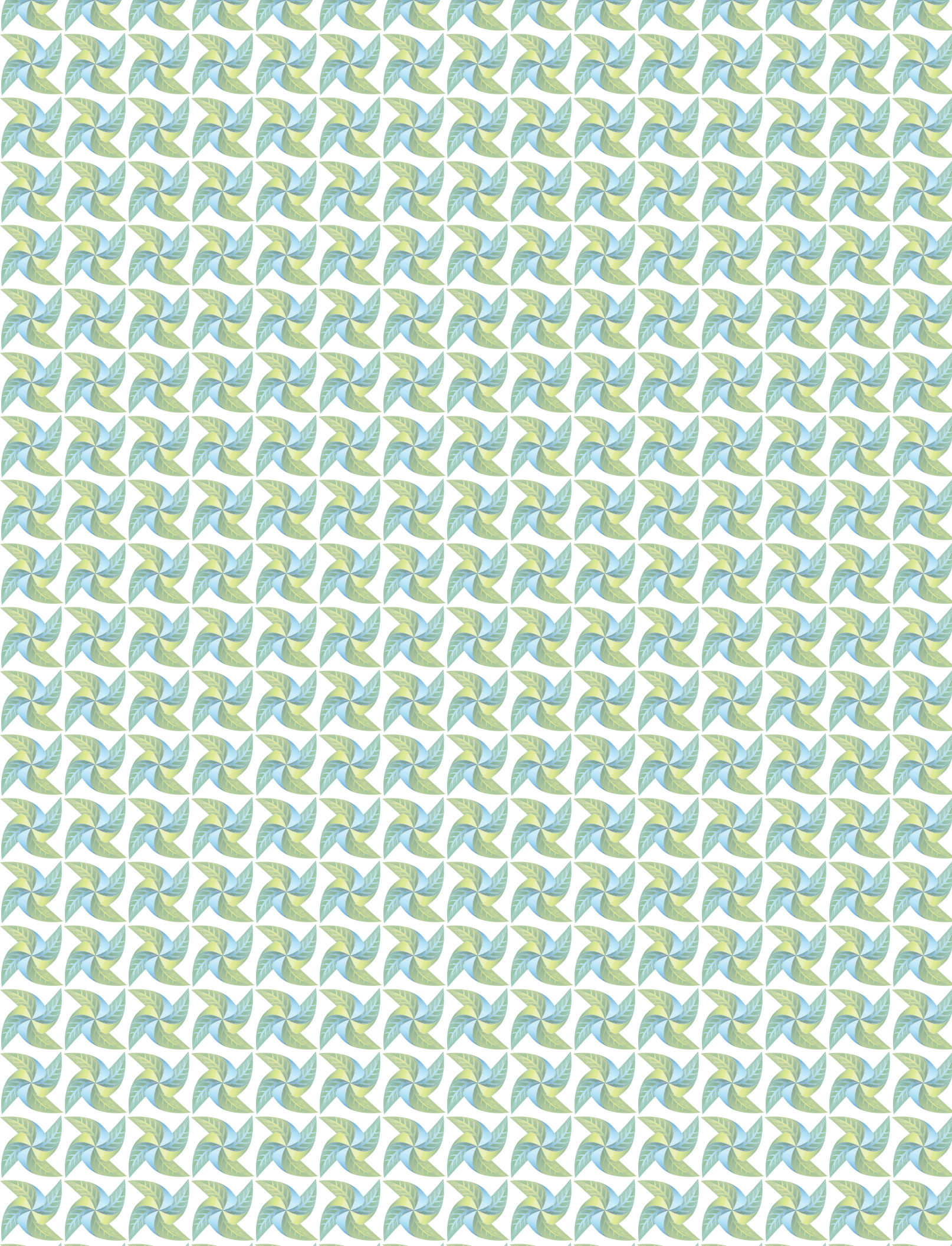
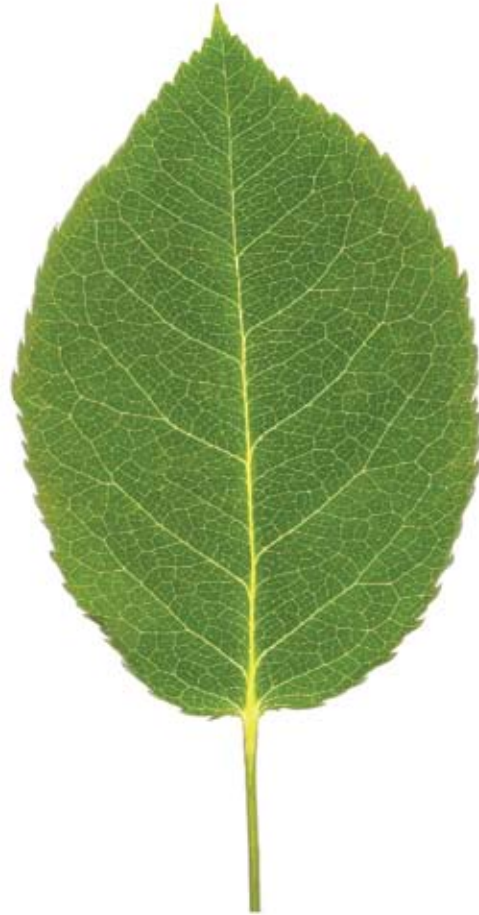




HELPING NASHVILLE TURN OVER A NEW LEAF





**“NO ONE PERSON HAS TO DO IT ALL
BUT IF EACH ONE OF US FOLLOWS OUR
HEART AND OUR OWN INCLINATIONS
WE WILL FIND THE SMALL THINGS THAT
WE CAN DO TO CREATE A SUSTAINABLE
FUTURE AND A HEALTHY ENVIRONMENT.”**

— JOHN DENVER





The past year has been a busy and successful one for Nashville Electric Service. We worked to meet the vibrant Nashville-area's energy needs and prepared our infrastructure for future demands – all while doing our part to encourage energy conservation and increase green power use in our community.

Along the way we invested more than \$70 million in capital projects, developed and implemented a documented outage reporting process, completed design plans and monitored construction of a 69kV duct bank for the Rolling Mill Hill development, and implemented a transmission and distribution system plan. All of this was done to meet the increasing demand for electric power.

We also completed construction of a screening wall around our Central Substation, which is adjacent to the newly constructed A.A. Birch Building, as we continue to fulfill our commitment to the community to make our infrastructure more aesthetically pleasing whenever possible.

Providing adequate power was once as simple as balancing supply and demand. Today, we must balance the growing demand for power with a reduction in our environmental impact. For NES, being "green" requires us to place an emphasis on energy-efficiency and make it a part of our corporate culture.

That is why NES partnered with the state of Tennessee and local businesses to facilitate a geothermal heat pump installation as part of the restoration project at the Executive Residence, the official home of Tennessee's governor. We also helped Street Dixon Rick



Architecture become our first commercial customer to connect to the NES electric grid via solar panels through our Generation Partners program. The firm is an example of the growing number of electric consumers who are taking a heightened interest in protecting the environment, as shown by increased participation in our Green Power Switch program with the Tennessee Valley Authority.

On a corporate basis, NES purchases 25 blocks of green power each month for our internal use, has 108 dual-fuel fleet vehicles, recycles transformer oil for reuse when a transformer is decommissioned, and when possible, purchases poles taller than 70 feet in nonwood materials.

For 68 years, NES has supplied our customers with affordable and reliable electricity that has enhanced our standard of living and helped to keep our local economy competitive in the global marketplace. We are proud of

The solar panels at the Adventure Science Center make up one of 11 TVA green power stations in Tennessee. NES President and CEO Decosta Jenkins, left, and NES Chairman of the Board William F. Blaufuss take pride in offering green energy sources to the Nashville community.

that legacy, and are prepared to continue it. While we face many challenges, our business plan is sound, and our employees understand the responsibility they have to provide our customers with the reliable energy needed to power Nashville in the years ahead.

Decosta Jenkins

Decosta Jenkins

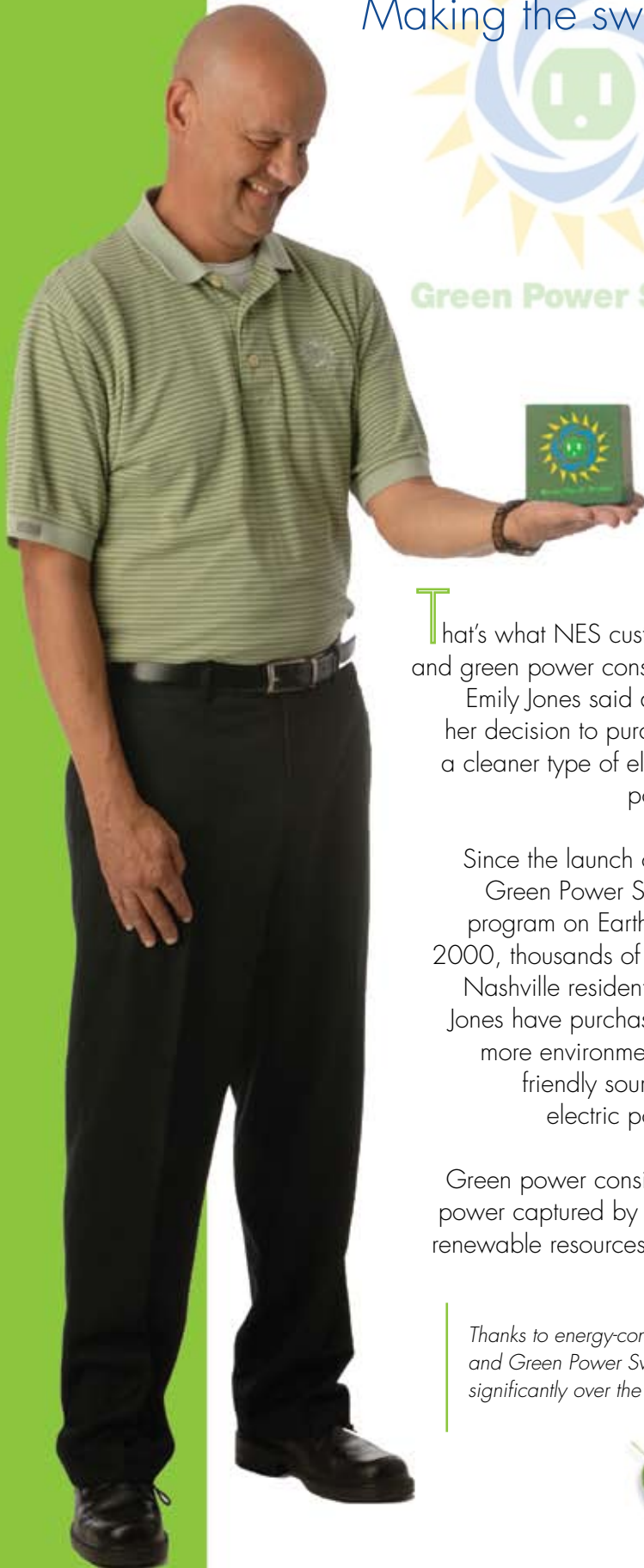
William F. Blaufuss

William F. Blaufuss

"It's how I do my part to help the environment. Making the switch was just the right thing to do."



Green Power Switch®



That's what NES customer and green power consumer Emily Jones said about her decision to purchase a cleaner type of electric power.

Since the launch of the Green Power Switch program on Earth Day 2000, thousands of other Nashville residents like Jones have purchased a more environmentally friendly source of electric power.

Green power consists of power captured by using renewable resources such

as solar rays, wind, and methane gas. NES partners with TVA to provide green power to its customers by using 17 TVA green power stations throughout the TVA service area. Stations located in Tennessee include the Buffalo Mountain Wind Park (Oliver Springs), Allen Fossil Plant (Memphis), and Adventure Science Center (Nashville).

Customers may purchase green power in 150-kilowatt-hour blocks. These blocks represent about 12 percent of a typical household's monthly power usage.

At only \$4 per block of power, not only is going green good for the environment, it is affordable, too. NES customers can help the environment each month by spending only slightly more than the cost of a few cups of coffee. The extra fee is added to a customer's regular monthly electric bill and accounts for the operational costs of building, running and maintaining the technology used to capture and harness the power.

The overall impact of one consumer purchasing a block or two of green power might seem negligible, but when thousands of consumers buy just one block of it, the numbers add up. In fact, a green power investment of \$8 per month on your electric bill is equivalent to not driving your car for four months.

Thanks to energy-conscious customers like Emily Jones, Jim Purcell, NES energy services manager and Green Power Switch liaison, left, has seen the number of residential green power users grow significantly over the past 12 months with 3,350 users currently signed up.

