 million.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily Mark-to-Market (“MTM”) fluctuations for three-month, six-month, and 12-month periods. The chi-square test measures how well the actual distribution of mark-to-market fluctuations matches the ideal distribution. The chi-square value for the period is within the selected significance level indicating a valid VaR calculation.

TVA has no merchant capacity assets or transactions which expose TVA to market risk. TVA does have long-term transactions, the energy supplied under which will serve native load requirements (see note 12 — *Commitments — Power Purchase Obligations*). The market risk associated with the structure of these transactions is captured in the VaR estimates above.

As indicated by the following chart, TVA’s average electricity market risk exposure decreased from 2001 to 2003 and then increased from 2003 to 2005. The increase is largely due to increased volatility in the electricity markets and the increased consistency of TVA’s short position due to load growth.



Natural Gas

**Natural Gas Value at Risk
Associated with Energy Trading Contracts and Related Energy Derivative Contracts
For the Year Ended September 30, 2005**

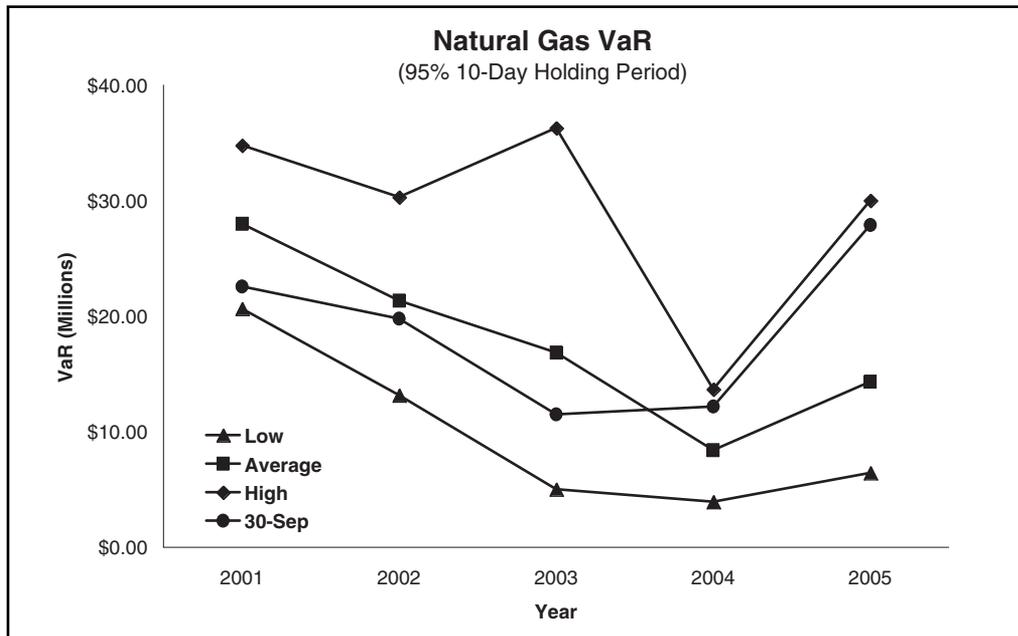
	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 27.90
Average for the period	14.34
High	30.02
Low	6.45
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 11.38
Average for the period	5.85
High	12.25
Low	2.63

Notes:

The VaR calculations are for the TVA natural gas portfolio for 2005. The calculations are for the rolling forward 12-month portfolio. The VaR method used is the parametric variance/covariance method accepted as an industry standard.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily MTM profit and loss fluctuations for three-month, six-month, and 12-month periods. The chi-square value for the period is within the selected significance level indicating a valid VaR calculation.

The historical performance of TVA's natural gas VaR calculation is represented in the following graph:



TVA has tracked natural gas VaR exposure since 2001. As shown in the graph above, the average natural gas VaR decreased from 2001 through 2004, but increased in 2005. This is in large part because TVA's expected natural gas needs have increased. Natural gas demand has increased in large part due to the increase in volume of electricity deals which are indexed to natural gas. TVA has made a strategic decision to replace a large percentage of electricity forwards with purchase power agreements with counterparties that own combined cycle natural gas generators within the Tennessee Valley. These transactions are called natural gas tolling agreements ("Tolls"). Tolls are agreements in which TVA purchases the right to generation produced from a given generator provided that TVA supplies the natural gas to run in the counterparty's generator during contractually agreed periods of time.

Fuel Oil

TVA purchases fuel oil as a substitute fuel source for TVA's gas turbine fleet. TVA's hedge against market risk for fuel oil is the use of natural gas and is captured in the natural gas VaR. TVA monitors the spread between fuel oil and natural gas for hedging purposes. During 2005, natural gas had a significant advantage over fuel oil for most of the year. Therefore, TVA's fuel oil position was not materially affected by market risk.

Coal

TVA's contracts with coal suppliers have specified rates and volumetric flexibility which limit TVA's exposure to market risk. Given TVA's contract mix, TVA is approximately 89 percent hedged to coal market risk exposure through 2006, a nine percent decrease over the previous year. There are two primary contributors to this decrease. First, increases in generation forecasts caused the coal demand to increase for 2006 (Central Appalachian ("CAP") and Illinois Basin ("ILB") are the only coal options available to meet this increase in demand). Second, continued poor performance of the western railroad has limited receipts of coal from the Powder River Basin and Colorado. TVA is planning to expand the use of eastern coals such as CAP and ILB to fill this need. Because of issues concerning coal's lack of fungibility and market transparency, TVA does not currently maintain a coal VaR calculation.

Sulfur Dioxide (SO₂) Allowances

**SO₂ Allowance Value at Risk
Associated with Energy Trading Contracts and Related Energy Derivative Contracts
For the Year Ended September 30, 2005**

	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 16.34
Average for the period	15.56
High	37.31
Low	3.10
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 6.67
Average for the period	6.35
High	15.22
Low	1.27

Notes:

The VaR calculations are for the TVA SO₂ allowance portfolio for 2005. The calculations are for the rolling forward nine-year portfolio. The VaR method used is the parametric variance/covariance method accepted as an industry standard.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily MTM profit and loss fluctuations for three-month, six-month, and 12-month periods. The chi-square test measures how well the actual distribution of mark-to-market fluctuations matches the ideal distribution. The chi-square value for the period is within the selected significance level indicating a valid VaR calculation.

Nitrogen Oxides (NO_x) Allowances

**NO_x Allowance Value at Risk
Associated with Energy Trading Contracts and Related Energy Derivative Contracts
For the Year Ended September 30, 2005**

	<u>Company Wide VaR</u> (in millions)
95% Confidence level, ten-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 6.58
Average for the period	10.36
High	22.09
Low	5.22
99% Confidence level, one-day holding period, two-tailed	
For the year ended September 30, 2005	\$ 2.69
Average for the period	4.23
High	9.01
Low	2.13

Notes:

The VaR calculations are for the TVA NO_x allowance portfolio for 2005. The calculations are for the rolling forward nine-year portfolio. The VaR method used is the parametric variance/covariance method accepted as an industry standard.

Back-testing of the VaR calculation is done using a statistical procedure called the chi-square test. TVA performs back-tests of the actual daily MTM fluctuations for three-month, six-month, and 12-month periods. The chi-square test measures how well the actual distribution of mark-to-market fluctuations matches the ideal distribution. The chi-square value for the period is within the selected significance level indicating a valid VaR calculation.

Mark-to-Market Valuation

Sensitivity analyses are performed on a daily and weekly basis to determine the market price impact on TVA's electricity portfolio when the market price moves beyond TVA's projections.

TVA also monitors the mark-to-market ("MTM") fair value of electricity assets in future years. MTM accounting reports 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 transactions include, but are not limited to, native system load contracts, energy forwards, energy options, and other energy derivative instruments for unit specific generation units. Due to the public service nature of its business, TVA historically values its resource positions for at least the year ahead. TVA values certain of its resource positions further in the future as necessary.

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.

Based on September 30, 2005, closing prices, the MTM value of TVA's electricity portfolio for 2006 is \$3.6 billion. The fair value calculation determines a profit or loss for each source of fair value, e.g. load, based on market prices. Market prices for electricity have a small impact on TVA margins because only a small portion of TVA's energy needs are bought or sold in the market.

Credit Risk

Credit risk is the exposure to economic loss that would occur as a result of a counterparty's nonperformance of its contractual obligations.

The majority of TVA's credit risk is limited to trade accounts receivable from delivered power sales to municipal and cooperative distributors, all located in the seven-state Tennessee Valley region. To a lesser extent, TVA is exposed to credit risk from industries and federal agencies directly served and from exchange power arrangements with a small number of investor-owned regional utilities related to either delivered power or the replacement of open positions of longer-term purchased power or fuel agreements.

Where exposed to credit risk, TVA analyzes the counterparty's financial condition prior to entering into an agreement, establishes credit limits, monitors the appropriateness of those limits on an ongoing basis, and employs credit mitigation measures, such as collateral or prepayment arrangements and master purchase and sale agreements, to mitigate credit risk.

The table below summarizes TVA's counterparty credit risk exposure as of September 30, 2005:

Counterparty Credit Risk Exposure
(in millions)

Trade Accounts Receivable: ⁽¹⁾	
Municipalities & Cooperative Distributors	
Investment Grade	\$ 659
Internally Rated — Investment Grade	369
Industries & Federal Agencies Directly Served	
Investment Grade	30
Non-investment Grade ⁽²⁾	25
Internally Rated — Investment Grade	6
Internally Rated — Non-investment Grade	7
Exchange Power Arrangements	
Investment Grade	10
Non-investment Grade	—
Internally Rated — Investment Grade	3
Internally Rated — Non-investment Grade	1
Subtotal	<u>1,110</u>
Other Accounts Receivable:	
Miscellaneous Accounts	42
Provision for Uncollectible Accounts	(7)
Subtotal	<u>35</u>
Total	<u>\$ 1,145</u>

Notes:

- (1) Includes unbilled power receivables of \$786 million.
- (2) Includes receivable of \$17 million from one customer rated "B2" by Moody's Investor Service and "B-" by Standard and Poor's.

TVA has concentrations of accounts receivable from seven customers that represented 35.9 percent of total accounts receivable as of September 30, 2005.

Rating Triggers

In the normal course of business, TVA enters into physical and financial contracts, some of which contain rating triggers. Under most of these rating triggers, the amount of the collateral that TVA would have to post under certain circumstances would increase if TVA's credit rating were downgraded. So long as TVA maintains an investment grade credit rating, the requirement to post collateral under these contracts, if triggered, would not have a material effect on TVA's financial condition.

Derivatives

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

Derivative contracts utilized by TVA include currency, inflation, and interest rate swap agreements, swaptions, futures contracts, and option contracts on various coal and electricity 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 (see note 8 — *Foreign Currency, Interest Rate, and Inflation Swaps*). Based on TVA's overall interest rate exposure at September 30, 2005, including derivative and other interest rate sensitive instruments, a near-term one percentage point change in interest rates would not have a material impact on TVA's financial condition.

Forward Contracts

TVA enters into electricity forward contracts for the sole purpose of limiting or otherwise hedging its economic risks directly associated with meeting its power supply obligations in the Tennessee Valley region. During 2005, TVA supplied approximately 2.1 percent of system requirements with power purchased under electricity forward contracts.

These contracts qualify for normal purchase and normal sale accounting under SFAS No. 133, as interpreted by DIG Issue C15 (see “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” — “*Critical Accounting Policies and Estimates*” — “*Normal Purchases and Normal Sales Special Exemption*”). At September 30, 2005, management does not anticipate a materially adverse effect on TVA’s financial position or results of operations as a result of electricity market fluctuations.

Financial Trading Program

A financial trading pilot program to reduce TVA’s economic risk exposure associated with TVA’s physical electricity generation, purchases, and sales was approved by the Board on September 11, 2003 (“Pilot Program”). Under the Pilot Program, TVA was authorized to use futures and options on futures to hedge economic risks directly associated with the cost of natural gas and fuel oil for TVA’s power generation operations and risks under power purchase or sale arrangements where the energy price varies based upon a fuel index.

The Pilot Program was scheduled to end on August 31, 2005, but on May 17, 2005, the Board established a permanent financial trading program (“Program” and, together with the Pilot Program, “Programs”) that allows TVA to: (1) continue to hedge the risks authorized under the Pilot Program; (2) broaden the type of risks that TVA can hedge to include economic risks directly associated with both the cost of natural gas for tolling agreements and the purchase or sale arrangements where the energy price is based at least in part upon a fuel price index or proxy; and (3) hedge risks more effectively by using swaps and options on swaps in addition to futures and options on futures. Trading is not authorized for speculative purposes under this Program. See note 8 — *Financial Trading Program*.

At September 30, 2005, TVA had 112 derivative positions outstanding under the Program. The Programs have enabled TVA to effectively hedge the price risk associated with a portion of its natural gas and power purchases. TVA recognized unrealized gains of approximately \$0.5 million which were included as an offset to purchased power expense for the year ended September 30, 2005. The same year also produced realized gains of about \$3.3 million which were included as an offset to purchased power expense. The gains on the positions were less than eight percent of the total natural gas expense for the period.

Financial Trading Program Activity For the Year ended September 30

	2005		2004	
	Notional Amount (in mmBtu)	Contract Value	Notional Amount (in mmBtu)	Contract Value
Futures contracts				
Financial positions at beginning of period	—	\$ —	—	\$ —
Purchased	4,370,000	33.2	1,250,000	8.0
Sold	(3,490,000)	(26.9)	(1,250,000)	(7.0)
Realized gains (losses)	—	3.3	—	(1.0)
Net positions--long	880,000	9.6	—	—
Options contracts				
Financial positions at beginning of period	—	—	—	—
Calls purchased	580,000	0.6	—	—
Calls and puts sold	980,000	(0.6)	—	—
Positions closed or expired	(1,320,000)	—	—	—
Net positions--long	240,000	—	—	—
Holding gains (losses)				
Unrealized gain at beginning of period, net	—	—	—	—
Unrealized gain for the period	—	0.5	—	—
Unrealized gains at end of period, net	—	0.5	—	—
Financial positions at end of period, net	1,120,000	10.1	—	—

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

TENNESSEE VALLEY AUTHORITY
 STATEMENTS OF INCOME
 For the years ended September 30
 (in millions)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating revenues			
Sales of electricity			
Municipalities and cooperatives	\$ 6,561	\$ 6,457	\$ 5,974
Industries directly served	962	842	781
Federal agencies and other	181	140	120
Other revenue	90	94	78
Total operating revenues	<u>7,794</u>	<u>7,533</u>	<u>6,953</u>
Operating expenses			
Fuel and purchased power	2,601	2,081	1,957
Operating and maintenance	2,359	2,319	2,039
Depreciation and accretion	1,154	1,115	1,073
Tax-equivalents	365	338	329
Loss on asset impairment/project cancellation	24	20	-
Total operating expenses	<u>6,503</u>	<u>5,873</u>	<u>5,398</u>
Operating income	1,291	1,660	1,555
Other income, net	33	37	29
Unrealized gains (losses) on derivative contracts, net	3	(7)	(7)
Interest expense			
Interest on debt	1,337	1,379	1,396
Amortization of debt discount, issue, and reacquisition costs, net	21	24	28
Allowance for funds used during construction	(116)	(99)	(74)
Net interest expense	<u>1,242</u>	<u>1,304</u>	<u>1,350</u>
Income before cumulative effects of accounting changes	85	386	227
Cumulative effect of change in accounting for unbilled revenue	-	-	412
Cumulative effect of change in accounting for asset retirement obligations	-	-	(195)
Net income	<u>\$ 85</u>	<u>\$ 386</u>	<u>\$ 444</u>

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

TENNESSEE VALLEY AUTHORITY
BALANCE SHEETS
At September 30
(in millions)

ASSETS

	2005	2004
Current assets		
Cash and cash equivalents	\$ 538	\$ 519
Restricted cash and investments <i>(note 1)</i>	107	-
Short-term investments, net	-	335
Accounts receivable, net	1,145	1,034
Inventories and other <i>(note 1)</i>	479	498
Total current assets	2,269	2,386
Property, plant, and equipment <i>(note 3)</i>		
Completed plant	35,215	34,786
Less accumulated depreciation	(14,407)	(13,424)
Net completed plant	20,808	21,362
Construction in progress	2,643	1,923
Nuclear fuel and capital leases	437	414
Total property, plant, and equipment, net	23,888	23,699
Investment funds <i>(note 1)</i>	858	744
Regulatory and other long-term assets <i>(note 5)</i>		
Deferred nuclear generating units	3,912	3,909
Other regulatory assets	2,367	2,510
Subtotal	6,279	6,419
Other long-term assets	1,272	1,032
Total regulatory and other long-term assets	7,551	7,451
Total assets	\$ 34,566	\$ 34,280

LIABILITIES AND PROPRIETARY CAPITAL

Current liabilities		
Accounts payable	\$ 860	\$ 761
Accrued liabilities	274	284
Accrued interest	380	402
Current portion of lease/leaseback obligations	35	35
Current portion of energy prepayment obligations	106	105
Short-term debt, net	2,469	1,924
Current maturities of long-term debt, net <i>(note 9)</i>	2,693	2,000
Total current liabilities	6,817	5,511
Other liabilities		
Other liabilities	2,500	2,293
Regulatory liabilities <i>(note 5)</i>	897	600
Asset retirement obligations	1,857	1,782
Lease/leaseback obligations	1,108	1,143
Energy prepayment obligations <i>(note 1)</i>	1,244	1,350
Total other liabilities	7,606	7,168
Long-term debt, net <i>(note 9)</i>	17,751	19,337
Total liabilities	32,174	32,016
Commitments and contingencies <i>(note 12)</i>		
Proprietary capital		
Appropriation investment	4,783	4,803
Retained earnings	1,244	1,162
Accumulated other comprehensive income (loss)	27	(52)
Accumulated net expense of nonpower programs	(3,662)	(3,649)
Total proprietary capital	2,392	2,264
Total liabilities and proprietary capital	\$ 34,566	\$ 34,280

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CASH FLOWS
For the years ended September 30
(in millions)

	2005	2004	2003
Cash flows from operating activities			
Net income	\$ 85	\$ 386	\$ 444
Items not requiring (providing) cash			
Depreciation, amortization, and accretion	1,280	1,239	1,140
Allowance for funds used during construction	(116)	(99)	(74)
Nuclear fuel amortization	131	132	127
Loss on asset impairment/project cancellation	24	20	-
Cumulative effects of accounting changes	-	-	(217)
Other, net	188	132	101
Changes in current assets and liabilities			
Accounts receivable, net	(112)	(41)	78
Inventories and other current assets	(12)	10	(65)
Accounts payable and accrued liabilities	77	26	149
Accrued interest	(22)	(5)	2
Proceeds from energy prepayments	-	1,504	51
Refueling outage costs	(122)	(86)	(93)
Other	(55)	(27)	(14)
Net cash provided by operating activities	1,346	3,191	1,629
Cash flows from investing activities			
Construction expenditures	(1,338)	(1,552)	(1,693)
Proceeds from project cancellation settlement (note 1)	-	15	-
Allowance for funds used during construction	116	99	74
Nuclear fuel expenditures	(141)	(119)	(187)
Investments			
Short-term investments, net	335	(68)	(118)
Change in restricted cash and investments	(107)	-	-
Purchases	1	-	-
Loans and other receivables			
Advances	(12)	(17)	(33)
Repayments	18	22	24
Proceeds from sale of loans (note 1)	55	-	-
Other, net	1	1	(9)
Net cash used in investing activities	(1,072)	(1,619)	(1,942)
Cash flows from financing activities			
Long-term debt			
Issues	1,650	772	2,309
Redemptions and repurchases	(2,368)	(2,251)	(1,285)
Short-term borrowings (redemptions), net	546	(157)	(1,412)
Proceeds from call monetizations	5	-	256
Proceeds from equipment financing	-	-	389
Proceeds from combustion turbine financing	-	-	325
Bond premium received	-	97	-
Proceeds from swap receivable monetization	-	55	-
Payments on lease/leaseback financing	(29)	(32)	(36)
Payments on equipment financing	(6)	(29)	-
Financing costs, net	(17)	(3)	(58)
Payments to U.S. Treasury	(36)	(38)	(42)
Net cash (used in) provided by financing activities	(255)	(1,586)	446
Net change in cash and cash equivalents	19	(14)	133
Cash and cash equivalents at beginning of period	519	533	400
Cash and cash equivalents at end of period	\$ 538	\$ 519	\$ 533

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

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL
For the years ended September 30
(in millions)

	Appropriation Investment	Retained Earnings	Accumulated Other Comprehensive (Loss)/Income	Accumulated Net Expense of Nonpower Programs	Total	Comprehensive Income
Balance at September 30, 2002	\$ 4,843	\$ 349	\$ (150)	\$ (3,626)	\$ 1,416	\$ -
Net income (loss)	-	456	-	(12)	444	444
Return on appropriation investment	-	(22)	-	-	(22)	-
Other comprehensive income (note 7)	-	-	76	-	76	76
Return of appropriation investment	(20)	-	-	-	(20)	-
Balance at September 30, 2003	4,823	783	(74)	(3,638)	1,894	\$ 520
Net income (loss)	-	397	-	(11)	386	386
Return on appropriation investment	-	(18)	-	-	(18)	-
Other comprehensive income (note 7)	-	-	22	-	22	22
Return of appropriation investment	(20)	-	-	-	(20)	-
Balance at September 30, 2004	\$ 4,803	\$ 1,162	\$ (52)	\$ (3,649)	\$ 2,264	\$ 408
Net income (loss)	-	98	-	(13)	85	85
Return on appropriation investment	-	(16)	-	-	(16)	-
Other comprehensive income (note 7)	-	-	79	-	79	79
Return of appropriation investment	(20)	-	-	-	(20)	-
Balance at September 30, 2005	\$ 4,783	\$ 1,244	\$ 27	\$ (3,662)	\$ 2,392	\$ 164

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

NOTES TO FINANCIAL STATEMENTS

(Dollars in millions except where noted)

1. Summary of Significant Accounting Policies

General

TVA is a wholly owned corporate agency and instrumentality of the United States. It was established by the Tennessee Valley Authority Act of 1933, as amended, 16 U.S.C. §§ 831-831ee (2000 and Supp. II 2002) (the "Act" or the "TVA Act") with the objective of developing the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense by providing: (1) an ample supply of power within the region, (2) navigable channels and flood control for the Tennessee River system, and (3) agricultural and industrial development and improved forestry in the region. TVA carries out these regional and national responsibilities in a service area that centers on Tennessee and 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 non-power programs. Substantially all TVA revenues and assets are attributable to the power program. The power program has historically been separate and distinct from the nonpower programs and is required to be self-supporting from power revenues and proceeds from power 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 United States Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Until 2000, most of the funding for TVA's nonpower programs was provided by congressional appropriations. These programs are now funded largely with power funds. Certain nonpower activities are also funded with various revenues and user fees. Prior to 2004, TVA presented information separately on its power program and nonpower programs in its financial statements. Because of the change in funding explained above, beginning with the fourth quarter of 2004, TVA began presenting consolidated financial statements which include both power and nonpower activities. See notes 3 and 14 for information related to TVA's power and nonpower programs.

