Striking Results

Memphis Light, Gas and Water Division's

2002 Annual Report

Hometown Energy
MLGW
Working for You

About Memphis Light, Gas and Water

Memphis Light, Gas and Water is the nation's largest three-service municipal utility. Since 1939, MLGW has met the needs of Memphis and Shelby County residents by delivering reliable and affordable electricity, natural gas and water services.

Electricity is supplied to MLGW by the Tennessee Valley Authority, while natural gas is transported to us by two open access pipeline companies, Texas Gas Transmission Corporation and CMS Trunkline Gas Company. Memphis receives its water from one of the largest artesian water systems in the world, which is owned and operated by MLGW.

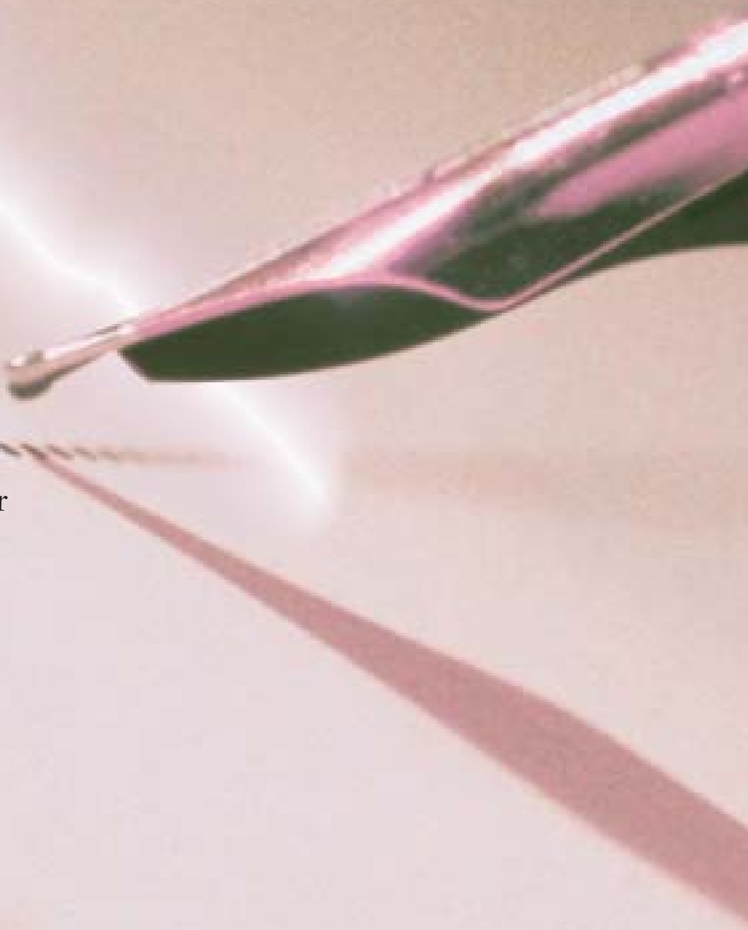
MLGW's president and five-member board of commissioners are appointed by the Mayor of Memphis.

Board of Commissioners

Olin Morris
Chairman
Dr. James L. Netters
Vice Chairman
Bishop William Graves
Franketta Guinn
L.R. Jalenak, Jr.

Executive Management Team

Herman Morris Jr.
President and CEO
Curtis Dillihunt
Senior Vice President and CAO
John McCullough
Senior Vice President, CFO and Secretary-Treasurer
Larry Thompson
Senior Vice President and COO
Christopher Bieber
Vice President, Engineering
Sherry DuBose
Vice President, Customer Service & Marketing
Michael Magness
Vice President, Human Resources
Linda Peppers
Vice President, Information Services
Wade Stinson
Vice President, Construction & Maintenance
Alonzo Weaver
Vice President, Operations
J. Maxwell Williams
Vice President and General Counsel



Letter from the President

Herman Morris Jr.
President and Chief Executive Officer
Memphis Light, Gas and Water

Striking a fine balance between being compassionate toward our community and making sound business decisions has helped Memphis Light, Gas and Water maintain its trusted leadership status for nearly 64 years. And, as a leader in our community and in the utility industry, MLGW's 2,800 employees work everyday to make sure the results of our hard work are what our customers have come to expect.

As the nation's largest three-service municipal utility, MLGW continues to set the standard for others as evidenced by our works in 2002. MLGW's efforts last year ran the gamut; from renegotiating our contract with the Tennessee Valley Authority to our strategic tree-trimming efforts, MLGW continues to think outside the box.

In 2002, we also made national headlines in the *Wall Street Journal* with our efforts to bring pre-paid power to the electric industry and our employees raised a record $768,000 for the United Way. From purchasing additional office space to expanding our electrical capacity, 2002 was a year of growth for MLGW.

While sticking to our hometown values, MLGW still manages to provide world-class service. Looking at our accomplishments over the last year, we have surely laid the groundwork toward continued success. We will continue to work toward our vision of being a trusted leader and a positive influence in our community, to satisfy our customers' needs and to contribute to the prosperity of our city.

quality products and services

Memphis Light, Gas and Water is a cornerstone in our community and industry, and it's an honor and responsibility our 2,800 employees don't take lightly. While we are the hometown energy company with hometown values, we challenge ourselves daily to be a cutting edge utility that inspires innovation and excellence in all aspects of our operations, and one which sets the standard by which others are measured. These challenges drive us to stay true to our vision of being a trusted leader in our industry and a positive influence in our community, satisfying our customers' utility service needs, and continuing to foster an environment that will contribute to the prosperity of our city.

Our service is on the "cutting edge"

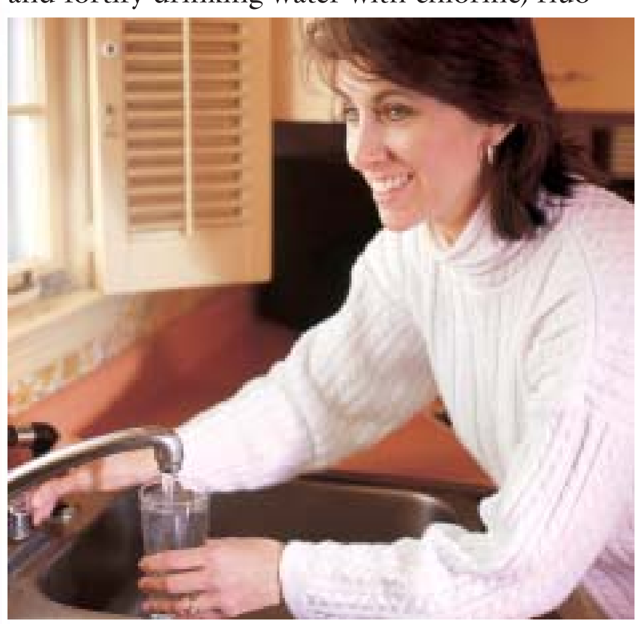
The backbone of our operations is our service, and as a leader in providing electric, gas and water services, we must preserve and enhance what customers have come to know and expect from us: reliable utilities, some of the lowest rates in the nation and some of the best service in the nation.

To preserve the integrity of our infrastructure, MLGW constantly works to keep up with the growing demands placed on our electric, gas and water systems. Our employees are dedicated to their work and view their duties in the highest regards.

We have implemented a three-year plan to build six new substations in the fastest growing areas of Memphis and Shelby County. Two of these substations were built and energized in 2002, and will help to reduce the likelihood of outages and equipment failure. Efforts are also being made to ensure the reliability and safety of our gas system. We are replacing 340 miles of cast iron pipes throughout Shelby County with more flexible polyethylene pipes. Along with reduced maintenance costs, this pipe replacement project will help ensure reliability in the event of a disaster. This project, which began in 1992, was originally slated to take place over a 30-year period. Fast-paced work has dramatically reduced the estimated completion time by seven years.

Meeting the needs of our growing community is more challenging than it has been at any other time in our history, but our employees continue to rise to the occasion. Our customer base has increased significantly in recent years, but thanks to the efficiency and unparalleled commitment of our employees, we continue to provide outstanding service. The numbers tell the story. In 1987, we had a customer/employee ratio of 281 to 1, but by 2002 the ratio has increased to 349 to 1. Despite this added responsibility, our community perception index remained in the 90th percentile in 2002.

Many cities across the nation obtain their water from surface sources such as lakes and rivers. But in Memphis, our water comes from a vast underground water system composed of clay, gravel and sand. And although Memphis sits atop an aquifer system and our water supply is abundant, MLGW works diligently to make sure this precious resource is kept safe and reliable. MLGW's 10 water-pumping stations throughout Shelby County operate more than 175 wells. We use a three-phase process to filter and fortify drinking water with chlorine, fluo-




innovative
solutions

ride and phosphate to ensure the highest standards of purity. And although our naturally pure water needs little treatment, our water chemists perform more than 38,000 tests a year to ensure the quality of our water.