Like many other Nashville residents, Jones began buying blocks of green power in 2004 to do her part to conserve resources and help the environment.



Purchasing two blocks of green power per month over the course of one year is the environmental equivalent of recycling 15,322 aluminum cans, 1,766 pounds of old newspapers or planting an entire acre of trees.

"I heard about the Green Power Switch program offered by NES and TVA, and immediately decided to join," Jones said. "It just made sense to me; buying green power is an inexpensive and easy way for me to help protect the environment."

Emily Jones isn't the only Nashville resident to take advantage of the program.

In recent months,

record numbers of NES customers have signed up for the program. May and June 2007 produced the highest numbers of new Green Power Switch users in the NES service area since the program was started, with 340 and 434 customers making the switch during each month, respectively. The trend is expected to continue. NES' Green Power Switch program is anticipated to break the 3,500-customer mark before the end of 2007.

It's a sign of good things to come – for a clean and green Nashville.

Purchasing 94 blocks of Green Power annually, Ensworth School is setting a great example in Nashville as a leader in responsible energy practices.

"It is our promise and our goal to teach our future customers how to save on their electric bills and how to save our environment... These children really can, and do, make a difference."

*Deborah Gardner,
NES consumer information specialist*



*Lily Harper, Cardrejah Bonds and Ian Clark
think using low-energy fluorescent bulbs is smart.*

When NES employee Deborah Gardner looks out at classrooms full of students, she doesn't just see future NES customers, she sees Nashville's future.

At NES, we understand that today's youth are tomorrow's customers, so teaching students about conservation is a responsibility we take seriously. When children are taught positive energy-saving habits at a young age, they become better consumers and more responsible citizens. That's why we began a comprehensive youth education program in 1977.

As NES' consumer information specialist, Gardner delivers messages about conservation

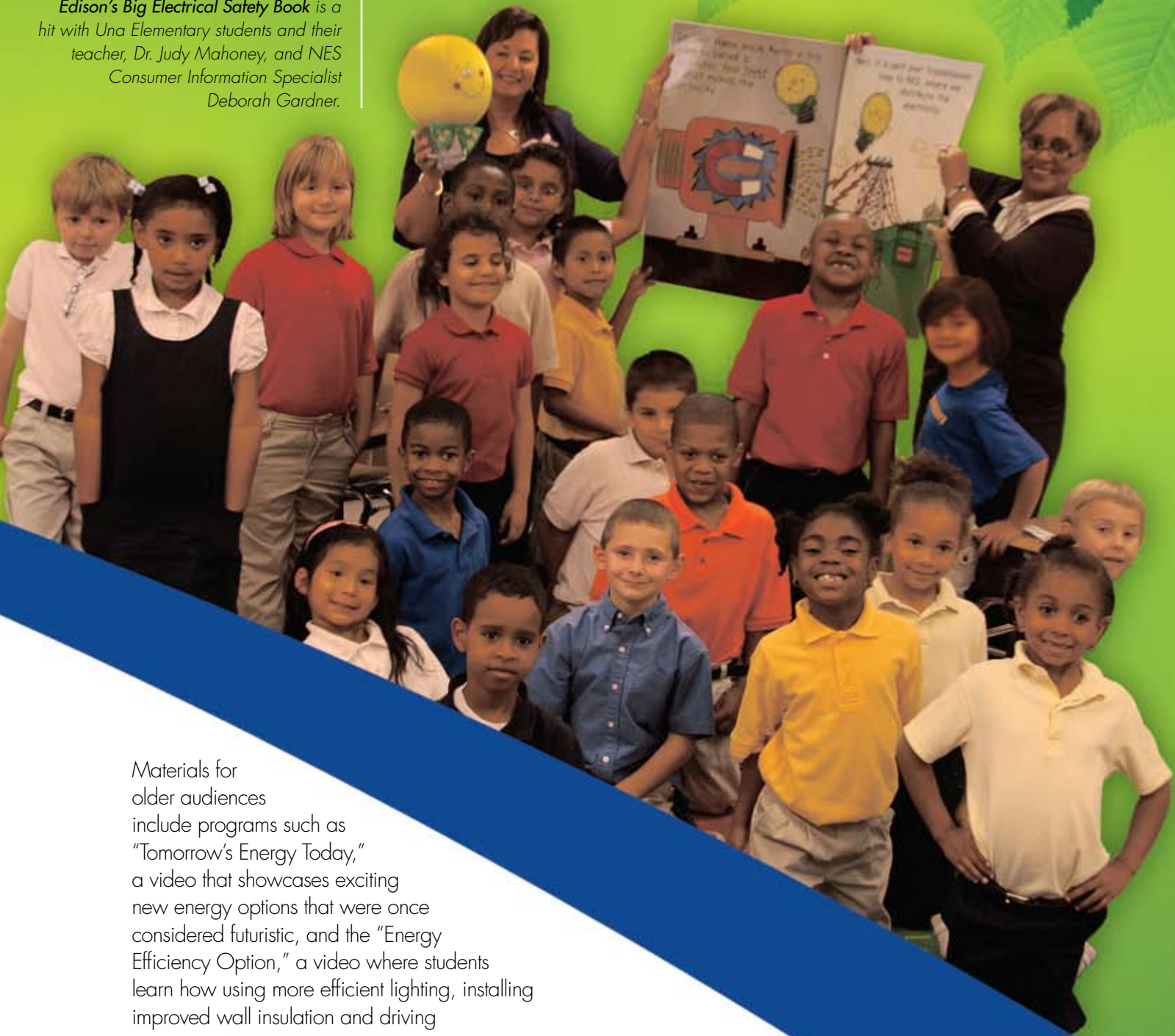
and electric safety to school-age children across the city. Whether she is giving a classroom presentation or taking students on a field trip, Gardner provides a variety of resources for teachers to educate their students about conservation.

"I love talking to students and getting them really excited about conserving energy. They take the information I bring them in the classroom home to their families," Gardner said. "These children really can, and do, make a difference."

Gardner provides a variety of programs and videos for students of all ages to learn about conservation. These programs are designed to target each grade level, so that both younger and older students can become energy-aware and environmentally responsible consumers.

Programs for younger students include the "Energy Savers," an instructional video where Disney characters learn about saving natural resources, and "Energy Video Quiz," where students learn about energy, environmental concerns and alternative energy sources. NES also provides students with a customized energy activity book, a fact-filled book where Edison, NES' favorite spokesbulb, teaches students in third through fifth grades about green energy and gives conservation tips.

Edison's Big Electrical Safety Book is a hit with Una Elementary students and their teacher, Dr. Judy Mahoney, and NES Consumer Information Specialist Deborah Gardner.



Materials for older audiences include programs such as "Tomorrow's Energy Today," a video that showcases exciting new energy options that were once considered futuristic, and the "Energy Efficiency Option," a video where students learn how using more efficient lighting, installing improved wall insulation and driving



electric cars dramatically reduce energy consumption. Older students can also benefit from tools such as an interactive CD-ROM that explains the ease of maintaining an environmentally safe home.

*NES' energy activity book, called **Edison's Energy Book**, provides fun games, interesting facts, valuable electrical safety information and conservation tips to middle-school students in Metro Nashville.*

"Electric safety and energy conservation go hand-in-hand," said Gardner. "It is our promise and our goal to teach our future customers how to save on their electric bills and how to save our environment."



Janice Woodard, right, NES senior energy services specialist, discusses the energy and cost-saving advantages geothermal power will provide to the new Burton School of Pharmacy building at David Lipscomb University with Don Johnson, the school's director of facilities.

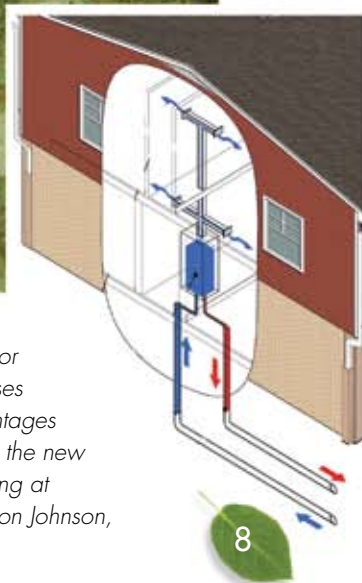
From the Sumner County school system to entire neighborhoods, more and more Nashville-area organizations, buildings and communities are going green with geothermal heating and cooling systems. So when David Lipscomb University officials considered the school's heating and cooling options for new and existing campus buildings, it was not surprising that they chose geothermal technology.

Renovations to the university's Burton School of Pharmacy building, the construction of three new dorms and the recently completed Ezell Center included plans for geothermal heat pumps. As a result, school officials expected to see more than 15 percent savings, but have actually seen an overall 31 percent savings in their total utility bills.

"Using geothermal as an energy source is not only a sound long-term investment, but also a decision that exemplifies environmental responsibility, which sends an important message to our students," said Don Johnson, David Lipscomb director of facilities.

Many other local organizations and businesses are looking to geothermal as an alternative energy option, including Metro Parks and the Radnor Lake Natural Area. Both groups plan to implement geothermal systems in the coming years.

Here's how it works: In winter, the Earth's natural heat is collected through a series of pipes, called a loop, which are installed below the surface of the ground. Fluid circulating in the loop carries the heat from the ground to the building where electrically driven



This diagram shows how a building similar to the Burton building on Lipscomb's campus will be heated in the winter and cooled in the summer by underground pipes. Lack of both year-round sun and constant wind makes geothermal heating and cooling a practical method of alternative energy in Middle Tennessee.

“Using geothermal as an energy source is not only a sound long-term investment, but also a decision that exemplifies environmental responsibility, which sends an important message to our students.”

Don Johnson, director of facilities, David Lipscomb University

compressors and heat exchangers in a vapor compression cycle (the same process used in a refrigerator) release the heat inside the building at a higher temperature. In summer, the process is reversed in order to cool. Excess heat is drawn from the building, expelled to the loop, and absorbed by the Earth.

“Customers find that geothermal is an infinite source of energy. It can operate efficiently because the temperature underground remains a constant 57 degrees Fahrenheit,” said Janice Woodard, NES senior energy services specialist.

Despite the higher upfront costs, geothermal heat pumps use less electricity during their lifetimes and are much more environmentally friendly than regular heating and cooling systems. Additionally, the underground pipes are filled with environmentally safe transfer fluids, meaning that no harmful chemicals can seep into the ground.

“We are happy to talk with any business or organization about how to go geothermal,” said Woodard.

“Whether converting an existing building to geothermal or constructing a brand-new facility using the technology, it’s a decision that makes sense in many situations.”

The aerial view, below, taken during the installation of the Lipscomb geothermal bore field, shows the drilling and placement of the loop piping.





“Architects constantly advise clients to ‘think green,’ and we wanted to lead the way in this environmentally friendly initiative.”

Steve Rick, principal, Street Dixon Rick Architecture

Drive by the office of Street Dixon Rick Architecture on Kenner Avenue in West Nashville, and you’ll see why the firm considers itself a pioneer in “thinking green.” The 72 solar panels that line the roof are a definite giveaway.

“Architects constantly advise clients to ‘think green,’ and we wanted to lead the way in this environmentally friendly initiative,” said Steve Rick, principal at the firm.

Vaughn D. Spears, left, senior engineer for NES Energy Services, discusses the wattage generated from the rooftop solar panels of Generation Partner Street Dixon Rick Architecture firm with SDR principals Steve Rick and Baird Dixon.

“While working on a recent green residential project, our ‘green team’ decided to add the solar panels to our own roof, providing energy back to NES. We expect this project to pay for itself in 10 to 12 years.”

The initiative is part of NES’ Generation Partners program, which supports the installation of alternative energy generators.

In order to become involved with the program, a homeowner or small commercial power customer must install a solar or wind generation source. Customers then produce green energy, which is transmitted to TVA. In exchange, TVA purchases the green power at a rate of 15 cents for every kilowatt-hour of power generated.

Street Dixon Rick is the first commercial firm to partner with NES on this initiative. The firm’s solar generation system replaces approximately 1,050 square feet of black rubber roofing, thereby reducing heat buildup in the building. The office also avoids emission of 34,000 pounds of carbon dioxide, 178 pounds of sulfur dioxide and 90 pounds of nitrous oxide each year.

Vaughn Spears, senior engineer, NES Energy Services, works with the firm and oversees Generation Partners. “This program offers businesses an easy way to be energy-efficient and reduce their electric bills,” said Spears. “We hope Street Dixon Rick Architecture is the first of many business and residential partners interested in helping to preserve the Tennessee Valley today and in the future.”

