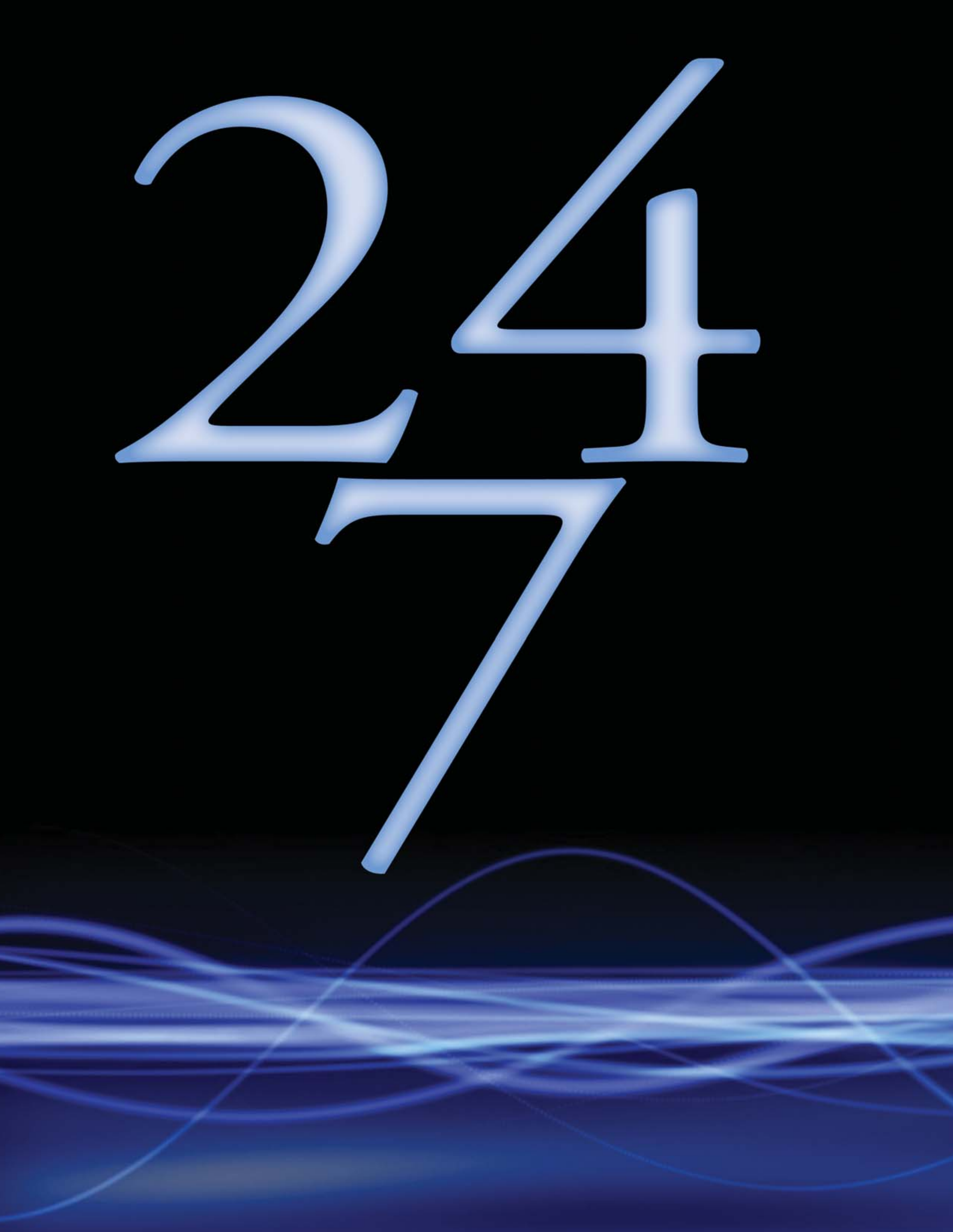
2006 ANNUAL REPORT

OUR COMMITMENT IS FULL TIME.


24/7

In today's fast-paced society, many businesses are rushing to offer 24/7 service to their customers. Twenty-four-hour pharmacies. Overnight shipping. Anytime tellers. Midnight drive-throughs. All of these are possible because of the one service that Nashville Electric Service has been providing to its customers large and small since 1939. Electricity.

Although it's something often taken for granted, economical, reliable electrical service is possible in Nashville because the dedicated people at NES embrace a commitment to work each and every day to provide continuous electric service to the citizens of our city.

For 67 years, NES has provided safe and affordable electric service 24 hours a day, seven days a week to Nashville and surrounding communities – long before 24/7 became such a popular buzz word. Throughout our years of service, we've powered the giant engines of commerce and the little conveniences that make your house a home. We've been here for every new arrival to Nashville, every step in building this community and every leap in growth Nashville has made in the last few years. We prove every day that NES is committed to this community, and we work hard to make this city shine.

Each one of our nearly 1,000 employees takes great pride in offering reliable service to our customers. From the lineman to the engineer to the customer service rep to the meter reader, we work seven days a week to make sure our customers are satisfied. That's our commitment to you.

And we've kept our promise. In the following pages, you will see just how committed we are. You will see how our commitment to reliable, quality electric service keeps a hospital able to care for the sick and newborns, and how our commitment to clear downed trees after a storm ensures customers have power. You'll also read about our commitment to teaching Nashville's children about the importance of electric safety and our commitment to innovation, which pushes us to look for new ways to meet customer needs.

We've enjoyed working for you the past 67 years. And you can bet we will be here 67 years from now, working to deliver on our commitment to this community. Because 24 hours a day, seven days a week, you can count on us.

Twenty-four hours a day, 365 days a year, Nashville Electric Service employees can be found working to provide safe, reliable and economical electric power to our customers. This core responsibility is something we work hard at each day to be certain that we are providing our customers with the level of service they expect and deserve.

But living up to our responsibility takes more than just hard work. It takes skilled employees, a commitment to teamwork, two-way communications, a desire to make our community a better place to live and, most important, a game plan for accomplishing our goals.

In July 2005, NES implemented our five-year Strategic Plan – a set of strategies we are using to address cost-containment, training and stakeholder relationships – many of which are already showing results.

This past year, specific cost-containment measures implemented in our medical plan saved NES customers more than $2 million. We addressed the issue of workplace safety by introducing a new safety program geared toward accident reduction for all personnel.

To determine how we could improve relations with stakeholders – from residential customers to large commercial customers to government officials – we conducted a series of focus groups to gather feedback so we could become more attuned and responsive to their needs.

Our employees worked on a multitude of projects to improve service and reliability. Some were large, multimillion-dollar projects that are readily visible and identifiable, such as the construction of the Old Smyrna Road Substation. But there were also numerous smaller achievements that had an impact on individual customers and our entire community, such as placing a map on the NES Web site to notify customers of where tree-trimming activities were taking place.

NES also continued our dedication to being a good corporate citizen. Last fall, we worked with Metro Parks, the Nashville Tree Foundation, and the Metro Tree Advisory Committee to plant power line-friendly trees in Neil Park. We also provided financial support to 50 community organizations, including the Girl Scouts, the Boy Scouts, and the Alcohol & Drug Council.

All of these endeavors can be tied to the key issues and strategies identified in the NES Strategic Plan. These tasks require employee commitment and thousands of work hours. It is a commitment and dedication that we proudly promote to our community wherever we go.