Securing our future

In addition to keeping up with the growing demands of our community, we strive to keep one of our most precious resources, our employees, safe. As part of our overall seismic mitigation plan to protect our data infrastructure and to strengthen our ability to maintain critical services in the event of a disaster, we purchased additional office space in 2002. In this new $8.55 million facility, employees from our Information Center, Information Services and Service Dispatching areas will have ample space and will help us to further decentralize our operations. Employees will begin occupying this new facility when construction is complete in 2003.

While MLGW has always had a well-trained, security team to watch over our efforts on a daily basis, since the events of Sept. 11, we have also devoted additional resources to strengthen security. From workplace enhancement to employing more technological measures, we are committed to making sure key facilities are secured at all times and that our employees are able to carry out their duties in a safe environment. We will also continue seismic mitigation work at our water pumping stations to protect against damage in the event of an earthquake.

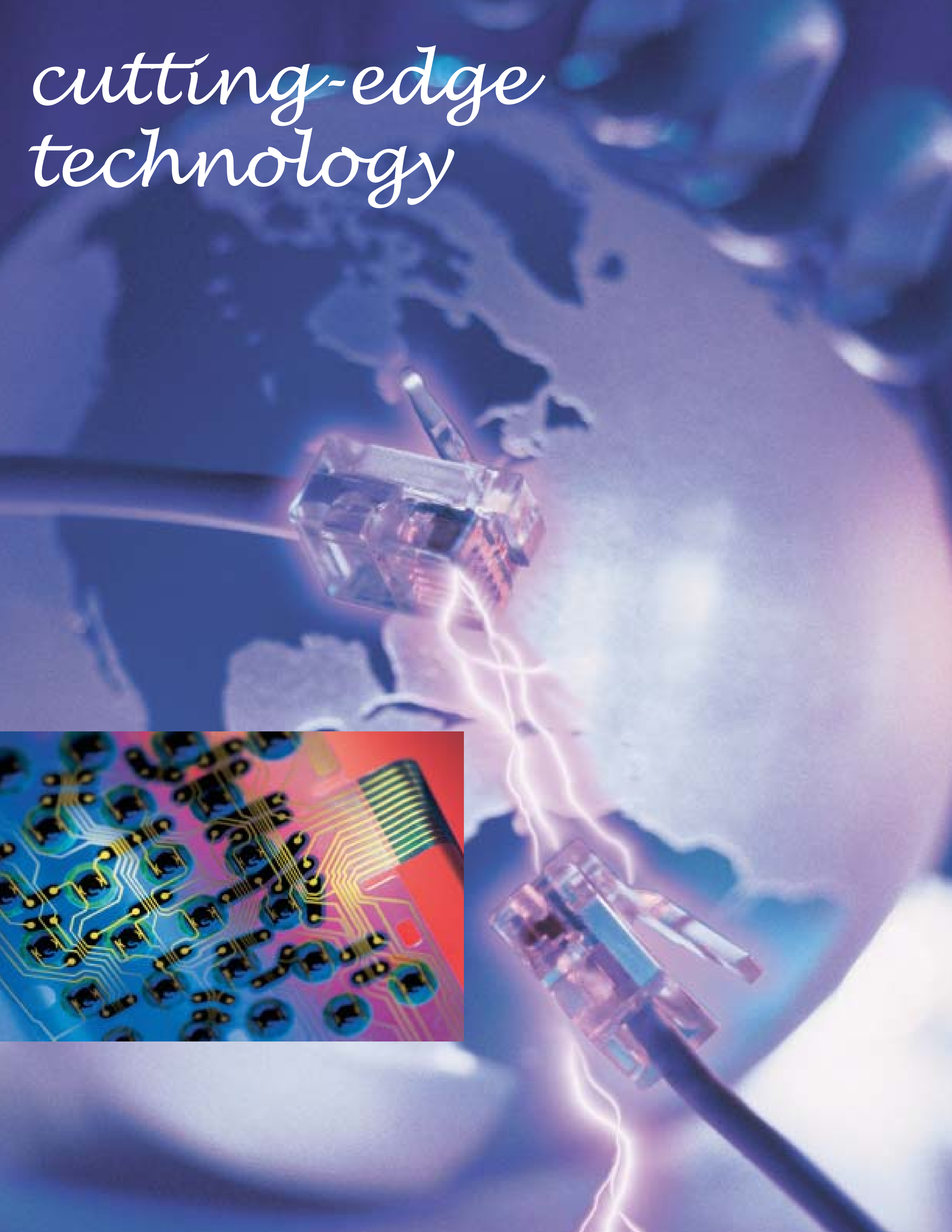
Operational Excellence

MLGW pursues many endeavors to stake our claim as the best utility for Memphis. One of the more innovative efforts we introduced in 2002 is our proposed electric prepayment plan with the Tennessee Valley Authority (TVA). Under the proposed plan, MLGW will issue tax-exempt municipal bonds to pre-purchase $1.5 billion of electricity from TVA at a discount, which would save us approximately $15 million

annually for 15 years, and keep $225 million in the local economy. If approved, this plan will be the first of its kind in the electric industry, although such agreements are allowed-and frequently occur on a smaller level in the gas industry. This proposal has been agreed upon by MLGW and TVA, but must still receive approval from the U.S. Department of Treasury, the State Legislature, the Memphis City Council and the TVA Board. We were lauded nationally in the *Wall Street Journal* for our efforts to bring this kind of innovation to the utility industry.

As the utility industry evolves, MLGW is helping shape the future for itself and its peers. To that extent, we made history in 2002 with the renegotiation of our contract with the Tennessee Valley Authority. MLGW consumes 12 percent of TVA's total production, paying more than $800 million in annual purchased power costs. This agreement, which allows us greater flexibility should electric restructuring come to Tennessee, is the result of years of arduous negotiations by MLGW. Among its benefits, the agreement gives MLGW the power to terminate its contract with TVA with five years advance notice rather than the 10 years that had been required previously. In addition, the contract gives MLGW more control and greater flexibility with its rates, rules and regulations.

cutting-edge technology



Our prudent financial management is evidenced in other accomplishments as well. For instance, in 2002 MLGW refunded $41.9 million of revenue bonds originally issued in 1993, a move that saves us and our customers $2.2 million in interest payments.

Our endeavors don't stop there. Realizing the importance for our customers and city to be on the forefront of technology, MLGW ventured during the year 2000 to close the digital divide in Memphis. The result is Memphis Networx, a partnership with some of the nation's most prominent business professionals to create a state-of-the-art fiber optic network capable of delivering telecommunications services to virtually all areas of the city. In 2002, Memphis Networx completed construction on its network infrastructure, ahead of schedule and under budget; signed on its first customer and began making revenues. The City of Memphis will benefit from increased franchise fees and tax revenue and the community will enjoy digital telecommunications services second to none.

Continuing to work for the greater good of the utility industry, MLGW's President and CEO, Herman Morris Jr., testified in 2002 before the U.S. House Transit Committee on Transportation and Infrastructure and the Subcommittee on Highways on the importance of enhancing safety and security along the nation's gas pipelines. Representing the American Gas Association and the American Public Gas Association, Morris asked congressional leaders for a single point of contact and defined threat levels as well as a joint industry/government effort to develop a comprehensive, continually evolving security and safety plan.

Optimal Service

At MLGW, our commitment to customer service defines us as an organization and directs our decisions each and every day. As public servants, being responsive to customers' needs is more than a philosophy; it's a way of life. We strive to exceed customers' expectations by

being a hometown energy company, providing world-class service.

Customers will soon reap the benefits of our new Customer Information System that will enhance our ability to access data and make integration with other MLGW systems easier. This system also will create fully automated and easier-to-read bills and eventually make online viewing of bills and billing history possible, as well as additional interactive functions.

The final testing on the $27 million system began in 2002, and is expected to be in operation in 2003.

While providing customers with enhancements to make life a little easier is important, it is just as vital that the necessities remain predictable. Our customers rely on us to keep their services on with as few interruptions as possible. Helping us to achieve this goal is the technologically advanced SCADA system (Supervisory Control and Data Acquisition) installed in 1998. This system along with the consolidation of our electric, gas and water dispatching areas and our CARES system (Computer Aided Restoration of Electric Service) have reduced our restoration time and greatly enhanced our operational efficiency. In 2001, we set out to develop a strategic plan to systematically improve our reliability. In 2002, we continued to develop that plan to ultimately eliminate all interruptions lasting more than ten hours and to reduce the number of customers experiencing more than

customer-oriented operations

three outages a year. In addition, our proactive tree trimming efforts and facility maintenance programs are just two strategies helping us meet these goals.

A major asset to MLGW's business operations is its five business offices located throughout the city to service customers. In 2002, MLGW purchased property in downtown Memphis for the construction of a new building to replace the existing Downtown Community Office. In addition, we are also in the process of obtaining land for the construction of a new building to replace the existing North Community Office.

