Tennessee Valley Authority
Form 10-Q
February 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13, 15(d), OR 37 OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2006

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____ to ____

Commission file number 000-52313

TENNESSEE VALLEY AUTHORITY

(Exact name of registrant as specified in its charter)

A corporate agency of the United States created by an act of Congress	62-0474417
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
400 W. Summit Hill Drive Knoxville, Tennessee	37902
(Address of principal executive offices)	*(Zip Code)*

(865) 632-2101

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes o No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Page 1 of 38

Table of Contents

Table of Contents

Table of Contents

FORWARD-LOOKING INFORMATION

This Quarterly Report on Form 10-Q (this Quarterly Report) contains forward-looking statements relating to future events and future performance. All statements other than those that are purely historical may be forward-looking statements.

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, likely, potential, or other similar expressions.

Examples of forward-looking statements include, but are not limited to:

- Statements regarding strategic objectives;
- Projections regarding potential rate actions;
- Estimates of costs of certain asset retirement obligations;
- Estimates regarding power and energy forecasts;
- Expectations about the adequacy of Tennessee Valley Authority s (TVA) pension plans and nuclear decommissioning trust;
- The impact of new accounting pronouncements and interpretations, including Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R);*
- Estimates of amounts to be reclassified from Other Comprehensive Income to earnings over the next year;
- TVA s plans to continue using short-term debt to meet current obligations; and
- The anticipated cost and timetable for returning Browns Ferry Nuclear Plant Unit 1 to service.

Although the 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:
  - TVA s protected service area,
  - The sole authority of the TVA Board of Directors to set power rates,
  - Various environmental and nuclear matters,
  - TVA s management of the Tennessee River system,
  - TVA s credit rating, and
  - TVA s debt ceiling;
- Performance of TVA s generation and transmission assets;
- Availability of fuel supplies;
- Compliance with existing environmental laws and regulations;

Significant delays or cost overruns in construction of generation and transmission assets;

Significant changes in demand for electricity;

Legal and administrative proceedings;

Weather conditions;

Failure of transmission facilities;

An accident at any nuclear facility, even one unaffiliated with TVA;

Catastrophic events such as fires, earthquakes, floods, pandemics, wars, terrorist activities, and other similar events, especially if these events occur in or near TVA s service area;

Events at non-TVA facilities that affect the supply of water to TVA s generation facilities;

Changes in the market price of commodities such as coal, uranium, natural gas, fuel oil, electricity, and emission allowances;

Changes in the prices of equity securities, debt securities, and other investments;

Changes in interest rates;

Creditworthiness of TVA or its counterparties;

Rising pension costs and health care expenses;

Increases in TVA s financial liability for decommissioning its nuclear facilities;

Limitations on TVA s ability to borrow money;

Changes in economic conditions;

Ineffectiveness of TVA s disclosure controls and procedures and internal control over financial reporting;

Changes in accounting standards;

The loss of TVA s ability to use regulatory accounting;

Loss of key personnel;

Changes in technology; and

Unforeseeable events.

Table of Contents

Additionally, other risks that may cause actual results to differ from forward-looking statements are set forth in TVA s Annual Report on Form 10-K for the fiscal year ended September 30, 2006, particularly in Item 1A, Risk Factors, and in this Quarterly Report. New factors emerge from time to time, and it is not possible for management to predict all such factors or to assess the extent to which any factor or combination of factors may impact TVA s business or cause results to differ materially from those contained in any forward-looking statement.

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

GENERAL INFORMATION

Fiscal Year

Unless otherwise indicated, years (2007, 2006, etc.) in this Quarterly Report refer to TVA s fiscal years ending September 30.

Notes

References to Notes are to the Notes to Financial Statements contained in Item 1, Financial Statements in this Quarterly Report.

Available Information

The public may read and copy any reports or other information that TVA files with the Securities and Exchange Commission (SEC) at the SEC s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. TVA s SEC reports are also available to the public without charge from the website maintained by the SEC at www.sec.gov and TVA s website at www.tva.gov. Information contained on TVA s website shall not be deemed to be incorporated into, or to be a part of, this Quarterly Report.