Nashville is experiencing tremendous growth. Our city's future is bright, and at NES we understand the role we will play in the years to come as Nashville grows. It is why we are working hard today to improve our service so we can provide our community with the energy to build Nashville's future.

Decosta Jenkins

Justin P. Wilson

Decosta Jenkins Justin P. Wilson

Nashville is in one of the nation's fastest-growing areas, and this summer it was rated as the top city in the country to live in by a popular personal finance magazine. The vibrancy and excitement in Music City are obvious to those who live, work and visit here.

A driving factor that has powered Nashville to the top of so many rankings is something that is vital to all facets of everyday life. At the office, a Titans or Predators game, a concert at the Ryman or in the Baptist Hospital maternity ward, one thing is necessary, but often taken for granted – reliable electric power.

Nashville Electric Service provides reliable and affordable power to the almost 600,000 residents of Metropolitan Davidson County, as well as to homes and businesses in the seven-county area that surrounds Nashville – a feat unmatched by most utilities of NES' size.

In keeping with NES' strategic planning goals of being No. 1 in employee and customer satisfaction, we have committed ourselves to providing the best electric service possible, and the company has received recognition recently that has validated that commitment.

As Nashville's prominence as a thriving city becomes more widely known, so too does NES' prominence as a premier utility company. Few others have bested the reliability that NES provides to its citizens, and organizations in the industry such as the American Public Power Association (APPA) have taken note.

NES recently won the prestigious Reliable Public Power Provider Award at the 2006 APPA Engineering & Operations Conference in Sacramento, Calif. NES is among only 64 of the nation's more than 2,000 public power utilities to earn the designation of Reliable Public Power Provider, and it is the largest utility to receive the APPA Platinum Award.

"Our Platinum-level designation reflects a team effort and recognizes all of the contributions that everyone makes on a daily basis," said Paul Allen, NES vice president of operations. Attaining a Platinum designation denotes that the utility has met more than 90 percent of the criteria set forth by the APPA.

The four very specific criteria that participating utilities are judged on and must prove proficiency in for award consideration are reliability, safety, training and system improvement.

"This award is a reflection of our commitment to our customers and to our community, both inside and outside of the company," Allen said. "Each employee at NES works hard to provide affordable and reliable electric service to our customers, and the accolades we have received show that customer satisfaction is a top priority to us."

As Nashville continues to grow in the coming years, perhaps the only thing more reliable than its position at the top of the national rankings is the quality service that NES provides to power that growth.


12:24

It's 12:24 a.m. The day begins with nurse Lisa Stack providing a routine check of three healthy premature infants in the Baptist Hospital Neonatal Critical Care Unit. Nashville Electric Service provides the reliable electric service that Baptist and other area hospitals require and have come to expect.

Electricity is powerful. Across our 700-square-mile service area, NES has 87,538 distribution transformers, 253 distribution substations, 5,619 miles of pole lines, almost 200,000 electric poles and up to 2,532,350 kilowatts flowing through the system at peak demand.

That's powerful stuff, and we know that with that power come many dangers and responsibilities, which is why Nashville Electric Service is dedicated to providing electric safety education to our children. From kindergarten to 12th grade, learning in the classroom or on a field trip, NES is committed to education.

NES has provided free energy and electric safety education to the Metro Public School system for more than 30 years. For the past eight years, Deborah Gardner has delivered NES' electric safety message to our kids.

"I enjoy teaching electric safety," Gardner said. "Each student I meet is eager to learn, especially when they know learning about electricity could save a life. I know students who have asked their parents to make changes to their homes after my presentation. That's when I know I've made a difference."

NES works to provide students and teachers with a wide range of educational programs targeted at making students energy-aware consumers by developing programs at each grade level.

Introducing Edison

For the past few years, we have brought energy and electric safety education to students with the help of Shirley and Wattson. This year there is a new kid in school. Edison, our friendly spokesbulb, will begin visiting schools this year to help kids learn about electricity. Look for him at a school near you.

Third-grade students from Thomas Edison Elementary School with Principal Dr. Ronald Powe and NES' Deborah Gardner.

For students in grades K-8, one of the most popular programs we've developed is the Power Town safety presentation. The presentation features a scaled replica of power poles and lines, powered by a small transformer that teaches students how and where to avoid the dangers of electricity. For our younger students, we also offer electrical safety videos and a library of energy education interactive teaching aids.

Our older students have many opportunities as well. We offer "Ask an Engineer" and "NES Behind the Scenes" sessions onsite at NES where high school students who are looking into the engineering field can talk directly with highly skilled and experienced NES engineers.

We understand that today's youth are tomorrow's customers. So while we are teaching kids about electrical safety and energy-related topics, we are equally committed to teaching conservation and energy-efficiency methods.

"Electric safety and energy conservation methods really go hand-in-hand," said Gardner. "When teaching about electricity, we train students not to touch a live wire and when to turn the lights off. You're never too young to start learning about electrical safety."

At NES, we believe educating our children today makes better consumers and more responsible citizens. That's why we will continue to offer electric safety and conservation education to our children to ensure a brighter future for everyone.


8:37
82
FROZEN

It's 8:37 a.m.

The school day is in full swing at Thomas Edison Elementary School in Antioch, Tennessee. NES Consumer Information Specialist Deborah Gardner fields students' questions after discussing electrical safety using her custom-built power-safety board.

Nashville Electric Service is no stranger to innovation. Over the years, NES has made substantial investments in technology, infrastructure and new applications to ensure safety and reliability. These advancements have helped NES become one of the top electric utilities in the country for customer satisfaction.

Following that innovative spirit, NES has rolled out a new program that will help improve upon an already favorable rating with its customers. We now offer an electronic bill-payment option at "eWiz" kiosks at 16 ExxonMobil *On the Run* convenience stores in the NES service area. These kiosks allow customers to make real-time, self-serve automated bill payments 24 hours a day.

The kiosks are, in part, a response to NES' Strategic Direction, which is to become No. 1 in customer and employee satisfaction. We know our customers are more mobile than ever before; we also know that some do not like to mail their bills, and oftentimes with a packed schedule they find it difficult to pay in person at the NES main office. The kiosks allow customers to take care of their electric bill in one stop while they fill up for gas, grab their morning coffee or stock up on snacks, along with the convenience of paying their bill whenever they want.

"At NES, we are always looking for ways to make it easier for our customers to do business with us," said NES President and CEO Decosta Jenkins, "so implementing the new kiosk program was an easy decision for us to make. If it helps our customers, then we are happy to try it out."

To make this new payment option as easy as possible, customers do not even need to have their bill to make a payment. Instead, customers can enter either their 16-digit account number or the telephone number associated with the account. Once they have entered a security code, they are able to access their information and pay their bill quickly and easily.

NES is also mindful of other reasons why established and new customers may prefer paying their electric bills at kiosks. As Middle Tennessee continues to attract immigrants from around the world, NES' customer base is reflecting those changes. We know that many newcomers to the region from other parts of the world are accustomed to different methods of conducting business. We've found that many of those people feel more comfortable paying their bills with cash. Now with the kiosk option, the local immigrant population can pay their electric bills at multiple convenient locations.

It's 10:56 a.m.