For those customers looking to save time, our 24-hour automated pay stations are a welcomed amenity, as well as the option to make payments online at www.mlgw.com. Also at our website, customers can evaluate the energy usage of their homes and of their business through the website's "Home e-Valuation" and "Business e-Valuation" surveys. We have also added a Spanish section to our website that greatly enhances communication with the growing number of Spanish-speaking customers. The section contains information regarding services including payment programs, tips on safety, special services, energy conservation services, a company profile and contact information.

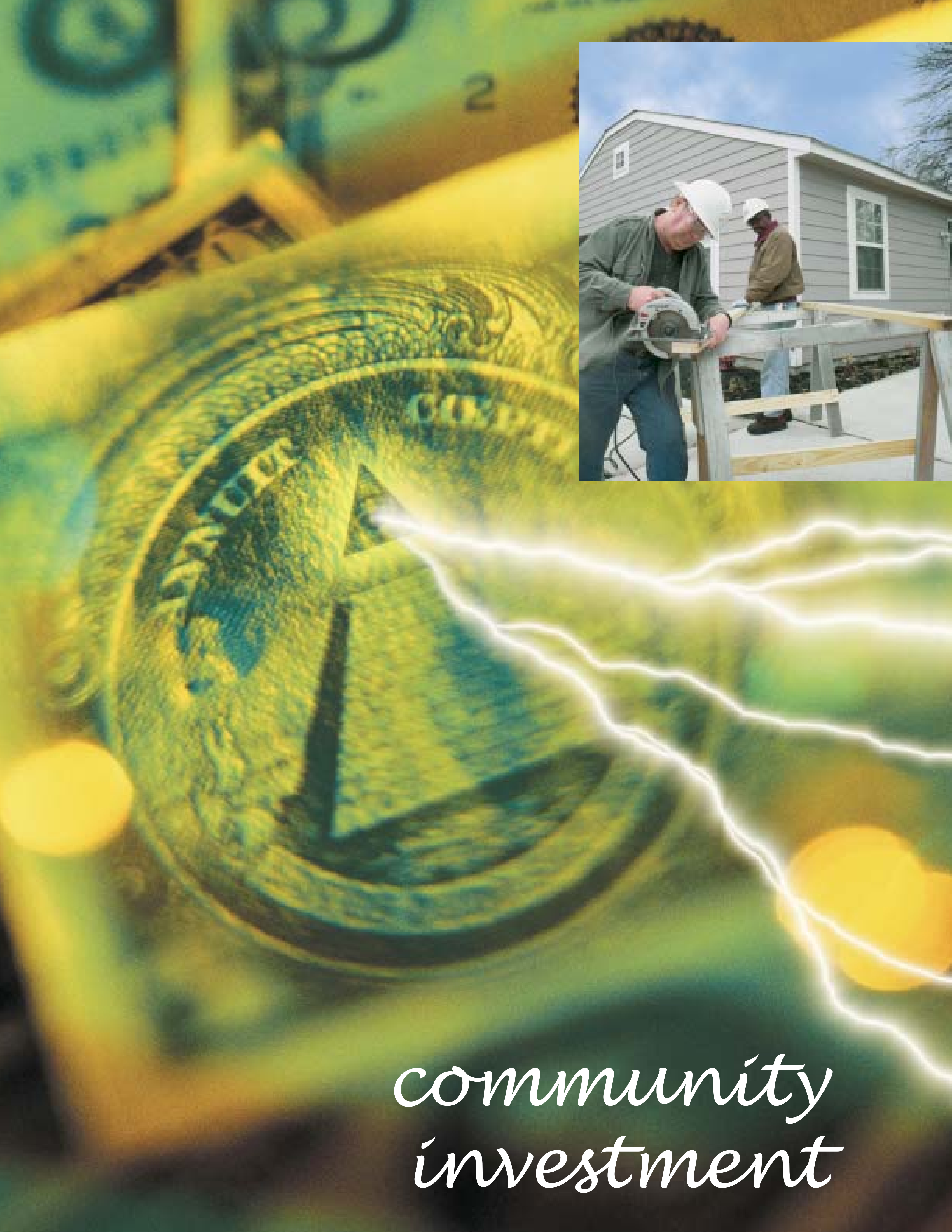
MLGW's sensitivity to customers' needs is demonstrated by the compassionate care we share with our community. In this vein, MLGW has developed several programs that address some of the unique needs of our low-income customers.

On Track is one such program that is specifically targeted toward customers with limited incomes. This free program is designed to help customers gain skills in managing their debts and paying their bills, including their MLGW debts, over a period of time. In 2002, On Track assisted 162 customers.

Sometimes the condition of a customer's home may lead to outstanding energy costs, leaving little funds for other necessities. But almost 20 years ago, MLGW developed the Project MAX program to provide assistance to the elderly, low-income and handicapped homeowners in Memphis and Shelby County. Employees volunteer to weatherize these homes in addition to caulking, painting, weather-stripping and in some cases, providing wheelchair ramp construction. In 2002, 71 employees worked from the spring through fall months to provide this assistance to 134 homeowners. But the highlight of the year was when more than 250 employees volunteered to build an energy efficient home along with Habitat for Humanity for a low-income customer. This effort was so enthusiastically embraced by employees, that in 2003, employees have pledged to build four more homes for low-income customers.

MLGW goes the extra mile to maintain a cutting-edge status and in 2001, we introduced to our customers the MAX Impact Home Weatherization Loan Program. MAX Impact provides low interest loans to qualified low-income, elderly and handicapped customers needing to make home repairs to improve their energy usage and reduce their energy consumption. In 2002, MAX Impact made loans to 225 customers totaling $566,000.

But the most gratifying aspect of MLGW's commitment to customers comes from employ-



community investment

ees who are dedicated to giving back to the community. Employees often go beyond the call of duty to help those in need. Community outreach isn't just a catch-phrase at MLGW; our employee base is made up of compassionate individuals who are a part of the community they serve. Fundraising, volunteering and donating are just some of the activities that keep MLGW in constant motion. Employees give more than $1 million annually in goods and services. When employees are not using their hands with Project MAX to weatherize homes of the low-income and elderly or working in partnership with others to build homes for Habitat for Humanity, they dig deep into their pockets to contribute financially to other causes.

MLGW employees have led the region in per capita contributions for the United Way of the Mid-South for several years, and the totals of these contributions have increased nearly every year. In 2002, employees pledged a record of more than $768,000. Among other organizations benefiting from the generosity of MLGW's employees: The Food Bank, American Cancer Society, Junior Achievement, Special Olympics, LifeBlood and Plus-1, MLGW's utility assistance program funded by customers, in which MLGW employees contributed $22,727.

Fueling the Economy

As stated in our vision, MLGW is committed to fostering an environment of economic prosperity, and because our community has seen tremendous growth within the last ten years, MLGW has been there every step of the way. Because MLGW belongs to the citizens it serves, we have a heightened interest in making certain our community thrives. MLGW works diligently with the Memphis Regional Chamber to foster an environment for business expansion and retention. In 2002, the Memphis economy grew in terms of new capital investments by $1,033,836,041, thanks in part to MLGW. Also, a recent study by Younger Associates showed that MLGW, as a cornerstone in the community, contributes to the prosperity of the city in significant ways. The study shows MLGW activities have a local economic impact of $2.15 billion annually on the Memphis economy. The study examined MLGW employment, payroll and capital spending data based on local consumer-spending levels and related tax revenues.

MLGW's Supplier Diversity program has provided a great economic boost for the city. The program offers, minority-owned, women-owned and locally-owned business enterprises (MWBE/LSB) with opportunities to do business with us. MLGW spent 22 percent of its procurement budget with these businesses in 2002 that equaled more than $20 million. Since the program's inception in 1997, we have spent $130 million with these MWBE/LSBs. MLGW is also a member of the Mid-South Minority Business Council, which provides local minority-owned businesses with the resources needed to stimulate the growth of their businesses.

environmental protection

Fostering Environmental Health

Being on the cutting edge for MLGW doesn't always mean we have to do things in high-tech fashion. And for the environment, hammer and nails, not high-tech tools, help us cultivate wildlife habitats on right-of-ways. Employees working on MLGW's right-of-ways over the years have built thousands of shelters and feeding areas for various wildlife such as deer, quail, blue birds and blue heron.

MLGW is a good steward of the environment. We are actively monitoring the water rights' issues through our participation in the Groundwater Quality Control Board, and we are a founding partner in the Ground Water Institute at the University of Memphis. In preserving the environment we work to ensure that the land we own throughout Shelby County is utilized to its fullest potential, and were recently recognized as the Tennessee Conservation League's Wildlife Conservationist of the Year. In addition, MLGW supports and contributes to a cleaner environment through alternative vehicle usage. For nearly 20 years, MLGW has operated compressed natural gas vehicles in its fleet and we recently added an electric-gas hybrid car.

As good stewards of the earth, we must be forwarding thinking in our approach to protecting the environment. In 2002, we began developing plans for a green building program that will certify homes, apartments and commercial buildings as being "green" or sustainable. The goals for the program will focus on energy conservation; water and wastewater conservation; resource-efficient materials use; indoor quality issues; and community issues. We also joined President Bush's effort along with other utilities around the country to reduce greenhouse gas emissions. As always, MLGW will continue to work toward a greener and brighter future.