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TENNESSEE VALLEY AUTHORITY

STATEMENTS OF INCOME (UNAUDITED)

For the three months ended December 31

(in millions)

	2006	2005
Operating revenues		
Sales of electricity		
Municipalities and cooperatives	$ 1,748	$ 1,769
Industries directly served	302	230
Federal agencies and other	26	26
Other revenue	28	27
Total operating revenues	2,104	2,052
Operating expenses		
Fuel and purchased power	739	745
Operating and maintenance	585	600
Depreciation, amortization, and accretion	356	388
Tax equivalents	108	94
Total operating expenses	1,788	1,827
Operating income	316	225
Other income	12	12
Unrealized gain on derivative contracts, net	15	14
Interest expense		
Interest on debt	336	335
Amortization of debt discount, issue, and reacquisition costs, net	5	5
Allowance for funds used during construction and nuclear fuel expenditures	(49)	(36)
Net interest expense	292	304
Net income (loss)	$ 51	$ (53)

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

Table of Contents

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

	December 31 2006	September 30 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 502	$ 536
Restricted cash and investments (Note 1)	206	198
Accounts receivable, net	1,164	1,359
Inventories and other	652	576
Total current assets	2,524	2,669
Property, plant, and equipment		
Completed plant	35,849	35,652
Less accumulated depreciation	(15,563)	(15,331)
Net completed plant	20,286	20,321
Construction in progress	3,727	3,539
Nuclear fuel and capital leases	566	574
Total property, plant, and equipment, net	24,579	24,434
Investment funds	1,037	972
Regulatory and other long-term assets (Note 1)		
Deferred nuclear generating units	3,423	3,521
Other regulatory assets	1,788	1,809
Subtotal	5,211	5,330
Other long-term assets	970	1,115
Total deferred charges and other assets	6,181	6,445
Total assets	$ 34,321	$ 34,520
LIABILITIES AND PROPRIETARY CAPITAL		
Current liabilities		
Accounts payable	$ 800	$ 890
Accrued liabilities	194	211
Collateral funds held	206	195
Accrued interest	296	403
Current portion of lease/leaseback obligations	36	37
Current portion of energy prepayment obligations	106	106
Short-term debt, net	2,567	2,376
Current maturities of long-term debt (Note 3)	382	985

Total current liabilities	4,587	5,203
Other liabilities		
Other liabilities	2,269	2,305
Regulatory liabilities (Note 1)	423	575
Asset retirement obligations	2,007	1,985
Lease/leaseback obligations	1,071	1,071
Energy prepayment obligations (Note 1)	1,112	1,138
Total other liabilities	6,882	7,074
Long-term debt, net (Note 3)	20,127	19,544
Total liabilities	31,596	31,821
Commitments and contingencies		
Proprietary capital		
Appropriation investment	4,758	4,763
Retained earnings	1,613	1,565
Accumulated other comprehensive income	28	43
Accumulated net expense of nonpower programs	(3,674)	(3,672)
Total proprietary capital	2,725	2,699
Total liabilities and proprietary capital	$ 34,321	$ 34,520