“Becoming a Generation Partner was a big commitment initially,” said Rick. “But when we considered the alternatives, we knew we made the right choice. After all, a clean environment is the best legacy we can leave for Nashville’s future generations.”

Nashville Electric Service **Green Power** Participants

Street Dixon Rick Architecture is leading the charge in energy-conscious business practices by becoming NES’ first Generation Partner. Other companies and organizations are also doing their part to conserve by joining the Green Power Switch program. Below is a listing of those groups.

Company Name	Blocks purchased annually
State of Tennessee	414
Kinko’s, Inc.	197
Ensworth School	94
Hospital Corporation of America	90
Nashville Sounds	75
Faith Church	60
Mount Zion Baptist Church	59
Starbucks Corporation	45
Buntin Advertising Inc.	38
W.L. Hailey & Co.	26
Amerisite LLC	25
Christ Church Episcopal	25
Staples Inc.	25
Tennessee Botanical Garden	25
Good Earth Market	5
St. Andrew’s Episcopal Church	5



When renovation started on the Executive Residence four years ago, Tennessee First Lady Andrea Conte knew from the beginning she wanted to make the

formal home of our state's governor as energy-efficient as possible. The challenge was to preserve the historical aspects of the home while updating the energy-efficiency needs to today's standards.

"This is the first major renovation to the infrastructure of the home since the Wills family sold the property to the state in 1949," said Conte. "We knew we needed to repair cracks in the ceiling and broken stairs, but it was even more important to us to make the changes you can't see, like installing energy-efficient window panes and lighting."

Tony Viglietti, NES senior energy services specialist, worked with Rex Garton of Hart Freeland Roberts Architects and Alan Robertson with the State of Tennessee Architects Office to make sure the structure was as energy-efficient as possible. Viglietti said, "Our engineers will work with any business, school, residential home or historical home to make adjustments big or small to conserve energy and money."

With the improvements to the home, the state is expected to see decreased energy operating costs. These savings will come as a result of the installation of dual-pane and

Tony Viglietti, right, NES senior energy services specialist, shows before and after restoration slides of the Executive Residence. NES was proud to assist with new energy-saving technology advice and installation.



interior storm windows, attic ventilation, energy-efficient lighting and a 110-ton geothermal HVAC unit which uses the Earth to heat and cool the home.

LEED, an acronym for Leadership in Energy and Environmental Design, is a nationally accepted benchmark for the design, construction and operation of high-performance green buildings. The program recognizes performance in specific areas such as energy-efficiency and water savings, and rates each project to measure its success.

It can be a challenge to receive LEED certification for a historical home like the Executive Residence, but the team is working toward certification.

"It's very important for state government to set a good example when it comes to energy conservation, and we knew we had an opportunity with this renovation project to do just that. Conserving our natural and fiscal resources is a top priority for our state, and I want this project to incorporate the ideals of green construction."

Andrea Conte, First Lady of Tennessee

As the old saying goes, you've got to practice what you preach. As an electric utility that advocates energy conservation methods and is a distributor of green power, NES is doing just that.

Through multiple initiatives, NES recycles and reuses equipment and supplies that are used every day to provide electricity to the Nashville area. Many of the light-duty NES vehicles and trucks that you see on the roads are environmentally friendly, too.

In addition to its recycling efforts, NES also buys 25 blocks of green power each month. Annually, that's the environmental equivalent of planting 12 acres of trees or recycling almost 200,000 aluminum cans.

Here are just a few of the things NES is doing to help our community stay green.

NES has 108 light-duty vehicles and trucks, used by field employees, which are capable of running on E85 ethanol and bio-diesel unleaded fuels. NES has an on-site E85 tank, and company drivers can fill up there daily before heading out for the day's work. NES was one of the first companies in Middle Tennessee to have an on-site tank of this kind.

E85 is a corn-based brand of fuel that uses renewable sources 'grown' right here in the United States, and it requires less petroleum than regular gas that standard automobiles use. It also emits fewer greenhouse gases than standard gasoline, making it better for our environment.

Oil used in NES transformers is recycled on-site. The water content is removed from the used oil, and additives found in domestic-use oil that are lost during the work-cycle of the transformer are then added back to the oil mixture. In most cases, the oil recycled on-site is better than the original oil was.

All scrap metals such as copper wire, aluminum, and steel are collected and sold to salvage companies



“We encourage our customers to conserve energy and natural resources not only to save money but also to protect our environment. We plan to do our part to care for our planet while also setting an example for others to follow.”

– Decosta Jenkins, NES president and CEO

where they are recycled for later use. Transformer shells are sold to salvage operators that break them down and recycle everything but the paper and porcelain.

Streetlamps and fluorescent bulbs are sent to a recycling company in Johnson City, Tenn., where they go through a 100 percent reuse process. The mercury vapor found in the street lamps is recaptured in a retort process and sold as usable mercury, the glass from the bulbs is ground up and used by road manufacturers to create asphalt and the aluminum end caps are collected and sold to salvage companies.

NES also recycles used wooden poles that are removed from service. The poles have been used by local farmers, parks, youth organizations, and even Mennonite developments in southern Kentucky in construction projects. Some customers have even processed the poles into dimensional lumber,

NES employee Myra Felts fills up her company car with E85 ethanol at NES' on-site E85 tank. NES was one of the first companies in Middle Tennessee to have an on-site tank of this kind.



NES employees (left to right) William Friedberg and Larry Chunn recycle the oil found in a transformer. In most cases, the oil recycled on-site is cleaner than the original oil.

which looks very similar to material that could be purchased at local home improvement centers.

With these and future conservation initiatives, the future looks bright for companywide conservation methods at NES. “We’re constantly looking for ways to provide superior service to our community,” said Decosta Jenkins, NES president and CEO. “What better way to enhance the service to our customers than to help protect the environment where they live?”



EXECUTIVE MANAGEMENT

Left to right, Allen Bradley, executive vice president and chief operating officer, Teresa Broyles-Aplin, vice president and chief financial officer, and Decosta Jenkins, president and chief executive officer

BOARD MEMBERS



William F. Blaufuss
board chair



Leo Waters
board vice-chair



Mary Jo Price



Marilyn Robinson



Justin Wilson

*ELECTRIC POWER BOARD OF THE METROPOLITAN GOVERNMENT
OF NASHVILLE AND DAVIDSON COUNTY*

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Independent Auditors' Report

Members of the Electric Power Board of the
Metropolitan Government of
Nashville and Davidson County
Nashville, Tennessee

We have audited the accompanying statements of net assets of the Electric Power Board of the Metropolitan Government of Nashville and Davidson County (the "Board"), a component unit of the Metropolitan Government of Nashville and Davidson County, Tennessee, as of June 30, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board as of June 30, 2007 and 2006, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis as listed in the accompanying table of contents is not a required part of the basic financial statements but is supplementary information. This supplementary information is the responsibility of the Board's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Crosslin, Vaden & Associates, P.C.

Nashville, Tennessee
September 28, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS

As financial management of the Electric Power Board of the Metropolitan Government of Nashville and Davidson County (the "Board"), we offer readers of these financial statements this narrative overview and analysis of the financial activities of the Board for the fiscal years ended June 30, 2007 and 2006, as compared to fiscal years 2006 and 2005, respectively. In conducting the operations of the electrical distribution system, the Board does business as Nashville Electric Service ("NES"). NES is a component unit of the Metropolitan Government of Nashville and Davidson County, Tennessee. This discussion and analysis is designed to assist the reader in focusing on the significant financial issues and activities and to identify any significant changes in financial position. We encourage readers to consider the information presented here in conjunction with the financial statements taken as a whole.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to NES' financial statements, which are composed of the basic financial statements and the notes to the financial statements. Since NES is composed of a single enterprise fund, no fund-level financial statements are shown.

Basic Financial Statements

The basic financial statements are designed to provide readers with a broad overview of NES' finances in a manner similar to that of a private-sector business.

The statements of net assets present information on all of NES' assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of NES is improving or deteriorating. Net assets increase when revenues exceed expenses. Increases to assets without a corresponding increase to liabilities results in increased net assets, which indicates an improved financial position.

The statements of revenues, expenses, and changes in net assets present information showing how NES' net assets changed during the fiscal year. All changes in net assets are reported as soon as the underlying event occurs, regardless of timing of related cash flows. Thus, revenues and expenses are reported for some items that will only result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

The statements of cash flows present changes in cash and cash equivalents resulting from operating, financing, and investing activities. These statements present cash receipts and cash disbursement information, without consideration for the earnings event, when an obligation arises, or depreciation of capital assets.

Summary of Changes in Net Assets

Assets exceeded liabilities by \$439 million at June 30, 2007, and \$395 million at June 30, 2006. This represents an increase of \$44.0 million in 2007 and \$34.3 million for 2006. All of those increases are attributable to operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The largest portion of the Board's net assets reflects its investment in capital assets less any related debt used to acquire those assets that are still outstanding. The Board uses these capital assets to provide service, and consequently, these assets are not available to liquidate liabilities or other spending.

An additional portion of the Board's net assets represents resources that are subject to external restrictions on how they may be used. These restrictions include bond proceeds to be used for construction projects and reserve funds required by bond covenants.

STATEMENTS OF NET ASSETS (\$000 omitted)

	June 30,		
	2007	2006	2005
ASSETS			
CURRENT ASSETS	\$213,612	\$188,344	\$139,980
INVESTMENT OF RESTRICTED FUNDS	47,892	78,967	118,165
UTILITY PLANT, NET	742,333	703,763	674,728
ENERGY CONSERVATION PROGRAMS' NOTES	789	1,153	1,646
OTHER NON-CURRENT ASSETS	2,703	2,989	3,232
TOTAL	<u>\$1,007,329</u>	<u>\$975,216</u>	<u>\$937,751</u>
CURRENT LIABILITIES	\$120,326	\$119,305	\$104,103
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS	16,525	15,960	16,745
LONG-TERM DEBT	428,091	441,340	453,853
OTHER NON-CURRENT LIABILITIES			
Payable to TVA – energy conservation programs	789	1,153	1,646
Other	2,978	2,839	1,113
	<u>3,767</u>	<u>3,992</u>	<u>2,759</u>
COMMITMENTS AND CONTINGENCIES			
NET ASSETS	\$438,620	\$394,619	\$360,291
TOTAL	<u>\$1,007,329</u>	<u>\$975,216</u>	<u>\$937,751</u>

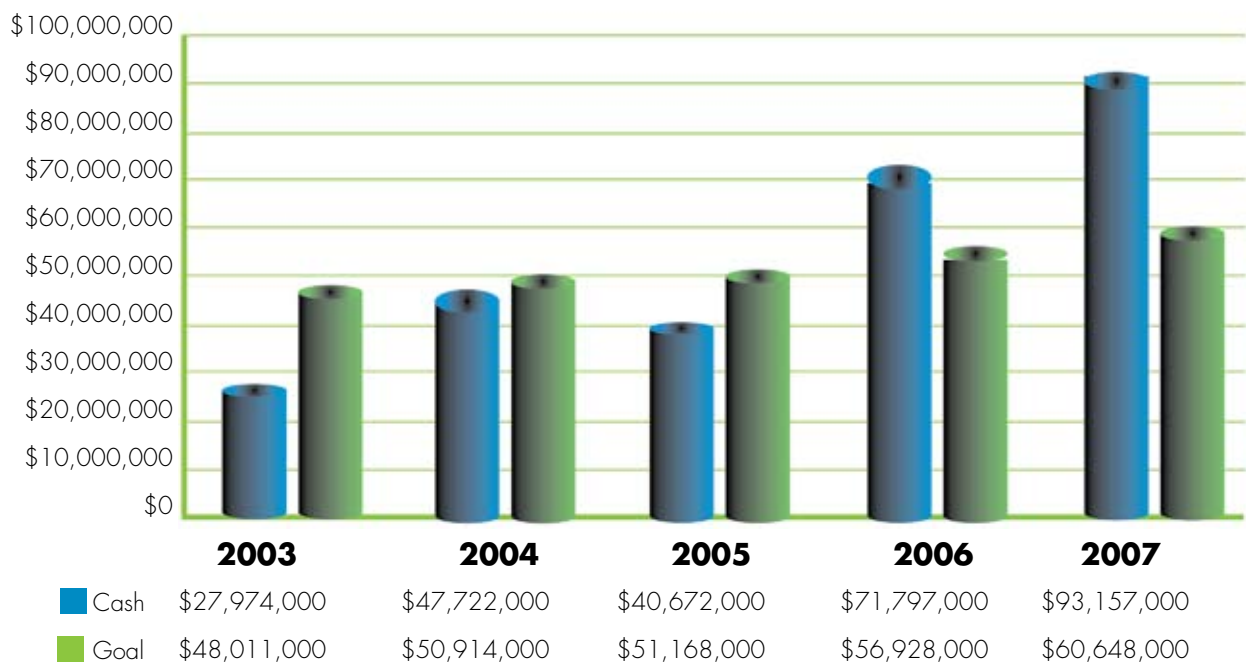
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)**Liquidity and Capital Resources**

The Board's ongoing sources of liquidity are operating cash flow and proceeds from tax-exempt bonds. During fiscal year 2007, NES drew down \$32.7 million from the Construction Fund, which represented the final proceeds from the 2004 Series A, Electric System Revenue Bonds. The Board, as a matter of practice, funds 50 percent of the capital budget with the proceeds from tax-exempt bonds. The remainder is funded with operating revenues. The Board has sufficient debt capacity and a strong financial position. Therefore, it is expected that the tax-exempt bond market will be a future source of liquidity to supplement the cash flow from operations. The Board's current financial projections incorporate a bond issuance in the spring of 2008.