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, however, 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.

TVA prepares its financial statements in conformity with generally accepted accounting principles in the United States of America applied on a consistent basis and, in some cases, TVA's financial statements reflect amounts based on the best estimates and judgment of management.

Fiscal Year

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

Cost-Based Regulation

Although TVA's power rates are not subject to regulation through a public service commission or other similar agency, its Board of Directors is authorized by the TVA Act to maintain and operate the property of TVA and to set binding rates for power sold to its customers in accordance with the provisions of the TVA Act. The rate-setting authority vested in the TVA Board by the TVA Act meets the "self-regulated" provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," and TVA meets the remaining criteria of SFAS No. 71. Accordingly, TVA records certain assets and liabilities that result from the regulated ratemaking process that would not be recorded under generally accepted accounting principles ("GAAP") for non-regulated entities. Regulatory assets generally represent incurred costs that have been deferred because such costs are probable of future recovery in customer rates. Regulatory liabilities generally represent obligations to make refunds to customers for previous collections for costs that are not likely to be incurred or deferral of gains that will be credited to customers in future periods. Management assesses whether the regulatory assets are probable of future recovery by considering factors such as applicable regulatory changes, potential legislation, and changes in technology. Based on this assessment, management believes the existing regulatory assets are probable of recovery. This determination reflects the current regulatory and political environment and is subject to change in the future. If future recovery of regulatory assets ceases to be probable, TVA

could be required to write-off these costs under the provisions of SFAS No. 101, "Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71." Any asset write-offs would be required to be recognized in earnings in the period in which regulatory accounting under SFAS No. 71 ceased to apply.

Management Estimates

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

Reclassifications

Certain reclassifications have been made to the 2003 and 2004 financial statements to conform to the 2005 presentation, including reclassification of cash flows associated with short term investments, reclassification of foreign currency translation gains and losses from UNAMORTIZED DISCOUNT AND PREMIUM, NET to SHORT-TERM DEBT, NET and LONG-TERM DEBT, NET and reclassification of certain assets from OTHER LONG-TERM ASSETS and DEFERRED NUCLEAR GENERATING UNITS to OTHER REGULATORY ASSETS.

Cash flows associated with the net activity of short-term investments were reclassified from cash used in operating activities to cash provided by investing activities. The reclassification improved operating cash flows by \$68 million and \$118 million in 2004 and 2003, respectively, and conversely was an additional use of cash in investing activities on the 2004 and 2003 Statements Cash Flows.

Deferred outage costs of \$86 million and reacquisition costs of \$277 million, previously reported as OTHER DEFERRED CHARGES and capital lease assets of \$90 million previously reported as NUCLEAR FUEL and CAPITAL LEASES, increased OTHER REGULATORY ASSETS by \$453 million on the September 30, 2004 Balance Sheet. In addition, DEFERRED NUCLEAR GENERATING UNITS of \$3.9 billion on the September 30, 2004 Balance Sheet have been reclassified to REGULATORY AND OTHER LONG-TERM ASSETS on the September 30, 2004 Balance Sheet.

Foreign currency translation losses of \$113 million were previously reported as UNAMORTIZED DISCOUNT AND OTHER ADJUSTMENTS on the September 30, 2004 Balance Sheet. These losses have been reclassified to LONG-TERM DEBT, NET. Capital lease obligations of \$122 million previously reported as OTHER LIABILITIES on the September 30, 2004 Balance Sheet have been reclassified to REGULATORY LIABILITIES.

These reclassifications had no effect on previously reported results of operations and net cash flows.

Cash and Cash Equivalents

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

Restricted Cash and Investments

As of September 30, 2005, TVA had \$107 million in restricted cash and investments on its balance sheet as a result of collateral posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap contract. Due to the uncertainty of the timing of the return of these funds to the counterparty, the funds are reported in RESTRICTED CASH AND INVESTMENTS and the corresponding liability is reported in ACCOUNTS PAYABLE on the September 30, 2005, Balance Sheet.

Accounts Receivable

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

	<u>At September 30</u>	
	<u>2005</u>	<u>2004</u>
Power receivables billed	\$ 323	\$ 288
Power receivables unbilled	<u>787</u>	<u>713</u>
Total power receivables	1,110	1,001
Other receivables	42	41
Allowance for uncollectible accounts	<u>(7)</u>	<u>(8)</u>
Net accounts receivable	<u>\$ 1,145</u>	<u>\$ 1,034</u>

Allowance for Uncollectible Accounts. The allowance for uncollectible accounts reflects TVA's best estimate of probable losses inherent in the accounts receivable and loans receivable balances. TVA determines the allowance based on known accounts, historical experience, and other currently available evidence including events such as customer bankruptcy and/or a customer failing to fulfill payment arrangements after 90 days. TVA's corporate credit department is consulted to assess the financial condition of a customer and quality of the accounts. The allowance for doubtful accounts was \$7 million and \$8 million at September 30, 2005, and 2004, respectively, for accounts receivable and \$15 million and \$14 million at September 30, 2005 and 2004, respectively, for loans receivable.

Inventories

Fuel, materials, and supplies. Coal, oil, limestone, tire-based fuel inventories, and materials and supplies inventories are valued using an average unit cost method. A new average cost is computed after each transaction and inventory issuances are priced at the latest moving weighted average unit cost. At September 30, 2005, and 2004 TVA had \$185 million and \$193 million, respectively, in fuel inventories and \$283 million and \$299 million, respectively, in materials and supplies inventory.

Allowance for Inventory Obsolescence. TVA reviews supplies and materials inventories by category and usage on a periodic basis. Each category is assigned a probability of becoming obsolete based on the type of material and historical usage data. Based on the estimated value of the inventory, TVA adjusts its allowance for inventory obsolescence. The allowance for surplus and obsolete inventory was \$36 million at September 30, 2005 and 2004.

Emission Allowances. TVA has emission allowances for sulfur dioxide ("SO₂") and nitrogen oxide ("NO_x") which are accounted for as inventory. The average cost of allowances used each month is charged to operating expense based on tons of SO₂ and NO_x emitted.

Property, Plant, and Equipment, and Depreciation

Additions to plant are recorded at cost, which includes direct and indirect costs and an allowance for funds used during construction. The cost of current repairs and minor replacements is charged to operating expense. Nuclear fuel inventories, which are included in PROPERTY, PLANT, AND EQUIPMENT, are valued using the average cost method for raw materials and the specific identification method for nuclear fuel in a reactor. Amortization of nuclear fuel is calculated on a units-of-production basis and is included in fuel expense. The TVA Act requires TVA's Board to allocate the cost of completed multipurpose projects between the power and nonpower programs, subject to the approval of the President of the United States. TVA accounts for its electric properties using the composite convention of accounting. Accordingly, the original cost of property retired, together with removal costs less salvage value, is charged to accumulated depreciation. Depreciation is generally computed on a straight-line basis over the estimated service lives of the various classes of assets. Depreciation expense expressed as a percentage of the average annual depreciable completed plant was 3.33 percent for 2005 and 3.32 percent for 2004 and 2003. Depreciation rates (percent) by asset class are as follows:

Asset Class	As of September 30		
	2005	2004	2003
Nuclear	3.40	3.37	3.36
Coal-Fired	3.53	3.51	3.48
Hydro	1.78	1.72	1.70
Combustion turbine/diesel generators	4.55	4.41	4.63
Transmission	2.52	2.53	2.53
Other	5.60	6.05	6.26

Blended Low Enriched Uranium Program

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

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

Under the terms of the interagency agreement, DOE supplies off-specification, highly enriched uranium materials to the appropriate Third Party Fuel Processors for processing into usable fuel for TVA. In exchange, DOE will participate to a degree in the savings generated by TVA’s use of this blended nuclear fuel product. As of September 30, 2005, TVA projects that DOE’s share of savings generated by TVA’s use of this blended nuclear fuel product could result in future payments to DOE of as much as \$212 million. TVA anticipates these future payments could begin in 2010. However, due to the uncertainty of the ultimate fuel cost savings and related payments to DOE under the program, TVA has not accrued an obligation related to such future potential payments. TVA will re-assess the estimated amount and probability of these future potential payments each time a BLEU fuel assembly is loaded into one of TVA’s nuclear reactors. The next BLEU fuel reload is currently scheduled for March 2006.

The Third Party Fuel Processors own the conversion and processing facilities and will retain title to all land, property, plant, and equipment used in the BLEU fuel program. There is no provision for TVA to own or otherwise take title to the facilities, materials, or equipment now or at any time in the future. However, in accordance with the requirements of EITF No. 01-08, “*Determining Whether an Arrangement Contains a Lease*,” and SFAS No. 13, “*Accounting for Leases*,” TVA recognized a capital lease asset and corresponding lease obligation related to amounts paid or payable to a Third Party Fuel Processor. Accounting recognition of the capital lease asset and obligation was brought about due to a contract modification to the pre-existing fuel fabrication contract.

During the quarter ended March 31, 2005, TVA recorded a capital lease asset of \$60 million comprised of \$23 million in pre-recharacterization contract payments and \$37 million in post-recharacterization contract payments either paid or payable. Also during the quarter, TVA recorded an initial capital lease obligation of \$37 million. This obligation has subsequently been reduced by \$19 million in post-recharacterization principal payments leaving an unpaid capital lease obligation of \$18 million at September 30, 2005. Additionally, TVA has recognized asset amortization expense of \$9 million and interest expense of \$2 million related to the capital lease obligation through September 30, 2005.

Investment Funds

Investment funds consist primarily of trust funds designated to fund nuclear decommissioning requirements (see note 12 — *Contingencies — Decommissioning Costs*). Decommissioning funds, which are classified as trading, are invested in portfolios of securities generally designed to earn returns in line with overall equity market performance.

Energy Prepayment Obligations

During October 2002, TVA introduced an energy prepayment program, the Discounted Energy Units (“DEU”) program. Under this program, TVA customers purchase DEUs generally in \$1 million increments, and each DEU entitles them to a \$0.025/kilowatt-hour discount on a specified quantity of firm power over a period of years (five, ten, 15, or 20) for each kilowatt-hour in the prepaid block. The remainder of the price of the kilowatt-hours delivered to the customer is due upon billing.

TVA did not offer the DEU program in 2005. Sales for the 2004 program included 5.5 DEUs totalling \$5.5 million over a ten year period and 1.75 DEUs totalling \$1.75 million over a five year period. Total sales for the program since inception are \$54.5 million. TVA is accounting for the prepayment proceeds as unearned revenue and is reporting the obligations to deliver power as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the September 30, 2005, and 2004 Balance Sheets. TVA recognizes revenue as electricity is delivered to customers, based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of September 30, 2005, nearly \$15 million has been applied against power billings on a cumulative basis during the life of the program, of which nearly \$6 million was recognized as noncash revenue during 2005 and 2004.

During 2004, TVA and its largest customer, MLGW, entered into an energy prepayment agreement under which MLGW prepaid TVA \$1.5 billion for the future costs of electricity to be delivered by TVA to MLGW over a period of 180 months. TVA received the \$1.5 billion prepayment in December 2003, accounted for the prepayment as unearned revenue, and is reporting the obligation to deliver power under this arrangement as ENERGY PREPAYMENT OBLIGATIONS and CURRENT PORTION OF ENERGY PREPAYMENT OBLIGATIONS on the September 30, 2005 and 2004 Balance Sheets. TVA expects to recognize approximately \$100 million of noncash revenue in each year of the arrangement as electricity is delivered to MLGW based on the ratio of units of kilowatt-hours delivered to total units of kilowatt-hours under contract. As of September 30, 2005, over \$190 million had been recognized as noncash revenue on a cumulative basis during the life of the agreement, \$100 million of which was recognized as noncash revenue during 2005 and over \$90 million of which was recognized as noncash revenue during 2004.

Insurance

Although TVA uses private companies to administer its health-care plans for eligible active and retired employees not covered by Medicare, TVA does not purchase health insurance. Consulting actuaries assist TVA in determining certain liabilities for self-assumed claims. TVA recovers the costs of losses through power rates and through adjustments to the participants' contributions to their benefit plans. These liabilities are included in OTHER LIABILITIES on the Balance Sheet.

TVA purchases nuclear liability insurance, nuclear property, decommissioning, and decontamination insurance and nuclear accidental outage insurance. (See note 12 — *Contingencies — Nuclear Insurance*.)

TVA does not currently purchase commercial general liability, auto liability, or workers' compensation insurance. TVA recovers the costs of losses through power rates. The Federal Employees' Compensation Act governs liability to employees for service-connected injuries.

On March 31, 2005, the TVA Board approved the purchase of property and business interruption/outage insurance for its non-nuclear assets. TVA implemented the property insurance program on October 1, 2005, and the outage insurance program on November 7, 2005.

On April 25, 2005, the TVA Board approved the purchase of Directors and Officers Liability insurance. This type of insurance provides coverage, subject to the terms and conditions of the policy, for claims against corporate directors and officers for alleged breach of duty while acting in their capacity as a director or officer of TVA. The insurance program went into effect on May 20, 2005.

Revenues

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

Off-system sales are presented in the accompanying Statements of Income as a component of SALES OF ELECTRICITY-FEDERAL AGENCIES AND OTHER. Off-system sales are sales of excess power after meeting TVA native load and direct served requirements.

Sale of Loans

On December 2, 2004, TVA sold a portfolio of 51 power distributor loans receivable. The portfolio was sold for \$55 million without recourse and contained loans with maturities ranging from less than one year to over 34 years. The principal amount due on the loans at the time of the sale was \$57 million. The \$2 million loss is reported in OTHER INCOME, NET on the Income Statement for the year ended September 30, 2005.

Asset Retirement Obligations

In accordance with the provisions of SFAS No. 143, "Accounting for Asset Retirement Obligations," TVA recognizes legal obligations associated with the future retirement of certain tangible long-lived assets. TVA only records estimates of such disposal costs at the time the legal obligation arises or costs are actually incurred. See note 4.

Based on new engineering studies performed annually in accordance with NRC requirements, revisions to the amount and timing of certain cash flow estimates of nuclear asset retirement obligations may be made. TVA recognizes as incurred all obligations related to closure and removal of its nuclear units. TVA measures the liability for closure at the present value of the weighted estimated cash flows required to satisfy the related obligation, discounted at the credit adjusted rate of interest in effect at the time the liability was actually incurred or originally accrued, and subsequently modified to comply with the prevailing accounting provisions. Earnings from decommissioning fund investments, amortization of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred (see note 12—*Contingencies—Decommissioning Costs*). Beginning in 2003, TVA evaluated the nature and scope of its decommissioning policy as it relates to all electric plant. The evaluation was used to determine the need for recognition of additional asset retirement obligations as described in SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 became effective for TVA at the beginning of 2003 (see note 4).

Allowance for Funds Used During Construction

TVA capitalizes an allowance for funds used during construction based on the average rate of TVA's outstanding debt. The allowance is applicable to construction in progress, excluding deferred nuclear generating units.

Tax Equivalents

The TVA Act requires TVA to make payments to states and local governments where the power operations of the Corporation are conducted and in which TVA has acquired properties previously subject to state and local taxation. The amount is five percent of gross receipts from the prior year's sale of power, excluding sales or deliveries to other federal agencies and off-system sales with other utilities, with a provision for minimum payments under certain circumstances.

Project Cancellation

In December 2003, TVA was notified that Regenesys Technologies Limited ("RTL") would not proceed with manufacturing of the fuel cells to be installed in the partially completed Regenesys energy storage plant in Columbus, Mississippi. TVA had invested approximately \$35 million in the Regenesys project. RTL reimbursed TVA for early termination of the contract in the amount of \$15 million, which reduced the net loss to \$20 million on the cancellation of the Regenesys project.

Impairment of Assets

TVA evaluates long-lived assets for impairment in accordance with the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. For long-lived assets to be held and used, TVA bases its evaluation on impairment indicators such as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, and other external market conditions or factors that may be present. If such impairment indicators are present or other factors exist that indicate that the carrying amount of an asset may not be recoverable, TVA determines whether an impairment has occurred based on an estimate of undiscounted cash flows attributable to the asset, as compared with the carrying value of the asset. If an impairment has occurred, the amount of the impairment recognized is measured as the excess of the asset's carrying value over its fair value. See note 6.

Reduction in Workforce

During 2004, organizations within TVA performed program and staffing reviews to identify surplus staffing situations. In areas where surplus staffing existed, TVA asked for employees to apply for voluntary resignations beginning in February 2004. To the extent there were not enough volunteers, TVA conducted an involuntary Reduction in Force ("RIF"). As of September 30, 2005, there were 739 employees impacted by this change — 49 employees in 2005 and 690 employees in 2004. As shown in the table below, TVA has recognized total expense in the amount of

\$40 million for termination costs incurred through September 30, 2005. Payout of benefits occurs as employees retire from TVA. Substantially all affected employees will have retired by the end of 2005, and no further reductions are anticipated at this time.

Changes in the associated liability are as follows:

Termination Costs Liability Activity At September 30		
	<u>2005</u>	<u>2004</u>
Termination costs liability at October 1	\$ 14	\$ -
Liability incurred	4	36
Actual costs paid	(14)	(22)
Termination costs liability at September 30	<u>\$ 4</u>	<u>\$ 14</u>

Impact of New Accounting Standards and Interpretations

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

TVA considered the provisions of FIN 46(R) for application to its lease/leaseback transactions. Under FIN 46(R), TVA would be deemed the primary beneficiary of the variable interest entities created in connection with these transactions and would therefore be required to consolidate the assets and liabilities of these VIEs. TVA has already effectively consolidated these assets and liabilities under the accounting guidance provided by SFAS No. 66 and SFAS No. 98 as described in note 10.

TVA has not identified any material VIEs created or interest in VIEs obtained after December 31, 2003, which require consolidation or disclosure under FIN 46(R). TVA continues to assess the existence of any interests in VIEs created on or prior to December 31, 2003, which may or may not be material to its results of operations or financial position, and is still in the process of determining whether it can obtain the financial information necessary to make the assessment.

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

Medicare Prescription Drug, Improvement and Modernization Act of 2003. In December 2003, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" became law. The act introduces a prescription drug benefit under Medicare (Part D) as well as a federal subsidy to employers who provide a retiree prescription drug benefit that is at least actuarially equivalent to Medicare Part D. Beginning in 2006, Medicare will provide prescription drug coverage under Medicare Part D. After analyzing a number of options available to plan sponsors for integration with the new Medicare Part D, TVA elected to provide an employer-sponsored Part D prescription drug plan ("PDP"), with alternative coverage over and above Medicare standard Part D coverage, for Medicare-eligible retirees who participate in TVA's Medicare supplement. By providing an employer-sponsored PDP, any Medicare subsidies will be passed through to retirees in the form of lower participant premiums and should not affect TVA's cost of providing prescription drug coverage.