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

Table of Contents

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

	2006	2005
Cash flows from operating activities		
Net income (loss)	$ 51	$ (53)
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation, amortization, and accretion	360	393
Nuclear refueling outage amortization	21	23
Loss on project write-downs	22	
Amortization of nuclear fuel	27	35
Non-cash retirement benefit expense	50	75
Net unrealized gain on derivative contracts	(15)	(14)
Prepayment credits applied to revenue	(26)	(26)
Other, net	(15)	(5)
Changes in current assets and liabilities		
Accounts receivable, net	214	171
Inventories and other	(78)	(111)
Accounts payable and accrued liabilities	(120)	(145)
Accrued interest	(107)	(79)
Deferred nuclear refueling outage costs	(41)	(3)
Other, net	(19)	(26)
Net cash provided by operating activities	**324**	**235**
Cash flows from investing activities		
Construction expenditures	(344)	(282)
Combustion turbine asset acquisitions	(98)	
Nuclear fuel expenditures	(22)	(116)
Change in restricted cash and investments	(8)	(10)
Purchase of investments	(1)	(8)
Loans and other receivables		
Advances	(1)	(2)
Repayments	4	4
Proceeds from sale of receivables/loans	2	
Other, net	(1)	(1)
Net cash used in investing activities	**(469)**	**(415)**
Cash flows from financing activities		
Long-term debt		
Issues	9	49
Redemptions and repurchases	(77)	(152)
Short-term issues, net	190	275
Payments on lease/leaseback financing	(1)	(1)
Financing costs, net		(1)
Payments to U.S. Treasury	(10)	(9)

Net cash provided by financing activities	**111**	**161**
Net change in cash and cash equivalents	(34)	(19)
Cash and cash equivalents at beginning of period	536	538
Cash and cash equivalents at end of period	**$ 502**	**$ 519**

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

Table of Contents

TENNESSEE VALLEY AUTHORITY
STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL (UNAUDITED)
For the three months ended December 31
(in millions)

	Appropriation Investment	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Accumulated Net Expense of Stewardship Programs	Total	Comprehensive (Loss) Income
Balance at September 30, 2005	$ 4,783	$ 1,244	$ 27	$ (3,662)	$ 2,392	$
Net (loss)		(50)		(3)	(53)	(53)
Return on appropriated investment		(4)			(4)	
Accumulated other comprehensive income (Note 2)			17		17	17
Return of appropriated investment	(5)				(5)	
Balance at December 31, 2005	$ 4,778	$ 1,190	$ 44	$ (3,665)	$ 2,347	$ (36)
Balance at September 30, 2006	$ 4,763	$ 1,565	$ 43	$ (3,672)	$ 2,699	$
Net income (loss)		53		(2)	51	51
Return on appropriated investment		(5)			(5)	
Accumulated other comprehensive loss (Note 2)			(15)		(15)	(15)
Return of appropriated investment	(5)				(5)	
Balance at December 31, 2006	$ 4,758	$ 1,613	$ 28	$ (3,674)	$ 2,725	$ 36

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

Table of Contents

NOTES TO FINANCIAL STATEMENTS (unaudited)
(Dollars in millions except where noted)
1. Summary of Significant Accounting Policies
Organization

The Tennessee Valley Authority (TVA) is a wholly-owned corporate agency and instrumentality of the United States. TVA was created by the U.S. Congress in 1933 by virtue of the Tennessee Valley Authority Act of 1933, *as amended*, 16 U.S.C. §§ 831-831ee (2000 & Supp. IV 2004) (as amended, the TVA Act). TVA was created to improve navigation on the Tennessee River, reduce flood damage, provide agricultural and industrial development, and provide electric power to the Tennessee Valley region. TVA manages the Tennessee River and its tributaries for multiple river-system purposes, such as: navigation; flood damage reduction; power generation; environmental stewardship; shoreline use; and water supply for power plant operations, consumer use, recreation, industry, and other stewardship purposes.

Substantially all TVA revenues and assets are attributable to the power program. TVA s service area includes most of Tennessee, northern Alabama, northeastern Mississippi, and southwestern Kentucky, and portions of northern Georgia, western North Carolina, and southwestern Virginia, and it has a total population of approximately 8.7 million people. The power program has historically been separate and distinct from the stewardship programs. It is required to be self-supporting from power revenues and proceeds from power financings, such as proceeds from the issuance of bonds, notes, and other evidences of indebtedness (Bonds). Until 2000, most of the funding for TVA s stewardship programs was provided by congressional appropriations. These programs are now funded largely with power revenues. Certain stewardship activities are also funded with various revenues and user fees. These activities related to stewardship properties do not meet the criteria of an operating segment, pursuant to Statement of Financial Accounting Standard (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information.* Accordingly, these assets and properties are included as part of the power program, TVA s only operating segment.