In addition to operating cash flow and proceeds from tax-exempt bonds, the Board has a \$25 million line of credit, which is renewed each year. The credit facility is not a source of liquidity for ongoing operations. It is available as an additional funding source in the event of a natural catastrophe.

In order to maintain its strong credit ratings, the Board has adopted certain financial goals. Such goals provide a signal to the Board as to the adequacy of rates for funding ongoing cash flows from operations. One such goal is a cash goal of 7 percent of in-lieu-of-tax payments, purchased power, and operating and maintenance expenses. That goal was met every month of the fiscal year 2007. That percentage was 10.75 percent as of June 30, 2007, and 8.83 percent as of June 30, 2006.

During the fiscal year ended June 30, 2007, Standard & Poor's reaffirmed NES' AA bond rating. In issuing bond ratings, agencies typically evaluate financial operations, rate-setting practices, and debt ratios. Higher ratings aid in securing favorable borrowing rates, which results in lower interest costs.

COMPARISON OF CASH BALANCES TO NES' GOAL

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Operations**Summary Revenue & Expense Data (\$000 ommitted)**

	Year Ended June 30, 2007	Year Ended June 30, 2006	Net Asset Effect	Year Ended June 30, 2005	Net Asset Effect
Operating Revenues	\$ 962,828	\$ 903,455	\$ 59,373	\$ 785,711	\$ 117,744
Purchased Power	<u>733,735</u>	<u>686,639</u>	<u>(47,096)</u>	<u>597,659</u>	<u>(88,980)</u>
Margin	<u>229,093</u>	<u>216,816</u>	<u>12,277</u>	<u>188,052</u>	<u>28,764</u>
Operating Expenses	107,433	102,550	(4,883)	108,666	6,116
Depreciation and Taxes	62,242	60,026	(2,216)	55,980	(4,046)
Interest Income	8,788	4,322	4,466	5,876	(1,554)
Interest Expense	<u>24,205</u>	<u>24,234</u>	<u>29</u>	<u>24,922</u>	<u>688</u>
Increase in Net Assets	<u>\$ 44,001</u>	<u>\$ 34,328</u>	<u>\$ 9,673</u>	<u>\$ 4,360</u>	<u>\$ 29,968</u>

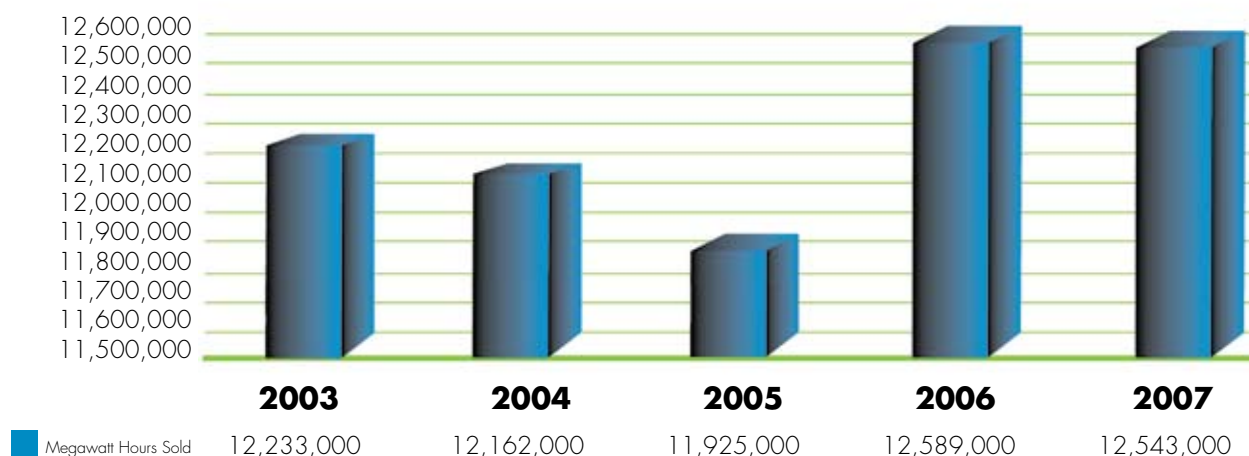
2007 and 2006 Results of Operations

Operating Revenues. Operating revenues increased by \$59.4 million, or 6.6 percent, when compared to 2006. Total electric sales were \$946 million for the period versus \$887 million last year. The average realized rate on electric sales was \$.0756 per kilowatt-hour in 2007 compared to \$.0705 per kilowatt-hour in 2006. Megawatt-hours sold in 2007 decreased by 0.4 percent when compared to 2006. In October 2006, TVA reduced wholesale rates 4.50 percent, which reduced retail rates by 3.40 percent. TVA also implemented a quarterly Fuel Cost Adjustment (FCA) on all firm energy effective October 2006. The wholesale rate reduction and quarterly FCA were implemented as a pass-through to our retail customers. Since the reduction in wholesale rates and fluctuations in the wholesale FCA were matched by corresponding adjustments in retail rates, there was no direct impact on NES net income. Management feels that there will be sufficient resources to meet all our objectives through fiscal year 2010 without requiring additional rate increases. However, any rate action by TVA would be passed along to the customer. Weather plays an important part in determining revenue for any year. The impact of weather is reflected in the comparison of degree-days from one period to the next. Degree-days represent the difference between the weather's average daily temperatures minus 65 degrees. Temperatures above 65 degrees are considered cooling degree-days; temperatures below 65 degrees are considered heating degree-days. Total cooling degree-days were 2,020 compared to 2,022 in 2006. Total heating degree-days were 3,248 compared to 3,321 in 2006. Total heating and cooling degree-days were 5,268 compared to 5,343 in 2006 or a decrease of approximately 1 percent. Total average number of active year-to-date customers increased by 1.6 percent when compared to 2006.

Non-operating and Other Revenues. Interest Income was \$8.8 million compared to \$4.3 million in 2006. The average rate of return on the General Fund was 5.40 percent in 2007 compared to 4.40 percent in 2006. The average monthly balance of the General Fund was \$86 million in 2007 compared to \$58 million in 2006, which represents an increase of 48 percent. Revenue in Excess of Net Bills (Late Charges) increased by \$0.3 million, and Rentals of Electric Property (primarily pole attachments) increased by \$0.4 million.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

MEGAWATT-HOURS SOLD



Operating Expenses. The Board purchases all of its power from TVA under an all-requirements contract that had an initial term of 20 years. Beginning on December 19, 1989, and on each subsequent anniversary thereafter, the contract is automatically extended for an additional one-year term. The contract is subject to earlier termination by either party on not less than 10 years' prior written notice. Purchased power was \$733.7 million for the period compared to \$686.6 million last year. The average realized rate on purchased power was \$.0565 per kilowatt-hour in 2007 compared to \$.0530 per kilowatt-hour in 2006. Megawatt-hours purchased were 13.0 million in 2007 compared to 12.9 million in 2006. Line losses were 3.30 percent in 2007 compared to 2.56 percent in 2006, or an increase of 28.9 percent.

Distribution expense for the period was \$44.0 million compared to \$42.3 million last year. This is an increase of \$1.7 million or 4.0 percent. The change is primarily attributable to increases in operation and maintenance of station equipment of \$1.1 million and miscellaneous of \$1.0 million.

Customer Account expense and Customer Service and Information expenses combined were \$18.4 million for the period compared to \$18.0 million last year, or an increase of \$0.4 million or 2.2 percent. This is primarily the result of an increase in the customer orders and service expense of \$0.5 million and data processing of \$0.3 million offset by a decrease in customer assistance of \$0.3 million.

Administrative and General (A&G) expenses were \$45.0 million for the period compared to \$42.2 million last year. This was an increase of \$2.8 million or 6.6 percent. The increase is primarily the result of an increase in employee pensions of \$1.3 million, administrative and general salaries of \$0.4 million; maintenance of general plant of \$0.3 million and office supplies and expenses of \$0.3 million.

Depreciation and Tax Equivalents were \$37.0 million and \$25.2 million compared to \$36.0 million and \$24.1 million for 2007 and 2006, respectively. The increase in depreciation was the result of increased investment in the utility plant. Tax equivalents consist primarily of payments in-lieu-of taxes to the Metropolitan Government and the surrounding counties. Such payments are calculated based on a prescribed formula that takes into consideration utility plant value and the average of the Board's last three years' operating margin. The increase in payments in-lieu-of taxes was the result of increases in tax rates coupled with increased investment in the utility plant.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)**2006 and 2005 Results of Operations**

Operating Revenues. Operating revenues increased by \$117.7 million, or 15.0 percent, when compared to 2005. Total electric sales were \$887 million for 2006 versus \$770 million in 2005. The average realized rate on electric sales was \$0.0705 per kilowatt-hour in 2006 compared to \$.0646 per kilowatt-hour in 2005. Megawatt-hours sold in 2006 increased by 5.6 percent when compared to 2005. In October 2005, NES increased retail rates by 5.9 percent to cover a rate increase from the Tennessee Valley Authority ("TVA"). In addition, NES added 2.6 percent, which resulted in a total retail rate increase of 8.5 percent. In April 2006, TVA further increased rates, which required NES to add an additional 7.7 percent to cover this increase plus 1.2 percent for NES. The principal reasons cited by TVA for these rate increases were increases in the cost of fuel and purchased power. NES included an increase to fund capital improvement projects, which would provide service to new and expanding customers, strengthening the electric distribution system, and improved reliability for our customers. Our five-year financial model also included the estimated annual required contribution ("ARC") for other post-employment benefits (OPEB) for medical and life insurance benefits. Recording of this ARC is prescribed by Statement No. 45 of the Governmental Accounting Standards Board and is required to be recorded by NES in Fiscal 2008. Total heating and cooling degree-days were 5,343 in 2006 compared to 4,501 in 2005 or an increase of approximately 18.7 percent. Total average number of active year-to-date customers increased by 1.7 percent when compared to 2005.

Non-operating and Other Revenues. Interest Income was \$4.3 million compared to \$5.9 million in 2005. Interest rates continued to rise during the year. The average rate of return on the General Fund was 4.4 percent in 2006 compared to 2.2 percent in 2005. The average monthly balance of the General Fund was \$58 million in 2006 compared to \$51 million in 2005, an increase of 14 percent. Revenue in Excess of Net Bills (Late Charges) increased by \$0.5 million. However, the draw-down of the Construction Fund by \$40.5 million during the year resulted in a decrease in interest earnings.

Operating Expenses. Purchased power costs paid to TVA were \$686.6 million for 2006 compared to \$597.7 million in fiscal 2005. The average realized rate on purchased power was \$.0530 per kilowatt-hour in 2006 compared to \$.0485 per kilowatt-hour in 2005. Megawatt-hours purchased were 12.9 million in 2006 compared to 12.3 million in 2005. Line losses were 2.56 percent in 2006 compared to 2.93 percent in 2005, or a decrease of 12.6 percent.

Distribution expense for 2006 was \$42.3 million compared to \$45.7 million in 2005. This is a decrease of \$3.4 million or 7.4 percent. The change is primarily attributable to decreases in tree-trimming of \$2.3 million, overhead line maintenance of \$0.8 million, and miscellaneous of \$0.7 million.