NES customer Jaron Eaton stops at an eWiz kiosk in a local ExxonMobil *On The Run* convenience store, types in her electric bill account number, pays her bill in cash and is quickly back on her way. Within seconds, the payment has been logged and credited to the customer's account, where it can be easily accessed by customer service representatives like Lisa Porter. Using the kiosk is an easy, fast and convenient way for customers to pay their electric bills.


net Access.
NASHVILLE ELECTRIC SERVICE
CREDIT SUMMARY
SATISFACTORY
LAVERGNE
LATEST-DISCONNECTS
ELECTRIC
DELL

It was a challenging spring for Nashville Electric Service's employees and customers. The storms that ripped through West Tennessee and then closer to home in early April threatened to severely challenge NES' proud tradition of rising to the occasion when disaster strikes. But, as usual, NES' dedicated employees rose to the challenge and passed with flying colors.

It all started on April 2, 2006, when one of the deadliest tornadoes in Tennessee's history plowed through Dyer and Gibson counties. NES, as it always does, reacted swiftly to the crisis, immediately sending crews 200 miles away to assess and help repair the areas most damaged by the storm, which killed 23 people and left many others injured.

It was a monumental task, and it occurred outside our service area, but NES helped get the job done. Unfortunately, there was little time to rest. Another storm was brewing, and this time it was headed for NES' own backyard. On Friday, April 7, six tornadoes tore through parts of Middle Tennessee,

killing 12 people, making that storm the most devastating in Middle Tennessee since 1933.

NES crews quickly packed up their equipment and headed back to the Nashville area, where they began working in the hardest hit areas of Goodlettsville and Hendersonville. More than 16,000 NES customers were without power, and a huge portion of the city's electrical system had been destroyed.

"I've never been in combat, never seen a war, but what I saw in my city that day was nothing short of what you might see in a war zone," said Jim Thomas, Goodlettsville city manager. "It was unlike anything I'd ever seen in my lifetime."

Challenges such as this one test the fiber of communities and organizations, and we at NES are proud of the way our crews responded to this one. On a normal day, many employees would have looked forward to heading for home after a full day on the job. Between 3 and 4 p.m. on April 7, however, it became clear that rest, meals and sleep were not in their immediate future.

Our crews, like many other emergency personnel and volunteers across several counties in Middle Tennessee, put their own safety on the line to help their neighbors. High winds, torrential rains and swirling debris made restoration of power seem like an impossible task to most people. But the numbers tell the story of the effectiveness of these brave individuals working in swift-moving teams.

At 4 p.m., the storms had knocked out power to 16,494 customers served by NES. By 5 p.m., 7,971 of them already had seen their power restored. By 8 p.m., just about four hours after the windstorm hit, all but 1,802 customers had their power back on. These outages were the biggest challenge, because most of them were in areas destroyed or severely damaged by the tornadoes. Another 600 customers had their power restored by the following evening, and just 12 customers remained without power two days after the storm.

While statistics can't convey the emotion and effort of these people who went sleepless so others could be comforted, they are very impressive numbers and show the effective work of NES crews under seemingly impossible circumstances.

"Not a day has gone by since the storm that the people of Goodlettsville have not talked about the incredible job NES did," said Thomas. "The work shown by NES, its leadership and its workers is nothing short of miraculous."


3:14

It's 3:14 p.m. NES crews work to restore power to victims of the deadly tornadoes that swept through Middle Tennessee in April.

It's official once again – Nashville is the nation's Hottest City. For the second year in a row, *Expansion Management* magazine in its January 2006 issue named Nashville-Davidson-Murfreesboro Metropolitan Statistical Area (MSA) the nation's top metro for business expansions and relocations.

That news was buoyed by Nissan North America's move of its North American corporate headquarters and more than 1,300 jobs to Music City in 2006.

These relocations and expansions are helping fuel the explosive growth of downtown, which is seeing developments such as Rolling Mill Hill as well as several other new lodging and housing options, adding to the trend of living in an urban setting and adding to the increasing excitement being generated in the downtown area.

Nashville's Minor League baseball team – the Nashville Sounds – will also have a new home downtown. Plans are under way to build a 12,500-seat baseball stadium on the site of the old Nashville Thermal Transfer Plant. Located on the banks of the Cumberland River, the ballpark is expected to be instrumental in bringing new life to the downtown area.

With the increases in new construction, newcomers and visitors, Nashville continues to experience growth in its immigrant population, creating a city with a diverse and inclusive culture. With more than 70 different languages now spoken in the city, Nashville is positioning itself as the real Athens of the South.

There's no question about it. Nashvillians are witnessing a great deal of change – they have become accustomed to seeing cranes and construction as announcements are made regarding the Viridian, Signature Tower, several new hotels and more.

But one thing hasn't changed in Nashville – NES' commitment to quality service. To support this phenomenal growth, the infrastructure must be there to meet the demand. NES officials have worked closely with Rolling Mill Hill and Sounds stadium planners to make certain the new developments have the reliable service they need to bring these projects to fruition.

The demands for service in Nashville are higher than ever, but NES is ready to meet those needs, both now and in the future. Our strategic approach to short-term and long-range capacity planning will make sure that our infrastructure – just like our dedicated employees – remains up to the task.


5:43

It's 5:43 p.m. Familiar sounds of downtown include country twang and the hustle and bustle of construction crews building new condos…and soon the crack of the bat. An NES engineer inspects the plans for the new Rolling Mill Hill area and Sounds stadium.

When most people think of the "typical" NES employee, they most likely see images of the lineman up in a bucket truck fixing a power line, a meter reader outside a house or a customer service representative on the other end of the phone. All are accurate images, but NES employees are so much more than that.

Our nearly 1,000 employees perform all sorts of valuable services, from engineering to telecommunications to fleet operations. On any given day, NES employees may be speaking to business professionals about conservation methods, drawing blueprints for substations or manning the control room as electricity reaches peak demand.

It takes all of these employees doing their jobs to ensure reliable and affordable electric service for our customers. And, what makes it possible for all of these people to do their jobs well is a superior training program.

Training is an important part of every job at NES, from the lineman to the customer service representative to the control room technician. For example, the Cable Splicer/Electrician Apprentice Program gives employees the skills and the knowledge to safely perform tasks like fixing underground cables.

"Today's world is one of continual technological advancement and high customer expectations," said NES operations manager Don Hill. "In our Cable Splicer/Electrician Apprentice Program, we are able to develop employees who meet this company's high standards for providing reliable electric service."