Power rates are established by the TVA Board of Directors (the TVA Board) as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that will produce gross revenues sufficient to provide funds for operation, maintenance, and administration of its power system; tax equivalent payments to states and counties; debt service on outstanding indebtedness; payments to the U.S. Treasury in repayment of and as a return on the outstanding amount TVA is required to repay the United States for its investment in TVA s power facilities (the appropriation investment in power facilities); and such additional margin as the TVA Board may consider desirable for investment in power system assets, retirement of outstanding indebtedness, additional reduction of the outstanding amount TVA is required to repay the United States for its investment in TVA s power facilities, and other purposes connected with TVA s power business. In setting rates, the TVA Board is charged by the TVA Act to have due regard for the primary objectives of the TVA Act, including the objective that power shall be sold at rates as low as are feasible. Rates set by the TVA Board are not subject to review or approval by any state or federal regulatory body.

Basis of Presentation

TVA prepares its interim financial statements in conformity with 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 notes required by GAAP 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, 2006, and the notes thereto, which are contained in TVA s Annual Report on Form 10-K for the fiscal year ended September 30, 2006 (the Annual Report).

Subsequent to its fourth quarter of 2006 closing, TVA reviewed projects related to construction work in progress and identified errors in classification related primarily to 2006 and also prior periods. Based on the results of the review, TVA recorded project write-offs of $5 million in the first quarter of 2007. Additionally, TVA recorded a $4 million expense during the first quarter of 2007 related to pending litigation during the fourth quarter of 2006. These charges are included in Operating and Maintenance expense on the Income Statement for the quarter ended December 31, 2006. Since TVA uses cash flows from operating activities as its primary measure of materiality, it determined that these noncash adjustments were not material to its reported results for prior and current periods on a quantitative basis based on TVA s operating cash flows or a qualitative basis and did not require restatement of those results.

Table of Contents

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.

Use of Estimates

In preparing financial statements that conform to GAAP, management must make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the 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 (2007, 2006, etc.) refer to TVA s fiscal years.

Reclassifications

Certain reclassifications have been made to the 2006 financial statements to conform to the 2007 presentation, including the reclassification of interest income of $5 million for the three months ended December 31, 2005, which was previously included in Interest on Debt on the Statement of Income. Interest income is now included in Other Income.

These reclassifications had no effect on previously reported results of operations and net cash flows.

Revision to Statement of Cash Flows

As of September 30, 2006, TVA began reporting the allowance for funds used during construction (AFUDC) related to construction expenditures as a noncash component of investing activities rather than a noncash component of operating activities. The revised classification is consistent with guidance for the cash flow presentation for capitalized interest. The previous method of reporting AFUDC was consistent with the industry practice for the combined reporting of debt and equity AFUDC. The result of this reclassification is an increase in cash from operating activities of $36 million and an increase in funds used by investing activities of $36 million for the period ended December 31, 2005.

Restricted Cash and Investments

As of December 31, 2006, and September 30, 2006, TVA had $206 million and $198 million, respectively, in Restricted Cash and Investments on its Balance Sheets primarily related to collateral posted with TVA by a swap counterparty in accordance with certain credit terms included in the swap agreement, which result in the funds being reported in Restricted Cash and Investments. The corresponding liability is included in Collateral Funds Held on the December 31, 2006, and September 30, 2006, Balance Sheets.