Customer Account expense and Customer Service and Information expenses combined were \$18.0 million for 2006 compared to \$19.4 million in 2005 for a decrease of \$1.4 million, or 7.2 percent. This is primarily the result of a decrease in the data processing allocation of \$2.3 million offset by an increase in customer records and collections of \$0.4 million, customer assistance of \$0.3 million, and payroll of \$0.2 million.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Administrative and General expenses were \$42.2 million for 2006 compared to \$43.5 million in 2005. This was a decrease of \$1.3 million or 3.0 percent. The decrease is primarily the result of a decrease in employee health costs of \$1.9 million, and injuries and damages of \$0.9 million offset by an increase in the data processing allocation of \$1.5 million. NES is self-insured for medical claims. The decrease noted in employee health costs was primarily due to a new five-year labor contract that was effective July 1, 2005. Significant changes were made to reduce the escalating cost of health care. Increased premiums were implemented, and the Medicare benefits available to the retirees began to be utilized as the primary payer on medical claims, when possible. Management believes this directly resulted in the improvement of health care costs.

Depreciation and Tax Equivalents were \$36.0 million and \$24.0 million compared to \$34.0 million and \$22.0 million for 2006 and 2005, respectively. The increase in depreciation was the result of increased investment in the utility plant. Tax equivalents consist primarily of payments in-lieu-of taxes to the Metropolitan Government and the surrounding counties. Such payments are calculated based on a prescribed formula that takes into consideration utility plant value and the average of NES' last three years' operating margin. The increase in payments in-lieu-of taxes was the result of increases in tax rates coupled with increased investment in the utility plant.

The following table shows the composition of the operating expenses of the Board by major classification of expense for the last three years:

Major Classifications of Expense (\$000 Omitted)

Description	Fiscal 2007	Fiscal 2006	Increase (Decrease)	Fiscal 2005	Increase (Decrease)
Labor, excluding overtime	\$ 41,569	\$ 40,006	3.9%	\$ 40,192	(0.5%)
Benefits	24,522	23,870	2.7%	26,497	(9.9%)
Tree-trimming	9,818	11,166	(12.1%)	13,489	(17.2%)
Outside Services	7,555	6,258	20.7%	5,944	5.3%
Materials	4,370	4,266	2.4%	3,853	10.7%
Transportation	3,498	3,161	10.7%	3,372	(6.3%)
Accrual for Uncollectible Accounts	2,200	2,100	4.8%	1,881	11.6%
Postage	1,518	1,559	(2.6%)	1,126	38.4%
Security/Police	866	850	1.9%	878	(3.2%)
Rentals	872	867	0.6%	896	(3.2%)
Professional Fees	923	737	25.2%	518	42.3%
Insurance Premiums	755	653	15.6%	793	(17.6%)
Other	<u>8,967</u>	<u>7,057</u>	<u>27.1%</u>	<u>9,227</u>	<u>(23.5%)</u>
	<u>\$ 107,433</u>	<u>\$ 102,550</u>	<u>4.8%</u>	<u>\$ 108,666</u>	<u>(5.6%)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The Board's total operating expenses increased 4.8 percent from June 30, 2006, to June 30, 2007. Labor costs increased primarily due to step increases and merit raises. The total number of employees remained below 1,000. Tree-trimming decreased due to this being the second year of retrimming areas that were initially trimmed in the first three-year trimming cycle. Outside services increased partially due to a full year of the pole treatment and inspection program. Material costs were more than last year due to more maintenance projects being completed. Transportation costs increased as more operational and maintenance work was completed and the cost of maintaining and operating vehicles increased. The Other category contains a wide array of smaller accounts. The primary reason for the variance in that category is the result of a credit adjustment for reimbursements from TEMA and FEMA in the previous year that were not received in the current year. There was also an increase in Professional Fees of \$250,000 due to the use of more legal services during the fiscal year.

Total operating expenses decreased 5.6 percent from June 30, 2005, to June 30, 2006. This decrease was primarily due to changes in the labor contract that resulted in reduced medical costs. Payroll was also down as increased retirements left unfilled positions open during the year. The revised labor contract allowed for employees who met the "Rule of 85" to retire without a reduced pension benefit. Tree-trimming decreased as it was the first year of retrimming areas that were initially trimmed three years ago. Outside services increased because of the initiation of a pole treatment and inspection program during 2006. Materials were more than in 2005 as obsolete and unusable inventory was removed from stock. Transportation charged to operation and maintenance decreased as more work was done on capital projects.

Budgetary Highlights

The Board approves an Operating and Capital Budget each fiscal year. The operating budget remains in effect the entire year and is not revised except to adjust for rate changes.

	Year Ended June 30, 2007		
	(\$000 omitted)		
	Budget	Actual	Over (Under)
Operating Revenues	\$963,290	\$962,828	\$ (462)
Purchased Power	<u>738,671</u>	<u>733,735</u>	<u>(4,936)</u>
Margin	224,619	229,093	4,474
Operating Expenses	108,369	107,433	(936)
Depreciation and Taxes	63,516	62,242	(1,274)
Interest Income	6,345	8,788	2,443
Interest Expense	<u>23,555</u>	<u>24,205</u>	<u>650</u>
Increase in Net Assets	<u>\$ 35,524</u>	<u>\$ 44,001</u>	<u>\$ 8,477</u>
Capital Expenditures	<u>\$ 68,300</u>	<u>\$ 77,255</u>	<u>\$ 8,955</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The Board's increase in net assets was \$8.5 million over its budget of \$35.5 million for fiscal 2007. More than half of the increase over budget results from the actual margin being more favorable than budgeted. Interest income was also greater than budgeted due to higher interest rates earned during the fiscal year. The major contributors to the variance in operating expenses from budget were decreases in medical of approximately \$1 million and tree-trimming of \$1.2 million.

	Year Ended June 30, 2006		
	(\$000 omitted)		
	Budget	Actual	Over (Under)
Operating Revenues	\$ 893,086	\$ 903,455	\$ 10,369
Purchased Power	<u>682,964</u>	<u>686,639</u>	<u>3,675</u>
Margin	<u>210,122</u>	<u>216,816</u>	<u>6,694</u>
Operating Expenses	108,376	102,550	(5,826)
Depreciation and Taxes	59,371	60,026	655
Interest Income	3,689	4,322	633
Interest Expense	<u>24,285</u>	<u>24,234</u>	<u>(51)</u>
Increase in Net Assets	<u>\$ 21,779</u>	<u>\$ 34,328</u>	<u>\$ 12,549</u>
Capital Expenditures	<u>\$ 66,837</u>	<u>\$ 65,936</u>	<u>\$ (901)</u>

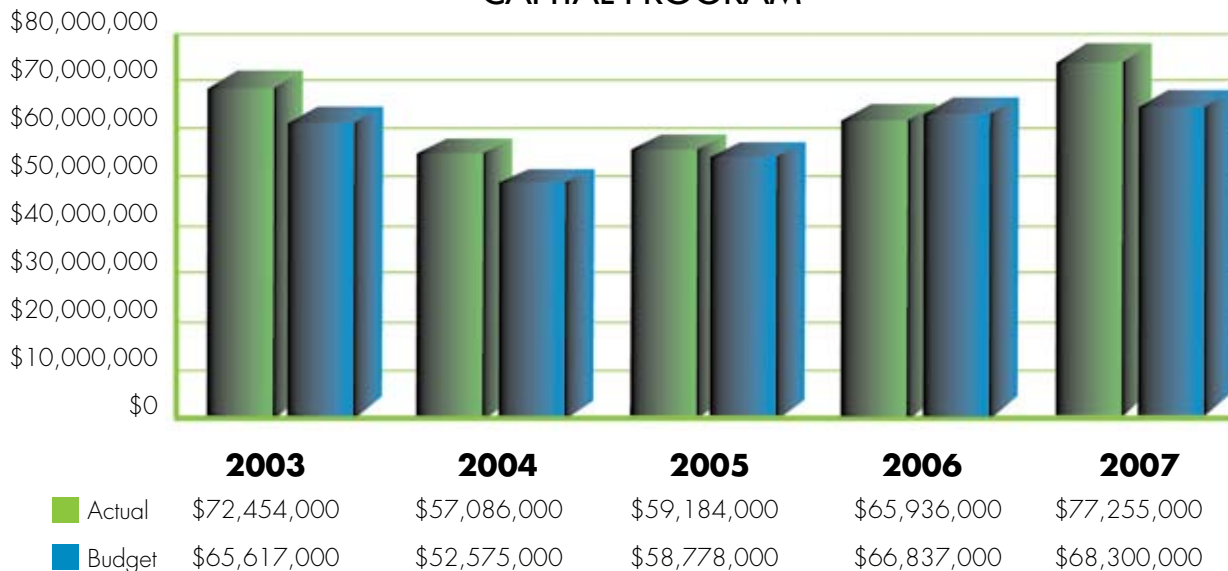
The Board's increase in net assets was \$12.5 million over its budget of \$21.8 million for fiscal 2006. The increase in margin was a major contributor to the increase in net assets. During the year, NES had two rate increases that made a large contribution to the increased margin. Degree-days were 98 percent of normal. Normal weather coupled with the 1.7 percent customer growth resulted in kilowatt-hour sales being 5.6 percent over the previous year. The major contributors to the variance in operating expenses from budget were decreases in medical of \$1.3 million, write-off of construction overhead totaling \$2.3 million, labor of \$1.2 million, and tree trimming of \$0.6 million.

The 2007 Capital Budget was \$68.3 million; \$77.3 million was spent. This budget variance is primarily associated with an increase in the inventory of transformers and a rise in commodity prices for materials used to manufacture transformers.

The 2006 Capital Budget was \$66.8 million; \$65.9 million was spent.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

CAPITAL PROGRAM



Capital Assets and Debt Administration

The Board's transmission and distribution facilities serve all of the 533 square miles located within the boundaries of the Metropolitan Government of Nashville and Davidson County, Tennessee. The Board serves an additional 167 square miles located in minor portions of the adjacent counties of Cheatham, Robertson, Rutherford, Sumner, Williamson, and Wilson. Such facilities require significant annual capital and maintenance expenditures. The Board's target is to have the capital expenditures funded equally from cash flow from operations and proceeds from tax-exempt bonds. The Board's investment in utility plant at June 30, 2007, was \$742.3 million compared to \$703.8 million at June 30, 2006. That total investment at June 30, 2005, was \$674.7 million. Major projects during fiscal year 2007 included \$7.4 million in the Old Smyrna Road substation, \$4.2 million in the Whites Creek substation addition, \$2.7 million in the Central substation, \$1.0 million in the Sharondale substation, and \$1.0 million in substation breaker replacements. Major projects during fiscal year 2006 included \$9.2 million in the Old Smyrna Road substation, \$3.5 million in the Whites Creek substation addition, \$1.3 million in substation breaker replacements, and \$1.8 million in the downtown network for new customers, including the new symphony hall and the Stahlman building.

The Board has outstanding bonds payable of \$442.9 million at June 30, 2007, compared to \$456.8 million at June 30, 2006. The total outstanding bonds payable as of June 30, 2005, were \$466.8 million. The decreases noted over the last three years are due to the normal retirement of bonds.

The Board's financing cost may be impacted by short-term and long-term debt ratings assigned by independent rating agencies. Debt ratings are based, in significant part, on the Board's performance as measured by certain credit measures such as the aforementioned cash targets and debt coverage ratios. The Board's debt coverage ratio for the 12 months ended June 2007 was 3.4 to 1. The Board continues to exceed its goal of 2 to 1. The Board's revenue bonds are rated Aa, AA, and AA by Moody's, Standard & Poor's, and Fitch, respectively. The outlook on all ratings is stable.

Respectfully submitted,

Teresa Broyles-Aplin
Vice President and
Chief Financial Officer

STATEMENTS OF NET ASSETS (\$000 OMITTED)
JUNE 30, 2007 AND 2006

	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash and short-term investments	\$ 93,157	\$ 71,797
Customer and other accounts receivable, less allowance for doubtful accounts of \$607 and \$695, respectively	100,064	101,126
Accrued interest receivable	859	132
Materials and supplies	18,067	13,803
Other current assets	<u>1,465</u>	<u>1,486</u>
TOTAL CURRENT ASSETS	<u>213,612</u>	<u>188,344</u>
INVESTMENT OF RESTRICTED FUNDS:		
Cash and cash equivalents	43	110
Other investments	<u>47,849</u>	<u>78,857</u>
TOTAL RESTRICTED FUNDS	<u>47,892</u>	<u>78,967</u>
UTILITY PLANT:		
Electric plant, at cost	1,153,066	1,104,963
Less: Accumulated depreciation	<u>(410,733)</u>	<u>(401,200)</u>
TOTAL UTILITY PLANT, NET	<u>742,333</u>	<u>703,763</u>
ENERGY CONSERVATION PROGRAMS'		
Notes receivable	789	1,153
UNAMORTIZED BOND ISSUANCE COSTS	2,341	2,610
OTHER NON-CURRENT ASSETS	<u>362</u>	<u>379</u>
TOTAL ASSETS	<u>\$1,007,329</u>	<u>\$ 975,216</u>

See notes to financial statements.