Looking ahead

Looking ahead, our future is very bright. Our vision of being a trusted leader, a positive influence, meeting customers' needs and contributing to the prosperity of our city will drive us to be the 21st century's number one public power company. And though we may be a shining example to the world, we are dedicated to ensuring that our city and our customers prosper. We will continue to think outside of the box and go beyond our traditional utility responsibilities. As our community prospers and grows, we will continue to stimulate economic growth by partnering with others and by introducing innovative programs and services. While our endeavors may be cutting-edge, we still rely on the hometown values our customers have come to know and trust as part of the exceptional customer service we provide.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2002
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Memphis Light, Gas and Water
2002 Annual Report

Letter of Transmittal

2002 could best be described as a year of innovation for Memphis Light, Gas and Water as we challenged ourselves to be the best utility for Memphis. Dedicated to excellence and committed to our goals, we remained true to our vision: to be a trusted leader in our industry and a positive influence in our community, satisfying our customers' utility service needs, and continuing to foster an environment that will contribute to the prosperity of our city.

Operational Excellence

We made groundbreaking history in 2002 by proposing an innovative electric prepayment plan that would help ensure our rates remain stable. Under the plan, MLGW would issue tax-exempt bonds to pre-purchase $1.5 billion of electricity from TVA at a discount, which would save us $15 million annually, serve us for 15 years and keep $225 million in the local economy. We were lauded nationally in the *Wall Street Journal* for our efforts to bring this innovative plan to the electric industry. This proposal has been agreed upon by MLGW and TVA, but must still receive approval from the U.S. Department of Treasury, the Memphis City Council and the TVA Board.

Another major development of 2002 was the renegotiation of our contract with the Tennessee Valley Authority. This was a huge step in a direction that would allow us greater flexibility should electric restructuring come to Tennessee. The contract is the result of years of arduous negotiations by MLGW to obtain a more flexible and favorable agreement for us and our customers. Among its many benefits, the agreement gives MLGW the power to terminate its contract with TVA with five year's advance notice. This will be an important right if energy industry restructuring comes to pass.

Our prudent financial management is evidenced in other accomplishments as well. For instance, last year MLGW refinanced $41.9 million of revenue bonds originally issued in 1993, a move that will save us and our customers $2.2 million in interest payments.

Reliable service is a key component to our business and in 2002, MLGW continued to upgrade its service and preserve the integrity of its electric system by energizing two substations. These additions to our system are part of an aggressive three-year plan to build six new substations in some of the fastest growing areas of Memphis and Shelby County. Substation 73 on Old Houston Levee Rd. in Collierville was energized on July 31, just one month after substation 84 was turned on in Bartlett.

Building, constructing and relocating seemed to be a recurrent theme for MLGW in 2002. As part of our overall seismic mitigation plan to protect our data infrastructure and to strengthen our ability to maintain critical services in the event of a disaster, we purchased additional office space last year. The plan is to relocate about 300 employees from

results

our Administration Building to the new 94,000 square foot building located in the eastern part of our service area. Personnel from our Information Center, Information Services and Service Dispatching areas will move to the building in 2003. This will allow us to better respond to our customers needs.

Optimal Service

As an industry leader, MLGW must be flexible enough to embrace changes beyond our control, but strong enough to stand our ground on the old-fashioned basics that have carried us through good times and bad. Last year we implemented changes to our customer credit policy that we believed would strike a balance of good business practice for us while helping our customers facing financial hardships to meet their obligations.

Good service is essential to our success and we want to provide our customers with options that will help them. Another customer service upgrade we worked on diligently throughout 2002 is our new customer information system that will be implemented in the near future. The new system will not only allow us to better serve our customers by streamlining our operations, but customers will also notice changes such as a new 16-digit account number and a new, easy-to-read bill.

Economic Prosperity

MLGW not only recognizes the need to stimulate economic growth, but walks the walk to make this a reality. A recent study by Younger Associates shows that MLGW activities have an economic impact of $2.15 billion annually on the Memphis economy. The study comprised of MLGW employment, payroll and capital spending data based on local consumer-spending levels and related tax revenues.

In 2002 we saw more of our goals come to fruition. Memphis Networx, a venture that is creating greater telecommunications access on the wholesale market saw several mini milestones throughout the year, including completing construction on the network; signing its first customer, Kentucky Data Link; seeing its first monthly revenues; and signing additional customers in the later part of the year. Memphis Networx is just another example of how MLGW contributes to the prosperity of our city.

In 2002, the Memphis economy grew in terms of new capital investments by more than $1 billion, thanks in large part to MLGW's Economic Development department. Their efforts, combined with those of the Memphis Regional Chamber of Commerce, are crucial to bringing new business to Memphis. A total of 8,350 jobs were created and 165 companies relocated to or expanded in Memphis in 2002.

MLGW's Supplier Diversity program has also helped to spark an economic boost for the city. The program presently offers women-, minority- and locally-owned small businesses opportunities to contract with us. Last year, 22 percent of MLGW's procurement budget was spent with these groups.

To further position itself as a business authority, MLGW joined the West Tennessee

Industrial Association, which works with utilities to promote economic prosperity not just locally, but regionally throughout West Tennessee.

Beyond the Call of Duty

Community outreach isn't just a catch-phrase at MLGW; our employee base is made up of compassionate individuals who are very dedicated to community efforts that go beyond their everyday jobs.

In 2002, as part of our Southern Heritage Classic/Project MAX effort, employees eagerly volunteered for a collaborative effort with the Junior League, Habitat for Humanity and CMS Trunkline, to build an energy-efficient, low-cost house for a customer in need. Employees enjoyed the camaraderie of this experience so much that in 2003, we have pledged to build four homes for customers through Habitat for Humanity.

MLGW employees volunteer to give more than their time and talents to the community; they also give generously of their own finances. One of our proudest accomplishments comes from our association with the United Way of the Mid-South. Each year, we work with the United Way, and each year we take our giving to new heights. This year while I chaired the community-wide campaign, our employees once again reached a milestone for the company by donating their largest gift ever: more than $768,000. In all, our employees gave more than $3 million to the community through volunteerism, fundraising and financial support in 2002.

MLGW is a company in tune with its business needs and community needs, and through our well-developed strategic planning process we are accomplishing our goals each and everyday. As we continue to grow and lay the groundwork for an outstanding future, we will remain an example of model citizenship and stewardship of the resources and responsibilities for which we are given charge.

Herman Morris Jr.
President and Chief Executive Officer
Memphis Light, Gas and Water

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Management's Discussion and Analysis

This discussion and analysis is intended to be an introduction to the financial statements and notes that follow this section and should be read in conjunction with them.

Financial Statement Overview

The financial statements of Memphis Light, Gas and Water Division (MLGW) herein are comprised of the Balance Sheets, the Statements of Revenues, Expenses, and Changes in Net Assets, the Statements of Cash Flows, and the accompanying Notes.

MLGW is an Enterprise Fund of the City of Memphis, Tennessee. MLGW's periodic statements are provided to the City of Memphis and reformatted to conform to the City's format for Enterprise Funds. The City of Memphis incorporates MLGW's statements ending December 31 into its statements ending June 30.

MLGW, the nation's largest three-service utility, independently accounts for its electric, gas and water divisions. Costs are allocated to the three divisions in a manner that ensures results of operations and changes in financial position of each division are presented fairly and consistently from year to year.

Highlights

- **No rate increases** in any of the three divisions during 2002, representing the 9th consecutive year without a rate increase in the Electric Division, the 8th consecutive year in the Gas Division, and the 7th consecutive year in the Water Division.
- Increased net assets in the Electric Division by $26.8 million, the Gas Division by $7.2 million and the Water Division by $5.8 million.
- Negotiated an amended power supply contract with the Tennessee Valley Authority (TVA), providing greater flexibility and reduced exposure to potential stranded costs.
- Decreased total MLGW debt to the lowest level in 20 years.
- Refunded $41.9 million 1993 Electric Revenue Bonds netting a savings of over $2.2 million to the Electric Division.
- Paid the City of Memphis a combined total of $42.7 million for payment in lieu of taxes to support critical city services, up $2.3 million from 2001.

MLGW Negotiates Amended Power Contract with TVA

During 2002, MLGW and TVA reached agreement on an amended power contract. The contract amendment, effective August 20, 2002, provides MLGW greater flexibility if industry restructuring occurs and a rolling five-year termination notice contract. The new contract also potentially saves MLGW customers millions of dollars by exempting MLGW from the liability of stranded costs and transmission fees in the event of termination. Prior to the agreement, MLGW risked being charged over $1 billion in stranded costs, as well as the loss of $150 million in transmission credits. MLGW also gained more control and greater flexibility with rates, rules, and regulations.