Accounts Receivables

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

Table of Contents

Accounts Receivable

	At December 31 2006	At September 30 2006
Power receivables billed	$ 206	$ 303
Power receivables unbilled	918	1,031
Total power receivables	1,124	1,334
Other receivables	47	35
Allowance for uncollectible accounts	(7)	(10)
Net accounts receivable	$ 1,164	$ 1,359

Cost-Based Regulation

Regulatory assets capitalized under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation,* are included in Deferred Nuclear Generating Units and Other Regulatory Assets on the December 31, 2006, and September 30, 2006, Balance Sheets. Components of Other Regulatory Assets include certain charges related to the closure and removal from service of nuclear generating units, debt reacquisition costs, deferred outage costs, unrealized losses related to power purchase contracts, deferred capital lease asset costs, a deferred loss relating to TVA s financial trading program, minimum pension liability, and, beginning in 2007, an estimated fuel cost adjustment (FCA) related to rate actions taken during 2006. All regulatory assets are probable of recovery in future revenues. Components of Regulatory Liabilities include unrealized gains on coal purchase contracts and capital lease liabilities.

TVA s regulatory assets and liabilities are summarized in the table below.

TVA Regulatory Assets and Liabilities

	At December 31 2006	At September 30 2006
Regulatory Assets		
Minimum pension liability	$ 914	$ 914
Nuclear decommissioning costs	429	474
Reacquisition costs	226	232
Deferred purchased power costs	8	6
Deferred outage costs	106	85
Deferred capital lease asset costs	74	76
Unrealized losses on purchased power contracts	17	22
Estimated fuel cost adjustment deferral	14	
Subtotal	1,788	1,809
Deferred nuclear generating units	3,423	3,521
Total	$ 5,211	$ 5,330
Regulatory Liabilities		
Unrealized gain on coal purchase contracts	$ 340	$ 487

Capital lease liability		83		88
Total	$	423	$	575

TVA has established a reserve for future generation funded by power customers which is also classified as a regulatory liability. Because of the nature of the reserve, it is considered as an offset to Property, Plant and Equipment on the December 31, 2006 Balance Sheet. See *Reserve for Future Generation* in this Note 1.

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.

On September 30, 2006, TVA began applying Financial Interpretation (FIN) 47, *Accounting for Conditional Asset Retirement Obligations,* which resulted in the recognition of additional asset retirement obligation (ARO) liabilities for asbestos and polychlorinated biphenyls (PCB) abatement costs.

During the first three months of 2007, TVA s total ARO liability increased $22 million due to accretion expense. The nuclear accretion expense of $15 million was deferred and charged to a regulatory asset in accordance with SFAS No. 71. The remaining accretion expense of $7 million, related to coal-fired and gas/oil combustion turbine plants, asbestos, and PCB, was expensed during 2007. 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 combustion turbine plants, was expensed during 2006.

Reconciliation of Asset Retirement Obligation Liability

For the Three Months Ended December 31

	2006	2005
Balance at beginning of year	$ 1,985	$ 1,857
Liabilities		
Accretion expense	22	26
Revisions in estimated cash flows		
Balance at end of year	$ 2,007	$ 1,883

Energy Prepayment Obligations

As of December 31, 2006, TVA had entered into sales agreements for 54.5 discounted energy units totaling $54.5 million. Total credits applied to power billings on a cumulative basis during the life of the program through December 31, 2006, exceeded $21.6 million. Of this amount, over $1 million was recognized as revenue for the quarterly periods ended December 31, 2006, and 2005.

In November 2003, TVA, Memphis Light, Gas, and Water Division (MLGW), and the City of Memphis entered into agreements whereby MLGW prepaid a portion of its power requirements for 15 years for a fixed amount of kilowatt-hours. The amount of the prepayment was $1.5 billion. The prepayment credits are being applied to reduce MLGW s monthly power bill on a straight-line basis over the same 15-year period. Total credits applied to power billings on a cumulative basis through December 31, 2006, exceeded $315 million. Of this amount, $25 million was recognized as revenue for the quarterly periods ended December 31, 2006, and 2005. These amounts were based on the ratio of kilowatt-hours of electricity delivered to the total kilowatt-hours under contract.

At December 31, 2006, and September 30, 2006, obligations for these energy prepayments were $1,218 million and $1,244 million, respectively. These amounts are included in Energy Prepayment Obligations and Current Portion of Energy Prepayment Obligations on the December 31, 2006, and September 30, 2006, Balance Sheets.