STATEMENTS OF NET ASSETS (\$000 OMITTED)
JUNE 30, 2007 AND 2006

	2007	2006
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable for purchased power	\$ 92,506	\$ 89,486
Other accounts payable and accrued expenses	16,474	19,176
Customer deposits	<u>11,346</u>	<u>10,643</u>
TOTAL CURRENT LIABILITIES	<u>120,326</u>	<u>119,305</u>
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS:		
Construction contracts payable	1,675	1,110
Accrued interest payable	2,359	2,147
Current portion of long-term debt	<u>12,491</u>	<u>12,703</u>
TOTAL CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS	<u>16,525</u>	<u>15,960</u>
LONG-TERM DEBT, LESS CURRENT PORTION	428,091	441,340
OTHER NON-CURRENT LIABILITIES:		
Payable to TVA – energy conservation programs	789	1,153
Other	<u>2,978</u>	<u>2,839</u>
TOTAL OTHER NON-CURRENT LIABILITIES:	<u>3,767</u>	<u>3,992</u>
COMMITMENTS AND CONTINGENCIES		
NET ASSETS:		
Invested in capital assets, net of related debt	302,464	284,013
Restricted for debt payment	45,532	44,026
Unrestricted	<u>90,624</u>	<u>66,580</u>
	<u>438,620</u>	<u>394,619</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$1,007,329</u>	<u>\$ 975,216</u>

See notes to financial statements.

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (\$000 OMITTED)
YEARS ENDED JUNE 30, 2007 AND 2006**

	2007	2006
OPERATING REVENUES:		
Residential	\$ 391,316	\$ 364,076
Commercial and industrial	540,998	510,127
Street and highway lighting	13,444	12,816
Other	<u>17,070</u>	<u>16,436</u>
Total operating revenues	962,828	903,455
PURCHASED POWER	<u>733,735</u>	<u>686,639</u>
MARGIN	<u>229,093</u>	<u>216,816</u>
OPERATING EXPENSES:		
Distribution	43,994	42,341
Customer accounts	17,397	16,652
Customer service and information	1,053	1,331
General and administrative	44,989	42,226
Tax equivalents	25,239	24,062
Depreciation	<u>37,003</u>	<u>35,964</u>
Total operating expenses	<u>169,675</u>	<u>162,576</u>
Operating income	<u>59,418</u>	<u>54,240</u>
NON-OPERATING REVENUE (EXPENSE):		
Interest income	8,788	4,322
Interest expense	<u>(24,205)</u>	<u>(24,234)</u>
Total non-operating expense	<u>(15,417)</u>	<u>(19,912)</u>
NET INCREASE IN NET ASSETS	44,001	34,328
NET ASSETS, Beginning of Year	<u>394,619</u>	<u>360,291</u>
NET ASSETS, End of Year	<u>\$ 438,620</u>	<u>\$ 394,619</u>

See notes to financial statements.

STATEMENTS OF CASH FLOWS (\$000 OMITTED)
YEARS ENDED JUNE 30, 2007 AND 2006

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers	\$ 964,956	\$ 887,359
Payments to suppliers for goods and services	(803,167)	(735,727)
Payments to employees	(41,963)	(40,370)
Payments for tax equivalents	<u>(24,844)</u>	<u>(23,698)</u>
Net cash provided by operating activities	<u>94,982</u>	<u>87,564</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition and construction of utility plant	(66,141)	(61,646)
Utility plant removal costs	(10,450)	(4,311)
Salvage received from utility plant retirements	1,018	958
Principal payments on revenue bonds	(12,703)	(12,940)
Interest paid on revenue bonds	<u>(24,482)</u>	<u>(23,845)</u>
Net cash used in capital and related financing activities	<u>(112,758)</u>	<u>(101,784)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investment securities	(177,992)	(151,765)
Proceeds from sales and maturities of investment securities	209,067	190,963
Interest on investments	<u>8,061</u>	<u>6,131</u>
Net cash provided by investing activities	<u>39,136</u>	<u>45,329</u>
NET INCREASE IN CASH AND SHORT-TERM INVESTMENTS - UNRESTRICTED	21,360	31,109
CASH AND SHORT-TERM INVESTMENTS AT BEGINNING OF YEAR - UNRESTRICTED	<u>71,797</u>	<u>40,688</u>
CASH AND SHORT-TERM INVESTMENTS AT END OF YEAR - UNRESTRICTED	<u>\$ 93,157</u>	<u>\$ 71,797</u>

See notes to financial statements.

STATEMENTS OF CASH FLOWS (\$000 OMITTED)
YEARS ENDED JUNE 30, 2007 AND 2006 (continued)

	2007	2006
Reconciliation of operating income to net cash provided		
by operating activities:		
Operating income	\$ 59,418	\$ 54,240
Adjustments to reconcile operating income		
to net cash provided by operating activities:		
Depreciation	37,003	35,964
Changes in assets and liabilities:		
Decrease (Increase) in customer and other accounts receivable	1,062	(17,353)
Increase in materials and supplies	(4,264)	(1,846)
Decrease in other current assets	21	135
Decrease in energy conservation programs' notes receivable	364	493
Decrease in other non-current assets	17	14
Increase in accounts payable for purchased power	3,020	11,730
(Decrease) increase in other accounts payable and accrued expenses	(2,137)	2,190
Increase in customer deposits	703	764
Decrease in payable to TVA – energy conservation programs	(364)	(493)
Increase in other non-current liabilities	139	1,726
	<u>\$ 94,982</u>	<u>\$ 87,564</u>
Net cash provided by operating activities	<u>\$ 94,982</u>	<u>\$ 87,564</u>

NON-CASH CAPITAL AND RELATED FINANCING ACTIVITIES:

During 2007 and 2006, NES charged \$19.7 million and \$11.0 million, respectively, to accumulated depreciation representing the cost of retired utility plant.

During 2007 and 2006, \$208,000 and \$206,000, respectively, were charged to interest expense for amortization of bond premiums. Also, \$629,000 and \$656,000 were charged as amortization of the bond-issuance costs in 2007 and 2006, respectively.

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Electric Power Board of the Metropolitan Government of Nashville and Davidson County (the "Board") was established in 1939 when the City of Nashville purchased certain properties of the Tennessee Electric Power Company for the purpose of exercising control and jurisdiction over the electric distribution system. In conducting the operations of the electric distribution system, the Board does business as Nashville Electric Service ("NES"). NES is a component unit of The Metropolitan Government of Nashville and Davidson County, Tennessee (the "Metropolitan Government"), and is operated by a five-member board appointed by the Mayor and confirmed by the Council of the Metropolitan Government. Members of NES serve five-year staggered terms without compensation. In accordance with the Charter of the Metropolitan Government, NES exercises exclusive control and management, except NES must obtain the approval of the Council before issuing revenue bonds. The Metropolitan Government does not assume liability for the financial obligations of NES. In addition, the assets of NES cannot be encumbered to satisfy obligations of the Metropolitan Government. NES appoints a chief executive officer, who is charged with the responsibility for the day-to-day operations, including hiring of employees.

The financial statements of NES have been prepared in conformity with accounting principles generally accepted in the United States of America. NES maintains its accounts in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission on the accrual basis of accounting. NES is not subject to the jurisdiction of federal or state regulatory commissions.

Under Governmental Accounting Standards Board ("GASB") Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, NES has elected to apply Financial Accounting Standards Board ("FASB") Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements.

The significant accounting policies followed by NES are outlined below.

Estimates used in the preparation of financial statements are based on management's best judgments. The most significant estimates relate to allowance for uncollectible accounts receivable, inventory obsolescence, depreciation, intangible asset valuations and useful lives, employee benefit plan obligations, accrued power receivable and payable and unreported medical claims. These estimates may be adjusted as more current information becomes available.

For purposes of the statements of cash flows, cash and cash equivalents include unrestricted cash, commercial paper, U.S. Treasury Bills and certificates of deposit with an original maturity of three months or less.

Restricted Assets of NES represent bond proceeds designated for construction and other monies required to be restricted for debt service.

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Utility Plant is stated at original cost. Such cost includes applicable general and administrative costs and payroll and related costs such as pensions, taxes and other fringe benefits related to plant construction. Interest cost incurred during the period of construction of certain plant is capitalized. Capitalized interest was \$547,000 and \$857,000 in 2007 and 2006, respectively. Costs of depreciable retired utility plant, plus removal costs, less salvage, are charged to accumulated depreciation.

Depreciation is provided at rates which are designed to amortize the cost of depreciable plant over the estimated useful lives ranging from five to 40 years. The composite straight-line rate expressed as a percentage of average depreciable plant were as follows for June 30, 2007 and 2006:

	2007	2006
Distribution plant, 18.2 to 40 years	3.3%	3.3%
Structure and improvements, 40 to 50 years	2.0%	2.0%
Office furniture and equipment, 7.1 to 16.7 years	13.8%	13.7%
Transportation equipment, 8 to 10 years	7.3%	7.3%
Other equipment, 8 to 33.3 years	6.5%	8.1%

Maintenance and repairs, including the cost of renewals of minor items of property, are charged to either maintenance expense accounts or applicable clearing accounts. Replacements of property are charged to utility plant accounts.

Investments and Cash Equivalents (including restricted assets) consist primarily of short-term U.S. government securities or mortgage-backed securities from agencies chartered by Congress, and certificates of deposit. In accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, investments are reflected at their fair value except those investments that have a remaining maturity at the time of purchase of one year or less and certificates of deposit, which are reflected at cost.

Materials and Supplies are stated at the moving weighted average cost.

Arbitrage Rebate Payable, which is included in other accounts payable and accruals, represents estimated amounts payable to the federal government for interest earnings on bond proceeds in excess of amounts allowed under federal regulations.

Unamortized Bond Issuance costs incurred in connection with the issuance of bonds are being amortized over the respective lives of the bond issues using the effective interest method.

Compensated Absences represent the liability for employees' accumulated vacation days. The general policy of NES permits the accumulation, within certain limitations, of unused vacation days.

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenues are recognized from meters read on a monthly cycle basis. Service that has been rendered from the latest date of each meter-reading cycle to month end is estimated and accrued as unbilled revenue receivable.

NES purchases electric power from the Tennessee Valley Authority ("TVA"). The cost of purchased power is calculated based upon retail billing units adjusted for estimated line losses. NES accrues for unbilled purchased power based on retail billing units.

Asset Retirement Obligations are periodically reviewed in accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations*, and management has concluded that, at present, NES does not have any such asset retirement obligations.

Operating and Non-operating Revenues and Expenses – Operating revenues include the sale of power and rental of electric property. Operating expenses include direct and indirect costs to operate and maintain the electric distribution system, including purchased power, fuel, depreciation, customer accounts, tax equivalents and general and administrative costs. Non-operating revenues and expenses consist primarily of interest income and expense.

Income Taxes – NES is not subject to federal or state income taxes. While NES is not subject to property tax, NES pays tax equivalents in-lieu-of taxes to the Metropolitan Government and surrounding counties.

NOTES TO FINANCIAL STATEMENTS

2. UTILITY PLANT AND ACCUMULATED DEPRECIATION

Utility plant activity for the years ended June 30, 2007 and 2006, was as follows (\$000 omitted):

	Balance June 30, 2006	Additions	Transfers & Retirements	Balance June 30, 2007
Distribution plant	\$ 912,935	\$ 79,939	\$ (16,965)	\$ 975,909
Land and land rights	1,139	-	-	1,139
Structures and improvements	38,986	3,006	-	41,992
Office furniture and equipment	34,015	2,493	(1,720)	34,788
Transportation equipment	5,830	555	(352)	6,033
Other equipment	34,403	810	(717)	34,496
Construction work-in-progress (a)	<u>77,655</u>	<u>-</u>	<u>(18,946)</u>	<u>58,709</u>
	<u>\$ 1,104,963</u>	<u>\$ 86,803</u>	<u>\$ (38,700)</u>	<u>\$ 1,153,066</u>

(a) Represents the net activity to the construction work-in-progress account after transfers to plant accounts.