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

Exchanges of Nonmonetary Assets. In December 2004, the FASB published SFAS No. 153, “*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29,*” which eliminates the exception to fair value for exchanges of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance—that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. This statement is intended to produce financial reporting that more faithfully represents the economics of the transactions. This guidance is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on TVA’s results of operations or financial condition.

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

Accounting Changes and Error Corrections. In May 2005, the FASB issued SFAS No. 154, “*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and SFAS 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 the date the statement is issued.

Accounting for Purchases and Sales of Inventory with the Same Counterparty. On September 28, 2005, the EITF ratified Issue No. 04-13, “*Accounting for Purchases and Sales of Inventory with the Same Counterparty.*” This issue relates to companies that sell inventory to another entity in the same line of business from which it also purchases inventory. The staff believes that the transition guidance in EITF Issue 04-13 should apply to all contracts entered into after March 15, 2006. The adoption of EITF Issue No. 04-13 beginning in the second quarter of 2006 is not expected to have a material effect on TVA’s results of operations or financial position.

Put and Call Options. In September 2005 the Derivatives Implementation Group of the FASB (“DIG”) 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, does not apply 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. TVA is evaluating the potential implications of these Issues on its transactions related to future call and put options which may or may not be material to its financial position or results of operations.

Accounting Changes

Effective October 1, 2002, the Board approved a change in the methodology for estimating unbilled revenue from electricity sales. The change in calculating unbilled revenue was from a method using cumulative generation to a method that uses only generation for the current billing period. TVA was able to make this change based on improved metering technology that allows TVA to more accurately capture the number of days power has been generated and transferred to its customers but not yet billed to those customers. Changing to this more accurate estimating methodology resulted in an increase in accounts receivable of \$412 million.

On October 1, 2002, TVA adopted SFAS No. 143, “Accounting for Asset Retirement Obligations,” which requires the recognition of a liability and capitalization of the associated asset retirement costs as part of the carrying amount of the long-lived asset for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or normal operation of long-lived assets. The effect of the adoption of SFAS No. 143 during 2003 included a cumulative effect charge to income of \$195 million, a recognition of a corresponding additional long-term liability of \$734 million, an increase in assets of \$745 million, and a recognition of related accumulated depreciation of \$206 million.

2. Nuclear Power Program

At September 30, 2005, TVA’s nuclear power program consisted of nine units—five operating, one in recovery, and three in deferred status (discussed below). The operating and recovery units are in three locations with investments in property, plant and equipment as follows and in the status indicated:

	Operating Units	Installed Capacity (MW)	Completed Plant, Net	Construction in Progress	Fuel Investment
Browns Ferry*	2	2,380	\$ 2,115	\$ 1,439	\$ 118
Sequoyah	2	2,442	1,778	28	93
Watts Bar	1	1,270	5,496	111	50
Raw materials	—	—	—	—	79
Total	<u>5</u>	<u>6,092</u>	<u>\$ 9,389</u>	<u>\$ 1,578</u>	<u>\$ 340</u>

Note

* Browns Ferry Unit 1, a unit in recovery, is discussed below.

Browns Ferry Unit 1 was taken offline in 1985 for plant modifications and regulatory improvements and will continue to remain in an inoperative status until recovered. In May 2002, the TVA Board initiated activities for the return of Unit 1 to service in order to meet long-term power requirements. The decision was made upon completion of the Detailed Scoping, Estimating and Planning project and the Final Supplemental Environmental Impact Statement, which demonstrated that Unit 1 could be returned to safe operation in a controlled manner and that operating the unit would have no significant, adverse impacts on the environment. TVA has determined that restarting Unit 1 is the best alternative currently available among the mix of generation options. It is anticipated the Unit 1 recovery project will add approximately 1,280 megawatts of generation at a cost of approximately \$1.8 billion, exclusive of AFUDC and estimated asset retirement obligation. Unit 1 is expected to return to service in 2007. The undepreciated cost of Unit 1 of \$24 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period. At September 30, 2005, TVA had incurred approximately \$1.3 billion of costs, including AFUDC of \$102 million, on the restart project, and the project was approximately 70 percent complete.

TVA has three units in deferred status. In 1988, TVA suspended construction activities on Watts Bar Unit 2.

Bellefonte Unit 1 and Unit 2 were deferred in 1988 and 1985, respectively. In December 1994, TVA determined that it would not, by itself, complete Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 as nuclear plants. The TVA Board determined as of the end of 2001 that the values of some of its existing assets were not appropriate in a competitive marketplace. Certain nuclear assets — portions of Bellefonte Unit 1 and Unit 2 and Watts Bar Unit 2 in its entirety — were identified as assets for which the estimated cash flows expected to be provided through future rates were less than recorded book values. Consequently, in 2001 TVA revalued these assets downward by \$2.2 billion and recognized an impairment loss. In 2004, it was determined that certain assets at the Bellefonte site, such as the diesel generators, training facilities, transmission structures, and other assets, had achieved a usable state. Consequently, during 2004, the Board approved the reclassification of approximately \$203 million of Bellefonte assets from DEFERRED NUCLEAR GENERATING UNITS to COMPLETED PLANT. In July 2005, the Board approved the amortization of TVA's remaining investment in the deferred generating units at Bellefonte Nuclear Plant over a ten-year period beginning in 2006 (see note 1--*Cost-Based Regulation*). The Board action to begin amortizing the investment of the \$3.9 billion deferred nuclear generating units at Bellefonte Nuclear Plant will not limit TVA's ability to use the Bellefonte site in the future.

In September 2005, NuStart Development LLC ("NuStart"), of which TVA is a member, selected Bellefonte as one of the two potential sites in the country for a new advanced design nuclear plant. Although neither TVA nor NuStart has decided to build an advanced nuclear reactor at this time, NuStart does intend to seek combined construction and operating licenses for the site for the new Advanced Passive 1000 reactor design by Westinghouse Electric Co. The combined operating license-approach allows the applicant to seek both a construction permit and an operating license at the front end to help ensure greater certainty of the outcome, so long as the applicant closely builds what is described in the application. TVA also recently led a team which prepared a cost and schedule study on building an Advanced Boiling Water Reactor ("ABWR") on the Bellefonte site. Other members of the team, operating under the DOE's Nuclear Power 2010 program, include Toshiba Corp., General Electric Corp., Bechtel Corp., USEC, and Global Nuclear Fuels – Americas. The ABWR has been design-certified in the United States by the Nuclear Regulatory Commission ("NRC"). The study was designed to verify the costs of building a new ABWR plant, which could provide another option for utilities interested in preserving the nuclear option for the future.

In December 2003, TVA submitted an application to the NRC for a 20-year extension of the operating licenses for three reactors at Browns Ferry Nuclear Plant. Current expiration dates of the operating licenses for the Browns Ferry units are:

Browns Ferry Unit 1	2013
Browns Ferry Unit 2	2014
Browns Ferry Unit 3	2016

The original 40-year term on licenses per the Atomic Energy Act and the NRC regulations was based on economic and antitrust considerations and not based on limitations of technology. If the NRC approves the application, it will allow TVA to continue production of power from the facility until 2033, 2034, and 2036 for units 1, 2, and 3, respectively.

3. Completed Plant

Completed plant consists of the following at September 30:

	2005			2004		
	Cost	Accumulated Depreciation	Net	Cost	Accumulated Depreciation	Net
Power Program						
Fossil	\$ 10,164	\$ 4,912	\$ 5,252	\$ 9,869	\$ 4,614	\$ 5,255
Combustion Turbine	1,176	447	729	1,171	393	778
Nuclear	15,517	6,128	9,389	15,441	5,623	9,818
Transmission	4,227	1,512	2,715	4,165	1,422	2,743
Hydro	1,861	648	1,213	1,823	616	1,207
Other	1,264	426	838	1,306	429	877
Total Power	34,209	14,073	20,136	33,775	13,097	20,678
Nonpower Program						
Multipurpose Dams	962	326	636	963	318	645
Other	44	8	36	48	9	39
Total Nonpower	1,006	334	672	1,011	327	684
Total	\$ 35,215	\$ 14,407	\$ 20,808	\$ 34,786	\$ 13,424	\$ 21,362

4. Asset Retirement Obligations

Effective October 1, 2002, TVA adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," which requires the recognition of a liability, and capitalization of the associated asset retirement cost as part of the carrying amount of the long-lived asset, for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or normal operation of long-lived assets. TVA identified and reviewed all relevant information in the determination of its potential asset retirement obligations ("AROs"). TVA identified three categories of AROs which represent legal obligations of TVA under the requirements set forth in the standard. Costs associated with retirement of coal-fired (including ash/waste ponds) and gas/oil turbine generating plants are being expensed as period costs while costs associated with retirement of nuclear generating plants are receiving SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," treatment based on the partially funded status of the nuclear decommissioning obligation (see note 1 — *Cost-Based Regulation*).

Nuclear Generating Plants. Prior to implementing SFAS No. 143, TVA had recognized a decommissioning liability related to its nuclear generating plants in accordance with NRC requirements. The adoption of SFAS No. 143 resulted in a change in the methodology of quantifying this nuclear decommissioning obligation in accordance with the new accounting standard. TVA has increased the nuclear decommissioning liability on the balance sheet to reflect the new methodology but has retained its regulatory accounting treatment of capturing all changes in the liability, investment funds, and certain other deferred charges as changes in the regulatory asset instead of recording these items on the income statement. This nuclear decommissioning liability is reported as ASSET RETIREMENT OBLIGATIONS on the 2005 and 2004 Balance Sheets.

Coal-Fired Generating Plants. The activities associated with coal plant retirement include plant shutdown, securing the physical property, closure of storage and/or waste areas (including ash/waste ponds), maintenance of stack lights, security patrols, and measures to contain asbestos and other hazardous materials from release into the environment. The estimated costs of these activities have been included in the calculation of TVA's coal plant AROs. Certain ash ponds and waste areas have estimated useful lives that are independent of the lives of the coal plants themselves. Accordingly, these specific ash/waste pond areas were quantified as separate AROs based on their specific estimated useful lives.

Gas/Oil Turbine Generating Plants. The activities associated with gas and oil turbine plant retirement include annual operating costs for site security, lighting, powerhouse and grounds maintenance, containment of asbestos, paint, and other materials, and groundwater monitoring. The estimated costs of these activities have been identified to be included in the calculation of TVA's combustion turbine plant AROs.

For each ARO identified, TVA calculated the net present value of the obligation as of the current period, the original and incremental cost of the long-lived asset at the time of initial operation, the cumulative effect of depreciation on the adjusted asset base, and accretion of the liability from the date of initial operation to the current period.

In September 2004, an additional ARO layer was added to the gas/oil turbine plants ARO category due to certain assets placed in service. The result was an increase in the original cost of the gas/oil assets of \$0.7 million and a corresponding increase in the gas/oil retirement obligation of \$3.9 million at September 30, 2004. During the first quarter of 2005, there was a change in the estimated closure date related to the Bellefonte diesel generators. The original estimate assumed asset retirement in 2029 and a six year waiting period before closure work would begin in 2035. The new estimate assumes that closure work will begin at the date the assets cease to operate in 2029. This change in estimate resulted in a decrease in the total future liability of nearly \$1 million, and an increase in the current net present value of the ARO asset liability of less than \$0.1 million.

In February 2004 and March 2005, TVA made revisions to the amount and timing of certain cash flow estimates related to its nuclear asset retirement obligations. The revisions in cost were based on new engineering studies performed 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 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 2004 adjustments resulted in an aggregate decrease of \$40 million in the asset retirement obligation, a \$12 million reduction in the asset base, a \$5 million reduction in accumulated depreciation, and a decrease of \$33 million in the originally recorded regulatory asset which TVA created in accordance with SFAS No. 71. Therefore, the result of the change described did not impact net income for the years ended September 30, 2005 and 2004.

During 2004, TVA's total ARO liability increased \$57 million due to accretion expense of \$97 million partially offset by the \$40 million revision to the nuclear ARO described above. The nuclear accretion expense of \$85 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of \$12 million, related to coal-fired and gas/oil plants, was expensed during 2004. During 2005, TVA's total ARO liability increased \$75 million due to accretion expense of \$100 million partially offset by the \$25 million revision in cash flow described above. The nuclear accretion expense of \$87 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of \$13 million, related to coal-fired and gas/oil plants, was expensed in 2005.

Reconciliation of Asset Retirement Obligation Liability
Year ended September 30

	<u>2005</u>	<u>2004</u>
Balance at beginning of year	\$ 1,782	\$ 1,725
Liabilities settled	—	—
Accretion expense	100	97
Revisions in estimated cash flows	(25)	(40)
Balance at end of year	<u>\$ 1,857</u>	<u>\$ 1,782</u>

5. Regulatory Assets and Liabilities

Regulatory assets capitalized under the provisions of SFAS No. 71 are included in DEFERRED NUCLEAR GENERATING UNITS and Other REGULATORY ASSETS on the September 30, 2005 and 2004 Balance Sheets. Components of OTHER REGULATORY ASSETS include certain charges related to the closure and removal from service of nuclear generating units, reacquisition costs, deferred outage costs, unrealized losses related to mark-to-market valuations and a purchase power contract, deferred capital lease asset costs, and an adjustment to accrue the minimum pension liability. See note 1 — *Cost-Based Regulation* and note 2.

The year-end balances of TVA's regulatory assets and liabilities are as follows:

	At September 30	
	2005	2004
Regulatory Assets:		
Adjustment to accrue minimum pension liability	\$ 1,158	\$ 1,243
Nuclear decommissioning costs	716	755
Reacquisition costs	264	277
Deferred outage costs	103	86
Capital leases	84	90
Unrealized losses on purchase power contract	<u>42</u>	<u>59</u>
Subtotal	2,367	2,510
Deferred nuclear generating units	<u>3,912</u>	<u>3,909</u>
Total	<u>\$ 6,279</u>	<u>\$ 6,419</u>
Regulatory Liabilities:		
Unrealized gain on coal purchase contracts	\$ 791	\$ 478
Capital lease liability	<u>106</u>	<u>122</u>
Total	<u>\$ 897</u>	<u>\$ 600</u>

Reacquisition expenses, call premiums, and other related costs, such as unamortized debt issue costs associated with redeemed bond issues, are deferred under provisions of the FERC's Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act. These costs are deferred and amortized (accrued) on a pooled straight-line basis over the weighted average life of TVA's debt portfolio. (Even though TVA is not a public utility subject generally to FERC jurisdiction, the TVA Act requires TVA to keep accounts in accordance with the requirements established by FERC.)

Deferred capital lease asset costs, representing the difference between the FERC's Uniform System of Accounts model balances and the SFAS No. 13, "Accounting for Leases," model balances, are also included in regulatory assets. Under the FERC uniform system of accounts, TVA recognized the initial capital lease asset and liability at inception of the lease in accordance with SFAS No. 13; however, the annual expense is equal to the annual lease payments, which differs from SFAS No. 13 accounting treatment. This practice results in TVA's capital lease asset balances being higher than they otherwise would have been under the SFAS No. 13 model, with the difference between FERC model balances and the SFAS No. 13 model balances representing an embedded regulatory asset within each capital lease. These costs are being amortized over the respective lease terms.

Nuclear decommissioning costs include certain charges related to the future closure and decommissioning of TVA's nuclear generating units under NRC requirements. These future costs will be funded through a combination of investment funds already set aside by TVA, future earnings on those investment funds, and if necessary, TVA cash contributions to the investment funds. See note 1 — *Investment Funds* and note 4.

Due to negative pension plan asset returns from 2002 and 2001, TVA's accumulated benefit obligation at September 30, 2005 and 2004 exceeded plan assets. As a result, TVA was required to recognize an additional minimum pension liability as prescribed by SFAS No. 87, "Employers' Accounting for Pensions." These future pension costs will be funded through a combination of the pension investment funds already set aside by TVA, future earnings on those pension investment funds, and, if necessary, future TVA cash contributions to the pension plan.

Unrealized loss on a purchase power contract represents the estimated unrealized loss related to the mark-to-market valuation of the contract. Under the accounting rules contained in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," this contract qualifies as a derivative contract but does not qualify for cash flow hedge accounting treatment. As a result, TVA recognizes the changes in the market value of this derivative contract as a regulatory asset. This treatment reflects TVA's ability and intent to recover the cost of this commodity contract on a settlement basis for ratemaking purposes. TVA has historically recognized the actual cost of purchased power received under this contract in purchased power expense at the time of settlement. The contract expires in 2007. See note 8.

At September 30, 2005, construction of the Bellefonte Nuclear Plant ("Bellefonte") remains in a deferred status (see note 2). In July 2005, the Board approved the amortization TVA's investment in the deferred nuclear generating units over a ten-year period beginning in 2006.

Regulatory liabilities accounted for under the provisions of SFAS No. 71 consist of mark-to-market valuation gains on certain derivative contracts and capital leases.

Unrealized gain on coal purchase contracts represents the estimated unrealized gains related to the mark-to-market valuation of coal purchase contracts. Under the accounting rules contained in SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*," these contracts qualify as derivative contracts but do not qualify for cash flow hedge accounting treatment. As a result, TVA recognizes the changes in the market value of these derivative contracts as a regulatory liability. This treatment reflects TVA's ability and intent to recover the cost of these commodity contracts on a settlement basis for ratemaking purposes. TVA has historically recognized the actual cost of fuel received under these contracts in fuel expense at the time the fuel is used to generate electricity. These contracts expire at various times through 2017. See note 8.

As a result of a capital lease payment stream requiring larger cash payments during the latter years of the lease term than during the early years of the lease term, TVA leveled the annual lease expense recognition related to this lease in order to promote the fair and equitable cost recovery from ratepayers. These costs are being amortized over the lease term.

Nuclear Fuel and Refueling Outage Costs

TVA's investment in the fuel used in the Sequoyah, Watts Bar, and Browns Ferry nuclear units is being amortized and accounted for as a component of fuel expense (see note 2). Nuclear refueling outage and maintenance costs are deferred and amortized on a straight-line basis over the estimated period until the next refueling outage. The amounts of deferred outage costs for the years ended September 30, 2005, 2004, and 2003 were \$103 million, \$86 million, and \$100 million, respectively.

6. Asset Impairment

During 2005, TVA recognized a total of \$24 million in impairment losses related to its property, plant and equipment. The losses included a \$16 million write-down of certain CONSTRUCTION IN PROGRESS assets related to new pollution-control and other technologies that had not been proven effective, and an \$8 million write-down on one of two buildings in TVA's Knoxville Office Complex ("KOC"). Based on TVA's desire, intent, and plans to sell or lease the East Tower of the KOC, TVA has recognized an impairment loss equal to the difference between the net book value of the East Tower of \$20 million and the current estimated market value of \$12 million. See note 1 — *Impairment of Assets*.

7. Proprietary Capital

Appropriation Investment

Since its creation in 1933 and continuing through 1999, TVA received appropriations from Congress to carry out its power and nonpower programs. The table below summarizes TVA's activities related to these funds. The TVA Act requires TVA to make annual payments to the Treasury from net power proceeds as a return on the investment that Congress made in the power system (the "Appropriation Investment") and as a repayment of \$1 billion of the Appropriation Investment. The payments required by the TVA Act may be deferred under certain circumstances for not more than two years. TVA paid \$20 million each year for 2005, 2004, and 2003 as a repayment of the Appropriation Investment. In addition, TVA paid the Treasury \$16 million in 2005, \$18 million in 2004, and \$22 million in 2003 as a return on the Appropriation Investment. The return is based on the amount of the Appropriation Investment as of the beginning of the year and on the computed average interest rate payable by the Treasury on its total marketable public obligations as of the same date. These rates were 3.71 percent, 3.82 percent, and 4.63 percent at September 30, 2005, 2004, and 2003, respectively. Cumulative repayments and return on investment paid by TVA's power program to the Treasury approximate \$3.6 billion. Approximately \$1.0 billion of the Appropriation Investment of \$1.4 billion has been repaid. Of the \$1.0 billion portion of the Appropriation Investment TVA is required to repay, \$170 million remains unpaid at September 30, 2005.

	<u>Congressional Appropriations</u>	<u>Appropriations for Nonpower Program</u>	<u>Appropriation Investment in Power Program</u>
Appropriations from Congress	\$ 11,055	\$ 9,636	\$ 1,419
Transfers of Property to TVA	66	42	24
Transfers of Property from TVA	(56)	(56)	-
Program Expenditures	(5,221)	(5,221)	-
Repayments to U.S. Treasury	(1,061)	(46)	(1,015)
Total	<u>\$ 4,783</u>	<u>\$ 4,355</u>	<u>\$ 428</u>

Accumulated Other Comprehensive Income

SFAS No. 130, "Reporting Comprehensive Income," requires the disclosure of comprehensive income or loss to reflect changes in capital that result from transactions and economic events from nonowner sources. The items included in accumulated other comprehensive loss consist of market valuation adjustments for certain derivative instruments (see note 8). The accumulated other comprehensive income (loss) as of September 30, 2005, 2004 and 2003, was \$26 million, \$(52) million, and \$(74) million, respectively.