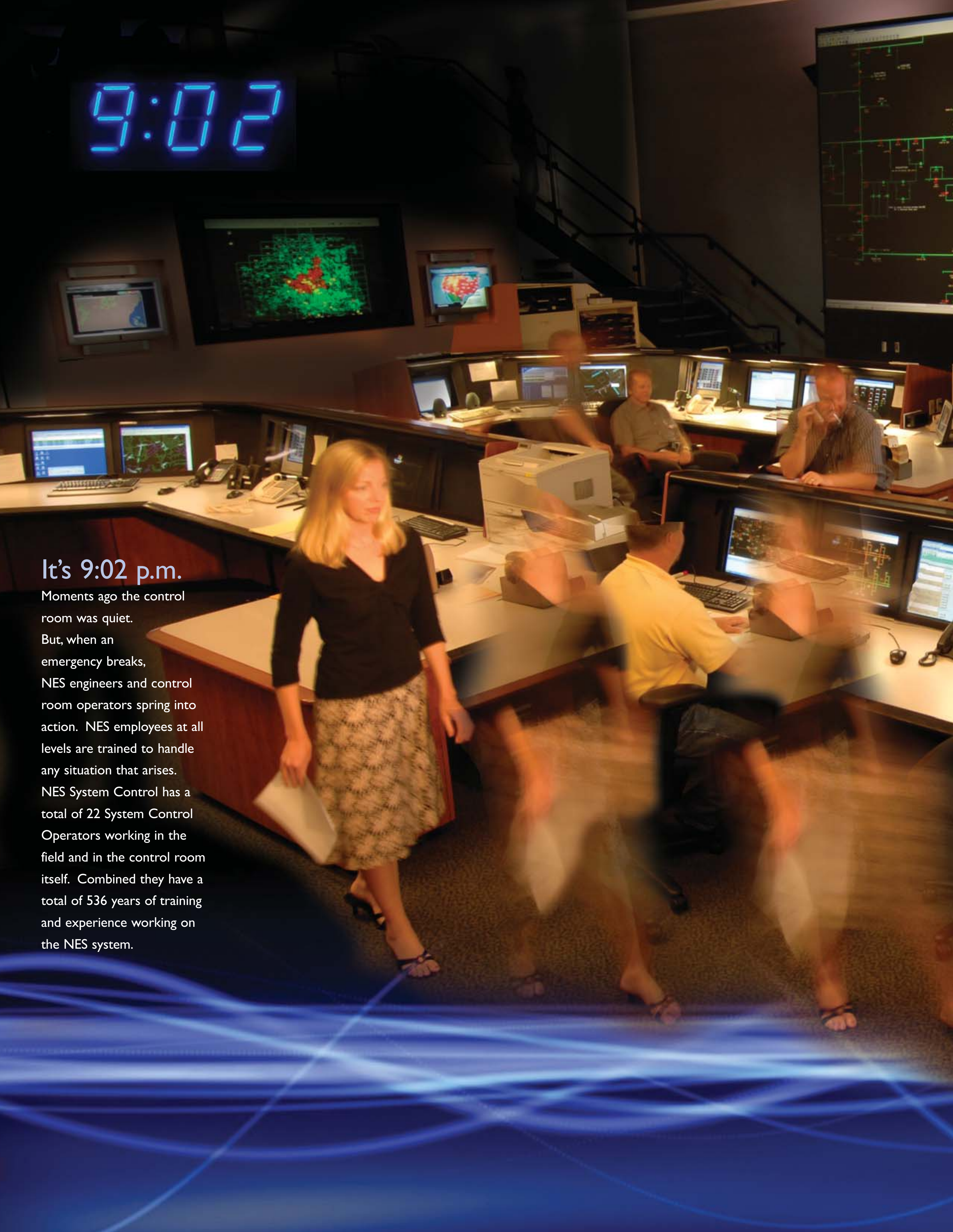
Another training program offered at NES is the Lineman Apprentice Program, a four-year program that includes workshops, labs and correspondence classes, along with on-the-job training. In addition to the apprentice program, NES also conducts two advanced lineman training classes annually to give linemen the opportunities to continue to hone and refresh their skills.

"These training programs and classes are an investment in our most important resources at NES, our employees," said operations manager Tony Richman, who supervises the Lineman Apprentice Program. "By building a workforce with the knowledge, skills and experience to handle the complex operations of a large electric utility, we are making an investment in our company, our customers and our future."

Safety and employee development are at the forefront of everything we do at NES. This past year, every employee participated in S.T.A.R.T. (Safety Training & Accident Reduction Techniques), an employee-driven, job-specific training plan introduced to produce a safety-minded culture throughout the company.

In addition to S.T.A.R.T., a cross-section of employees throughout the company worked with the Tennessee Valley Public Power Association to assess our future training needs for every NES department. The goal is to continuously produce a knowledgeable, highly skilled and productive workforce.

With this focus on education and training, NES employees will continue to lead the charge in providing reliable and affordable electric service for our customers and community.



It's 9:02 p.m.

Moments ago the control room was quiet. But, when an emergency breaks, NES engineers and control room operators spring into action. NES employees at all levels are trained to handle any situation that arises. NES System Control has a total of 22 System Control Operators working in the field and in the control room itself. Combined they have a total of 536 years of training and experience working on the NES system.

Board Members

Justin Wilson
Board Chair

Bill Blaufuss
Board Vice-chair

Mary Jo Price

Marilyn Robinson

Leo Waters

Executive Management

Decosta Jenkins
President and Chief Executive Officer

Allen Bradley
Executive Vice President and Chief Operating Officer

Dick Sittel
Vice President of Finance and Chief Financial Officer

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

TABLE OF CONTENTS

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 statement 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, 2006, and the related statements of revenues, expenses and changes in net assets, and cash flows for the year 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 audit. The financial statements of the Board as of June 30, 2005, were audited by other auditors whose report thereon dated November 16, 2005, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 audit provides 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, 2006, and its changes in net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Board's management. We have applied certain limited procedures, which consist principally of inquiries of management regarding the methods of measurement and presentation of required supplementary information. However, we did not audit this information and we do not express an opinion on it.

ACCT SIG

Nashville, Tennessee
September 8, 2006

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, 2006 and 2005. 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 in this statement for some items that will only result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

The statement of cash flows presents changes in cash and cash equivalents, resulting from operating, financing, and investing activities. This statement presents 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

Net assets may serve, over time, as a useful indicator of NES' financial position. In the case of NES, assets exceeded liabilities by $395 million at June 30, 2006. This represents an increase of $34.3 million over the previous year, all of which is attributable to operations.

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

An additional portion of NES' 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,	
	2006	**2005**
ASSETS		
CURRENT ASSETS	$188,344	$139,980
INVESTMENT OF RESTRICTED FUNDS	78,967	118,165
UTILITY PLANT, NET	703,763	674,728
ENERGY CONSERVATION PROGRAMS' NOTES	1,153	1,646
UNAMORTIZED BOND ISSUE COSTS	2,610	2,839
OTHER NONCURRENT ASSETS	379	393
TOTAL	$975,216	$937,751

STATEMENTS OF NET ASSETS ($000 omitted) con't

	June 30,	
	2006	2005
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES	$119,305	$104,103
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS	15,960	16,745
LONG-TERM DEBT	441,340	453,853
OTHER NONCURRENT LIABILITIES	3,992	2,759
NET ASSETS	394,619	360,291
TOTAL	$975,216	$937,751