Electric Division Credit Rating Upgraded

During 2002, the Electric Division refunded $41.9 million of 1993 electric revenue bonds, with a total savings of over $2.2 million in interest over the life of the bonds. At the time of the refunding, both Moody's Investors Service and Standard and Poor's upgraded the Electric Division's bond rating on the Division's remaining bonds not affected in the recent refunds. Moody's rating increased from Aa3 to Aa2 and Standard & Poor's upgraded from AA to AA+. The 2002 refunded issues rated Aa3 and AA respectively from Moody's and Standard & Poor's. Included in comments from Moody's Investors Services as reasons for the rating on the refunded issue were:

- Strong system financial operations
- Substantial and regionally important service area economy
- Low amount of rapidly retired debt and no additional debt plans

MLGW Labor Agreement

MLGW employs approximately 2,800 persons. IBEW Local No. 1288 represents approximately 1,800 non-supervisory employees throughout MLGW. 2002 was the first year of a three-year agreement including stable annual wage increases of 3.5 percent effective January 1, 2002, January 1, 2003 and January 1, 2004.

Electric Division Highlights

Operating Highlights

As indicated in Table 1 below, the Electric Division's total assets exceeded total liabilities by $717 million, up $26.8 million from 2001. Current and other assets decreased, and capital assets increased, in part due to capital expenditures paid for from cash balances, including purchase of a new business operations center and completion of two substations.

Total liabilities decreased due to a $31.1 million reduction in long-term debt.

Table 1

Electric Division Condensed Balance Sheets
December 31
(In Thousands)

	2002	2001
Current and other assets	**$ 302,155**	$339,493
Capital assets	**695,062**	659,330
Total assets	**997,217**	998,823
Current liabilities payable from current assets	**137,574**	144,233
Current liabilities payable from restricted assets	**44,960**	38,709
Non-current liabilities	**97,657**	125,619
Total liabilities	**280,191**	308,561
Net assets:		
Invested in capital assets, net of related debt	**604,074**	543,900
Restricted	**78,751**	110,462
Unrestricted	**34,201**	35,900
Total net assets	**$ 717,026**	$690,262

Over 84 percent of the net assets were related to capital assets, which included property, plant and equipment. Restricted funds comprised $78.8 million, and an additional $34.2 million of the net assets was in unrestricted funding, which can be used for on-going operations of the electric system.

Table 2

Electric Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2002 and 2001
(In Thousands)

	2002	2001
Revenues:		
Operating revenues	**$847,222**	$827,250
Non-operating revenues	**27,537**	32,977
Total revenues	**874,759**	860,227
Expenses:		
Depreciation expense	**26,427**	25,535
Purchased power	**676,281**	658,770
Other operating expense	**135,688**	128,686
Non-operating expense	**9,599**	9,248
Total expenses	**847,995**	822,239
Income before contributions in aid of construction	**26,764**	37,988
Contributions in aid of construction	**18,679**	15,871
Reduction of plant costs recovered through contributions in aid of construction	**(18,679)**	(15,871)
Changes in net assets	**26,764**	37,988
Beginning net assets	**690,262**	652,274
Ending net assets	**$717,026**	$690,262

Net assets in the Electric Division increased by almost $27 million in 2002. Operating revenues of the Electric Division totaled $847.2 million and were derived principally from the retail sales of electricity to an average of 414,823 customers. As depicted in Figure 1, commercial and residential customers comprise 87.3 percent of total sales revenue. Operating revenues were up 2.4 percent from 2001 revenues of $827.3 million. Power costs in 2002 were $676.3 million, up 2.7 percent from 2001. Contributing factors to the increase in kwh sales and power costs include an approximate 1 percent growth in the number of customers and an increase in both cooling degree days (4.5 percent) and heating degree days (9.9 percent).

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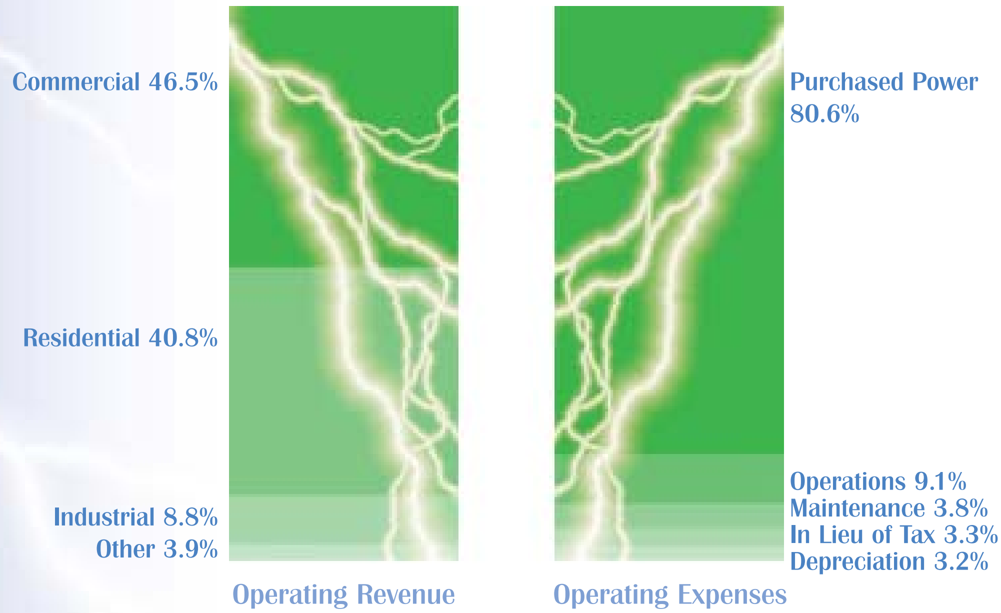
Electric Division Highlights

Figure 1:

Electric Division
Percentage of Each Utility Dollar



Of the increase in Electric Division revenues in 2002, $23.1 million was due to increased sales in residential and commercial customer classes and an additional $2.4 million from miscellaneous sources. Revenues in the industrial customer class decreased by $4.3 million due in part to the bankruptcy of a large industrial customer.

Adjustments for uncollectibles grew by $1.7 million over 2001, bringing the total adjustment for 2002 to $3.7 million. MLGW continues to be challenged with the effect of customer bankruptcies and delinquent payments. In addition, at the time of the 2003 Budget approval, the Memphis City Council required MLGW to adjust reconnect fees and also discontinue cutoffs annually during the high utility usage period of mid-December to mid-January. Although the actual impact is not known yet, it is believed that the changes to the credit policy may increase uncollectibles by several million dollars annually.

Non-operating revenues of $27.5 million were down $5.4 million from the prior year due primarily to a decrease in investment and other income, caused by declining interest rates and a lower average level of investments

Operating expenses of $838.4 million were up $25.4 million from the prior year expenses of $813.0 million. As shown in Figure 1, power costs account for over 80 percent of MLGW operating expenses. Approximately $17.5 million of the increase can be attributed to power cost, $2 million attributed to administrative and general expenses, and $2.5 million to distribution expenses. Rising medical costs contributed to the increase in administrative and general expense.

Rates

The Electric Division purchases its entire power supply requirements from the Tennessee Valley Authority (TVA). The current contract between the Electric Division and TVA was signed in 1984, with major amendments in 1990 and 2002, and includes a 5-year evergreen cancellation notice. TVA's most recent rate change occurred in October 1997 resulting in a 5.5 percent overall increase in MLGW's cost for purchased power. TVA is planning a rate increase to be effective beginning in October 2003. Preliminary figures indicate wholesale rates will increase by 8.1 percent in both the residential and commercial customer classes and decrease by 2.0 percent in the industrial customer class. Any rate increase by TVA will be passed through to MLGW customers. The Electric Division's last rate change other than TVA pass throughs was an overall 1.1 percent decrease in May 2000. Current MLGW plans call for no electric rate increases in 2003.

Rate options available to Electric Division customers include firm, seasonal, time-of-day, and interruptible service rates. Interruptible rate programs provide large commercial and industrial customers with the potential for reduced rates, along with the right for TVA to interrupt service as needed. There are 17 Electric Division customers participating in interruptible rate programs with a combined interruptible load of 238,250 kilo-watts, or about 7.5 percent of MLGW's annual peak load. TVA curtailed interruptible customers in March 2002 and January 2003. Prior to these curtailments, electric customers had not been curtailed since July 1999. Surveys conducted annually of electric rates in large U. S. cities show the Electric Division's rates are some of the most competitive in the nation.

Since 1995, Congress has been debating legislation to restructure the electric utility industry. Restructuring and competition at both the national and state levels are moving more slowly to the Tennessee Valley because of TVA's unique situation. Under existing law, TVA is the exclusive supplier of power within its statutorily defined service territory, an 80,000 square-mile area that includes virtually the entire state of Tennessee and parts of Kentucky, Mississippi, Alabama, Georgia, North Carolina, and Virginia. MLGW is effectively shielded from competition until federal restructuring legislation addresses the current law. MLGW alone, and also as a member of the Tennessee Valley Public Power Association, continues to be an active participant in the restructuring effort.