Total Other Comprehensive (Loss) Income Activity

Accumulated other comprehensive loss, October 1, 2002	\$ (150)
Changes in fair value:	
Inflation	13
Foreign currency swaps	63
Accumulated other comprehensive loss, September 30, 2003	<u>(74)</u>
Changes in fair value:	
Inflation	4
Foreign currency swaps	18
Accumulated other comprehensive loss, September 30, 2004	<u>(52)</u>
Changes in fair value:	
Inflation	4
Foreign currency swaps	75
Accumulated other comprehensive income, September 30, 2005	<u>\$ 27</u>

8. Risk Management Activities and Derivative Transactions

TVA is exposed to market risks, including changes in interest rates, foreign currency exchange rates, inflation 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, swaptions, and futures and option contracts on various commodities.

TVA is 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.

With respect to hedging activities, 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 or trading purposes. Prior to October 1, 2000, TVA accounted for hedging activities using the deferral method, and gains and losses were recognized in the financial statements when the related hedged transaction occurred. During 2001, TVA adopted 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."

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

**Mark-to-Market Values of TVA Derivatives
at September 30**

	<u>2005</u> <u>Balance</u>	<u>2004</u> <u>Balance</u>	<u>2005 Notional</u> <u>Amount</u>	<u>Year of</u> <u>Expiration</u>
Inflation swap	\$ 17	\$ 2	\$300 million	2007
Interest rate swap	(158)	(140)	\$476 million	2044
Currency swaps:				
Deutschemark	(68)	(62)	DM1.5 billion	2006
Sterling	21	13	£200 million	2021
Sterling	89	79	£250 million	2032
Sterling	36	32	£150 million	2043
Swaptions:				
\$1 billion notional	(314)	(225)	\$1 billion	2042
\$28 million notional	(4)	-	\$28 million	2022
\$14 million notional	(2)	-	\$14 million	2022
Emission allowance call options	-	6	-	2005
Coal contracts-volume options	791	478	118 million tons	2017
Purchase power option contracts	(42)	(59)	500 MW	2007

In accordance with SFAS No. 133, as amended, the inflation swap and foreign currency swap contracts are accounted for on a mark-to-market basis and resulted in a gain of \$79 million, \$22 million, and \$76 million for 2005, 2004, and 2003, respectively. Since such contracts represent cash flow hedges of certain debt transactions, the gains have been recognized in ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS). Because of the highly effective nature of these hedging transactions, TVA was not required to recognize gains from these transactions in the Statements of Income. If any loss/(gain) were to be incurred as a result of the early termination of the inflation swap contract or a foreign currency swap contract, any resulting charge/(income) would be amortized over the remaining life of the associated bond as a component of interest expense.

**Summary of Derivative Instruments that Receive Hedge Accounting Treatment
As of September 30, 2005**

<u>Derivative Hedging Instrument</u>	<u>Hedged Item</u>	<u>Purpose of Hedge Transaction</u>	<u>Type of Hedge—Fair Value (FV) or Cash Flow (CF)</u>	<u>Accounting for Derivative Hedging Instrument</u>	<u>Accounting for the Hedged Item</u>
Inflation Swap	Variable-principal debt	To fix the debt's variable cash flows to a fixed flow	CF	Cumulative gains and losses are recorded in other comprehensive income to the extent they are offset by cumulative gains and losses on the hedged transaction.	No adjustment is made to the basis of the hedged item.
Currency Swaps	Anticipated payment denominated in a foreign currency	To protect against changes in cash flows caused by changes in foreign-currency exchange rates	CF	Cumulative gains and losses are recorded in other comprehensive income to the extent they are offset by cumulative gains and losses on the hedged transaction.	No adjustment is made to the basis of the hedged item.
Swaption (2002)	Embedded call	To protect against a decrease in value of the embedded call	FV	All gains and losses on the derivative are recorded in earnings as unrealized gain/loss on derivative contracts.	All gains and losses on the hedged item are recorded in earnings as unrealized gain/loss on derivative contracts.

**Summary of Derivative Instruments that Do Not Receive Hedge Accounting Treatment
As of September 30, 2005**

<u>Derivative Type</u>	<u>Purpose of Derivative</u>	<u>Accounting for Derivative Instrument</u>
Coal Contracts—Volume Options	To protect against fluctuations in market prices of the item to be purchased	Gains and losses are recorded as regulatory assets or liabilities until settlement at which time they are recognized in fuel and purchased power expense.
Purchase Power Option Contracts	To protect against fluctuations in market prices of the item to be purchased	Gains and losses are recorded as regulatory assets or liabilities until settlement, at which time they are recognized in fuel and purchased power expense.
Interest Rate Swap	To fix short-term debt variable rate to a fixed rate	Fixed and variable interest cash flows are recorded in earnings as interest expense. MTM gains and losses are recorded in earnings as unrealized gains/losses on derivative contracts.
Swaptions (2005)	To protect against a decrease in value of the embedded call call	Gains and losses are recorded in earnings as unrealized gains/losses on derivative contracts.

Commodity Contracts

TVA enters into forward contracts that hedge cash flow exposures to market fluctuations in the price and delivery of certain commodities including coal, natural gas, and electricity. TVA expects to take or make delivery, as appropriate, under these forward contracts. Accordingly, these contracts qualify for normal purchases and normal sales accounting under SFAS No. 133, as amended, which describes the criteria that must be met in order for such contracts to qualify for the use of normal purchases and normal sales accounting.

Gains and losses on cash flow hedges are deferred in ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) and recognized as adjustments to the carrying amount of the items hedged. Deferral of the gains and losses continues until the items hedged are recognized in income. Gains and losses on derivatives not qualifying for hedge accounting are deferred in accordance with SFAS No. 71.

Foreign Currency, Interest Rate, and Inflation Swaps

During 1996, TVA entered into a currency swap contract as a hedge for a foreign currency denominated debt transaction. TVA issued DM1.5 billion of bonds and entered into a currency swap to hedge fluctuations in the DM exchange rate. The overall effective cost to TVA of these bonds and the associated swap was 7.13 percent. TVA also entered into currency swap contracts during 2003, 2001, and 1999 as hedges for sterling-denominated debt transactions in which TVA issued £150 million, £250 million, and £200 million of bonds, respectively. The overall effective cost to TVA of these bonds and the associated swaps was 4.96 percent, 6.59 percent, and 5.81 percent, respectively. Any gains or losses on the debt instruments due to the foreign currency transactions are offset by losses or gains on the swap contracts. At September 30, 2005, and 2004, the currency transactions had resulted in net translation losses of \$52 million and of \$113 million, respectively, which are included in CURRENT MATURITIES OF LONG-TERM DEBT, NET and LONG-TERM DEBT, NET. However, the net translation losses were offset by corresponding gains on the swap contracts, which are reported as a deferred asset.

Additionally, in 1997 TVA issued \$300 million of inflation-indexed accreting principal bonds. The ten-year bonds have a fixed coupon rate that is paid on the inflation-adjusted principal amount. TVA hedged its inflation exposure under the securities through a receive-floating, pay-fixed inflation swap agreement. The overall effective cost to TVA of these bonds and the associated swap was 6.64 percent. On September 21, 2004, TVA received a payment of \$55 million from the swap counterparty representing the present value of the accretion as of that date. The present value of the accretion is recorded as a long-term receivable on the September 30, 2005, and 2004 Balance Sheets. At the termination of the swap, instead of receiving the entire accreted balance from the counterparty, TVA will receive only the additional accretion from September 22, 2004, through the end of the swap.

Call Monetizations

During 2002, TVA monetized the call provisions on a \$1 billion public bond issue by entering into a swaption agreement with a third party in exchange for \$175 million. In 2003, TVA monetized the call provisions on a second public bond issue of \$476 million by entering into a swaption agreement with a third party in exchange for \$81 million. In the third quarter of 2005, TVA monetized the call provisions on two electronotes[®] issues (\$42 million total par value) by entering into swaption agreements with a third party in exchange for \$5 million. A swaption essentially grants a third party the right to exercise the embedded call provision of the applicable bond while TVA continues to pay the holders of the swaption pursuant to the original bond issuance. In February 2004, the counterparty to the 2003 swaption transaction exercised its option to enter into a swap with TVA, effective April 10, 2004, requiring TVA to make fixed rate payments to the counterparty of 6.875 percent and the counterparty to make floating payments to TVA based on London Interbank Offered Rate ("LIBOR"). These payments are based on a notional principal amount of \$476 million, and the parties began making these payments on June 15, 2004. The 2002 swaption is recorded in OTHER LIABILITIES on the September 30, 2005 Balance Sheet and is designated as a hedge of future changes in the fair value of the original call provision. Under SFAS No. 133, as amended, TVA records the changes in market value of both the swaption and the embedded call. These values historically have been highly correlated; however, to the extent that the values do not perfectly offset, any differences will be recognized currently through earnings. These differences (including those for the 2003 swaption prior to its being exercised in February 2004) amounted to a nearly \$10 million noncash gain for the year ended September 30, 2004, and a \$27 million noncash gain for the year ended September 30, 2005. The swap entered into pursuant to the 2003 swaption and the two electronotes[®] swaptions are also recorded in OTHER LIABILITIES on the September 30, 2005 Balance Sheet, and the changes in market value are recognized currently in earnings. These changes amounted to a \$23 million noncash loss for the year ended September 30, 2004, and a \$19 million noncash loss for the year ended September 30, 2005.

Financial Trading Program

A financial trading pilot program to reduce TVA's economic risk exposure associated with TVA's physical electricity generation, purchases, and sales was approved by the Board on September 11, 2003 ("Pilot Program"). Under the Pilot Program, TVA was authorized to use futures and options on futures to hedge economic risks directly associated with the cost of natural gas and fuel oil for TVA's power generation operations and risks under power purchase or sale arrangements where the energy price varies based upon a fuel index.

The Pilot Program was scheduled to end on August 31, 2005, but on May 17, 2005, the Board established a permanent financial trading program ("Program" and, together with the Pilot Program, "Programs") that allows TVA to: (1) continue to hedge the risks authorized under the Pilot Program; (2) broaden the type of risks that TVA can hedge to include economic risks directly associated with both the cost of natural gas for tolling agreements and the purchase or sale arrangements where the energy price is based at least in part upon a fuel price index or proxy; and (3) hedge risks more effectively by using swaps and options on swaps in addition to futures and options on futures. Trading is not authorized for speculative purposes under the Programs.

At September 30, 2005, TVA had 112 derivative positions outstanding under the Program. The Programs have enabled TVA to effectively hedge the price risk associated with a portion of its natural gas and power purchases. TVA recognized unrealized gains of approximately \$0.5 million which were included as an offset to purchased power expense for the year ended September 30, 2005. The same year also produced realized gains of about \$3.3 million which were included as an offset to purchased power expense. The gains on the positions were less than eight percent of the total natural gas expense for the period.

Financial Trading Program Activity For the Year ended September 30, 2005

	2005		2004	
	Notional Amount (in mmBtu)	Contract Value	Notional Amount (in mmBtu)	Contract Value
Futures contracts				
Financial positions at beginning of period	—	\$ —	—	\$ —
Purchased	4,370,000	33.2	1,250,000	8.0
Sold	(3,490,000)	(26.9)	(1,250,000)	(7.0)
Realized gains (losses)	—	3.3	—	(1.0)
Net positions--long	880,000	9.6	—	—
Options contracts				
Financial positions at beginning of period	—	—	—	—
Calls purchased	580,000	0.6	—	—
Calls and puts sold	980,000	(0.6)	—	—
Positions closed or expired	(1,320,000)	—	—	—
Net positions--long	240,000	—	—	—
Holding gains (losses)				
Unrealized gain at beginning of period, net	—	—	—	—
Unrealized gain for the period	—	0.5	—	—
Unrealized gains at end of period, net	—	0.5	—	—
Financial positions at end of period, net	1,120,000	\$ 10.1	—	—

9. Debt

Borrowing Authority

The TVA Act authorizes TVA to issue bonds, notes, and other evidences of indebtedness up to a total of \$30 billion outstanding at any one time. TVA must meet certain financial tests that are contained in the TVA Act and the Basic Resolution. Debt service on these obligations, which is payable solely from TVA's net power proceeds, has precedence over payments to the Treasury (see note 7—*Appropriation Investment*).

Short-Term Debt

The weighted average rates applicable to short-term debt outstanding in the public market as of September 30, 2005, 2004, and 2003, were 3.64 percent, 1.70 percent, and 1.00 percent, respectively. During 2005, 2004, and 2003, the maximum outstanding balances of short-term borrowings held by the public were \$3.1 billion, \$2.1 billion, and \$3.4 billion, respectively. For these same years, the average amounts (and weighted average interest rates) of short-term borrowings were approximately \$1.7 billion (2.72 percent), \$859 million (1.15 percent), and \$2.8 billion (1.28 percent), respectively.

TVA also has access to a financing arrangement with the Treasury whereby it is authorized to accept a short-term note with the maturity of one year in an amount not to exceed \$150 million. TVA may draw any portion of the authorized \$150 million during the year. Interest is accrued daily and paid quarterly at a rate determined by the Secretary of the Treasury each month based on the average rate on outstanding marketable obligations of the United States with maturities of one year or less. During 2005, 2004, and 2003, the daily average amounts outstanding (and average interest rates) were approximately \$103 million (2.46 percent), \$35 million (1.06 percent), and \$12 million (1.33 percent), respectively.

On May 26, 2005, TVA and a national bank entered into a revolving credit facility agreement with an initial term of 180 days. On November 9, 2005, the term was extended until May 22, 2006. The facility provides TVA with an unsecured revolving line of credit of up to \$2.5 billion. The interest rate on any borrowing under this agreement is variable and based on market factors and the rating of TVA's senior unsecured long-term non-credit enhanced debt at the time TVA draws on the facility. TVA is required to pay an unused facility fee on the portion of the \$2.5 billion against which TVA has not borrowed. This fee is similar to fees charged in the banking industry to similar customers for similar products and may fluctuate depending upon the rating of TVA's senior unsecured long-term non-credit enhanced debt. There were no outstanding borrowings under the facility at September 30, 2005.

Put and Call Options

Bond issues of \$2.3 billion held by the public are redeemable in whole or in part, at TVA's option, on call dates ranging from the present to 2020 and at call prices ranging from 100 percent to 106 percent of the principal amount. Additionally, TVA has bond issues of \$2.2 billion held by the public that are redeemable in whole or in part at the option of the respective bondholders, as follows: one bond issue totaling \$121 million, which matures in April 2036, is redeemable in 2006 by the bondholders; a second issue totaling \$1.5 billion, which matures in April 2036, is redeemable in 2006 at the option of the bondholders; and a third issue totaling \$600 million, which matures in December 2016, is redeemable in 2007 at the option of the bondholders. Each of these issues is reported in the debt schedule with maturity dates corresponding to the earliest redemption dates. Fifty-five issues totaling \$1.1 billion, with maturity dates ranging from 2008 to 2025, include a "survivor's option," which allows for right of redemption upon the death of a beneficial owner in certain specified circumstances. There is no accounting difference between a "survivor's option" put and a "regular" put on a put bond.

Additionally, TVA has two issues of Puttable Automatic Rate Reset Securities ("PARRS") outstanding. After a fixed-rate period of five years, the coupon rate on the PARRS may automatically be reset downward under certain market conditions on an annual basis. Investors have the option to redeem the bonds at par if and when the interest rate is reset. One PARRS issue totals \$466 million, matures in June 2028, and had its first reset date in June 2003. The rate reset to 5.952 percent from 6.75 percent in June 2003, at which time \$23 million of the original \$575 million 1998 Series D PARRS were redeemed at par, and reset to 5.49 percent from 5.952 percent in June 2005, at which time \$86 million of the 1998 Series D PARRS were redeemed at par. The second issue of PARRS totals \$410 million, matures in May 2029, and had its first rate reset date in May 2004. The rate reset in May 2004 to 5.618 percent from 6.50 percent, and \$115 million of the original \$525 million 1999 Series A PARRS were redeemed at par. If the potential reset rate is less than the current coupon on the bond, the bond automatically resets to the lower rate. If the coupon rate is reset, the bondholders have the option to put their bonds back to TVA at par.

Debt Securities Activity

The table below summarizes TVA's debt securities activity for the period from October 1, 2004, to September 30, 2005.

Activity from October 1, 2004 to September 30, 2005

Principal Amount

<u>Redemptions/Maturities:</u>	<u>2005</u>	<u>2004</u>
electronotes®		
First quarter	\$ 3	\$ 15
Second quarter	75	30
Third quarter	101	73
Fourth quarter	3	82
2000E QUINTS	100	-
1998D PARRS	86	-
1995 Series A	2,000	-
1998 Series I	-	400
2000C QUINTS	-	25
2000D QUINTS	-	25
1993 Series F	-	476
1999 Series A	-	115
2003 Series C	-	10
2001 Series C	-	1,000
Total	<u>\$ 2,368</u>	<u>\$ 2,251</u>
 <u>Issues</u>		
electronotes®		
First quarter	\$ -	\$ 93
Second quarter	25	114
Third quarter	105	15
Fourth quarter	20	-
2005 Series A	500	-
2005 Series B	1,000	-
2002 Series A (reopening)	-	550
Total	<u>\$ 1,650</u>	<u>\$ 772</u>
 Inflation-indexed bond accretion	 <u>\$ 11</u>	 <u>\$ 10</u>

Debt Outstanding

Debt outstanding at September 30, 2005 and 2004, consisted of the following:

	<u>2005</u>	<u>2004</u>
Short-term debt		
Discount notes (net of discount)	\$ 2,469	\$ 1,924
Current maturities of long-term debt, net - 5.50% to 7.125%	<u>2,693</u>	<u>2,000</u>
Total short-term debt, net	5,162	3,924
Long-term debt		
Maturing in 2006 - 5.880% to 7.125%	-	2,575
Maturing in 2007 - 4.875% to 6.643%	970	959
Maturing in 2008 - 2.45% to 3.30%	91	91
Maturing in 2009 - 3.20% to 5.375%	2,031	2,031
Maturing in 2010 - 4.125%	42	-
Maturing in 2011 - 5.625%	1,000	1,000
Maturing in 2012 - 4.375% to 7.14%	1,525	1,525
Maturing in 2013 through 2045 - 3.50% to 8.25%	<u>12,319</u>	<u>11,258</u>
Total long-term debt, net	17,978	19,439
Unamortized discounts, premiums, and other	<u>(227)</u>	<u>(102)</u>
 Total long-term debt, net	 <u>\$ 17,751</u>	 <u>\$ 19,337</u>

Note:

The above table includes net translation losses from currency transactions of \$52 million and \$113 million at September 30, 2005, and 2004, respectively.

Interest and Capital Costs

During 2005, 2004, and 2003, cash paid for interest on outstanding indebtedness (net of amount capitalized) is summarized below:

	Schedule of Interest Paid Year Ended September 30		
	2005	2004	2003
Statutory Debt (note 9)	\$ 1,243	\$ 1,286	\$ 1,320
Other Financing Obligations (note 10)	73	73	58
Return on Appropriation (note 7)	16	18	22
Total	<u>\$ 1,332</u>	<u>\$ 1,377</u>	<u>\$ 1,400</u>

10. Fair Value of Financial Instruments

TVA uses the methods and assumptions described below to estimate the fair value of each significant class of financial instrument. The fair market value of the financial instruments held at September 30, 2005, may not be representative of the actual gains or losses that will be recorded when these instruments mature or if they are called or presented for early redemption.

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

	2005		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 538	\$ 538	\$ 519	\$ 519
Short-term investments	—	—	335	335
Investment funds	858	858	744	744
Loans and other long-term receivables	93	93	144	144
Short-term debt, net of discount	2,469	2,469	1,924	1,924
Long-term debt (including current portion), net of discount	20,671	22,552	21,337	23,249
Other financing obligations	1,143	1,143	1,178	1,178

Cash and Cash Equivalents, Short-Term Investments, and Short-Term Debt

Because of the short-term maturity of these instruments, the carrying amount approximates fair value.

Investment Funds

Information on investments by major type at September 30 is as follows:

	2005	2004
Securities held as trading	\$ 835	\$ 720
Other	23	24
Total investment funds	<u>\$ 858</u>	<u>\$ 744</u>

Gains and losses on trading securities are recognized in current earnings and subsequently reclassified to a regulatory asset account in accordance with TVA's decommissioning accounting policy (see note 1—*Decommissioning Costs*). The decommissioning fund had unrealized gains of \$118 million in 2005, unrealized gains of \$88 million in 2004, and unrealized gains of \$129 million in 2003.