Liquidity and Capital Resources

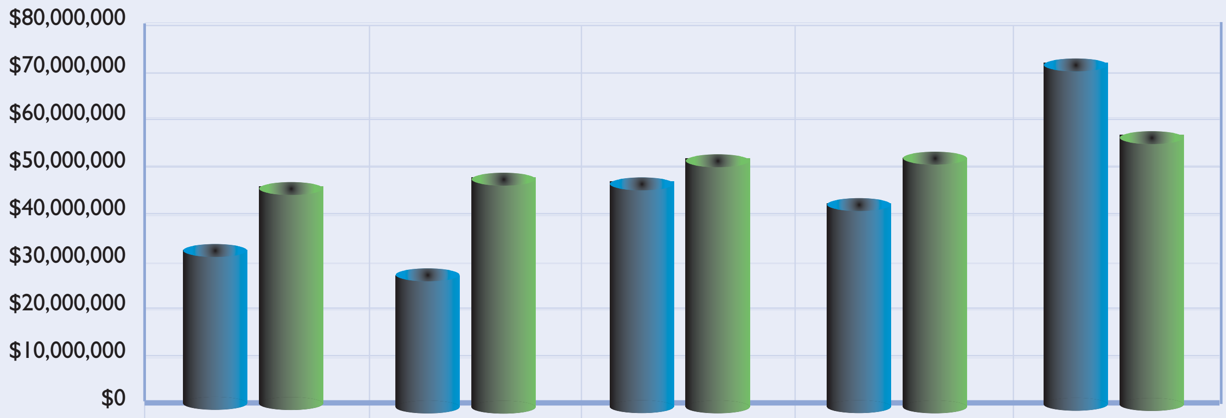
NES' ongoing sources of liquidity are operating cash flow and proceeds from tax-exempt bonds. On June 30, 2004, NES closed on the sale of $110 million Metropolitan Government of Nashville and Davidson County, Tennessee, Electric System Revenue Bonds, 2004 Series A. The purpose of the Bonds was to fund approximately 50 percent of NES' projected $193 million Capital Budget for the three fiscal years ending June 30, 2007. The remainder will be funded with operating revenues. During fiscal year 2006, NES drew down $40.5 million from these funds for capital expenditures. The remaining proceeds will be drawn down quarterly over the next fiscal year.

NES has sufficient debt capacity and a strong financial position and, therefore, expects the tax-exempt bond market to be a future source of liquidity to supplement the cash flow from operations.

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

In order to maintain its strong credit ratings, NES has adopted certain financial goals. Such goals provide a signal to NES 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. This is the first time since fiscal 1995 that this target has been met. This is the result of rate increases, favorable weather and control of expenses. Management believes that the rate increases were necessary to provide sound financial funding while meeting our goals.

COMPARISON OF CASH BALANCES TO NES' GOAL



	2002	2003	2004	2005	2006
Cash	$30,916,000	$27,974,000	$47,722,000	$40,688,000	$71,797,000
Goal	$46,514,000	$48,011,000	$50,914,000	$51,168,000	$56,928,000

Operations

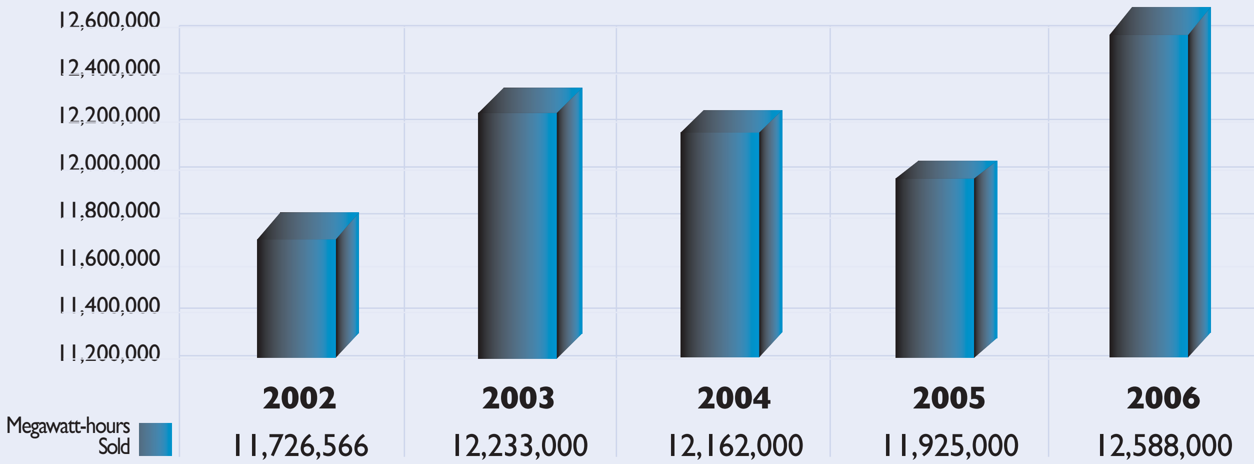
Summary Revenue & Expense Data
($000 omitted)

	Year Ended June 30, 2006	2005	Net Asset Effect
Operating Revenues	$ 903,455	$ 785,711	$ 117,744
Purchased Power	686,639	597,659	(88,980)
Margin	216,816	188,052	28,764
Operating Expenses *(excluding Depreciation and Taxes)*	102,550	108,666	6,116
Depreciation and Taxes	60,026	55,980	(4,046)
Interest Income	4,322	5,876	(1,554)
Interest Expense	24,234	24,922	688
Increase in Net Assets	$ 34,328	$ 4,360	$ 29,968

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 the period versus $770 million last year. The average realized rate on electric sales was $.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 resulting in a total retail rate increase of 8.5 percent. In April 2006 TVA further increased rates requiring 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. The reasons cited by NES were the funding of capital improvement projects which will 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. This ARC is prescribed by Statement No. 45 of the Governmental Accounting Standards Board and is required for NES in Fiscal 2008. Management currently believes that there will be sufficient resources to meet all our objectives as well as fund the ARC through fiscal year 2010 without requiring additional rate increases. However, any rate action by TVA will be passed along to the customers. 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 heating and cooling degree-days were 5,050 compared to 4,501 in 2005 or an increase of approximately 12.2 percent. Total average number of active year-to-date customers increased by 1.7 percent when compared to 2005.

Megawatt-hours Sold



Nonoperating 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 14.0 percent. Revenue in Excess of Net Bills (Late Charge) 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. NES 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. The contract is subject to earlier termination by either party on not less than 10 years' prior written notice. Purchased power was $686.6 million for the period compared to $597.7 million last year. 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 2.6 percent in 2006 compared to 2.9 percent in 2005, or a decrease of 12.6 percent.

Distribution expense for the period was $42.3 million compared to $45.7 million last year. This is a decrease of $3.4 million or 7.4 percent. The change is primarily attributable to decreases in tree-trimming, $2.3 million; overhead line maintenance $0.8 million; and miscellaneous $0.7 million. The decrease in tree-trimming resulted from the completion of the first three-year cycle.

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

Administrative and General (A&G) expenses were $42.2 million for the period compared to $43.5 million last year. This was a decrease of $1.3 million or 3.0 percent. The decrease is primarily a 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. On July 1, 2005, a new five-year labor contract was put into place. Significant changes were made to reduce the escalating cost of health care. Increased premiums were required with the retirees being required to make Medicare primarily responsible for medical claims where 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 NES by major classification of expense for the last two years:

Major Classifications of Expense ($000 Omitted)

Description	**Fiscal 2006**	**Fiscal 2005**	**Increase (Decrease)**
Labor, excluding overtime	$ 40,006	$ 40,192	(0.5%)
Benefits	23,870	26,497	(9.9%)
Tree-Trimming	11,166	13,489	(17.2%)
Outside Services	6,258	5,944	5.3%
Materials	4,266	3,853	10.7%
Transportation	3,161	3,372	(6.3%)
Accrual for Uncollectible Accounts	2,100	1,881	11.6%
Postage	1,559	1,126	38.4%
Security/Police	850	878	(3.2%)
Rentals	867	896	(3.2%)
Professional Fees	737	518	42.3%
Insurance Premiums	653	793	(17.6%)
Other	7,057	9,227	(23.5%)
	$102,550	$108,666	(5.6%)

NES' total operating expenses decreased 5.6 percent. This was accomplished to some degree by changes in the labor contract which resulted in reduced medical costs. Payroll was also down as increased retirements left unfilled positions open during the year. The labor contract allowed for employees who met the "Rule of 85" to retire without a reduced benefit. Tree-trimming decreased as this was the first year of retrimming areas that were initially trimmed three years ago. Outside services increased because of the starting of a pole treatment and inspection program. Materials were more than last year as obsolete and unusable inventory was removed from stock. Transportation charged to operations and maintenance decreased as more work was done on capital projects.