Impact of New Accounting Pronouncements and Interpretations

Accounting Changes and Error Corrections. In May 2005, the Financial Accounting Standards Board (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 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 became effective for TVA beginning in 2007.

Fair Value Measurements. In September 2006, FASB issued SFAS No. 157, *Fair Value Measurements.* This standard provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. SFAS No. 157 establishes a fair value hierarchy that prioritizes the information used to develop measurement assumptions. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. At this time, TVA is evaluating the requirements of this statement 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.

Accounting for Defined Benefit Pension and Other Postretirement Plans. On September 29, 2006, FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R).* This standard will require employers to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare, and other postretirement plans in their financial statements. Specifically, the new standard requires an employer to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status; measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions); and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective for TVA as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. TVA plans to apply the new standard for its 2007 year-end financial statements and recognize on its 2007 Balance Sheets the funded status of its pension and other postretirement benefit plans. However, had TVA been required to adopt the standard as of its last actuarial valuation date (September 30, 2006), TVA would have recorded the following amounts on its Balance Sheet for the year then ended: a regulatory asset of $795 million, additional pension and postretirement obligations of $368 million and $152 million, respectively, and the reclassification to regulatory assets of an intangible asset with a balance of $275 million, representing unamortized prior service cost. The net effect of recognizing such amounts would have been to increase total assets and liabilities by $520 million at that date.

Accounting for Misstatements. On September 13, 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* This bulletin provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. Application of the guidance will become effective for TVA with its annual report for the year ending September 30, 2007.

Reserve for Future Generation

During the first quarter of 2007, TVA began collecting in rates amounts intended to fund future generation based on the need for additional generating capacity that it believes will be required to meet future power demand in its service area. Because these amounts are intended to fund future costs, they were deferred as a regulatory liability. The reserve is funded by power customers based on a predetermined rate applied to electricity sales approved as part of TVA s 2007 budget. Collections for the three months ended December 31, 2006, amounted to $13 million which are recorded as a regulatory liability on the December 31, 2006, Balance Sheet as a component of Completed Plant. These and other funds collected for future generation will be recognized as revenue based on the useful lives of assets acquired or constructed and will offset the depreciation expense of these assets on the Statement of Income. This revenue recognition process will begin when the assets are placed into service.

Table of Contents

In December 2006, TVA purchased two combustion turbine facilities for a combined purchase price of $98 million. One facility is a 742-megawatt winter peaking capacity, dual-fuel combustion turbine facility and includes certain related transmission facilities. The second facility is a 555-megawatt winter peaking capacity, natural gas-fired combustion turbine facility. Once collections from power customers reach $98 million or the acquisition price of the combustion turbines, additional funds collected, if any, will be reported on the Balance Sheet as a regulatory liability until as such time another generating asset is built or acquired. The 555-megawatt capacity facility was released for dispatch during January 2007 and the 742-megawatt facility is scheduled for dispatch during the third quarter of 2007.

2. Accumulated Other Comprehensive Income

SFAS No. 130, *Reporting Comprehensive Income,* requires the disclosure of comprehensive income to reflect changes in capital that result from transactions and economic events from non-owner sources. The decrease of $15 million for the three months ended December 31, 2006, and the increase of $17 million for the three months ended December 31, 2005, are due to unrealized gains and losses related to mark-to-market valuation adjustments for certain derivative instruments.

Total Other Comprehensive Income (Loss) Activity

For the Three Months Ended December 31

	2006	2005
Accumulated other comprehensive income at beginning of period	$ 43	$ 27
Changes in fair value:		
Inflation swap	1	(10)
Foreign currency swaps	(16)	27
Accumulated other comprehensive income at end of period	$ 28	$ 44

Note:

Foreign currency swap changes are shown net of reclassifications from Other Comprehensive Income to earnings. The amounts reclassified from Other Comprehensive Income resulted in an increase to earnings of $51 million for the first quarter of 2007 and a charge to earnings of $40 million for the first quarter of 2006.