Loans and Other Long-Term Receivables

Fair values for these homogeneous categories of loans and receivables are estimated by determining the present value of future cash flows using a discounted rate equal to lending rates for similar loans made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amount approximates fair value.

Long-Term Debt

Fair value of long-term debt traded in the public market is determined by multiplying the par value of the bonds by the indicative market price at the balance sheet date.

Other Financing Obligations

In 2003, 2002, and 2000, TVA received approximately \$325 million, \$320 million, and \$300 million, respectively, in proceeds by entering into lease/leaseback transactions for 24 new peaking combustion turbine units. TVA also received approximately \$389 million in proceeds by entering into a lease/leaseback transaction for qualified technological equipment in 2003. Due to the nature of the transactions, the carrying amount of the obligation and the fair market value are equal. At September 30, 2005, and 2004, the total balances of the obligations were \$1,143 million and \$1,178 million, respectively.

Due to TVA's continuing involvement in the operation and maintenance of the leased units and equipment, and its control over the distribution of power produced by the facilities during the leaseback term, TVA accounted for the respective lease proceeds of \$714 million, \$320 million, and \$300 million as financing obligations as required in accordance with SFAS No. 66, "Accounting for Sales of Real Estate," and SFAS No. 98, "Accounting for Leases." Accordingly, the outstanding lease/leaseback obligations of \$1,143 million at September 30, 2005, and \$1,178 million at September 30, 2004, are included in CURRENT PORTION OF LEASE/LEASEBACK OBLIGATIONS (\$35 million and \$35 million, respectively) and LEASE/LEASEBACK OBLIGATIONS (\$1,108 million and \$1,143 million, respectively) in TVA's 2005 and 2004 year-end Balance Sheets.

11. Benefit Plans

Pension and Other Postretirement Benefits

TVA sponsors defined benefit pension plans which cover substantially all employees. Additionally, TVA provides postretirement health care benefits for substantially all employees who reach retirement age while still working for TVA. TVA's reported costs of providing these benefits, as described herein, are impacted by numerous factors including the provisions of the plans, changing employee demographics, and various actuarial calculations, assumptions, and accounting mechanisms.

In selecting an assumed discount rate, TVA reviews market yields on high-quality corporate debt and long-term obligations of the U.S. Treasury. Based on recent market trends, TVA reduced its discount rate from 6.00 percent and 5.81 percent at the end of 2003 and 2004, respectively, to 5.375 percent at the end of 2005. TVA reviews actual recent cost trends and projected future trends in establishing health care cost trend rates. Based on this review process, TVA reset its health care cost trend rate assumption used in calculating the 2005 accumulated postretirement benefit obligation. The assumed health care cost trend rate has been reset to 9.0 percent at the end of 2005 and mirrors the 9.0 percent trend rate used during 2004. TVA has reset its health care cost trend rate at the end of each of the last four years. The health care cost trend rate of nine percent is assumed to gradually decrease each successive year until it reaches a five percent annual increase in health care costs in 2013 and beyond.

In determining its expected long-term rate of return on pension plan assets, TVA reviews past long-term performance, asset allocations, and long-term inflation assumptions. TVA targets an asset allocation for its pension plan assets of approximately 60 percent equity securities and 40 percent fixed income securities. Pursuant to its allocation policy, the asset allocations are to be comprised of approximately 45 percent United States equities, of which five percent may be private equity or other similar investments, but not to include holding title to real property; 40 percent fixed income, of which ten percent may be high yield securities; and 15 percent non-United States equities. TVA's policy includes a permissible three percent deviation, plus or minus, from these target allocations. The Board can take action, as appropriate, to rebalance the system's assets consistent with the asset

allocation policy. TVA decreased its expected long-term rate of return on pension plan assets from 8.50 percent at the end of 2003 to 8.25 percent at the end of 2004 and will continue to use a similar asset return assumption for 2005. TVA utilized a rate of return of 8.00 percent during 2003 in the aftermath of the market declines of 2002 and 2001.

Actuarial Assumptions

TVA utilizes professional actuaries to perform valuation services related to the areas of pension, postretirement, and postemployment benefits. Net periodic pension cost is determined using assumptions as of the beginning of each year. Funded status is determined using assumptions as of the end of each year. The valuations performed at the end of 2005 were based on applications of actuarial assumptions that were consistent for all of TVA's benefit plans as can be seen in the disclosure tables that follow. For 2005, TVA recognized pension expense of \$243 million, postretirement benefit expense of \$46 million, which includes \$0.5 million in special termination cost, and postemployment benefit expense of \$71 million. Comparable items of expense for prior years include, respectively, for 2004, pension expense of \$178 million, postretirement benefit expense of \$36 million, which includes \$7 million in special termination cost, and postemployment benefit expense of \$66 million, and for 2003, pension expense of \$41 million, postretirement benefit expense of \$36 million, and postemployment benefit expense of \$90 million.

During 2003, TVA transitioned actuaries through a process in which both sets of actuaries performed calculations of the benefit obligations and other estimates inherent in the valuations for 2002. Since the 2002 valuations serve as the basis for amounts recorded in 2003, differences in actuarially calculated estimates were reconciled. Adjustments proposed by both predecessor and successor actuaries have been included in 2003 expense and reflected as amendments in the disclosure tables of the related pension and postretirement benefits obligations that follow.

Pension Plans and Other Retirement Benefits

TVA has a defined benefit plan for most of its full-time employees that provides two benefit structures: the Original Benefit Structure and the Cash Balance Benefit Structure. The plan is controlled and administered by a legal entity separate from TVA, the TVA Retirement System ("TVARS"), which is governed by its own independent board of directors. The plan assets are primarily stocks and bonds. TVA contributes to the plan such amounts as are agreed upon by the TVA and TVARS boards of directors.

The pension benefit for a member participating in the Original Benefit Structure is based on the member's years of creditable service, the member's average base pay for the highest three consecutive years, and the pension rate for the member's age and years of service, less a Social Security offset. The pension benefit for a member participating in the Cash Balance Benefit Structure is based on credits accumulated in the member's account and the member's age. A member's account receives credits each pay period equal to 6.0 percent of his or her straight-time earnings. The account also increases at an interest rate equal to the change in the Consumer Price Index ("CPI") plus 3.0 percent, with the provision that the rate may not be less than 6.0 percent or more than 10.0 percent. The actual change in the CPI for 2005 and 2004 was 2.4 percent and 1.7 percent, which resulted in interest rates of 6.0 percent and 6.0 percent, respectively.

Members of both the Original Benefit Structure and the Cash Balance Benefit Structure can also become eligible for a vested supplemental pension benefit, based on age and years of service, which is designed to help retirees offset the cost of medical insurance. TVARS also administers a defined contribution plan, a 401(k) plan to which TVA makes matching contributions of 25 cents on the dollar (up to 1.5 percent of pay) for members participating in the Original Benefit Structure and of 75 cents on the dollar (up to 4.5 percent of pay) for members participating in the Cash Balance Benefit Structure. TVA made matching contributions of about \$17 million to the plan during 2005.

Certain Pension Plan Results

Effective for the end of year measurement date and the calculation of funded status, the discount rate was reduced from 5.81 percent for 2004 to 5.375 percent for 2005. The cost of living rate was adjusted upward from the 2004 rate of 2.30 percent to 2.50 percent for 2005 to reflect current market and demographic conditions. Additionally, TVA continued to use its assumption related to mortality based on results of an experience study performed during the prior year which underlies the use of 1983 mortality tables. Based on the use of the assumptions described, the projected benefit obligation ("PBO") at September 30, 2005, increased approximately \$823 million compared to the restated PBO at October 1, 2004. The PBO at the beginning of fiscal 2005 was restated after a January 2005 TVARS Board approved plan change was effected in which future fixed growth rates on certain retirement accounts will now decrease

fifty basis points per annum until the adjusted rate reaches a TVARS Board approved floor. Prior to the plan change, such retirement accounts were assumed to grow at a ten percent rate per annum. The effect of the change was to lower the September 30, 2004, PBO by \$144 million from \$7.8 billion to a recalculated value of \$7.6 billion at October 1, 2004. From that point forward, PBO increased a total of \$823 million comprised, in part, of an increase of \$191 million due to normal operation of the plan (in the form of service cost and interest accruals, etc.). The remaining \$632 million increase in the PBO is due to changes in the discount rate (\$396 million), and changes in the cost of living assumptions (\$134 million), and incurred liability losses (\$102 million) related primarily to more-than-assumed early retirements. The assumptions used in the 2005 end-of-year actuarial valuation process had no effect on pension costs for 2005, 2004, or 2003. However, in conjunction with changes in the assumptions utilized and other plan participant dynamics, TVA expects pension expense for 2006 to increase approximately \$1 million compared to 2005. The accumulated benefit obligation (or ABO) at September 30, 2005, October 1, 2004, and September 30, 2004, was \$8.0 billion, \$7.2 billion, and \$7.4 billion respectively.

Other Postretirement Benefits

TVA sponsors an unfunded postretirement plan that provides for non-vested contributions toward the cost of certain retirees' medical coverage. This plan formerly covered all retirees participating in the TVA medical plan, and TVA's contributions were a flat dollar amount based on the participants' ages and years of service and certain payments toward the plan costs. This plan now operates on a much more limited basis, covering only certain retirees and surviving dependents who do not qualify for TVARS benefits, including the vested supplemental pension benefit.

The initial annual assumed cost trend for covered benefits was 9.0 percent in 2005, decreasing by one-half percent per year to a level of 5.0 percent in 2013 and thereafter. For 2004 and 2003, annual trend rates of 8.5 percent and 8.5 percent, respectively, were assumed. The effect of the change in assumptions on the cost basis was not significant. Increasing/(reducing) the assumed health-care cost trend rates by one percent would increase/(reduce) the accumulated postretirement benefit obligation ("APBO") as of September 30, 2005, by \$66 million/(\$73 million) and the aggregated service and interest cost components of net periodic postretirement benefit cost for 2005 by \$5 million/(\$5 million). The weighted average discount rate used in determining the end-of-year APBO was 5.375 percent for 2005, 5.81 percent for 2004, and 6.00 percent for 2003. Any net unrecognized gain or loss resulting from experience different from that assumed or from changes in assumptions, and exceeding ten percent of the APBO, is amortized over the average remaining service period of active plan participants.

Based on the use of the assumptions described, the 2005 APBO for postretirement benefits increased approximately \$97 million. The change in the obligation was comprised of a \$16 million increase due to normal operation of the plan (in the form of service cost and interest accruals, etc.) and an increase of \$81 million due to other actuarial and experience adjustments and losses. The \$81 million increase in the obligation is comprised of two components. The first component of the loss is comprised of an actuarial loss of approximately \$29 million related primarily to the actuarial discount rate which was lowered to 5.38 percent in 2005 from 5.81 percent in 2004. The second component includes a combined loss of approximately \$52 million due to TVA's decision to reset its health care cost trend rate assumption at the end of 2005 from what would have been about 8.5 percent to nine percent and an increase in retiree medical credit benefits (see next paragraph) available to TVA retirees to defray their out-of-pocket medical premiums. TVA not only bears the incremental funding requirement associated with these increased benefits but must recognize the funding costs as additional expense. TVA's exposure to further increases in these benefits will continue until such time as the cap established for this benefit is reached by all eligible retirees. The total payments made by TVA on behalf of its retirees increased by about 25 percent and the number of retirees receiving the medical credit increased by about 30 percent.

The set of assumptions used for the end-of-year actuarial valuation process had no effect on postretirement benefit costs for 2005, 2004, or 2003 but, when coupled with further experience adjustments related to claims and contributions, will increase postretirement benefits expense for 2006 by approximately \$12 million compared to 2005. TVA expects 2006 postretirement health care cost to approximate \$58 million, an increase of \$12 million over 2005 costs, excluding special termination benefits.

Effective July 1, 2002 (applied retroactively to January 1, 2002), TVA changed its retiree medical plan to provide an enhanced TVA contribution for certain retirees who retired with 20 or more years of service and are eligible for the supplemental pension benefit from TVARS. The benefit is in the form of a credit provided by TVA to eligible retirees to help offset the cost of medical premiums. The additional benefit increased the accumulated postretirement benefit obligation approximately \$97 million at the end of 2002. Pursuant to SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," the increase in cost is combined with the existing net unrecognized

prior service cost and amortized to expense over future periods. Expense for 2003 increased approximately \$17 million (from \$19 million in 2002 to \$36 million in 2003) due primarily to the additional prior service cost amortization and corresponding increases in service cost and interest cost coupled with changes in demographic information and actuarial assumptions.

Medicare Prescription Drug Improvement and Modernization Act of 2003

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 became law. The act introduces a prescription drug benefit under Medicare (Part D) as well as a federal subsidy to employers that provide a retiree prescription drug benefit that is at least actuarially equivalent to Medicare Part D. TVA decided that its retiree drug plan is not actuarially equivalent as described by the Act of 2003, and accordingly, has not included or utilized any manner of subsidy in the determination of APBO or postretirement benefit cost (see note 11 *Benefit Plans*), for the current or prior periods, in accordance with the requirements contained within the FASB Staff Position ("FSP"), FSP FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." Beginning in 2006, Medicare will provide prescription drug coverage under Medicare Part D. After analyzing a number of options available to plan sponsors for integration with the new Medicare Part D, TVA elected to provide an employer-sponsored Part D prescription drug plan ("PDP"), with alternative coverage over and above Medicare standard Part D coverage, for Medicare-eligible retirees who participate in TVA's Medicare supplement. By providing an employer-sponsored PDP, any Medicare subsidies will be passed through to retirees in the form of lower participant premiums and should not affect TVA's cost of providing prescription drug coverage.

Components of Pension and Postretirement Benefits

The components of pension expense and other postretirement benefits expense for the years ended September 30 were:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Change in benefit obligation				
Benefit obligation at beginning of year	\$ 7,754	\$ 6,950	\$ 447	\$ 314
Service cost	117	112	6	5
Interest cost	428	406	25	19
Plan participants' contributions	41	43	63	59
Amendments, including special events	—	—	—	7
Actuarial loss	489	605	91	120
Net transfers from variable fund/401(k) plan	24	21	—	—
Expenses paid	(4)	(5)	—	—
Benefits paid	(416)	(378)	(88)	(77)
Benefit obligation at end of year	<u>\$ 8,433</u>	<u>\$ 7,754</u>	<u>\$ 544</u>	<u>\$ 447</u>
Change in plan assets				
Fair value of plan assets at beginning of year	\$ 6,415	\$ 5,930	\$ —	\$ —
Adjustment to reconcile to system asset value	—	—	—	—
Actual return on plan assets	902	781	—	—
Plan participants' contributions	41	43	63	59
Net transfers from variable fund/401(k) plan	24	21	—	—
Employer contributions	53	23	25	18
Expenses paid	(4)	(5)	—	—
Benefits paid	(416)	(378)	(88)	(77)
Fair value of plan assets at end of year	<u>\$ 7,015</u>	<u>\$ 6,415</u>	<u>\$ —</u>	<u>\$ —</u>
Funded status	\$ (1,418)	\$ (1,338)	\$ (544)	\$ (447)
Unrecognized net actuarial loss	1,554	1,628	237	156
Unrecognized prior service cost	311	347	44	49
Unrecognized transition obligations	—	—	—	—
Prepaid (accrued) benefit cost	<u>\$ 447</u>	<u>\$ 637</u>	<u>\$ (263)</u>	<u>\$ (242)</u>
Amount recognized on balance sheet				
Prepaid benefit cost	\$ —	\$ —	\$ —	\$ —
Accrued benefit liability	(1,010)	(945)	(263)	(242)
Other long-term asset	311	347	—	—
Accumulated OCI reclassified to regulatory assets	1,146	1,235	—	—
Net amount recognized	<u>\$ 447</u>	<u>\$ 637</u>	<u>\$ (263)</u>	<u>\$ (242)</u>
Weighted average assumptions as of September 30				
Discount rate	2005 5.38%	2004 5.81%	2005 5.38%	2004 5.81%
Expected return on plan assets	8.25%	8.25%	NA	NA
Rate of compensation increase	3.3% – 10.1%	3.3% – 10.1%	NA	NA
Initial health care trend rate	NA	NA	9.00%	9.00%
Ultimate health care trend rate	NA	NA	5.00%	5.00%
Ultimate year in which trend rate is reached	NA	NA	2013	2012

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Components of net periodic benefit cost						
Service cost	\$ 117	\$ 112	\$ 90	\$ 6	\$ 5	\$ 6
Interest cost	429	406	411	25	18	23
Expected return on plan assets	(457)	(464)	(496)	NA	NA	NA
Amortization of prior service cost	36	36	36	5	5	5
Amortization of transition obligation	—	—	—	—	—	—
Recognized net actuarial loss	118	88	—	10	1	2
Net periodic benefit cost	243	178	41	46	29	36
Special events	—	—	—	—	7	—
Total benefits cost	\$ 243	\$ 178	\$ 41	\$ 46	\$ 36	\$ 36

Weighted average assumptions used to determine expense	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Discount rate	5.81%	6.00%	7.05%	5.81%	6.00%	7.05%
Expected return on plan assets	8.25%	8.50%	8.50%	NA	NA	NA
Rate of compensation increase	3.3%-10.1%	3.3%-10.1%	3.3%-10.1%	NA	NA	NA
Initial health care trend rate	NA	NA	NA	9.00%	8.50%	8.50%
Ultimate health care trend rate	NA	NA	NA	5.00%	5.00%	5.00%
Ultimate year in which trend rate is reached	NA	NA	NA	2012	2010	2009

Sensitivity to the assumed health care cost trend rates for 2005

	1% Increase	1% Decrease
Effect on total of service and interest cost components	5	(5)
Effect on end-of-year accumulated postretirement benefit obligation	66	(73)

Estimated future benefit payments

	Pension	Other
Fiscal Year 2006	\$ 498	\$ 21
Fiscal Year 2007	507	24
Fiscal Year 2008	522	27
Fiscal Year 2009	537	30
Fiscal Year 2010	549	33
Fiscal Years 2011-2015	2,955	187

Investments held in the TVA retirement plan are stated at fair value, which is determined by the Trustee of the fund.

The TVARS Board adopted the following revised asset allocation policy for investment of the TVARS's funds: 45 percent United States equities, of which five percent (as measured as a percentage of the total fund) may be private equity or other similar alternative investments as long as such investments do not involve holding title to real property; 40 percent fixed income, of which ten percent may be high yield (as measured as a percentage of the total fund); and 15 percent non-United States equities. A three percent deviation, either plus or minus, from these target allocations, including the target allocations for private equity and high yield fixed income, is permissible. The TVARS Board also renewed the Executive Secretary's authority to take action, as appropriate, to rebalance the TVARS's assets consistent with this asset allocation policy.

Plan Contributions

TVA contributed \$53 million to its qualified pension plans in 2005 and expects to contribute \$75 million in 2006.

Other Non-Qualified Retirement and Deferred Compensation Plans

In 1995, TVA established a Supplemental Executive Retirement Plan ("SERP") to provide additional benefits to specified individuals that are not available under the qualified pension plan. The SERP is invested in securities generally designed to achieve a return in line with a combination of overall fixed income and equity market performance.

The nature of these investments comprises physical securities and certain derivative instruments. The derivative instruments used include futures contracts. These instruments are used across various asset classes to achieve a desired investment structure. The derivative instruments in the fund are comprised of 228 contracts. Investments held in the SERP are stated at fair value, which is determined by the Trustee of the fund. Futures positions are marked to market on a daily basis. TVA has historically funded the annual calculated expense and due to the immaterial nature of the amounts, TVA has not made financial statement disclosures related to this plan. As of and for the year ended September 30, 2005, TVA recognized certain amounts related to the plan including plan assets in trust of \$17 million, a regulatory asset of \$12 million, an intangible asset of \$1 million, an estimated accrued and minimum pension plan obligation of \$35 million, expense of \$6 million, and current year gains on plan assets of \$1 million of which all was realized. In addition, \$2 million in benefit payments were made from the plan during the year, and TVA will make contributions of \$7 million to the plan in October 2005. As of and for the year ended September 30, 2004, TVA recognized certain amounts related to the plan including plan assets in trust of \$18 million with gains on plan assets of \$0.7 million of which \$0.2 million was unrealized. In addition, \$2 million in benefit payments were made from the plan during the year, and TVA made contributions of \$3 million to the plan during the year.

Other Postemployment Benefits

Other postemployment benefits include workers' compensation provided to former or inactive employees and their beneficiaries and covered dependents for the period after employment but before retirement. TVA's workers' compensation program is administered through the Department of Labor by the Office of Workers' Compensation Programs ("OWCP") in accordance with the provisions of the Federal Employees' Compensation Act ("FECA"). FECA provides compensation benefits to federal employees for permanent and temporary disability due to employment-related injury or disease. TVA recognizes these costs as incurred.