Budgetary Highlights

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

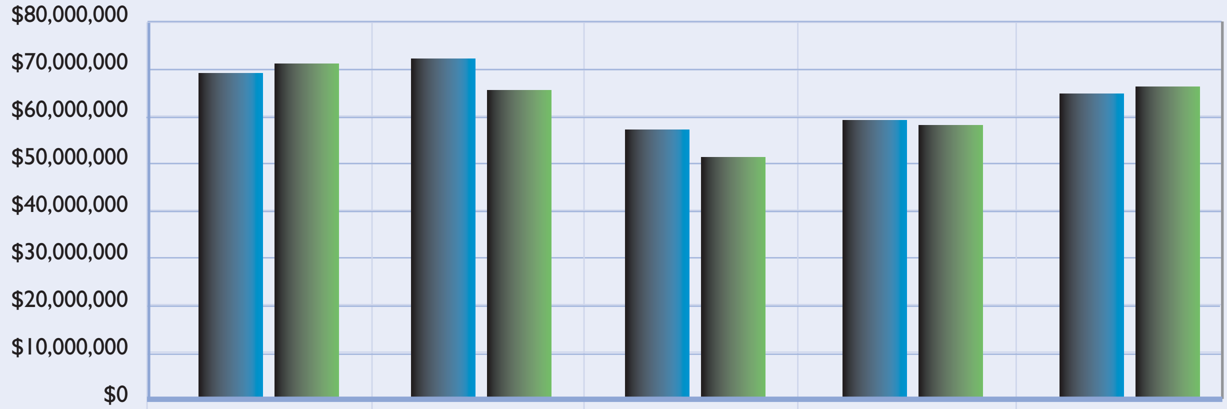
Year Ended June 30, 2006
($000 omitted)

	Budget	Actual	Over (Under)
Operating Revenues	$893,086	$903,455	$ 10,369
Purchased Power	682,964	686,639	3,675
Margin	210,122	216,816	6,694
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	24,285	24,234	(51)
Increase in Net Assets	$ 21,779	$ 34,328	$ 12,549
Capital Expenditures	$ 66,837	$ 65,936	$ (901)

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

The 2006 Capital Budget was $66.8 million; $65.9 million was spent. In total, the expenditures were over-budgeted.

CAPITAL PROGRAM



	2002	2003	2004	2005	2006
Actual	$68,938,000	$72,454,000	$57,086,000	$59,184,000	$65,936,000
Budget	$71,735,000	$65,617,000	$52,575,000	$58,778,000	$66,837,000

Capital Assets and Debt Administration

NES' 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. NES serves an additional 167 square miles located in minor portions of the adjacent counties of Cheatham, Rutherford, Robertson, Sumner, Wilson, and Williamson. Such facilities require significant annual capital and maintenance expenditures. NES' target is to have the capital expenditures funded equally from cash flow from operations and proceeds from tax-exempt bonds. NES' investment in utility plant at June 30, 2006, was $703.8 million compared to $674.7 million at June 30, 2005. 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.

NES has outstanding bonds payable of $454.0 million at June 30, 2006, compared to $466.8 million at June 30, 2005; the decrease is due to the normal retirement of bonds.

NES' financing cost may be impacted by short-term and long-term debt ratings assigned by independent rating agencies, which are based, in significant part, on NES' performance as measured by certain credit measures such as the aforementioned cash targets and debt coverage ratios. NES' debt coverage ratio for the 12 months ended June 2006 was 3.2 to 1. NES continues to exceed its goal of 2 to 1. NES' 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,

Dick Sittel

Dick Sittel
Vice President and
Chief Financial Officer

STATEMENTS OF NET ASSETS ($000 OMITTED)
JUNE 30, 2006 AND 2005

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash and short-term investments	$ 71,797	$ 40,688
Customer and other accounts receivable, less allowance for doubtful accounts of $695 and $407, respectively	101,126	83,773
Accrued interest receivable	132	1,941
Materials and supplies	13,803	11,957
Other current assets	1,486	1,621
TOTAL CURRENT ASSETS	188,344	139,980
INVESTMENT OF RESTRICTED FUNDS:		
Cash and cash equivalents	110	442
Other investments	78,857	117,723
TOTAL RESTRICTED FUNDS	78,967	118,165
UTILITY PLANT:		
Electric plant, at cost	1,104,963	1,052,427
Less accumulated depreciation	(401,200)	(377,699)
TOTAL UTILITY PLANT, NET	703,763	674,728
ENERGY CONSERVATION PROGRAMS NOTES RECEIVABLE	1,153	1,646
UNAMORTIZED BOND ISSUANCE COSTS	2,610	2,839
OTHER NONCURRENT ASSETS	379	393
TOTAL ASSETS	$975,216	$937,751

See notes to financial statements.

LIABILITIES AND NET ASSETS ($000 OMITTED)
JUNE 30, 2006 AND 2005

	2006	2005
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable for purchased power	$ 89,486	$ 77,756
Other accounts payable and accrued expenses	19,176	16,468
Customer deposits	10,643	9,879
TOTAL CURRENT LIABILITIES	119,305	104,103
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS:		
Construction contracts payable	1,110	1,628
Accrued interest payable	2,147	2,177
Current portion of long-term debt	12,703	12,940
TOTAL CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS	15,960	16,745
LONG-TERM DEBT, LESS CURRENT PORTION	441,340	453,853
OTHER NONCURRENT LIABILITIES		
Payable to TVA – energy conservation programs	1,153	1,646
Other	2,839	1,113
TOTAL OTHER NONCURRENT LIABILITIES	3,992	2,759
COMMITMENTS AND CONTINGENCIES		
NET ASSETS:		
Invested in capital assets, net of related debt	284,013	282,415
Restricted for debt payment	44,026	42,719
Unrestricted	66,580	35,157
	394,619	360,291
TOTAL LIABILITIES AND NET ASSETS	$975,216	$937,751

See notes to financial statements.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS ($000 OMITTED)
YEARS ENDED JUNE 30, 2006 AND 2005

	2006	2005
OPERATING REVENUES:		
Residential	$364,076	$308,782
Commercial and industrial	510,127	449,286
Street and highway lighting	12,816	12,328
Other	16,436	15,315
Total operating revenues	903,455	785,711
PURCHASED POWER	686,639	597,659
MARGIN	216,816	188,052
OPERATING EXPENSES:		
Distribution	42,341	45,714
Customer accounts	16,652	18,425
Customer service and information	1,331	978
General and administrative	42,226	43,549
Tax equivalents	24,062	21,993
Depreciation	35,964	33,987
Total operating expenses	162,576	164,646
Operating income	54,240	23,406
NONOPERATING REVENUE (EXPENSE):		
Interest income	4,322	5,876
Interest expense	(24,234)	(24,922)
Total nonoperating revenue (expense)	(19,912)	(19,046)
NET INCREASE IN NET ASSETS	34,328	4,360
NET ASSETS, Beginning of Year	360,291	355,931
NET ASSETS, End of Year	$394,619	$360,291

See notes to financial statements.