Changes in Capital Assets

Construction Activities

During 2002, the Electric Division expended $61.2 million on construction activities. Major Electric Division capital projects included the completion of two new substations in the high growth areas of eastern and northeastern Shelby county ($13.0 million), associated transmission lines ($2.9 million), revenue extensions to serve new customers ($14.2 million), purchase of transformers ($4.4 million), and purchase of a building to house a new business operations center ($8.8 million). The customer call center and critical customer service operations, as well as the mainframe computer systems, will be located in this facility.

Capital Assets

The Electric Division's investment in capital assets as of December 31, 2002, was $695.1 million, net of accumulated depreciation. This includes transmission, distribution, general plant, construction work in progress, and non-utility plant. The increase in capital assets for 2002 was 5.4 percent. Major plant additions from construction work in progress include expansion of the fiber optic cable system for communication and protective relaying, relocation of electric facilities for a new downtown sports arena, streetlights for a portion of southeast Shelby County annexed by the City of Memphis, and the purchase of meters and transformers.

Electric Division Highlights
Table 3

Electric Division Capital Assets
December 31
(In Thousands)

	2002	2001
	(net of depreciation)	
Transmission plant		
Land	**$ 3,249**	$ 3,249
Land rights	**2,220**	1,738
Structures and improvements	**4,391**	4,599
Station equipment	**34,795**	35,217
Overhead transmission equipment	**27,835**	29,206
Underground transmission equipment	**1,277**	1,359
Total	**73,767**	75,368
Distribution plant		
Land	**1,732**	1,609
Land rights	**2,076**	2,237
Structures and improvements	**2,680**	2,132
Station equipment	**21,552**	24,918
Overhead distribution equipment	**108,503**	104,203
Underground distribution equipment	**141,676**	134,845
Line transformers	**99,355**	99,927
Services and meters	**77,319**	72,421
Street lighting and signal systems	**42,576**	37,683
Total	**497,469**	479,975
General plant		
Land	**1,360**	997
Structures and improvements	**10,575**	9,601
Miscellaneous equipment	**28,243**	26,228
Total	**40,178**	36,826
Total utility plant in service	**611,414**	592,169
Non-utility plant (land)	**17,780**	17,778
Construction work in progress	**65,868**	49,383
Total	**$695,062**	$659,330

Table 4

Electric Division Schedules of Additions and Retirements to Utility Plant Years Ended December 31, 2002 and 2001 (In Thousands)

	2002	2001
Electric capital assets, beginning balance	**$1,021,466**	$ 967,196
Additions	**63,008**	62,713
Retirements and Sales	**(10,384)**	(8,443)
Electric capital assets, ending balance	**$1,074,090**	$1,021,466

Note: Utility plant, shown before depreciation, includes plant in service, non-utility plant and construction work in progress. See Table 3 of Management's Discussion and Analysis and Note 4 to the accompanying financial statements for utility plant, net of depreciation, of $695,062 and $659,330 for the years ended 2002 and 2001, respectively.

Debt Administration

The Electric Division's long-term debt, comprised of revenue bonds and a note payable, decreased $31.1 million during 2002. The current outstanding balance is $70.7 million and all existing bonds are scheduled to be retired by January 1, 2011. During 2002, the Electric Division also refunded $41.6 million of 1993 electric revenue bonds, with a savings of over $2.2 million in interest to its customers. Please see additional information in Note 7 of the accompanying financial statements.

MLGW's Electric Division Bond Covenant requires that the ratio of net revenues available for debt service to maximum amount of principal and interest for any fiscal year (coverage) must be not less than 1.25. Coverage as of December 31, 2002, was 2.96.

Current credit ratings from Moody's Investors Service are a split rating of Aa3 on the $41.6 million Electric System Revenue Refunding Bonds, Series 2002, and Aa2 on the remaining debt. Standard and Poor's also issued a split rating of AA on the Series 2002 debt and AA+ on the remaining revenue refunding bonds.

Payment In Lieu of Taxes

MLGW makes a payment in lieu of tax to the City of Memphis and the incorporated towns of Shelby County based on the formula provided by the State of Tennessee Municipal Electric System Tax Equivalent Law of 1987. The formula includes a property tax equivalency calculation plus 4% of operating revenue less power costs (three year average). The 2002 Electric Division in lieu of tax payments paid by MLGW were $27.6 million. This amount represents a 3.8 percent increase over 2001.

Other Significant Items

Memphis Networx

In August 1999, the MLGW Board of Commissioners approved the establishment of the Telecommunications Division, a subdivision of the Electric Division and in November 1999, MLGW entered into a partnership to organize a limited liability company, Memphis Networx, LLC. Subsequently, in November 2000, Memphis Broadband, LLC, a Delaware limited liability company, acquired the original partner's interest and MLGW entered into an amended and restated operating agreement

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Electric Division Highlights

with Memphis Broadband, LLC, to continue the operation of Memphis Networx, LLC. In September 2001, Memphis Networx, LLC obtained approval from the Tennessee Regulatory Authority (TRA) to provide telecommunications services in the State of Tennessee. Please see additional information in Note 9 of the accompanying financial statements.

MLGW's gross investment in Memphis Networx through 2002 has been $19.3 million, and MLGW is authorized for an investment amount up to $32 million. MLGW's share of Memphis Networx losses in 2002 was $4.2 million and the cumulative net investment in Memphis Networx was $10.1 million. Memphis Networx has completed construction and testing of the first phase of a fiber optic backbone network. Memphis Networx has successfully signed contracts with a number of local and national companies. It has signed contracts for collocation space with a local Internet provider, a data restoration company, and a managed service company. Network customers include four inter-exchange carriers, four competitive local exchange carriers, and a wireless transport aggregator. MLGW expects to fund approximately $10 million in 2003.

Extensive safeguards against cross-subsidization between MLGW and Memphis Networx have been established with the guidance of the TRA in order to avoid any unfair competitive advantage relative to other companies. An annual compliance audit is required to test compliance with Tennessee law and the requirements of the TRA's final order that granted approval for Memphis Networx to provide telecommunications services in the State of Tennessee.

Gas Division Highlights

Operating Highlights

As shown in Table 5, the Gas Division's total assets of $507 million exceeded total liabilities by $398 million, up $7.2 million from 2001.

Table 5

Gas Division Condensed Balance Sheets
December 31
(In Thousands)

	2002	2001
Current and other assets	**$186,859**	$121,785
Capital assets	**320,529**	324,881
Total assets	**507,388**	446,666
Current liabilities payable from current assets	**82,908**	40,741
Current liabilities payable from restricted assets	**6,667**	6,626
Non-current liabilities	**19,475**	8,131
Total liabilities	**109,050**	55,498
Net assets:		
Invested in capital assets, net of related debt	**320,529**	324,881
Restricted	**24,654**	28,948
Unrestricted	**53,155**	37,339
Total net assets	**$398,338**	$391,168

Current and other assets increased by $65.1 million due to an increase in cash, accounts receivable, and the transfer of assets related to the Williams Companies pipelines from capital to a lease receivable. The change in total liabilities increased primarily due to accounts payable for gas purchases and unearned return on the Williams Companies lease receivable.

Table 6

Gas Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Year Ended December 31, 2002 and 2001
(In Thousands)

	2002	2001
Revenues:		
Operating revenues	**$254,864**	$343,462
Non-operating revenues	**6,935**	8,156
Total revenues	**261,799**	351,618
Expenses:		
Depreciation expense	**10,679**	10,307
Purchased gas	**173,635**	281,199
Other operating expense	**70,315**	64,064
Non-operating expense	**—**	619
Total expenses	**254,629**	356,189
Income before contributions in aid of construction	**7,170**	(4,571)
Contributions in aid of construction	**1,926**	5,967
Reduction of plant costs recovered through contributions in aid of construction	**(1,926)**	(5,967)
Beginning net assets	**391,168**	395,739
Ending net assets	**$398,338**	$391,168

Over 80 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $24.7 million of the net assets and the remaining $53.2 million was in unrestricted asset accounts used for on-going operations of the gas system.

Changes in net assets for the Gas Division amounted to an increase of $7.2 million between 2001 and 2002. Operating revenues of the Gas Division totaled $254.9 million and were derived principally from the retail sale of gas to an average of 310,794 customers and transportation of gas to an average of 37 customers. The largest amount of revenue is derived from residential customers as identified in Figure 2.

Operating revenues were down 25.8 percent from 2001 due mainly to lower winter wholesale gas prices. Gas costs in 2002 amounted to $173.6 million, down 38.3 percent from 2001.