Postemployment benefit cost estimates are revised to properly reflect changes in actuarial assumptions made at the end of the year. TVA modified certain of its assumptions based on information in existence at the end of 2004 and determined it appropriate to shorten slightly the period of time over which it expects to pay out claims related to certain estimated losses. Accordingly, TVA lowered its 2004 discount rate assumption. For 2005, TVA has determined to utilize a discount rate of 4.34 percent representing the risk-free rate corresponding to the U. S. Treasury rate for a ten year maturity. Use of the ten year maturity corresponds to calculated average durations of TVA's future estimated postemployment claims payments. The use of a 4.34 percent discount rate resulted in the recognition of 2005 annual expense of approximately \$72 million and an unpaid benefit obligation of about \$429 million at year end. TVA utilized a discount rate of 5.75 percent and 6.00 percent in 2004 and 2003 respectively. The changes in 2005 assumptions had no effect on postemployment expense for 2004 and 2003.

12. Commitments and Contingencies

As of September 30, 2005, the amounts of contractual cash obligations maturing in each of the next five years and thereafter are shown below:

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Debt	\$ 5,240	\$ 970	\$ 91	\$ 2,031	\$ 42	\$ 14,714	\$ 23,088
Interest on debt	1,220	1,027	1,001	945	891	12,196	17,280
Leases	84	82	72	66	63	46	413
Lease/leaseback transactions	85	85	89	85	89	1,209	1,642
Power purchase obligations	184	165	133	138	139	3,565	4,324
Other obligations	420	146	111	5	2	7	691
Fuel purchase obligations	958	333	299	208	166	363	2,327
Decommissioning	25	-	-	-	-	-	25
Retirement system*	75	-	-	-	-	-	75
Total	<u>\$ 8,291</u>	<u>\$ 2,808</u>	<u>\$ 1,796</u>	<u>\$ 3,478</u>	<u>\$ 1,392</u>	<u>\$ 32,100</u>	<u>\$ 49,865</u>

Notes:

*Contributions/payments beyond 2006 to be determined based on funding requirements.

In addition to the cash requirements above, TVA has contractual obligations in the form of revenue discounts related to energy prepayments discussed above.

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
Energy Prepayment Obligations	\$ <u>106</u>	\$ <u>106</u>	\$ <u>105</u>	\$ <u>105</u>	\$ <u>105</u>	\$ <u>823</u>	\$ <u>1,350</u>

Commitments

Leases. TVA leases certain property, plant, and equipment under agreements with terms ranging from one to 30 years. Obligations under capital lease agreements in effect at September 30, 2005, total \$60 million for 2006, \$63 million for 2007, \$59 million for 2008, \$57 million for 2009, \$57 million for 2010, and an aggregate of \$36 million thereafter, for a total commitment of \$332 million. Of this amount, \$76 million represents the cost of financing. Obligations under non-cancelable operating lease agreements in effect at September 30, 2005, total \$24 million for 2006, \$19 million for 2007, \$13 million for 2008, \$9 million for 2009, \$6 million for 2010, and \$10 million thereafter for a total commitment of \$81 million.

Lease/Leaseback Transactions. Obligations under combustion turbine and qualified technological equipment lease/leaseback transactions in effect at September 30, 2005, total \$85 million annually for 2006 and 2007, \$89 million for 2008, \$85 million for 2009, \$89 million for 2010, and an aggregate of \$1.2 billion thereafter, for a total commitment of \$1.6 billion. Of this amount, \$499 million represents the cost of financing.

Power Purchase Obligations. TVA has contracted with various independent power producers and power distributors for additional capacity to be made available to TVA. In total, these agreements constitute 2,578 megawatts of winter net dependable capacity. Approximately 80 percent of this total capacity is made available to TVA under power purchase agreements that will expire within two years. The total financial obligation of these contracts is approximately \$4.2 billion. Additionally, TVA has contracted with various other counterparties for the purchase of power from renewable sources (wind and methane gas technologies). These arrangements constitute about 33 megawatts of capacity. Of this total, 27 megawatts are attributable to wind generation, and due to the nature of this energy source, they are not included in the determination of net winter dependable capacity. TVA's financial obligation related to these renewable resource power purchase agreements is \$100 million. In total, TVA's financial obligation for all of its power purchase agreements is approximately \$4.3 billion. Costs under these contracts are included in the Statements of Income for the years ended September 30, 2005, 2004, and 2003 as FUEL AND PURCHASED POWER expense and are expensed as incurred in accordance with the normal purchases and sales exemption described in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

Under the Public Utility Regulatory Policies Act of 1978, TVA is obligated to purchase power from qualifying facilities. There are currently two independent power producers, with a combined capacity of 1,600 megawatts, that qualify under this program. However, the potential for TVA being required to take substantial amounts of power from these facilities under these circumstances has been mitigated by certain contractual arrangements entered into in 2005. Costs associated with these purchases are based on rates as specified in "Attachment A" of the Dispersed Power Production Guidelines for TVA and the Distributors of TVA Power as approved annually by the Board.

TVA also has an agreement with the Southeastern Power Administration to receive 405 megawatts of net dependable capacity from the Cumberland River Basin Projects for use in the TVA system. TVA receives a yearly energy allocation of 607,500 megawatt hours which is based on the reserved capacity. Once this allocation is exceeded, TVA is assessed an additional energy charge for the excess generation received based on rates as specified in the *Federal Register*.

Other Obligations. Other obligations of \$691 million consist of contracts negotiated as of September 30, 2005, for goods and services primarily related to capital projects as well as other major recurring operating costs. TVA has approximately \$587 million in long-term construction commitments consisting primarily of the construction of generating assets (including Browns Ferry Unit 1), and emission control equipment. In addition to construction commitments, TVA is committed under various other contracts for recurring goods and services of \$104 million with terms extending into 2010.

Fuel Purchase Obligations. TVA has approximately \$1.2 billion in long-term fuel purchase commitments ranging in terms of up to four years for the purchase and transportation of coal, and approximately \$1.1 billion of long-term commitments ranging in terms of up to 10 years for the purchase of enriched uranium and fabrication of nuclear fuel assemblies.

Tritium-Related Services. In September 2002, the NRC issued an amendment to the Watts Bar Nuclear Plant operating license, allowing TVA to irradiate tritium-producing burnable absorber rods ("TPBARS") at the plant to assist DOE in producing tritium. TVA's license amendment currently allows operation with a maximum of 240 TPBARS in the Watts Bar reactor. A planned future license amendment will permit installation of up to 2,304 TPBARS. In general, the TPBARS will be irradiated for a full cycle, which lasts about 18 months. TVA will then remove the irradiated TPBARS for shipment to DOE's tritium-extraction facility and load a fresh set of TPBARS into the reactor. TVA began irradiating TPBARS at Watts Bar in the fall of 2003 with the first removal of TPBARS occurring in the spring of 2005. The first batch of irradiated TPBARS has been successfully shipped to the DOE facility. Also in September 2002, the NRC issued a similar amendment to the Sequoyah Nuclear Plant operating license allowing TVA to provide tritium-related irradiation services. At this time, no tritium-related services have been scheduled at the Sequoyah Nuclear Plant. While irradiating TPBARS, TVA is able to operate the reactors for its program mission of producing electricity. Income related to these services is included in OTHER REVENUE.

TVA has a long-term interagency agreement with DOE to utilize TVA's Sequoyah and Watts Bar Nuclear Plants to produce tritium. This agreement, ending in 2035, requires DOE to reimburse TVA for costs incurred plus a fee per TPBAR produced for irradiation services.

Contingencies

Concentration of Credit Risk. Seven customers, which represented an aggregate of 35 percent of TVA's total power sales in 2005, 2004 and 2003, purchased power from TVA under contracts that require either five or ten years' notice to terminate. Outstanding accounts receivable for these customers at September 30, 2005, were \$411 million, or 36 percent, and at September 30, 2004, were \$368 million, or 35 percent, of total outstanding accounts receivable.

Nuclear Insurance. The Price-Anderson Act provides a layered framework of protection to compensate for losses arising from a nuclear event. For the first layer, all NRC nuclear plant licensees, including TVA, purchase \$300 million of nuclear liability insurance from American Nuclear Insurers ("ANI") for each plant with an operating license. The second layer, the Secondary Financial Program ("SFP"), would come from an assessment of up to \$100.59 million from the licensees of each of the 104 NRC licensed reactors in the United States. The assessment for any nuclear accident would be limited to \$15 million per year per reactor. ANI, under a contract with the NRC, administers the SFP. With its six licensed units, TVA could be required to pay a maximum of \$603.54 million per nuclear incident, but it would have to pay no more than \$90 million per incident in any one year. When the contributions of the nuclear plant licensees are added to the insurance proceeds of \$300 million, over \$10.7 billion would be available. Under the Price-Anderson Act, if the first two layers are exhausted, Congress is required to take action to provide additional funds to cover the additional losses.

TVA carries property, decommissioning, and decontamination insurance of \$2.06 billion for its licensed nuclear plants to cover the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums up to a maximum of approximately \$62 million.

TVA purchases accidental outage (business interruption) insurance for TVA's nuclear sites from Nuclear Electric Insurance Limited ("NEIL"). In the event that an accident covered by this policy takes a nuclear unit offline or keeps a nuclear unit offline, NEIL will pay TVA, after a deductible waiting period, an indemnity (a set dollar amount per week) up to a maximum indemnity of \$490 million per unit. This insurance policy may require the payment of retrospective premiums up to a maximum of approximately \$24 million.

Decommissioning Costs. Provision for decommissioning costs of nuclear generating units is based on options prescribed by NRC procedures to dismantle and decontaminate the facilities to meet NRC criteria for license termination.

TVA recognizes as incurred all obligations related to closure and removal of its nuclear units. The liability for closure is measured as the present value of the weighted estimated cash flows required to satisfy the related obligation and discounted at the credit adjusted rate of interest in effect at the time the liability was actually incurred or originally accrued, and subsequently modified to comply with the prevailing accounting provisions. The charge to recognize the additional obligation is effected by adjusting the corresponding regulatory asset. Earnings from decommissioning fund investments, amortization expense of the decommissioning regulatory asset, and interest expense on the decommissioning liability are deferred in accordance with SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." At September 30, 2005, the present value of the estimated future decommissioning cost of \$1.6 billion was included in ASSET RETIREMENT OBLIGATIONS, and the unamortized regulatory asset of \$716 million was included in

OTHER REGULATORY ASSETS. This decommissioning cost estimate is based on amounts prescribed by the NRC for removing a plant from service, releasing the property for unrestricted use, and terminating the operating license. The actual decommissioning costs may vary from the derived estimates because of, among other things, changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology, and changes in the cost of labor, materials, and equipment. Utilities that own and operate nuclear plants are required to use different procedures in calculating nuclear decommissioning costs under SFAS No. 143 than those that are used in calculating nuclear decommissioning costs when reporting to the NRC. Accordingly, the two sets of procedures produce different estimates for the costs of decommissioning. See note 4.

TVA maintains a decommissioning trust fund to provide funding for the decommissioning of nuclear plants. The fund is invested in securities generally designed to achieve a return in line with overall equity market performance. The nature of these investments comprises physical securities and certain derivative instruments. The derivative instruments that may be used include options, futures, forwards, and swaps. These instruments are used across various asset classes to achieve a desired investment structure. The derivative instruments in the fund are comprised of 919 contracts. These contracts include futures, options on futures, and swap agreements. Investments held in the decommissioning fund are stated at fair value, which is determined by the Trustee of the fund. Futures and options on futures positions are marked to market on a daily basis. The swap agreements are marked to market on a monthly basis. The assets of the fund as of September 30, 2005, totaled \$835 million for a total gain of \$115 million of which \$48 million was unrealized. The assets of the fund as of September 30, 2004, totaled \$720 million for a total gain of \$88 million of which \$29 million was unrealized. The assets of the fund as of September 30, 2003, totaled \$632 million for a total gain of \$133 million of which \$132 million was unrealized.

Cost-Based Regulation. Regulatory assets for TVA totaled approximately \$6.3 billion and regulatory liabilities totaled approximately \$897 million at September 30, 2005. Management cannot predict the potential impact, if any, of the change in the regulatory environment on TVA's future financial position and results of operations. (See note 1—*Cost-Based Regulation* and note 5.)

Environmental Matters. TVA's activities are subject to certain federal, state, and local environmental statutes and regulations. Major areas of regulation affecting TVA's activities include air quality control, water quality control, and management and disposal of solid and hazardous wastes.

TVA has incurred and continues to incur substantial capital and operating/maintenance costs in order to comply with evolving environmental requirements. Many of these costs are associated with the operation of TVA's 59 coal-fired generating units. While it is not possible to predict with any precision how these evolving requirements will impact the operation of existing and new coal-fired and other fossil-fuel generating units, it is virtually certain that environmental requirements placed on the operation of these generating units will continue to become more restrictive. Litigation over emissions from coal-fired generating units is also growing, including litigation against TVA.

Several existing regulatory programs have been and are being made more stringent in their application to fossil-fuel units and additional regulatory programs affecting fossil-fuel units have been promulgated in the past year. The total cost of future compliance with nitrogen oxide ("NO_x"), sulfur dioxide ("SO₂"), and mercury emission reduction requirements cannot reasonably be determined with precision at this time because of the uncertainties surrounding emerging EPA regulations, resultant compliance strategies, the potential for the development of new emission control technologies, court litigation, and future amendments to the Clean Air Act ("CAA"). However, additional costs for future regulations could be \$3.0 to \$3.5 billion through 2020, in addition to the costs to install SCRs and scrubbers described below. In addition to these costs, there could be other substantial costs if reductions of carbon dioxide ("CO₂") are mandated (discussed in more detail below). Predicting how and when CO₂ may be regulated is very uncertain, even more so than the future regulation of other substances. TVA will continue to monitor this issue and will assess and respond to potential financial impacts as they become more certain.

Expenditures related to TVA's clean air projects during 2005 and 2004 were approximately \$202 million and \$400 million, respectively. During 2005, TVA spent \$51 million on its publicly announced SCR program and \$146 million on its publicly announced scrubber programs.

Clean Air Developments. Air quality in the United States has significantly improved since the enactment of the modern CAA in 1970. These air quality improvements are expected to continue as the CAA and its implementing programs evolve through legislative and regulatory changes. Three substances emitted from coal-fired units have historically been the focus of emission reduction regulatory programs: SO₂, NO_x, and particulates. TVA's total cost through 2010 is expected to reach \$5.7 billion to reduce these emissions, \$4.4 billion of which TVA has already spent as of

September 30, 2005. This figure includes the publicly announced SCR and scrubber programs outlined above, but not the \$3.0 to \$3.5 billion in potential future costs for additional reductions. Recently, attention has been given to two other substances emitted by coal fired units: mercury and CO₂. Increasingly stringent regulation of some or all of these substances will continue to result in significant capital and operating costs for coal-fired generating units, including those operated by TVA.

Sulfur Dioxide. Coal-fired utilities have historically emitted large amounts of SO₂. Utility SO₂ emissions are extensively regulated and will be regulated further under state programs to achieve and maintain EPA's National Ambient Air Quality Standard for SO₂, the acid rain control program, and – depending on when units commenced operation and their effect on sensitive areas – the regional haze program. EPA's new, stringent fine particle national ambient air quality standard is expected to result in additional significant reductions of utility SO₂ emissions because SO₂ can transform into sulfates, and sulfates are a major component of fine particles in the eastern United States. Since 1977, TVA has reduced its SO₂ emissions by approximately 78 percent by switching to lower-sulfur coals, re-powering a unit at its Shawnee Fossil Plant with the advanced Atmospheric Fluidized Bed Combustion Technology, and installing flue gas desulphurization technology ("scrubbers") on six of its larger units. A seventh scrubber at unit 3 of its Paradise Fossil Plant is under construction. In 2005, TVA broke ground on its eighth scrubber at its Bull Run Fossil Plant in East Tennessee, as part of its previously announced plans to install additional scrubbers to achieve a total SO₂ emission reduction of 80 to 85 percent. TVA also has switched, or plans to switch to lower sulfur coal on several additional units in the next few years. These plans may change depending on the timing and severity of new SO₂ emission reductions that have been promulgated but not yet fully implemented under the Clean Air Interstate Rule ("CAIR"). The State of North Carolina also petitioned EPA under Section 126 of the CAA to impose additional emission reductions requirements for SO₂ and NO_x emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama where TVA's coal-fired power plants are located. The EPA proposes to deny the North Carolina petition primarily on the basis that CAIR remedies the problem.

Nitrogen Oxide. Utility NO_x emissions are extensively regulated and are expected to be regulated further under state programs to achieve and maintain EPA's national ambient air quality standard for ozone (NO_x combines with volatile organic compounds in the presence of sunlight to produce ozone under certain meteorological conditions), the acid rain control program, and - depending on when units commenced operation and their effect on sensitive areas - the regional haze program. EPA's new, more stringent eight-hour ozone and fine particle national ambient air quality standards could result in requirements to further reduce NO_x emissions from coal-fired power plants and other fossil-fuel generation such as combustion turbines. (NO_x emissions can transform into nitrates, another component of fine particles.) Since 1995, TVA has reduced its NO_x emissions during the summer (when ozone levels increase) by approximately 80 percent by installing various combustion controls on all 59 coal fired units. TVA has also installed selective catalytic reduction technology ("SCRs") on 20 of its units and is in the process of installing an SCR on one additional unit. Also in 2005, TVA began evaluations of Selective Non-Catalytic Reduction ("SNCR") systems at two units. TVA's NO_x emission reduction program is expected to continue to depend primarily on SCRs, but will also likely incorporate SNCRs if the evaluations are favorable. These plans may change depending on the timing and severity of new NO_x emission requirements that have been promulgated under CAIR but have not yet been finally implemented. The State of North Carolina has petitioned EPA to establish additional emission reduction requirements for SO₂ and NO_x emitted by coal-fired power plants in 13 states, including Kentucky, Tennessee, and Alabama where TVA's coal-fired power plants are located. The EPA proposes to deny the North Carolina petition primarily on the basis that CAIR remedies the problem.

Particulates/Opacity. Larger particulates (fly ash), as opposed to fine particles discussed above, have long been regulated by states to meet EPA's national ambient air quality standard for particulate matter (this has evolved into the new fine particle standard). TVA's coal-fired units have been equipped with mechanical collectors, electrostatic precipitators, scrubbers, or baghouses, which have reduced particulate emissions from the TVA system by more than 99 percent. As part of the periodic review of the national ambient air quality standards, EPA is evaluating additional, more stringent options for setting the standard. Issues about utility compliance with state opacity requirements are also increasing. Opacity measures the denseness (or color) of power plant plumes and has traditionally been used by states as a means of monitoring good maintenance and operation of particulate control equipment. Under some conditions, retrofitting a unit with additional equipment to better control SO₂ and NO_x emissions can adversely affect opacity performance, and TVA and other utilities are now addressing this issue. There are also disputes with special interest groups over the role of continuous opacity monitors in determining compliance with opacity limitations.

Mercury. The EPA has issued a rule to regulate mercury emissions from coal-fired generating units under the CAA. TVA supports a cap and trade program for mercury due to the resounding success of the same program when it was used to reduce SO₂ emissions. TVA endorses EPA's approach to setting the first phase of mercury reductions

at a level consistent with the co-benefits received from the reduction of SO₂ and NO_x under the CAIR. The billions of dollars TVA has spent and will continue to spend in response to CAIR and other rules to further reduce SO₂ and NO_x emissions is expected to help TVA satisfy the additional requirements of EPA's mercury rule.

Carbon Dioxide. The existence, cause, and importance of global climate change continue to be widely debated. CO₂ is a greenhouse gas and is believed by some to contribute to climate change. Legislation has been introduced in Congress to require reductions of CO₂ that, if enacted, could result in significant additional costs for TVA and other coal-fired utilities. The Bush Administration has proposed a voluntary initiative that established a goal of reducing the greenhouse gas intensity of the U.S. economy by 18 percent and has asked the electric utility sector and other industry sectors to support this initiative. TVA is supporting this effort in cooperation with electric utility industry trade associations and the Department of Energy. The last administration also asked utilities to voluntarily participate in an effort to reduce, sequester, or avoid greenhouse gases. Under that program, TVA reduced, sequestered, or avoided more than 275 million tons of CO₂ from 1994 through 2004, as reported under Section 1605b of the Energy Policy Act. TVA has also brought on line about 3,850 megawatts of non CO₂-emitting generation since 1990, and is in the process of adding another 1,800 megawatts of non CO₂-emitting generation.