STATEMENTS OF CASH FLOWS ($000 OMITTED)
YEARS ENDED JUNE 30, 2006 AND 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers	$887,359	$789,331
Payments to suppliers for goods and services	(735,727)	(669,537)
Payments to employees	(40,370)	(40,543)
Payments for tax equivalents	(23,698)	(21,642)
Net cash provided by operating activities	87,564	57,609
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition and construction of utility plant	(61,646)	(49,973)
Utility plant removal costs	(4,311)	(4,554)
Salvage received from utility plant retirements	958	446
Principal payments on revenue bonds	(12,940)	(17,485)
Interest paid on revenue bonds	(23,845)	(19,295)
Net cash used in capital and related financing activities	(101,784)	(90,861)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investment securities	(151,765)	(311,194)
Proceeds from sales and maturities of investment securities	190,963	333,369
Interest on investments	6,131	4,027
Net cash provided by investing activities	45,329	26,202
NET (DECREASE) INCREASE IN CASH AND SHORT-TERM INVESTMENTS - UNRESTRICTED	31,109	(7,050)
CASH AND SHORT-TERM INVESTMENTS AT BEGINNING OF YEAR - UNRESTRICTED	40,688	47,738
CASH AND SHORT-TERM INVESTMENTS AT END OF YEAR - UNRESTRICTED	$ 71,797	$ 40,688

STATEMENTS OF CASH FLOWS ($000 OMITTED)
YEARS ENDED JUNE 30, 2006 AND 2005

	2006	2005
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 54,240	$ 23,406
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	35,964	33,987
Changes in assets and liabilities:		
Increase in customer and other accounts receivable	(17,353)	(635)
Increase in materials and supplies	(1,846)	(1,505)
Decrease (increase) in other current assets	135	(215)
Decrease in energy conservation programs notes receivable	493	731
Decrease in other noncurrent assets	14	95
Increase (decrease) in accounts payable for purchased power	11,730	(4,659)
Increase in other accounts payable and accruals	2,190	5,430
Increase in customer deposits	764	1,454
Decrease in payable to TVA energy conservation programs	(493)	(731)
Increase in other noncurrent liabilities	1,726	251
Net cash provided by operating activities	$ 87,564	$ 57,609

NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES:

During 2006 and 2005, NES charged $11.0 million and $8.3 million, respectively, to accumulated depreciation representing the cost of retired utility plant.

During 2006 and 2005, ($206) thousand and ($155) thousand, respectively, were charged to interest expense for amortization of bond premiums. Also, $656 thousand and $681 thousand were charged as amortization of the bond-issuance costs in 2006 and 2005, 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. Members of NES serve five-year staggered terms without pay. 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 plans, accrued power receivable and payable and unrecorded medical claims. These estimaes 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.

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 $857 thousand and $578 thousand in 2006 and 2005, 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 5 to 40 years. The composite straight-line rates expressed as a percentage of average depreciable plant were as follows for June 30, 2006 and 2005:

	2006	2005
Distribution Plan, 18.2 to 40 years	3.3%	3.2%
Structure and improvements, 40 to 50 years	2.0%	2.0%
Office furniture and equipment, 7.1 to 16.7 years	13.7%	14.6%
Transportation equipment, 8 to 10 years	7.3%	7.3%
Other equipment, 8 to 33.3 years	8.1%	7.5%

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 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.

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 Nonoperating 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. Nonoperating revenues and expenses consist of interest income and expense.

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

2. UTILITY PLANT AND ACCUMULATED DEPRECIATION

Utility plant activity for the years ended June 30, 2006 and 2005, was as follows ($000 omitted):

	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)	50,127	27,528	-	77,65
	$1,052,427	$63,589	$(11,053)	$1,104,963

	Balance June 30, 2004	Additions	Transfers & Retirements	Balance June 30, 2005
Distribution plant	$ 853,870	$36,060	$(5,046)	$ 884,884
Land and land rights	1,139	-	-	1,139
Structures and improvements	36,822	1,677	-	38,499
Office furniture and equipment	24,385	14,137	(1,451)	37,071
Transportation equipment	5,705	567	(346)	5,926
Other equipment	35,435	763	(1,417)	34,781
Construction work-in-progress (a)	51,357	(1,230)	-	50,127
	$1,008,713	$51,974	$(8,260)	$1,052,427

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

2. UTILITY PLANT AND ACCUMULATED DEPRECIATION (continued)

The related activity for accumulated depreciation for the years ended June 30, 2006 and 2005, was as follows ($000 omitted):

	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	16,882	2,790	(841)	-	29	18,860
	$377,699	$37,886	$(11,032)	$(4,311)	$958	$401,200

	Balance June 30, 2004	Provision	Original Cost	Cost of Removal	Salvage	Balance June 30, 2005
Distribution plant	$310,216	$27,687	$(5,046)	$(4,554)	$323	$328,626
Structures and improvements	10,906	752	-	-	-	11,658
Office furniture and equipment	16,751	4,496	(1,452)	-	6	19,801
Transportation equipment	580	426	(345)	-	71	732
Other equipment	15,625	2,627	(1,417)	-	47	16,882
	$354,078	$35,988	$(8,260)	$(4,554)	$447	$377,699

3. CASH AND INVESTMENTS

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

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	69,833	-	-	69,833	0.04
	$71,797	$46,173	$32,794	$150,764	0.37

2005

	Cash & Short-Term Investments	Bond Funds	Special Construction	Total	Weighted Average Maturity (Years)
Cash	$ 16	$ 614	$ 8,455	$ 9,085	-
U.S. Treasury Investments	-	44,282	-	44,282	0.96
Mortgage-backed Securities from Agencies Chartered by Congress	-	-	64,814	64,814	1.11
Other Investments	40,672	-	-	40,672	0.04
	$40,688	$44,896	$73,269	$158,853	0.78

3. CASH AND INVESTMENTS (continued)

Investments of $72.2 million and $88.8 million at June 30, 2006 and 2005, respectively, in U.S. Treasury investments are reported at fair value and investments of $76.6 million and $61.0 million at June 30, 2006 and 2005, 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 2006 was $931 thousand. 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 $1.5 million, which is recorded in interest income.

Custodial Credit Risk – As of June 30, 2006 and 2005, NES' cash held by financial institutions was $2.1 million and $442 thousand, respectively. Bank balances for such accounts totaled $74.4 million and $3.9 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, 2006 and 2005, 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 places no limit on the amount it may invest in any one issuer. More than 5 percent of NES' investments are in Freddie Mac, U.S. Treasury investments and a Public Fund Trust. These investments are 22.0 percent, 31.0 percent and 46.6 percent, respectively, of NES' total investments.

Interest Rate Risk – NES does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increase in interest rates.