	Balance June 30, 2005	Additions	Transfers & Retirements	Balance June 30, 2006
Distribution plant	\$ 884,884	\$ 33,143	\$ (5,092)	\$ 912,935
Land and land rights	1,139	-	-	1,139
Structures and improvements	38,499	487	-	38,986
Office furniture and equipment	37,071	1,703	(4,759)	34,015
Transportation equipment	5,926	265	(361)	5,830
Other equipment	34,781	463	(841)	34,403
Construction work-in-progress (a)	<u>50,127</u>	<u>27,528</u>	<u>-</u>	<u>77,655</u>
	<u>\$ 1,052,427</u>	<u>\$ 63,589</u>	<u>\$ (11,053)</u>	<u>\$ 1,104,963</u>

(a) Represents the net activity to the construction work-in-progress account after transfers to plant accounts.

NOTES TO FINANCIAL STATEMENTS

2. UTILITY PLANT AND ACCUMULATED DEPRECIATION (continued)

The related activity for accumulated depreciation for the years ended June 30, 2007 and 2006, was as follows (\$000 omitted):

	Balance June 30, 2006	Provision	Original Cost	Cost of Removal	Salvage	Balance June 30, 2007
Distribution plant	\$ 349,108	\$ 30,486	\$ (16,955)	\$ (10,450)	\$ 785	\$ 352,974
Structures and improvements	12,443	803	-	-	-	13,246
Office furniture and equipment	19,920	4,743	(1,720)	-	-	22,943
Transportation equipment	869	429	(352)	-	235	1,181
Other equipment	<u>18,860</u>	<u>2,248</u>	<u>(717)</u>	<u>-</u>	<u>(2)</u>	<u>20,389</u>
	<u>\$ 401,200</u>	<u>\$ 38,709</u>	<u>\$ (19,744)</u>	<u>\$ (10,450)</u>	<u>\$ 1,018</u>	<u>\$ 410,733</u>

	Balance June 30, 2005	Provision	Original Cost	Cost of Removal	Salvage	Balance June 30, 2006
Distribution plant	\$ 328,626	\$ 29,008	\$ (5,071)	\$ (4,311)	\$ 856	\$ 349,108
Structures and improvements	11,658	785	-	-	-	12,443
Office furniture and equipment	19,801	4,872	(4,759)	-	6	19,920
Transportation equipment	732	431	(361)	-	67	869
Other equipment	<u>16,882</u>	<u>2,790</u>	<u>(841)</u>	<u>-</u>	<u>29</u>	<u>18,860</u>
	<u>\$ 377,699</u>	<u>\$ 37,886</u>	<u>\$(11,032)</u>	<u>\$ (4,311)</u>	<u>\$ 958</u>	<u>\$ 401,200</u>

NOTES TO FINANCIAL STATEMENTS

3. CASH AND INVESTMENTS

Cash and investments consist of the following (\$'000 omitted):

2007					
	Cash & Short-term Investments	Bond Funds	Special Construction	Total	Weighted Average Maturity (Years)
Cash	\$ 484	\$ 43	-	\$ 527	-
U.S. Treasury Investments	-	47,849	-	47,849	0.35
Other Investments	<u>92,673</u>	<u>-</u>	<u>-</u>	<u>92,673</u>	<u>-</u>
	<u>\$ 93,157</u>	<u>\$ 47,892</u>	<u>\$ -</u>	<u>\$ 141,049</u>	<u>0.12</u>
2006					
	Cash & Short-term Investments	Bond Funds	Special Construction	Total	Weighted Average Maturity (Years)
Cash	\$ 1,964	\$ 26	\$ 84	\$ 2,074	-
U.S. Treasury Investments	-	46,147	-	46,147	0.69
Mortgage-backed Securities from Agencies Chartered by Congress	-	-	32,710	32,710	0.62
Other Investments	<u>69,833</u>	<u>-</u>	<u>-</u>	<u>69,833</u>	<u>0.04</u>
	<u>\$ 71,797</u>	<u>\$ 46,173</u>	<u>\$ 32,794</u>	<u>\$ 150,764</u>	<u>0.37</u>

NOTES TO FINANCIAL STATEMENTS

3. CASH AND INVESTMENTS (continued)

Investments of \$28.1 million and \$72.2 million at June 30, 2007 and 2006, respectively, in U.S. Treasury investments are reported at fair value. Investments of \$112.4 million and \$76.6 million at June 30, 2007 and 2006, respectively, in U.S. Treasury investments, commercial paper and certificates of deposit are reported at cost.

The net increase in the fair value of investments during fiscal year 2007 was \$2.4 million. This amount takes into account all changes in fair value (including purchases and sales) that occurred during the year. The unrealized gain on investments held at year-end was \$180,000, which is recorded in interest income.

Custodial Credit Risk – As of June 30, 2007 and 2006, NES' cash held by financial institutions was \$527,000 and \$2.1 million, respectively. Bank balances for such accounts totaled \$95.6 million and \$74.4 million, respectively. Deposits in financial institutions are required by state of Tennessee ("State") statute to be secured and collateralized by the institutions. The collateral must meet certain requirements and have a total minimum market value of 105 percent of the value of the deposits placed in the institutions less the amount protected by federal depository insurance. Collateral requirements are not applicable for financial institutions that participate in the State's collateral pool. As of June 30, 2007 and 2006, all of NES' deposits were held by financial institutions which participate in the bank collateral pool administered by the State Treasurer. Participating banks determine the aggregated balance of their public-fund accounts for the Metropolitan Government. The amount of collateral required to secure these public deposits is a certain percentage set by the State, depending on the financial institution, and must be at least that percentage of the average daily balance of public deposits held. Collected securities required to be pledged by the participating banks to protect their public-fund accounts are pledged to the State Treasurer on behalf of the bank collateral pool. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public-fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

Credit Risk – NES is authorized to invest in obligations of the U.S. Treasury and U.S. governmental agencies, mortgage-backed securities from agencies chartered by Congress, certificates of deposit, commercial paper rated A1 or equivalent and bonds of the state of Tennessee. Each of these investments is insured, registered or held by NES or its agent in NES' name.

Concentration of Credit Risk – NES has a policy prohibiting investment of greater than \$5 million or 20 percent of the total investment portfolio in any one issue, except for the U.S. government or any of its agencies. More than 5 percent of NES' investments are in U.S. Treasury investments and a Public Fund Trust. These investments are 34.0 percent and 65.5 percent, respectively, of NES' total investments.

Interest Rate Risk – NES restricts its investments to maturities less than two years from the date of settlement as a means of managing exposure to fair value losses arising from changes in interest rates.

NOTES TO FINANCIAL STATEMENTS

4. LONG-TERM DEBT

Long-term debt for the years ended June 30, 2007 and 2006, is as follows (\$000 omitted):

	Balance June 30, 2006	Deductions/ Repayments	Additions/ Amortization/ Accretion	Balance June 30, 2007
Electric System Revenue Bonds, 1996 Series A, bear interest at rates from 5.5% to 6%, maturing through May 15, 2013, interest paid semi-annually.	\$ 69,674	\$ (7,178)	\$ (1,990)	\$ 60,506
Electric System Revenue Bonds, 1998 Series A, bear interest at rates from 5.125% to 5.40%, maturing through May 15, 2023, interest paid semi-annually.	92,303	-	1,087	93,390
Electric System Revenue Bonds, 1998 Series B, bear interest at rates from 3.80% to 5.50%, maturing through May 15, 2017, interest paid semi-annually.	53,800	(3,810)	166	50,156
Electric System Revenue Bonds, 2001 Series A, bear interest at rates from 4.50% to 5.00%, maturing through May 15, 2017, interest paid semi-annually.	110,303	(1,715)	(20)	108,568
Electric System Revenue Bonds, 2001 Series B, bear interest at 5.50%, maturing through May 15, 2014, interest paid semi-annually.	18,597	-	(4)	18,593
Electric System Revenue Bonds, 2004 Series A, bear interest at rates from 4.50% to 5.00%, maturing through May 15, 2029, interest paid semi-annually.	109,366	-	3	109,369
	<u>454,043</u>	<u>\$ (12,703)</u>	<u>\$ (758)</u>	<u>440,582</u>
Less current portion of long-term debt	(12,703)			(12,491)
	<u>\$ 441,340</u>			<u>\$ 428,091</u>

NOTES TO FINANCIAL STATEMENTS

4. LONG-TERM DEBT (continued)

NES issues Revenue Bonds to provide funds primarily for capital improvements and for refundings of other bonds. All bond issues are secured by a pledge and lien on the net revenues of NES on parity with the pledge established by all bonds issued. Annual maturities on all long-term debt and related interest are as follows for each of the next five fiscal years and in five-year increments thereafter (\$000 omitted):

	Principal	Interest
2008	\$ 12,323	\$ 24,786
2009	12,182	24,946
2010	12,102	25,049
2011	12,072	25,105
2012	12,076	25,128
2013-2017	128,954	57,888
2018-2022	119,682	60,470
2023-2027	103,042	21,715
2028-2029	<u>28,149</u>	<u>2,188</u>
Total	<u>\$ 440,582</u>	<u>\$ 267,275</u>

NES had a \$25 million unsecured line of credit in 2007 and 2006 to be used for general operating purposes in case of a natural disaster. Borrowings under this line of credit bear a negotiated interest rate. At June 30, 2007 and 2006, there were no borrowings outstanding under this line of credit.

5. OTHER NON-CURRENT LIABILITIES

NES' other non-current liabilities consist primarily of TVA energy conservation program loans and customer contributions. The following table shows the activity for the year (\$000 omitted):

	June 30, 2006	Repayments	Additions	June 30, 2007
Other non-current liabilities	<u>\$ 3,992</u>	<u>\$ (2,906)</u>	<u>\$ 2,681</u>	<u>\$ 3,767</u>

NES is a fiscal intermediary for the TVA energy conservation programs whereby loans are made to NES' customers to be used in connection with TVA's Residential Energy Services Program. Pursuant to the terms of an agreement with TVA, the energy conservation loans made to NES' customers are funded and guaranteed by TVA.

NOTES TO FINANCIAL STATEMENTS

6. PENSION PLAN

The Nashville Electric Service Retirement Annuity and Survivors' Plan (the "Plan") is a single employer defined benefit pension plan administered by NES. The Plan provides retirement and survivors' benefits to members and beneficiaries. Cost-of-living adjustments are provided to members and beneficiaries annually. The Charter of the Metropolitan Government assigns the authority to establish and amend benefit provisions to NES. The Plan is not required to issue a separate financial report.

All full-time regular employees under age 65 are eligible to participate in the Plan. The vesting provision of the Plan provides for five-year cliff vesting. NES employees who retire at or after age 65 are entitled to annual retirement benefits payable monthly for life in an amount equal to 2 percent of final average compensation multiplied by years in the Plan not in excess of 35 years. Final average compensation is the average compensation in the 36 consecutive months in which compensation is highest. Unused sick leave may be used to increase credited service and benefit percentage under certain circumstances. Early retirement is an option beginning at age 55 with 15 years of credited service or at age 50 with 30 years of credited service with an actuarially-reduced monthly benefit.

If the participant has attained age 55, and his/her age plus service is 85 or greater, then there is no reduction for early receipt of the benefit. However, a participant cannot use accumulated sick leave to increase effective age to meet the requirements for this unreduced benefit. For a participant with 25 or more years of service, the minimum pension benefit is \$1,600 per month.

The contribution requirements of NES are established and may be amended by NES. The Plan is currently non-contributory. NES' practice is to typically fund at least the minimum contribution for a 30-year funding level. The current rate is 26.1 percent of annual covered payroll. NES contributed 100 percent of the required contribution for the Plan years 2007 and 2006.

The annual required contribution for the current year was determined as part of the April 1, 2007, actuarial valuation using the frozen initial liability method. The actuarial assumptions included (a) 8.0 percent investment rate of return and (b) projected salary increases of 4.5 percent. Both (a) and (b) included an inflation component. The assumptions include cost-of-living post-retirement benefit increases equal to 2 percent per year. The actuarial value of Plan assets is determined using techniques that smooth the effects of short-term volatility in the market value of investments over a three-year period. The unfunded actuarial accrual liability is being amortized over 30 years.