Clean Water Developments. In the second phase of a three-part rulemaking to minimize the adverse impacts from cooling water intake structures on fish and shellfish, as required under section 316(b) of the Clean Water Act, EPA promulgated a final rule for existing power producing facilities that became effective on September 7, 2004. The new rule requires existing facilities to select one of the following compliance options for reducing the number of organisms pinned against and/or drawn into the cooling systems: (1) have specific designated features, (2) install specific technologies, (3) meet performance standards or (4) seek a site-specific compliance option based on application of cost/cost or cost/benefit tests. The site specific tests are designed to ensure that a facility's costs are not significantly greater than cost projections in the rule, or than benefits derived from taking mitigation actions. Actions taken to compensate for any impacts by restoring habitat, or pursuing other options such as building hatcheries for fish/shellfish production count toward compliance. Some northeastern states and environmental groups have challenged the new regulation, and especially the compliance flexibility it offers, in federal court.

All of TVA's existing coal-fired and nuclear generating facilities will be regulated by this rule. Compliance will involve some level of new assessments at all generating plants, and will likely require some capital and/or operating expenditures at some or all facilities. The assessments, however, are complicated somewhat by the uncertainty created by pending legal action challenging EPA's rule. Since TVA's generating facilities are located in areas which are not particularly sensitive to the effects of intake structures, and its only previously identified intake related adverse impact has already been mitigated.

As is the case across the utility industry and in other industrial sectors, TVA is facing more stringent requirements related to protection of wetlands, reductions in storm water impacts from construction activities, water quality degradation and criteria, and laboratory analytical methods. TVA is also following litigation related to the use of herbicides, water transfers, and releases from dams. TVA has a good compliance record and is not facing any substantive requirements related to non-compliance with existing Clean Water Act regulations.

Hazardous Substances. Liability for releases and cleanup of hazardous substances is regulated by the federal Comprehensive Environmental Response, Compensation, and Liability Act, among others, and similar state statutes. In a manner similar to many other industries and power systems, TVA has generated or used hazardous substances over the years. TVA is aware of hazardous-substance releases at eleven offsite areas for which it may have some liability. TVA's potential liabilities for its share of cleanup costs at these sites are uncertain. In addition, TVA operations at some TVA-owned facilities have resulted in releases of oil and/or hazardous substances which require cleanup and/or remediation.

At September 30, 2005, and 2004, TVA's estimated liability for environmental cleanup for those sites for which sufficient information is available to develop an estimate was \$28 million and \$29 million, respectively, and was included in OTHER LIABILITIES on the 2005 and 2004 year-end Balance Sheets. However, TVA has insufficient information to develop an estimate for some of the sites.

Legal. TVA is involved in various claims amounting to approximately \$89 million incidental to the conduct of its business for which it has assessed the likelihood of gain or loss. The claims, grouped by likelihood of loss, include (1) claims recorded by TVA in the amount of \$13 million representing probable losses of \$12 million and losses deemed reasonably possible of \$1 million, and (2) claims of about \$76 million for which a determination of loss cannot be made at this time. (See note 17 — *Legal.*)

In the fall of 1999, the Environmental Protection Agency (“EPA”) commenced judicial or administrative actions against a number of utilities in the eastern United States, including TVA, alleging that they modified their coal-fired units without complying with the new source review (“NSR”) requirements under the CAA. Although no decision was rendered on the merits, TVA eventually prevailed in this litigation.

The National Parks Conservation Association (“NPCA”) and the Sierra Club filed cases in two federal district courts in 2001 alleging that TVA modified its Bull Run Fossil Plant (“Bull Run”) and Colbert Fossil Plant Unit 5 (“Colbert Unit 5”) without complying with the NSR requirements of the CAA. In March 2005, the district court granted TVA’s motion to dismiss the lawsuit in the Bull Run case. The plaintiffs’ motion for reconsideration was denied, and they have appealed to the Court of Appeals for the Sixth Circuit (“Sixth Circuit”). In the Colbert Unit 5 case, the parties have filed motions for summary judgment. The judge has ruled on some but not all of these motions, and dispositive motions remain to be considered. In similar lawsuits filed by EPA and others against other utility companies, the rulings by the respective courts differ widely.

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

- The Alabama Environmental Council and the Sierra Club filed a lawsuit in federal district court in Florence, Alabama, alleging that TVA violated CAA opacity limits applicable to Colbert Fossil Plant between July 1, 1997, and June 30, 2002. The groups sought a court order that could require TVA to incur substantial costs, in addition to the costs TVA is already planning to incur for environmental controls, and pay civil penalties of up to approximately \$250 million. On September 14, 2004, the court found that TVA had not violated the CAA, and the complaint was dismissed in its entirety. The plaintiffs have appealed the district court’s decision to the Court of Appeals for the Eleventh Circuit (the “Eleventh Circuit”), which held oral argument on the case on August 17, 2005. The parties are awaiting the Eleventh Circuit’s decision.
- On July 25, 2003, TVA received a notice of intent to sue from Our Children’s Earth Foundation (“OCE”). OCE contends that TVA violated the NSR requirements of the CAA by undertaking major modifications of TVA’s Allen Unit 3, Bull Run, Cumberland Units 1 and 2, Kingston Units 6 and 8, John Sevier Unit 3, Paradise Units 1, 2, and 3, Shawnee Units 1 and 4, Colbert Unit 5, and Widows Creek Unit 5 without installing additional pollution control equipment. OCE also contends the CAA new source performance standards at Colbert Unit 5 and the operations at TVA’s Johnsonville Fossil Plant have not met the applicable opacity requirements. This notice does not specify a monetary amount of TVA’s claimed liability. OCE’s allegations about Bull Run and Colbert Unit 5 are already the subject of litigation in federal district courts initiated by the NPCA and the Sierra Club. In 2004, OCE obtained the district court’s permission to join as a plaintiff in the Bull Run NSR suit. It made a similar request in the Colbert NSR suit which the court denied as untimely.
- The Sierra Club gave notice in a September 26, 2002, letter that it intends to sue TVA for violating CAA opacity limits applicable to the John Sevier and Kingston Fossil Plants. The notice claims that TVA violated opacity standards at the two plants from July 1, 1997, to the present. The alleged opacity violations substantially overlap those that were challenged in a lawsuit filed by the NPCA four years ago in federal court in Knoxville, Tennessee. TVA ultimately prevailed in that lawsuit. The Sierra Club has not filed suit.

On December 28, 2001, Bowater Incorporated and Bowater Newsprint South, Inc. (together, “Bowater”) filed a lawsuit against TVA in federal court in Knoxville challenging TVA’s charges for Economy Surplus Power (“ESP”) and Testing and Restart Power (“TRP”) for two Bowater plants. The lawsuit sought, among other things, compensatory damages in excess of \$45 million, plus interest. TVA and Bowater settled the lawsuit by entering into revised and extended power supply arrangements at the two plants. The settlement agreement does not require TVA to pay Bowater for the damages sought. On March 8, 2005, the court dismissed this case with prejudice.

On August 31, 1999, Birmingham Steel Corporation filed a lawsuit in the U.S. District Court for the Northern District of Alabama alleging that TVA overcharged for ESP during the summer of 1998. The lawsuit was filed as a class action on behalf of industrial customers who participated in TVA’s ESP program. Under ESP contracts, the hourly ESP energy price is calculated using TVA’s actual incremental cost of supplying the ESP load in each hour. The plaintiff alleges that TVA overcharged for ESP during the summer of 1998 by including in the price of ESP some costs that were added to TVA’s incremental cost. The complaint seeks over \$100 million in damages on behalf of Birmingham Steel and the other class members. In September 2002, the district court decertified the class and then dismissed

Birmingham Steel's individual claim without prejudice on a jurisdictional issue. The class lawyers appealed the ruling on class decertification, and in December 2003, the Eleventh Circuit reversed that ruling and sent the case back to the district court to allow the class lawyers a reasonable time to find a new class representative. The district court allowed the substitution of Johns Manville Corporation to represent the class. Motions for summary judgment were filed in October 2005.

In December 2004, a federal judge in Nashville, Tennessee, dismissed a lawsuit filed against TVA and 22 electric cooperatives by Tennessee residents and customers of some of the cooperatives, in part challenging TVA's practice of setting rates for electric power charged by distributors via its contracts. Both TVA and the cooperatives had filed motions to dismiss, which the court granted. The judge dismissed the plaintiffs' claims alleging violations of state law because the plaintiffs failed to carry out the steps necessary to bring these claims in court. The dismissal was without prejudice, allowing the plaintiffs to re-file the claims if these steps are carried out and suit is filed within the statutory period. As to the plaintiffs' allegations of federal law violations, the court found that Congress had specifically authorized TVA to set the rates charged by distributors via its contracts. In the face of such express Congressional authorization, the plaintiffs' federal law claims failed as a matter of law and were dismissed with prejudice, precluding them from being brought again. The plaintiffs moved for reconsideration of the dismissal, and the judge denied the plaintiffs' motion. The plaintiffs subsequently appealed to the Sixth Circuit.

In July 2004, two lawsuits were filed against TVA in federal court in New York City alleging that global warming is a public nuisance and that carbon dioxide ("CO₂") 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 CAA requirements limiting CO₂ emissions, and, accordingly, the suits do not involve allegations of regulatory noncompliance. The theory of the cases is that global warming constitutes a nuisance and defendants' CO₂ emissions are contributing to the nuisance. Plaintiffs do not seek monetary damages, but do seek injunctive relief. Specifically, plaintiffs seek a court order requiring each defendant to cap its CO₂ emissions and then reduce these emissions by a specified percentage each year for at least a decade. The defendants filed motions to dismiss on September 30, 2004. Oral argument was held on the motions on August 12, 2005. 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 Court of Appeals for the Second Circuit.

Pursuant to the Nuclear Waste Policy Act of 1982, TVA (and all other domestic nuclear utilities) entered into a contract with 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 has announced that it would not begin picking up spent nuclear fuel from any domestic nuclear utility until 2010 at the earliest. TVA, like other utilities, stores SNF in pools of borated water at its nuclear sites. Although TVA would have had sufficient space to continue to store SNF in those storage pools at its Sequoyah and Browns Ferry Nuclear Plants indefinitely had DOE begun accepting SNF, DOE's failure to do so required TVA to construct dry cask storage facilities at its Browns Ferry and Sequoyah Nuclear Plants and to purchase special storage containers for the SNF. (Watts Bar Nuclear Plant currently has sufficient storage capacity in its spent fuel pool to last until 2018.) Both Sequoyah's and Browns Ferry's dry cask storage facilities are operational. To recover the cost of providing long-term, on-site storage for SNF, TVA filed a breach of contract suit against the United States in the Court of Federal Claims in 2001. The evidentiary portion of the case for damages through 2004 was completed in Washington D.C. in July 2005. Closing arguments were made in October 2005. A decision is expected before the end of the calendar year 2005.

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 legal proceedings described above except as specifically noted.

13. Stewardship Responsibilities

During 2005, TVA continued to conduct certain nonpower programs, including maintaining navigable river channels, reducing flood damage, and overseeing certain recreation facilities. TVA's responsibilities include reservoir operations, navigation, dam safety, and the general stewardship of land, water, and natural resources.

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

Beginning in 2000, Congress stopped providing appropriations to TVA to fund essential stewardship activities. Consequently, in 2005, 2004, and 2003, TVA paid \$93 million, \$87 million, and \$83 million, respectively, for essential stewardship activities primarily with power revenues. In addition, administrative jurisdiction over Land Between The Lakes was transferred to the Secretary of Agriculture effective October 1, 1999. As part of the transfer, TVA assumed responsibility for certain transition expenses associated with the transfer and has paid \$10 million of transition expenses with the last payment of \$1 million having been made in 2004. TVA retains responsibility for management of the remaining nonpower assets and settlement of nonpower obligations.

At September 30, 2005, the net completed plant balances for multipurpose dams and other plant were \$636 million and \$36 million, respectively (see note 3). At September 30, 2004, the net completed plant balances for multipurpose dams and other plant were \$645 million and \$39 million, respectively.

14. Power and Nonpower Activities

In the fourth quarter of 2004, TVA began reporting its power and nonpower program activities on a consolidated basis in its financial statements. The table below details the separate results of operations of each program.

	2005			2004			2003		
	Power Program	Nonpower Program	Total	Power Program	Nonpower Program	Total	Power Program	Nonpower Program	Total
<i>(in millions)</i>									
<i>Operating revenues</i>									
Sales of electricity	\$ 7,704	\$ —	\$ 7,704	\$ 7,439	\$ —	\$ 7,439	\$ 6,875	\$ —	\$ 6,875
Other revenue	90	—	90	94	—	94	77	1	78
Total operating revenues	7,794	—	7,794	7,533	—	7,533	6,952	1	6,953
<i>Operating expenses</i>									
Fuel and purchased power	2,601	—	2,601	2,081	—	2,081	1,957	—	1,957
Operating and maintenance	2,356	3	2,359	2,319	—	2,319	2,037	2	2,039
Depreciation and accretion	1,144	10	1,154	1,104	11	1,115	1,062	11	1,073
Tax-equivalents	365	—	365	338	—	338	329	—	329
Loss on asset impairment/ project cancellation	24	—	24	20	—	20	—	—	—
Total operating expenses	6,490	13	6,503	5,862	11	5,873	5,385	13	5,398
Operating income (loss)	\$ 1,304	\$ (13)	\$ 1,291	\$ 1,671	\$ (11)	\$ 1,660	\$ 1,567	\$ (12)	\$ 1,555

15. Related Parties

TVA is a wholly-owned corporate agency of the federal government, and because of this relationship, TVA's revenues and expenses are included as part of the federal budget. TVA's purpose and responsibilities as an agency are described under the "Other Agencies" section of the federal budget. Although TVA's bonds are not guaranteed by the federal government, they are included in the federal budget. TVA's bonds are supported solely by the TVA power system.

TVA receives no appropriations from the government and funds its business using internally generated power system revenues, power financings, and other revenues. TVA is actually a source of cash to the federal government. Until TVA repays \$1 billion of the government's Appropriation Investment under the self-financing amendment to the TVA Act, TVA repays a portion of the government's investment in the TVA power system and also pays a return on this investment (see Note 7 — *Appropriation Investment*). In the normal course of business, TVA contracts with other federal agencies for sales of electricity and other services. Transactions with agencies of the federal government were as follows:

	Related Party Transactions		
	2005	2004	2003
Sales of electricity services	\$ 168	\$ 153	\$ 141
Other revenues	15	16	–
Other expenses	222	202	254
Receivables at September 30	26	18	22
Payables at September 30	131	203	211
Return on appropriation investment (note 7)	16	18	22
Return of appropriation investment (note 7)	20	20	20

16. Unaudited Consolidated Quarterly Financial Information

A summary of the unaudited quarterly results of operations for the years 2005 and 2004 follows. It should be read in conjunction with the audited financial statements appearing herein. Results for interim periods may fluctuate as a result of seasonal weather conditions, changes in rates, and other factors.

(in millions)	2005				
	First	Second	Third	Fourth	Total
Operating revenues	\$ 1,834	\$ 1,839	\$ 1,881	\$ 2,240	\$ 7,794
Operating expenses	1,435	1,562	1,553	1,953	6,503
Operating income	399	277	328	287	1,291
Net income (loss)	\$ 90	\$ (24)	\$ (15)	\$ 34	\$ 85

(in millions)	2004				
	First	Second	Third	Fourth	Total
Operating revenues	\$ 1,777	\$ 1,879	\$ 1,857	\$ 2,020	\$ 7,533
Historical operating expenses	1,378	1,443	1,463	1,568	5,852
Addition of nonpower expense	3	3	3	2	11
Reclassification of lease expense ⁽¹⁾	2	3	2	3	10
Operating expense after reclassification	1,383	1,449	1,468	1,573	5,873
Operating income	394	430	389	447	1,660
Reclassification of MTM gains ⁽²⁾	–	–	(3)	3	–
Net income (loss)	\$ 67	\$ 118	\$ 105	\$ 96	\$ 386

Notes

(1) In 2004, TVA reclassified certain lease expenses from other expenses to Operating and Maintenance (“O&M”). The result was an increase in O&M expense of \$10 million and corresponding increase in Other Income, net of \$10 million for year represented.

(2) Mark-to-market gains of \$3 million on purchases emissions allowance options have been reclassified to OTHER INCOME, NET from OCI. The reclassification was also transferred from the fourth quarter of 2004 to the third quarter of 2004.

17. Subsequent Events

Debt Securities

In October 2005, TVA issued \$27 million of electronotes[®] with an interest rate of 5.00 percent which mature in 2015 and are callable in 2007.

In November 2005, TVA issued \$11 million of electronotes[®] with an interest rate of 5.5 percent which mature in 2020 and are callable in 2008.

On October 2, 2005, TVA redeemed at par five bonds in the TVA electronotes® series. The bonds TVA redeemed are all of its 2001 6.35 percent electronotes® due June 15, 2021, with a par amount of \$28 million, all of its 2001 6.10 percent electronotes® due August 15, 2021, with a par amount of \$23 million, all of its 2002 6.00 percent electronotes® due May 15, 2017, with a par amount of \$40 million, all of its 2003 5.50 percent electronotes® due August 15, 2018, with a par amount of \$43 million, and all of its 2003 5.625 percent electronotes® due October 15, 2023, with a par amount of \$14 million.

Legal

On November 9, 2005, TVA received two invoices totalling \$76 million from Areva for Framatome ANP, Inc, the predecessor of Babcock and Wilcox Company ("B&W"). In 1970, TVA and B&W entered into a contract for fuel fabrication services for the Bellefonte Nuclear Plant. 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 did. TVA is reviewing Areva's claim.

Management

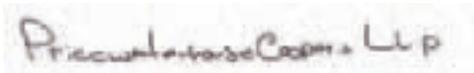
In November 2005, the President of the United States sent to the Senate nominations of five people to serve on the TVA Board. The Senate has not announced when it will consider the nominations. As soon as three new Board members take office, the restructured Board provided for in the Consolidated Appropriations Act, 2005, will take effect.

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of the Tennessee Valley Authority:

In our opinion, the accompanying balance sheets and the related statements of income, statements of cash flows, and statements of changes in proprietary capital present fairly, in all material respects, the financial position of the Tennessee Valley Authority at September 30, 2005, and 2004, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2005, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Tennessee Valley Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1 to the financial statements, effective October 1, 2002, Tennessee Valley Authority changed the methodology for estimating unbilled revenue from electricity sales and adopted Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*.



PricewaterhouseCoopers LLP
Knoxville, Tennessee
November 17, 2005

REPORT OF MANAGEMENT

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

The Tennessee Valley Authority maintains an adequate system of internal controls to provide reasonable assurance that transactions are executed in accordance with management's authorization, that financial statements are prepared in accordance with generally accepted accounting principles, and that the assets of the corporation are properly safeguarded. The system of internal controls is documented, evaluated, and tested on a continuing basis. No internal control system can provide absolute assurance that errors and irregularities will not occur due to the inherent limitations of the effectiveness of internal controls; however, management strives to maintain a balance, recognizing that the cost of such a system should not exceed the benefits derived. TVA performed an assessment of its internal control system and concluded that, as a result of internal control deficiencies, TVA's disclosure controls and procedures were not effective as of September 30, 2005 (see "*Controls and Procedures*" in Part II).

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



Michael E. Rescoe
Chief Financial Officer
and Executive Vice President of Financial Services
November 17, 2005

REPORT OF INSPECTOR GENERAL

To the Board of Directors of the Tennessee Valley Authority

The Tennessee Valley Authority (TVA) contracted with the independent certified public accounting firm of PricewaterhouseCoopers LLP (PricewaterhouseCoopers) to audit the balance sheets as of September 30, 2005 and 2004, and the related statements of income, changes in proprietary capital, and cash flows for each of the three years in the period ended September 30, 2005. The contract required the audit be done in accordance with generally accepted government auditing standards.

Under the Inspector General Act, the Inspector General (IG) is responsible for taking appropriate steps to assure that any work performed by nonfederal auditors, including PricewaterhouseCoopers, complies with generally accepted government auditing standards. The Chief Financial Officers Act also places responsibilities on the IG regarding TVA's annual financial statement audit. In keeping with these statutory responsibilities, the TVA Office of Inspector General reviewed PricewaterhouseCoopers' reports and related audit documentation, interviewed their representatives, and performed such other procedures as we deemed appropriate in the circumstances to provide reasonable assurance the audit was performed in accordance with generally accepted government auditing standards.

The objective of our review was not intended to enable us to express, and we do not express, an opinion on the TVA's financial statements or on management's conclusions about the effectiveness of its system of internal control. PricewaterhouseCoopers is responsible for the auditor's reports dated November 17, 2005, and the conclusions expressed in the reports. However, our review disclosed no instances where PricewaterhouseCoopers did not comply, in all material respects, with generally accepted government auditing standards. Our review was performed in accordance with generally accepted government auditing standards.



Richard W. Moore
Inspector General
November 18, 2005

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

During 2005, there were no changes in or disagreements with TVA's independent auditors on accounting matters or financial disclosure.