4. LONG-TERM DEBT

Long-term debt for the years ended June 30, 2005 and 2006, is as follows ($000 omitted):

	Balance June 30, 2005	Deductions/ Additions	Additions/ Amortization/ Retirements	Balance June 30, 2006
Electric System Revenue Bonds, 1996 Series A, bear interest at rates from 5.5% to 6%, maturing through May 15, 2013, interest paid semiannually.	$ 78,344	$ (7,660)	$(1,010)	$ 69,674
Electric System Revenue Bonds, 1998 Series A, bear interest at rates from 5.125% to 5.40%, maturing through May 15, 2023, interest paid semiannually.	91,272	-	1,031	92,303
Electric System Revenue Bonds, 1998 Series B, bear interest at rates from 3.80% to 5.50%, maturing through May 15, 2017, interest paid semiannually.	57,252	(3,645)	193	53,800
Electric System Revenue Bonds, 2001 Series A, bear interest at rates from 4.50% to 5.00%, maturing through May 15, 2017, interest paid semiannually.	111,966	(1,635)	(28)	110,303
Electric System Revenue Bonds, 2001 Series B, bear interest at 5.50%, maturing through May 15, 2014, interest paid semiannually.	18,595	-	2	18,597
Electric System Revenue Bonds, 2004 Series A, bear interest at rates from 4.50% to 5.00%, maturing through May 15, 2029, interest paid semiannually.	109,364	-	2	109,366
	466,793	$(12,940)	$ 190	454,043
Less current portion of long-term debt	(12,940)			(12,703)
	$453,853			$441,340

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
2007	$ 12,504	$ 24,582
2008	12,323	24,786
2009	12,182	24,946
2010	12,102	25,049
2011	12,072	25,105
2012-2016	125,837	60,744
2017-2021	108,063	73,524
2022-2026	117,761	27,856
2027-2029	41,199	4,309
Total	$454,043	$290,901

In March 2001, NES issued $18.4 million (original issue at a premium) of Electric System Revenue Refunding Bonds, 2001 Series B Bonds, to provide funds which were used to purchase and deposit in an irrevocable trust with an escrow agent certain U.S. Government securities, the principal of and interest on which, when due, will provide funds sufficient to pay all principal and interest on a portion of 1996 Series A Bonds at their respective maturity date. As a result of this advance refunding, the liability for a portion of 1996 Series A Bonds are considered defeased. This advance refunding resulted in a deferred loss of $1.5 million for the year ended June 30, 2001. In accordance with Statement No. 23 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Refunded Debt Reported by Proprietary Activities*, the loss is reported in the accompanying financial statements as a deduction from long-term debt and is being charged to operations through the year 2014 using the effective interest method. NES completed the advance refunding to reduce its total debt-service payments over 13 years by $1.1 million and to obtain an economic gain of $697 thousand.

4. LONG-TERM DEBT (continued)

NES has a $25 million unsecured line of credit in 2006 and 2005 to be used for general operating purposes in case of a material disaster. Borrowings under this line of credit bear a negotiated interest rate. At June 30, 2006 and 2005, there were no borrowings outstanding under this line of credit.

5. OTHER NONCURRENT LIABILITIES

NES' other noncurrent 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, 2005	Repayments	Additions	June 30, 2006
Other noncurrent liabilities	$2,759	$(2,153)	$3,386	$3,992

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.

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 survivor's 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.

The contribution requirements of NES are established and may be amended by NES. The Plan is currently noncontributory. NES' policy is to fund at least the minimum contribution for a 30-year funding level. The current rate is 27.1 percent of annual covered payroll. NES contributed 100 percent of the required contribution for the Plan years 2006 and 2005.

The annual required contribution for the current year was determined as part of the April 1, 2006, 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.

If a participant has attained age 55, and age plus years of service is 85 or greater, there is no reduction for early receipt of the benefit. However, a participant cannot use accumulated sick leave to increase one's 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 $1,200 per month.

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
2006	$13,165	100%
2005	12,719	100%
2004	11,652	100%

Schedule of employer contributions 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 (AUAL)	Funded Ratio	Covered Payroll	Unfunded Actuarial Accrued Liability as a Percent of Covered Payroll
	(a)	(b)	(b-a)	(a/b)	(c)	(b-a)/c
4/1/2006	$245,465	$305,564	$60,099	0.80	$55,061	109.15%
4/1/2005	223,611	273,464	49,853	0.82	54,008	92.31%
4/1/2004	205,139	256,149	51,010	0.80	51,616	98.83%

In 1994, NES established a nonqualified 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 Survivor's 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.

7. DEFERRED COMPENSATION PLAN

NES has a deferred compensation plan (the "Plan") created in accordance with Internal Revenue Code ("IRC") Section 457. The Plan, 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 $2.9 million and $2.8 million and NES contributed $1.5 million and $1.4 million to the Plan during the years ended June 30, 2006 and 2005, respectively.

8. POST-EMPLOYMENT BENEFITS

In addition to the pension benefits described in Note 6 and Note 7, NES provides post-retirement 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, 2006, approximately 501 retirees meet those eligibility requirements. Expenses for post-retirement health care benefits are recognized as retirees report claims. Expenses of $5.7 million and $7.3 million for the years ended June 30, 2006 and 2005, respectively, were recognized for post-retirement health care.

The Governmental Accounting Standards Board (GASB) has issued statement No. 45 titled "*Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions*." GASB Statement No. 45 requires the accrual of liabilities of other post-employment benefits (OPEB) generally over the working careers of plan members rather than on a pay-as-you-go basis which is the current practice. NES will have to comply with GASB statement No. 45 for the fiscal year ending June 30, 2008.

To begin to assess the magnitude of these requirements, NES commissioned a valuation report as of January 1, 2005, 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. These ARCs varied from $19.1 million to $28.5 million based on these various assumptions. Projected payouts of $8.2 million resulted in net costs of between $10.9 million and $20.3 million. The unfunded accrued liability is estimated at between $293.4 million and $303.7 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.

9. LEASES

Total rental expense entering into the determination of net operating revenues amounted to approximately $898 thousand and $939 thousand in 2006 and 2005, 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 and $2.0 million for the years ended June 30, 2006 and 2005, 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 thousand for employee medical claims. The changes in the insurance reserves for medical and dental benefits for the years ended June 30, 2006 and 2005, are as follows ($000 omitted):

Balance – June 30, 2004	$ 1,436
Payments	(16,630)
Incurred Claims	16.954
Balance – June 30, 2005	$ 1,760
Payments	(14,039)
Incurred Claims	14,779
Balance – June 30, 2006	$ 2,500

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 two 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.

11. COMMITMENTS AND CONTINGENCIES

NES has 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 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 commitments remaining under these agreements are: $4.9 million (2007) and $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, 2006 and 2005, are summarized as follows ($000 omitted):

Balances:		
Accounts receivable	$2,509	$1,408
Accounts payable	8	96
Transactions:		
Street and highway lighting revenue – Metropolitan Government	4,561	4,445
Commercial and industrial revenue – Metropolitan Government entities	41,006	36,011
Tax equivalents – Metropolitan Government	22,535	20,535

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 $475 million and $510 million at June 30, 2006 and 2005, respectively.

President & CEO Decosta Jenkins and Chief Operating Officer Allen Bradley share a story with Dick Sittel, left, NES' long-time Chief Financial Officer who retired in 2006 after 23 years of service.

The 2005-06 executive management team would like to thank our *employees* for their unwavering commitment to 24/7 service, our *customers* for their confidence in us, and the *communities* we serve for creating a quality of life second to none.

Photography: Dean Dixon

Tornado power response photography: Tim Hill

1214 CHURCH STREET•NASHVILLE,TN37246•(615)747-3559 • WWW.NESPOWER.COM