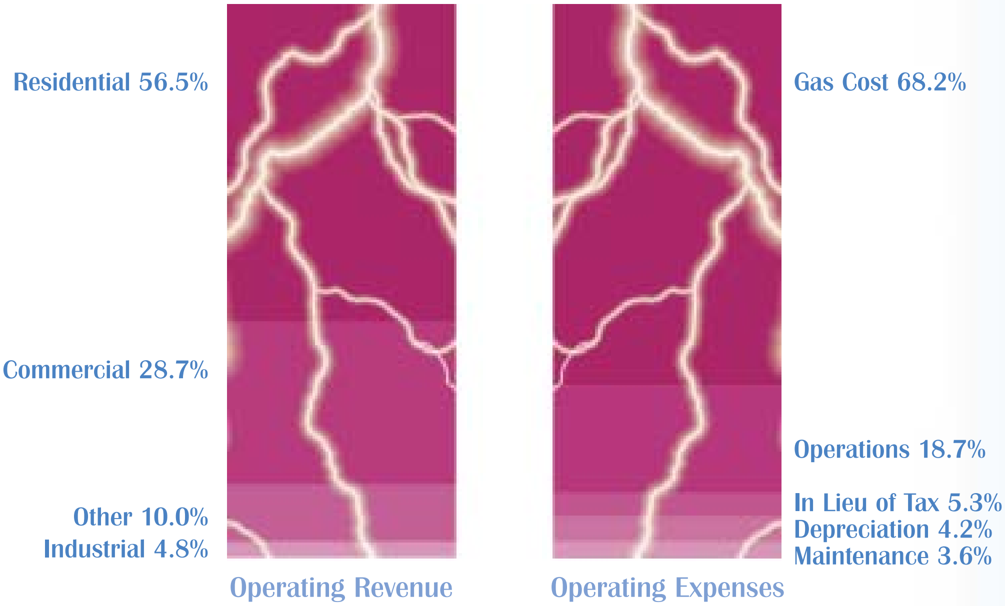
Sales increased by about 4.6 percent due in part to an approximate 1 percent increase in the number of customers and a 9.9 percent increase in heating degree days.

Gas Division Highlights

Adjustments for uncollectibles, which are deducted from gross operating revenues, amounted to $2 million during 2002, down 66.8 percent from last year. The abnormally high gas prices during the 2001 winter season caused many customers to be unable to pay their utility bills on schedule, thereby significantly increasing the adjustments for uncollectibles. As expected, 2002's expense trended downward due to lower wholesale natural gas prices.

Figure 2: Gas Division

Percentage of Each Utility Dollar



Total operating expenses of $254.6 million were down $100.9 million from 2001. Lower gas costs attributed to a $107.6 million decrease. There was also a $4.8 million increase in administrative and general expenses in 2002 and a $750,000 increase in distribution maintenance expense. Rising medical costs contributed to the increase in administrative and general expense.

Rates

Since deregulation of the natural gas industry in 1993, the Gas Division has purchased its gas requirements on the open market from a variety of producers and marketers. These requirements are delivered through two interstate pipelines, Texas Gas Transmission and Trunkline Gas Company. Texas Gas Transmission also provides storage service through a bundled service rate that combines transmission and storage services. The Gas Division also owns and operates two LNG (Liquefied Natural Gas) facilities, which are used to help meet peak day requirements.

Rates offered to Gas Division customers include firm, interruptible and transportation service. Through MLGW's "Prime Gas Program," large industrial customers also have the option for MLGW to purchase gas on behalf of the customer in the spot market and transport this gas to their facility.

The cost of wholesale gas supply is controlled using combinations of spot market purchases, short-term contracts, long-term contracts, hedging, and management of storage and LNG supplies.

Variations in the Gas Division's gas costs above/below a baseline included in the basic rate schedules are billed/refunded to customers through a monthly Purchased Gas Adjustment (PGA).

In January 1999, MLGW decreased commercial and industrial customers' rates, ranging by customer class, from 8.7 percent to 28.0 percent. MLGW also temporarily lowered residential gas rates by 13.0 percent for the period January through April 2001. Current MLGW plans call for no gas rate increases in 2003.

Changes in Capital Assets

Construction Activities

During 2002, the Gas Division expended $21.6 million in construction costs. Included in the construction costs were cast iron system retrofits ($3.7 million) and revenue extensions ($2.9 million). The retrofit of the cast iron system project, which began in 1991 and was requested by the Tennessee Regulatory Authority, provides for replacement of 320 miles of old cast iron main that requires excessive maintenance. The expenditures for this program cover replacing approximately 72,000 feet of cast iron main per year. To date, 187 miles of cast iron main have been replaced (56 percent complete). Another major project is the purchase and installation of a new customer information system. Costs included in 2002 were $6.9 million. The total cost of the new system is estimated to be $26.6 million with implementation scheduled for 2003. The new system will be windows based, more user-friendly and will increase efficiency in daily operations. Customers will have new billing flexibility and a new billing format. The Electric and Water Divisions will share the cost of the new system with the Gas Division through the payment of rents to the Gas Division. During 2002, $14.6 million less contributions of $4.1 million was transferred from construction in progress to lease receivable pursuant to an agreement with the Williams Companies whereby Williams is leasing two pipelines under a direct financing lease.

Capital Assets

The Gas Division's investment in capital assets as of December 31, 2002, was $320.5 million, net of accumulated depreciation. This includes production, distribution, general plant, construction work in progress, non-utility plant and plant held for future use. The decrease in capital assets for 2002 was 1.3 percent. Major additions to plant from work in progress were the replacement of cast iron main and the purchase of meters and transportation equipment.

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Gas Division Highlights

Table 7

Gas Division Capital Assets
December 31
(In Thousands)

	2002	2001
	(net of depreciation)	
Natural gas processing plant		
Land	**$ 4,185**	$ 4,185
Structures and improvements	**5,950**	6,093
Storage equipment	**12,200**	12,499
Processing equipment	**13,226**	14,252
Miscellaneous equipment	**3,201**	3,471
Total	**38,762**	40,500
Distribution plant		
Land	**244**	244
Mains	**131,097**	127,861
Measuring and regulating equipment	**5,249**	5,413
Services and meters	**59,334**	58,162
Total	**195,924**	191,680
General plant		
Land	**2,573**	2,936
Structures and improvements	**23,555**	24,736
Office furniture and fixtures	**6,953**	7,349
Miscellaneous equipment	**8,405**	9,936
Total	**41,486**	44,957
Total utility plant in service	**276,172**	277,137
Non-utility plant		
Land	**66**	66
Other non-utility plant	**165**	1,492
Total non-utility plant	**231**	1,558
Plant held for future use	**149**	149
Construction work in progress	**43,977**	46,037
Total	**$320,529**	$324,881

Table 8

Gas Division Schedules of Additions and Retirements to Utility Plant Years Ended December 31, 2002 and 2001 (In Thousands)

	2002	2001
Gas capital assets, beginning balance	**$481,919**	$467,594
Additions	**21,645**	16,793
Retirements and Sales	**(4,491)**	(2,468)
Transfer of Williams pipeline capital lease	**(10,544)**	—
Gas capital assets, ending balance	**$488,529**	$481,919

Note: Utility plant, shown before depreciation, includes plant in service, non-utility plant and construction work in progress. See Table 7 of Management's Discussion and Analysis and Note 4 to the accompanying financial statements for utility plant, net of depreciation, of $320,529 and $324,881 for the years ended 2002 and 2001, respectively.

Debt Administration

The Gas Division does not have any long-term debt at this time.

Payment In Lieu of Taxes

MLGW makes a payment in lieu of tax to the City of Memphis and the incorporated towns of Shelby County based on the formula provided by the Municipal Gas System Tax Equivalent Law of 1987. The formula includes a property tax equivalency calculation plus 4 percent of operating revenue less gas costs (three-year average.) In 2002, MLGW Gas Division paid in lieu of tax payments of $13.4 million, which represents a 3.1 percent increase over 2001. In addition, the payment in lieu of tax represents 5.3 percent of the total Gas Division operating budget.

Water Division Highlights

Operating Highlights

As shown in Table 9, the Water Division's total assets exceeded total liabilities by over $256 million. Current and other assets decreased $8.3 million, with over half of the decrease from the prior year due primarily to construction activities drawing down the construction fund. Non-current liabilities also decreased due to a $6.7 million reduction in long-term debt. Almost 76 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $33.4 million of the net assets and the remaining $28.3 million was in unrestricted asset accounts used for on-going operations of the water system.