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 members of the Board, the Disclosure Control Committee, and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation has been performed under the supervision of TVA management, including members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) of the effectiveness of TVA's disclosure controls and procedures as of September 30, 2005. Based on that evaluation, the members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) concluded that, as a result of internal control deficiencies (described below), TVA's disclosure controls and procedures were not effective as of September 30, 2005. 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 members of the Board and of the Disclosure Control Committee (including the Chief Financial Officer and the Controller) have determined that there is reasonable assurance that the financial statements included in this Statement 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 implementing additional internal controls in the areas of project approval and cost classification, timely accounting review of account balances and asset addition and retirement transactions, and formal documentation of management's reviews and approvals.

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. As of June 30, 2005, an internal control deficiency was identified related to TVA's general computer controls as follows:

- Program development and program changes including (1) documentation of change authorization and (2) restricting programmer access to the production environment, and
- Unrestricted access to programs and data including (1) user administration, (2) application and system security configurations, and (3) periodic user access validation.

TVA is taking corrective actions to address this significant deficiency by implementing stronger controls over data and program changes, stricter logging and monitoring processes of data and program 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 developed and communicated a plan to obtain annual Statement on Auditing Standards ("SAS") 70 internal control reports on 12 specific control objectives from customers and their third party billing processors. The first SAS 70 reports will be due to TVA on August 31, 2006.

Also during the fourth quarter of 2004, TVA management identified a significant deficiency related to the market valuation of coal contracts that contain volumetric optionality. Although key controls have been designed to facilitate the complete and accurate capture and processing of coal contract activities, many control activities were not standardized. To improve controls in this area, personnel have performed independent reviews of all new contracts to be included, supplements included, and changes made to the valuation model during the quarter ended September 30, 2005. TVA has also implemented standard control procedures to address this internal control deficiency which include independent reviews of the input of contract terms into the valuation model and proper segregation of duties.

During the fourth quarter 2005, TVA improved the design of controls over the conduct of physical observations of materials and supplies inventory by requiring blind cycle counts, performing independent reviews and audits of periodic cycle counts, and segregating the cycle count duties between the personnel performing the counts and those recording and clearing differences. TVA also implemented the Automated Journal Entry System which automated the approval of manual journal entries and resulted in increased oversight and improvement in the completeness and management of supporting documentation.

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.

PART III

DIRECTORS AND EXECUTIVE OFFICERS

TVA is currently administered by a board of directors ("Board") composed of three persons appointed by the President of the United States and confirmed by the Senate, although only two Board members were in office as of September 30, 2005. TVA's management structure includes an Executive Committee which works with the Board to determine TVA's strategic mission and future direction, provides management oversight, and ensures that policies of the Board are carried out.

However, the Consolidated Appropriations Act, 2005 includes provisions which will result in the restructuring of the Board and the appointment of a Chief Executive Officer. The legislation restructures the Board by increasing the number of directors from three full-time members to nine part-time members, at least seven of whom must be legal residents of the TVA service area. As with the current Board, future Board members will be appointed by the President and confirmed by the Senate, but after a transition period will serve five-year terms rather than the current nine-year terms. The Board's role will continue to be, among other things, to develop long-term plans and strategies for TVA, approve annual budgets and an employee compensation plan for TVA, and have general responsibility for TVA policies. The Board will also create an audit committee consisting of members of the Board "independent of the management" to review reports from TVA's external auditors and Inspector General and make recommendations to the full Board. Congress also reaffirmed the authority of the Board to set electric rates charged by TVA. These provisions will go into effect on the date when three new members of the Board take office. The members of the Board will select a member to serve as Chairman. Additionally, the Board will appoint a Chief Executive Officer who will report directly to the Board.

The Board and selected officers, their ages, their years of employment with TVA, and their principal occupations for recent years are as follows:

<u>Directors</u>	<u>Age</u>	<u>Year Appointed</u>	<u>Year Term Expires</u>
William W. Baxter, Chairman	52	2001	2011
Skila Harris, Director	55	1999	2008

Mr. Baxter was appointed to the Board in November 2001. Prior to joining the Board, Mr. Baxter was Chairman and Chief Executive Officer of Holston Gases Inc. of Knoxville, Tennessee. Before joining Holston Gases Inc. in 1981, Mr. Baxter was an attorney with Garrett, Coffee, McGee & Baxter in Knoxville. From December 1997 through December 2000, Mr. Baxter was Commissioner of the Department of Economic and Community Development for the State of Tennessee.

Ms. Harris was appointed to the Board in November 1999. Prior to her current position, she served at the Department of Energy ("DOE") as Executive Director of the Secretary of Energy Advisory Board. From 1993 until 1997, she was a Special Assistant to Vice President Gore and Mrs. Gore's Chief of Staff. She came to the White House from Steiner-Liff Iron and Metal Company in Nashville, Tennessee, where she was Vice President for Development and Compliance. Ms. Harris served as a project manager at the U.S. Synthetic Fuels Corporation, and she was with the DOE during the Carter Administration. She has also held positions with management and engineering consulting firms specializing in energy-related work.

<u>Executive Officers</u>	<u>Title</u>	<u>Age</u>	<u>Year Employment Commenced</u>
Tom D. Kilgore	President and Chief Operating Officer	57	2005
Michael E. Rescoe	Chief Financial Officer & Executive Vice President of Financial Services	53	2003
Maureen H. Dunn	Executive Vice President and General Counsel	56	1978
John E. Long, Jr.	Executive Vice President, Administrative Services	53	1980
Kenneth R. Breeden	Executive Vice President, Customer Service and Marketing	57	2004
Ellen Robinson	Executive Vice President, Communications	51	2001
John Bradley	Senior Vice President, Economic Development	45	2002
Theresa A. Flaim	Senior Vice President, Pricing and Strategic Planning	56	2002

Mr. Kilgore was named President and Chief Operating Officer in March 2005. Prior to his current position, he served as president and chief executive officer of Progress Ventures, a subsidiary of Progress Energy. Prior to his tenure at Progress Ventures, he was senior vice president of power operations for Carolina Power & Light directing the operation of fossil-fuel plants and president and chief executive officer of Oglethorpe Power Corporation in Georgia from 1991-1998.

Mr. Rescoe was named Chief Financial Officer and Executive Vice President of Financial Services in July 2003. Prior to his current position, he served as Senior Vice President of Finance and Planning and Chief Financial Officer with 3Com Corp., as Chief Financial Officer of Pacific Gas & Electric, and as an investment banker serving utility and energy sectors with the New York-based Bear Stearns and Kidder, Peabody.

Ms. Dunn joined TVA as an attorney in May 1978, assumed the position of Assistant General Counsel in September 1986, and assumed the position of Executive Vice President and General Counsel in January 2001.

Mr. Long was named Executive Vice President of Administrative Services in September 2005. Since 2000, he had served as Vice President of Human Resources. Since 1992, he has also served as a management appointee to the TVA Retirement System Board. Mr. Long joined TVA in 1980 as a Personnel Officer in the Engineering Division.

Mr. Breeden was named Executive Vice President of Customer Service and Marketing in August 2004. He has more than 20 years of utility-industry experience having served in officer positions at TXU Corp. in Dallas and at Entergy Services, Inc. in Little Rock, Arkansas. Before joining Entergy, Mr. Breeden worked for 11 years with South Central Bell in Nashville and Memphis and with AT&T in Nashville and New Jersey.

Ms. Robinson was named Executive Vice President of Communications and Government Relations in June 2001. This position was retitled Executive Vice President of Communications in connection with the September 20, 2005, reorganization discussed in *"Management's Discussion and Analysis of Financial Condition and Results of Operations"* — *"Other Matters"* — *"Organizational Structure Changes"* in Part II. She served as Senior Vice President of Communications and Government Affairs at CNH Global NV in Racine, Wisconsin, and before that as Vice President of Communications and Government Affairs at Case Corporation. Ms. Robinson joined Case from Burson-Marsteller in New York, where she was a Vice President and a head of the business-to-business marketing unit.

Mr. Bradley was named Senior Vice President of Economic Development in August 2002. He is responsible for recruitment and retention of capital investment and job creation, business development, technical services, and community development. Mr. Bradley served as Senior Vice President for Economic Development for the Memphis Regional Chamber of Commerce from 1996 to 2002, and he worked in Memphis Light, Gas & Water's economic development department from 1980 to 1996.

Dr. Flaim was named as Senior Vice President of Pricing and Strategic Planning in August 2005 after serving as the Senior Vice President of Strategic Planning and Analysis since June 2002. She is responsible for developing pricing and strategies related to the ongoing competitive restructuring of the electric-utility industry. She served for nine years as Vice President of Strategic Planning for Niagara Mohawk. Dr. Flaim also worked at the Solar Energy Research Institute and the Los Alamos National Laboratory.

LABOR AGREEMENTS AND COMPENSATION

On September 30, 2005, TVA had 12,703 employees, of whom approximately 5,331 were trades and labor employees. Neither the federal labor relations laws covering most private sector employers nor those covering most federal agencies apply to TVA. However, the TVA Board has a long-standing policy of acknowledging and dealing with recognized representatives of its employees, which policy is reflected in long-term agreements to recognize the unions (or their successors) that represent TVA employees. Federal law prohibits TVA employees from engaging in strikes against TVA.

Salaries of regular TVA employees are limited by a federal pay cap (at September 30, 2005, the Executive Level III (Chairman) was \$149,200 and Executive Level IV was \$140,300). The federal pay cap makes it a challenge for TVA to recruit and retain top management talent. In response, TVA has developed and implemented supplementary compensation arrangements to reduce the impact of the pay cap and to enhance TVA's ability to attract and retain the caliber of executive talent required to manage one of the largest power systems in the country. TVA believes the implementation of these arrangements is within its legal authority. In the past, the Government Accountability Office ("GAO") has expressed the opinion that some of TVA's compensation arrangements are not within TVA's legal author-

ity. However, GAO has no authority to issue binding legal opinions on this matter or to stop any TVA payments. Congress has been aware of TVA's supplemental compensation arrangements and has not taken any action that would undermine TVA's position that the arrangements are within its legal authority.

The Consolidated Appropriations Act, 2005, in addition to providing for the restructuring of the Board and the creation of the position of a Chief Executive Officer, changed several aspects with respect to the compensation of TVA's employees. These changes will become effective when at least three members nominated under this act take office and include:

- The elimination of the requirement that no TVA officer or employee could have a salary in excess of that received by members of the Board.
- The Board will approve a compensation plan that:
 - Specifies the compensation for the Chief Executive Officer and employees of TVA;
 - Is based upon an annual survey of prevailing compensation for similar positions in private industries, including engineering and electric utility companies, publicly-owned electric utilities, and federal, state, and local governments; and
 - Provides that education, experience, level of responsibility, geographic differences, and retention and recruitment needs will be taken into account.
- The Board will approve the compensation of all managers and technical personnel that report to the Chief Executive Officer.

For purposes of the Consolidated Appropriations Act, 2005, "compensation" includes salary or any other pay, bonuses, benefits, incentives, and any other form of remuneration.

In October 1995, the President issued an Executive Order requiring government corporations, including TVA, to submit information to the Office of Management and Budget ("OMB") on bonuses paid to its senior executives. TVA submits information on these bonuses annually to OMB and also publicly disseminates this information. OMB approval of TVA's bonuses is not required.

CODE OF ETHICS

TVA has a Disclosure and Financial Ethics Code ("Ethics Code") that applies to all executive officers and directors of TVA as well as to all employees who certify information contained in quarterly reports, annual reports, or information statements or who have responsibility for internal control self-assessments. The Ethics Code includes provisions covering conflicts of interest, ethical conduct, compliance with applicable laws, rules and regulations, responsibility for full, fair, accurate, timely, and understandable disclosures, and accountability for adherence to the Ethics Code. The Ethics Code is posted on TVA's website at: www.tva.com. TVA will provide a current copy of the Ethics Code to any person, without charge, upon request. Requests may be made by calling 888-882-4975 or by sending an e-mail to: investor@tva.com. Any waivers of or changes to provisions of the Ethics Code will be promptly disclosed to the public, subject to limitations imposed by law.

PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table presents fees for professional services rendered by PricewaterhouseCoopers LLP for the years ended September 30, 2005 and 2004.

	<u>2005</u>	<u>2004</u>
Audit Fees (1)	\$ 785,008	\$ 624,208
Audit-Related Fees (2)	<u>512,607</u>	<u>—</u>
TOTAL	<u>\$ 1,297,615</u>	<u>\$ 624,208</u>

- (1) Audit fees consist of professional services rendered for the audit of TVA's annual financial statements and the review of the financial statements included in TVA's quarterly reports.
- (2) Audit-related fees are fees for services which are usually performed by the auditor and consist primarily of accounting assistance on proposed transactions and accounting standards and accounting assistance related to the adoption of the Sarbanes-Oxley Act.

PART IV

STATISTICAL AND FINANCIAL SUMMARIES

STATISTICAL AND FINANCIAL SUMMARIES

For the years ended September 30

Unaudited

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Winter net dependable generating capacity (megawatt)^(a)											
Hydro	5,104	4,981	5,022	4,924	4,941	4,808	4,756	4,755	4,648	4,652	4,489
Fossil	15,075	15,076	15,029	15,023	15,050	15,042	15,049	15,003	15,014	15,012	15,032
Nuclear units in service	5,790	5,777	5,776	5,751	5,715	5,729	5,729	5,620	5,625	5,545	3,342
Combustion turbine and diesel generators ^(b)	4,675	4,685	4,655	4,643	3,923	3,154	2,232	2,384	2,394	2,268	2,232
TVA facilities	30,644	30,519	30,482	30,341	29,629	28,733	27,766	27,762	27,681	27,477	25,095
Other facilities	3,337	2,670	1,176	1,176	736	736	736	736	736	736	736
Total long-term available capacity	33,981	33,189	31,658	31,517	30,365	29,469	28,502	28,498	28,417	28,213	25,831
System peak load (megawatt) – summer	31,924	29,966	28,530	29,052	27,368	29,344	28,295	27,253	26,661	25,376	25,496
System peak load (megawatt) – winter	29,278	27,997	29,866	26,061	27,163	25,940	26,388	23,204	26,670	25,995	24,676

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Percent gross generation by fuel source											
Fossil	62%	61%	60%	63%	64%	63%	63%	62%	61%	65%	71%
Hydro	10%	9%	11%	6%	6%	6%	7%	10%	11%	11%	12%
Nuclear	28%	30%	29%	30%	29%	31%	30%	28%	28%	24%	17%
Combustion turbine	<1%	<1%	<1%	1%	1%	NM	NM	NM	NM	NM	NM

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Fuel cost per kWh (cents)											
Fossil	1.65	1.48	1.43	1.39	1.32	1.27	1.28	1.25	1.23	1.23	1.26
Combustion turbine	11.44	9.01	7.61	4.65	6.07	6.22	3.94	4.01	5.22	4.54	3.61
Nuclear ^(c)	0.39	0.39	0.39	0.41	0.44	0.49	0.51	0.71	0.58	0.56	0.61
Aggregate fuel cost per kWh net thermal generation	1.30	1.14	1.14	1.11	1.08	1.05	1.05	1.10	1.04	1.06	1.14

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Fuel data											
Net thermal generation (millions of kWh)	144,114	140,890	134,931	141,272	146,806	143,224	137,169	139,727	135,736	131,898	118,097
Billion Btu	1,478,398	1,446,284	1,391,933	1,458,367	1,505,504	1,470,452	1,403,110	1,426,151	1,381,837	1,338,157	1,197,295
Fuel expense (millions of dollars)	1,870	1,602	1,534	1,564	1,588	1,504	1,434	1,538	1,406	1,395	1,348
Cost per million Btu (cents)	126.48	110.75	110.21	107.25	105.47	102.29	102.21	107.81	101.73	104.22	112.61
Net heat rate, total system	10,259	10,265	10,316	10,323	10,255	10,267	10,229	10,207	10,180	10,145	10,138

(a) See "Properties" — "Generating Resources" in Part I.
 (b) As of September 30, 2005, includes twenty-four 85-megawatt units subject to lease/leaseback arrangements.
 (c) TVA changed its method of expensing the interest component of nuclear fuel expense in 1995.

INDEPENDENT ACCOUNTANTS

The financial statements of TVA at September 30, 2005 and 2004, and for each of the three fiscal years in the period ended September 30, 2005, included herein as part of this Statement, have been audited by PricewaterhouseCoopers LLP, independent accountants, as stated in their report, dated November 17, 2005, which report is also included herein.

* * * * *

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

Tennessee Valley Authority

By: /s/ MICHAEL E. RESCOE
Michael E. Rescoe
Chief Financial Officer
and Executive Vice President of Financial Services

By: /s/ RANDY TRUSLEY
Randy Trusley
Vice President & Controller

CERTIFICATIONS OF THE INDIVIDUAL MEMBERS OF THE BOARD OF DIRECTORS

Bill Baxter and Skila Harris individually certify that:

1. I have reviewed this Information Statement ("Statement") of the Tennessee Valley Authority;
2. Based on my knowledge, this Statement 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 Statement;
3. Based on my knowledge, the financial statements and other financial information included in this Statement 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 Statement;
4. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Statement is being prepared;
 - b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Statement our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Statement based on such evaluation; and
 - c) disclosed in this Statement any change in internal control over financial reporting that occurred during the fourth quarter ended September 30, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and
5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: November 17, 2005



Bill Baxter
Chairman



Skila Harris
Director

CERTIFICATION OF THE CHIEF FINANCIAL OFFICER

I, Michael E. Rescoe, certify that:

1. I have reviewed this Information Statement ("Statement") of the Tennessee Valley Authority;
2. Based on my knowledge, this Statement 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 Statement;
3. Based on my knowledge, the financial statements and other financial information included in this Statement 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 Statement;
4. The other certifiers and I are responsible for establishing and maintaining disclosure controls and procedures for the Tennessee Valley Authority and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Tennessee Valley Authority is made known to us by others particularly during the period in which this Statement is being prepared;
 - b) evaluated the effectiveness of the Tennessee Valley Authority's disclosure controls and procedures and presented in this Statement our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Statement based on such evaluation; and
 - c) disclosed in this Statement any change in internal control over financial reporting that occurred during the fourth quarter ended September 30, 2005, that has materially affected, or is reasonably likely to materially affect, the Tennessee Valley Authority's internal control over financial reporting; and
5. The other certifiers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Tennessee Valley Authority's auditors and the Inspector General of the Tennessee Valley Authority:
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Tennessee Valley Authority's ability to record, process, summarize, and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Tennessee Valley Authority's internal control over financial reporting.

Date: November 17, 2005



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

SUPPLEMENTAL SCHEDULE

Valuation and Qualifying Accounts and Reserves

<u>Description</u>	<u>Balance at Beginning of Year</u>	<u>Additions Charged to Expense</u>	<u>Deductions</u>	<u>Balance at End of Year</u>
		(in millions)		
For the year ended September 30, 2005				
Allowance for doubtful accounts				
Receivables	\$ 8	\$ -	\$ (1)	\$ 7
Loans	14	1	-	15
Allowance for inventory obsolescence	<u>36</u>	<u>15</u>	<u>(15)</u>	<u>36</u>
Total allowances deducted from assets	<u>\$ 58</u>	<u>\$ 16</u>	<u>\$ (16)</u>	<u>\$ 58</u>
For the year ended September 30, 2004				
Allowance for doubtful accounts				
Receivables	\$ 8	\$ -	\$ -	\$ 8
Loans	14	-	-	14
Allowance for inventory obsolescence	<u>33</u>	<u>11</u>	<u>(8)</u>	<u>36</u>
Total allowances deducted from assets	<u>\$ 55</u>	<u>\$ 11</u>	<u>\$ (8)</u>	<u>\$ 58</u>
For the year ended September 30, 2003				
Allowance for doubtful accounts				
Receivables	\$ 13	\$ -	\$ (5)	\$ 8
Loans	13	1	-	14
Allowance for inventory obsolescence	<u>29</u>	<u>10</u>	<u>(6)</u>	<u>33</u>
Total allowances deducted from assets	<u>\$ 55</u>	<u>\$ 11</u>	<u>\$ (11)</u>	<u>\$ 55</u>

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**PRINCIPAL EXECUTIVE OFFICE OF TVA
400 W. Summit Hill Drive
Knoxville, TN 37902
U.S.A.**

**FISCAL AGENT
U.S. Federal Reserve Banks
c/o Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045
U.S.A.**

**U.S. TAX AND
LEGAL ADVISORS TO TVA
Orrick, Herrington & Sutcliffe LLP
666 Fifth Avenue
New York, NY 10103
U.S.A.**

**LEGAL COUNSEL FOR TVA
Maureen H. Dunn
Executive Vice President and
General Counsel
Tennessee Valley Authority
400 W. Summit Hill Drive
Knoxville, TN 37902
U.S.A.**

**U.S. LEGAL ADVISORS TO THE MANAGERS
Sullivan & Cromwell LLP
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006
U.S.A.**

**AUDITORS TO TVA
PricewaterhouseCoopers LLP
2030 Falling Water Road
Suite 280
Knoxville, TN 37922
U.S.A.**