3. Debt Securities

Debt Outstanding

Debt outstanding at December 31, 2006, including net translation losses of $246 million related to long-term debt denominated in foreign currencies, consisted of the following:

Debt Outstanding

	At December 31 2006	At September 30 2006
Short-term debt		
Discount notes (net of discount)	$ 2,567	$ 2,376
Current maturities of long-term debt	382	985
Total short-term debt, net	2,949	3,361
Long-term debt		
Long-term	20,305	19,722
Unamortized discount	(178)	(178)
Total long-term debt, net	20,127	19,544

Total outstanding debt	$	23,076	$	22,905

Table of Contents

Bondholder Protection Test

The TVA Act and the Basic Tennessee Valley Authority Power Bond Resolution each contain a bondholder protection test. Under the test, TVA must, in each successive five-year period use a certain amount of net power proceeds for either the reduction of its capital obligations (including Bonds and the outstanding amount TVA is required to repay the United States for its investment in TVA s power facilities), or investment in power assets. TVA must next meet this test for the five-year period ending on September 30, 2010.

Debt Securities Activity

The TVA Act authorizes TVA to issue Bonds up to a total of $30 billion outstanding at any one time. The table below summarizes TVA s Bond activity for the period from October 1, 2006, to December 31, 2006.

Bond Activity

	Date	Amount	Interest Rate
Redemptions/Maturities:			
electronotes®	First Quarter 2007	$ 2	4.65%
2001 Series D	December 2006	75	4.88%
Total		$ 77	
Issues:			
electronotes®	First Quarter 2007	$ 9	5.50%

<u>Note</u>

electronotes® interest rate is a weighted average rate.

4. Risk Management Activities and Derivative Transactions

TVA is exposed to market risks. These market risks include risks related to commodity prices, investment prices, interest rates, currency exchange rates, inflation, and credit risk. To help manage certain of these risks, TVA has entered into various derivative transactions, principally commodity option contracts, forward contracts, swaps, swaptions, futures, and options on futures. It is TVA s policy to enter into derivative transactions solely for hedging purposes and not for speculative purposes.

The table below summarizes the recorded amounts of these derivative instruments.

Mark-to-Market Value of Derivative Instruments

	At December 31 2006	At September 30 2006
Inflation Swap	$ 19	$ 22
Interest Rate Swap	(121)	(131)
Currency Swaps:		
Sterling	57	47
Sterling	150	133
Sterling	75	66
Swaptions:		
$1 Billion Notional	(290)	(296)
$28 Million Notional	(3)	(3)

$14 Million Notional	(1)	(2)
Coal Contracts with Volume Options	340	487
Purchase Power Option Contracts	(17)	(22)

TVA has a financial trading program under which TVA can purchase swaps, options on swaps, futures, and options on futures to hedge TVA s exposure to natural gas and fuel oil prices. At December 31, 2006, TVA had derivative instruments outstanding under the program equivalent to 691 contracts, made up of 691 futures contracts, zero swap contracts, and zero option contracts, with an approximate market value of $46 million as shown in the following table.

Financial Trading Program Activity
For the Three Months Ended December 31

	2006		2005	
	Notional Amount (in mmBtu)	**Contract Value** (in millions)	**Notional Amount** (in mmBtu)	**Contract Value** (in millions)
Futures contracts				
Financial positions, beginning of period, net	4,290,000	$ 35	880,000	$ 10
Purchased	4,260,000	32	2,420,000	26
Settled	(1,640,000)	(12)	(140,000)	(2)
Realized (losses)		(1)		
Net positions-long	6,910,000	54	3,160,000	34
Swap Futures				
Financial positions, beginning of period, net	1,822,500	11		
Fixed portion				
Floating portion realized	(1,822,500)	(9)		
Realized (losses)		(2)		