NOTES TO FINANCIAL STATEMENTS

6. PENSION PLAN (continued)

Schedule of employer contributions for the past three years is shown below (\$000 omitted):

Plan Year	Annual Required Contribution	Percentage Contributed
2007	\$ 14,938	100%
2006	\$ 13,165	100%
2005	\$ 12,719	100%

Schedule of funding progress for the past three years is shown below (\$000 omitted):

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability (AAL) Entry Age	Actuarial Unfunded Accrued Liability	Funded Ratio	Covered Payroll	Unfunded Actuarial Accrued Liability as a Percent of Covered Payroll
	(a)	(b)	(b-a)	(a/b)	(c)	(b-a)/c
4/1/07	\$ 270,549	\$ 331,081	\$ 60,532	0.82	\$ 58,298	103.83%
4/1/06	245,465	305,564	60,099	0.80	55,061	109.15%
4/1/05	223,611	273,464	49,853	0.82	54,008	92.31%

In 1994, NES established a non-qualified Supplemental Executive Retirement Plan (the "SERP"). The SERP was limited to certain employees of NES. Benefits accrued at the rate of 5 percent of salary for each year of credited service not to exceed 12 years and vests at the rate of 20 percent for each year of service, reduced by the percentage accrued and vested under NES' qualified plan. Effective April 1, 2005, the Board merged the SERP with the NES Retirement Annuity and Survivors' Benefit Plan. Adding the SERP benefits to the Plan increased the funding requirements for the Plan, but the amounts that had accumulated in the SERP Trust were transferred to the Plan in order to offset those increased costs. Future payments that would have been made into the SERP Trust will be directed into the Plan. At the time of conversion, no benefits had been paid from the SERP. Any change in funding requirements is reflected in the above schedule.

NOTES TO FINANCIAL STATEMENTS

7. DEFERRED COMPENSATION PLAN

NES has a deferred compensation plan (the "Plan") created in accordance with Internal Revenue Code ("IRC") Section 457. The Plan, which is available to all full-time employees, permits employees to defer a portion of their salary until future years. Employees may contribute up to the legal limit of their compensation to the Plan with NES providing a matching contribution of up to 3 percent of compensation. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. The Plan provides that assets or income of the Plan shall be used for the exclusive purpose of providing benefits for participants and their beneficiaries or defraying reasonable expenses of administration of the Plan. Since the assets of the Plan are held in custodial and annuity accounts for the exclusive benefit of Plan participants, the related assets of the Plan are not reflected on the balance sheet. Employees contributed \$3.0 million, and \$2.9 million and NES contributed \$1.6 million and \$1.5 million to the Plan during the years ended June 30, 2007 and 2006, respectively.

8. POST-EMPLOYMENT BENEFITS

In addition to the pension benefits described in Note 6 and Note 7, NES provides postretirement health care benefits to all employees who retire from NES under the provisions of the qualified plan and supplemental executive retirement plan. As of June 30, 2007, approximately 527 retirees meet those eligibility requirements. Expenses for postretirement health care benefits are recognized as retirees report claims. Expenses of \$6.8 million and \$5.7 million for the years ended June 30, 2007 and 2006, respectively, were recognized for postretirement health care.

The Governmental Accounting Standards Board has issued Statement No. 45 titled "Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions." GASB Statement No. 45 requires the accrual of liabilities of other postemployment benefits (OPEB) generally over the working careers of plan members rather than as claims are paid, which is the current practice. NES will have to comply with GASB Statement No. 45 for the fiscal year ending June 30, 2008.

To assess the magnitude of these requirements, NES commissioned a valuation report as of April 1, 2007, covering medical, dental and life insurance. The purpose of the valuation was to determine the Annual Required Contribution (ARC) under selected actuarial cost methods and amortization methods as prescribed by Statement No. 45. The Annual Required Contribution that resulted from the valuation is approximately \$15.6 million. Projected payouts of \$8.1 million resulted in net costs of \$7.6 million. The unfunded accrued liability is estimated to be \$219.4 million. The results of these evaluations must be viewed as estimates of the actual results that will occur in the future. In addition, certain assumptions have been made that will impact the results of the valuation.

NOTES TO FINANCIAL STATEMENTS

9. LEASES

Total rental expense entering into the determination of net operating revenues amounted to approximately \$874,000 and \$898,000 in 2007 and 2006, respectively. Rental expense consists primarily of payments for facilities rental and leasing arrangements for software licensing. NES leases these facilities and software under various cancelable lease agreements. Rental income is received under pole-attachment leases, which are accounted for as operating leases. These leases are cancelable. Therefore, future minimum rentals under these leases are not significant. Rental income from this source totaled \$1.9 million each year for the years ended June 30, 2007 and 2006, respectively.

10. RISK MANAGEMENT AND LIABILITY

NES is exposed to various risks of loss related to torts; theft or damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. NES is an agency of the Metropolitan Government and is covered under the Tennessee Governmental Tort Liability Act, TCA 29-20-101, et al, (the "Act") and is self-insured under the act for tort liability. NES is immune from any award or judgment for death, bodily injury and/or property damage in excess of the limits as set forth in the Act. Therefore, NES has not secured insurance coverage in excess of such limits. NES is a participant in the Metropolitan Government Insurance Pool (the "Pool") for coverage of all property losses. The Pool is currently operated as a common risk management and insurance program for several public entities, including NES, the Metropolitan Nashville Airport Authority, the Metropolitan Transit Authority and the Department of Water and Sewerage Services. The Pool is self-sustaining through member premiums. NES subrogates for all losses paid out for the negligence of other parties.

NES is self-insured for employee dental claims and self-insured up to \$100,000 for employee medical claims. The changes in the insurance reserves for medical and dental benefits for the years ended June 30, 2007 and 2006, are as follows (\$000 omitted):

Balance—June 30, 2005	\$ 1,760
Payments	(14,039)
Incurred Claims	<u>14,779</u>
Balance—June 30, 2006	2,500
Payments	(16,391)
Incurred Claims	<u>15,806</u>
Balance—June 30, 2007	<u>\$ 1,915</u>

NES continues to carry commercial insurance for all other risks of loss, including a retention with excess workers' compensation coverage and employee health and accident insurance. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

NES is party to various lawsuits filed against it in the normal course of business. Management does not believe that damages, if any, arising from outstanding litigation, will have a material effect on the financial position of NES.

NOTES TO FINANCIAL STATEMENTS**11. COMMITMENTS AND CONTINGENCIES**

NES has entered into an agreement with an outside firm, whereby the firm provides computer hardware services operation for NES' mainframe information system. The agreement will expire in November 2007. The contract is for three years and may be renewed for two additional one-year periods. NES also has entered into an agreement with an outside firm, whereby the firm provides professional services for the management, operation and support of NES' information and data processing system. The agreement will expire in October 2007. The contract may be renewed for two additional one-year periods. The minimum commitment remaining under these agreements is \$1.5 million (2008).

12. RELATED PARTY TRANSACTIONS

NES had related party balances and transactions as a result of providing electric power to the Metropolitan Government and entities of the Metropolitan Government, as well as making tax-equivalent payments to the Metropolitan Government and other payments to entities of the Metropolitan Government. These balances and transactions as of and for the years ended June 30, 2007 and 2006, are summarized as follows (\$000 omitted):

	2007	2006
Balances:		
Accounts receivable	\$ 2,370	\$ 2,509
Accounts payable	11	8
Transactions:		
Street and highway lighting revenue—Metropolitan Government	5,051	4,561
Commercial and industrial revenue—Metropolitan Government	43,757	41,006
Tax equivalents—Metropolitan Government	23,693	22,535

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value of Financial Instruments has been determined by NES using available market information. However, judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the fair values are not necessarily indicative of the amounts that NES could realize in a current market exchange. The carrying amounts of cash and short-term investments, investment of special funds, accounts receivable and accounts payable are a reasonable estimate of their fair value. The fair value of NES' long-term debt is estimated based on the quoted market prices for the same or similar issues. The fair value of NES' long-term debt is estimated to be \$461 million and \$475 million at June 30, 2007 and 2006, respectively.

Photography:

Dean Dixon, Dean Dixon Photography

David Lipscomb University geothermal field, aerial photography: Don Johnson, director of facilities, David Lipscomb University

Una Elementary students: Tim Hill, NES Corporate Communications Supervisor



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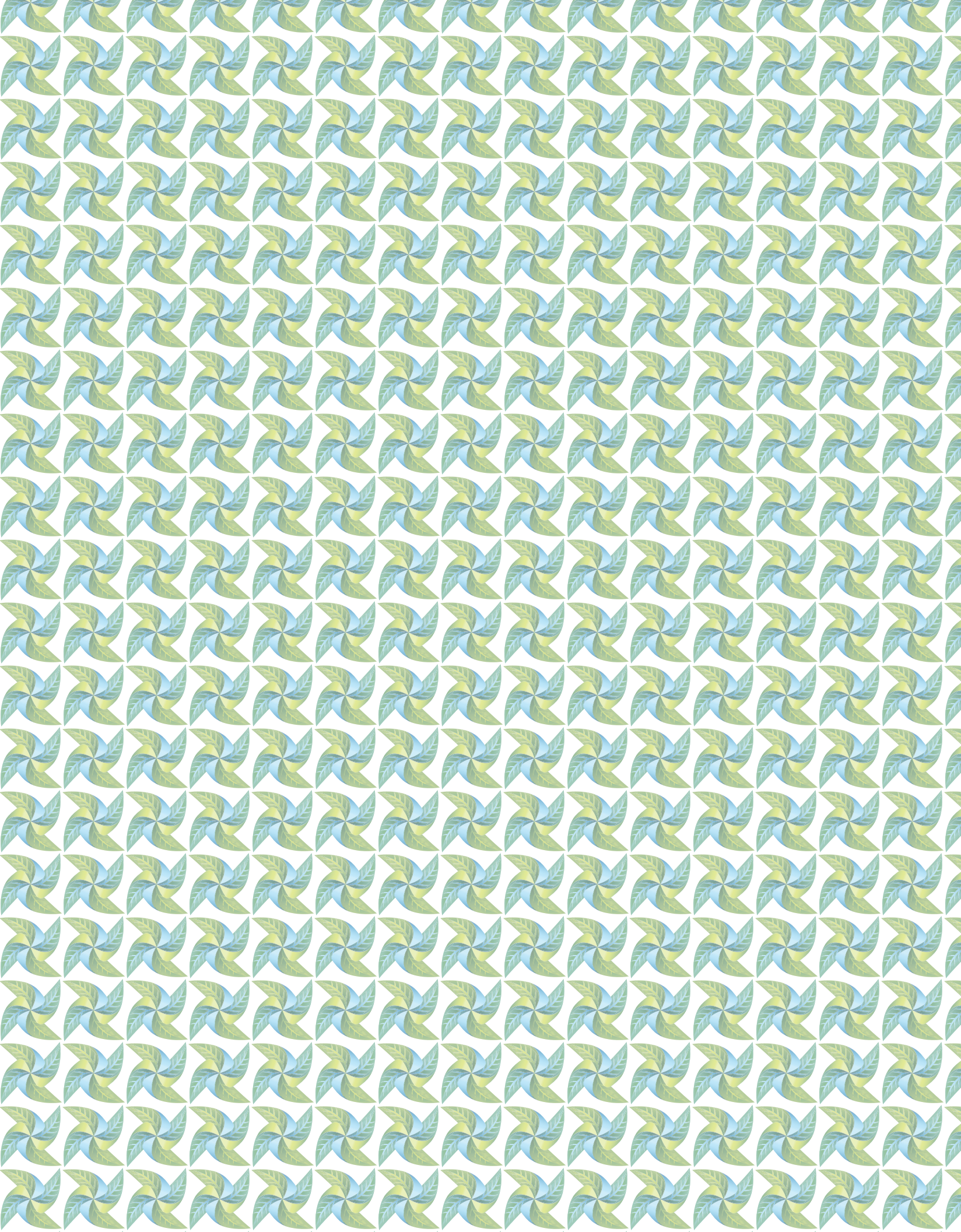
trees	water	energy	solid waste	greenhouse gases
17 fully grown	3,623 gallons	8 million Btu	792 pounds	1,339 pounds

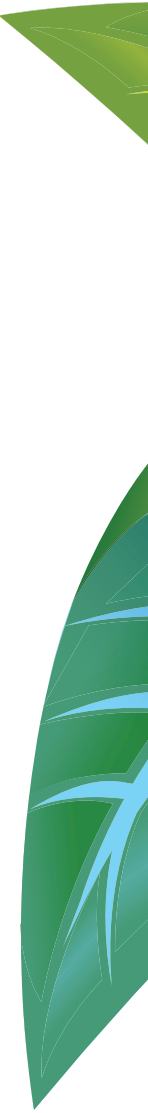
Calculations based on research by Environmental Defense and other members of the Paper Task Force.

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NASHVILLE ELECTRIC SERVICE

1214 CHURCH STREET • NASHVILLE, TN 37246 • 615-736-6900

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