Water Division Highlights

Table 9

Water Division Condensed Balance Sheets
December 31
(In Thousands)

	2002	2001
Current and other assets	**$ 82,859**	$ 91,196
Capital assets	**235,328**	226,762
Total assets	**318,187**	317,958
Current liabilities payable from current assets	**15,316**	16,614
Current liabilities payable from restricted assets	**10,350**	8,187
Non-current liabilities	**36,069**	42,459
Total liabilities	**61,735**	67,260
Net assets:		
Invested in capital assets, net of related debt	**194,776**	181,675
Restricted	**33,416**	38,381
Unrestricted	**28,260**	30,642
Total net assets	**$256,452**	$250,698

Table 10

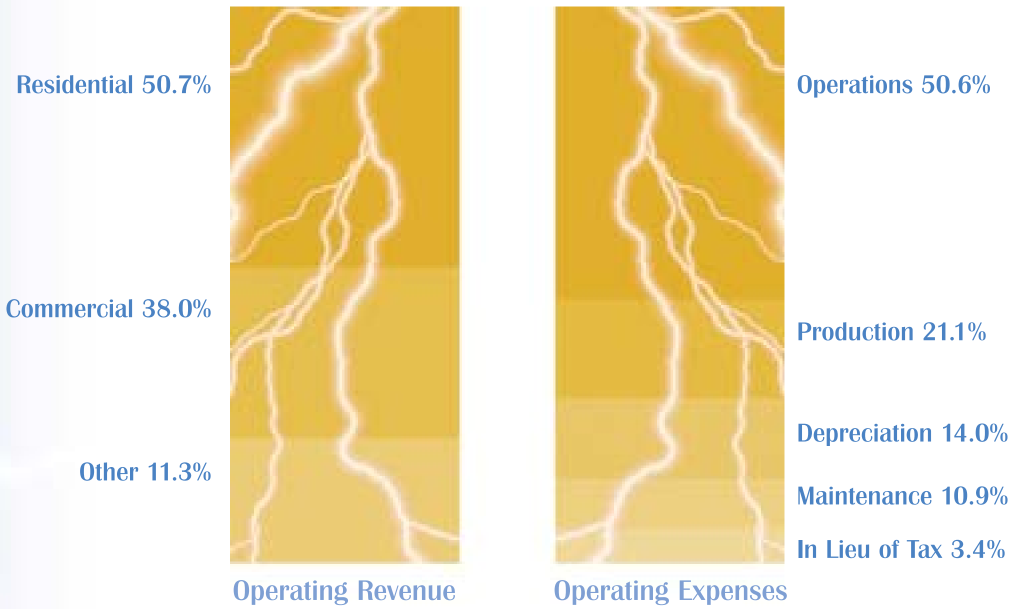
Water Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2002 and 2001
(In Thousands)

	2002	2001
Revenues:		
Operating revenues	**$ 56,259**	$ 59,771
Non-operating revenues	**2,294**	3,858
Total revenues	**58,553**	63,629
Expenses:		
Depreciation expense	**7,125**	6,555
Other operating expense	**43,568**	41,738
Non-operating expense	**2,106**	2,512
Total expenses	**52,799**	50,805
Income before contribution in aid of construction	**5,754**	12,824
Contributions in aid of construction	**5,451**	6,687
Reduction of plant costs recovered through contributions in aid of construction	**(5,451)**	(6,687)
Beginning net assets	**250,698**	237,874
Ending net assets	**$256,452**	$250,698

Net assets for the Water Division increased by almost $5.8 million in 2002 as shown in Table 10. For the twelve months ending December 31, 2002, operating revenues of the Water Division totaled $56.3 million and were derived principally from the sale of water to an average of 251,641 customers. Figure 3 depicts the breakdown of Water Division revenues, of which 50.7 percent are derived from residential customers. Operating revenues were down 5.9 percent from 2001, due in part to an increase in annual precipitation from 2001, reducing the normal summer seasonal demands.

Figure 3: Water Division

Percentage of Each Utility Dollar



Total operating expense of $50.7 million increased in 2002 by $2.4 million. Almost $900,000 of the difference was due to the full year impact of the Water Division payment in lieu of tax to the City of Memphis. Depreciation expense accounted for another $600,000 of the difference. The remainder was due to various increases in administrative and general expense, which includes the increase in medical expenses.

Source of Supply

Memphis is the largest city in the world to rely solely on artesian wells for its water supply. The aquifer system, providing an abundant supply of pure water, is one of Memphis' greatest natural resources. Four water-bearing layers of sand and gravel are situated from 50 to 2,600 feet below the Memphis ground surface. Memphis's water supply is drawn from the second layer of sand at depths that range from 350 to 1,000 feet.

Rates

The Water Division distributes water on an exclusive basis throughout the City of Memphis and the unincorporated areas of Shelby County. Water is also sold to three adjacent utility systems located in the communities of Bartlett, Collierville and Germantown. The Division is required by Section 696 of the MLGW Charter to furnish to the City free, sufficient water for all fire hydrants, fire protection,

Water Division Highlights

street sprinkling, the Memphis school board, the Memphis Crematory, police stations and any additional water deemed expedient for public purposes.

Rates offered to Water Division customers include firm, temporary, resale, and fire protection service with differentiation in rates between customers inside the city limits of Memphis and customers outside the city. The Water Division's last rate change occurred in January 1995 and represented an overall 15.0 percent increase. In 1999, the Water Division purchased the Shelby County Board of Public Utilities (SCBPU) water system with approximately 21,000 customers. Per the terms of the purchase agreement, former SCBPU customers receive a 3.0 percent rate decrease annually each July 1 from 1999 through 2003. In July 2003, the SCBPU rates will be equal to the Division's county water rates. Current MLGW plans call for no water rate increases in 2003.

Changes in Capital Assets

Construction Activities

The Water Division expended $17.2 million in construction activities during 2002. Included in this amount is a non-cash acquisition adjustment of $1.0 million relating to the amortization of the purchase of Shelby County Board of Public Utilities (SCBU). Projects for 2002 included improvements and purchases for various pumping stations ($1.5 million), purchase of meters ($2.7 million) and purchase of data processing equipment ($4.6 million).

The Water Division is also currently in the design phase of a $3.5 million hazard mitigation grant for the Lichterman and McCord pumping stations. This project will have capital expenditures through 2006, of which 75 percent is expected to be reimbursed by the Federal Emergency Management Agency (FEMA). Total expenditures for the grant in 2002 exceeded $258,000.

Capital Assets

The Water Division's investment in capital assets as of December 31, 2002, was $235.3 million, net of accumulated depreciation. This includes production, distribution, general plant, construction work in progress and the Shelby County Board of Public Utilities (SCBPU) Acquisition Adjustment. The acquisition adjustment is being amortized over a twenty-year period beginning in 1999. The increase in capital assets for 2002 was 3.8 percent. Major additions to plant include emergency generators at two pumping stations, three wells at Davis pumping station, and the purchase of meters and computer equipment.

Table 11

Water Division Capital Assets
December 31
(In Thousands)

	2002	2001
	(net of depreciation)	
Pumping and treatment plant		
Land	**$ 2,922**	$ 2,921
Structures and improvements	**21,937**	22,258
Wells and springs	**16,545**	15,577
Pumping equipment and treatment	**26,758**	23,502
Total	**68,162**	64,258
Transmission & distribution plant		
Land	**171**	171
Structures and improvements	**4**	4
Mains	**87,939**	87,004
Services and meters	**29,732**	27,199
Hydrants	**10,616**	10,088
Total	**128,462**	124,466
General plant		
Land	**1**	1
Structures and improvements	**2,216**	2,229
Miscellaneous equipment	**20,956**	20,929
Total	**23,173**	23,159
Total utility plant in service	**219,797**	211,883
Shelby County acquisition adjustment	**(15,898)**	(16,863)
Construction work in progress	**31,429**	31,742
Total	**$235,328**	$226,762

results

Water Division Highlights

Table 12

Water Division Schedules of Additions and Retirements to Utility Plant
Years Ended December 31, 2002 and 2001
(In Thousands)

	2002	2001
Water capital assets, beginning balance	**$338,809**	$326,524
Additions	**17,192**	12,884
Retirements and Sales	**(1,219)**	(599)
Water capital assets, ending balance	**$354,782**	$338,809

Note: Utility plant, shown before depreciation, includes plant in service, non-utility plant, construction work in progress and Shelby County acquisition adjustment. See Table 11 of Management's Discussion and Analysis and Note 4 to the accompanying financial statements for utility plant, net of depreciation, of $235,328 and $226,762 for the years ended 2002 and 2001.

Debt Administration

The Water Division's long-term debt, comprised of revenue bonds, decreased $6.7 million during 2002 due to scheduled repayments. The current outstanding balance is $33.8 million and all bonds are scheduled to be retired by 2012. Please see additional information in Note 7 of the accompanying financial statements.

MLGW's Water Division Bond Covenant requires that the ratio of net revenues to maximum amount of principal and interest for any fiscal year (coverage) must be not less than 1.25. Coverage as of December 31, 2002, was 1.92.

Payment In Lieu of Taxes

As of July 1, 2001, MLGW entered into an agreement with the City of Memphis requiring MLGW to pay to the City, as payment in lieu of taxes, an amount equal to $1.7 million in each of the City of Memphis' fiscal years 2002 and 2003 (July-June), and $2.5 million in each of fiscal years 2004 through 2028. This payment is to be paid out of the General Reserve Fund of the Water Division. The Water Division paid $1.7 million during MLGW's fiscal year ending December 31, 2002. This was the first full year of the in lieu of tax to be paid by the Water Division. MLGW's 2003 payment will increase to $2.1 million as a result of half of the year being at the new rate of $2.5 million per the City of Memphis' fiscal year.

Other Significant Items

Environmental Protection Agency (EPA) Grant

During 2002, MLGW applied for and received a vulnerability assessment and related security improvement grant designated for large drinking water utilities. The objective of this grant is to reduce the vulnerabilities that large drinking water utilities present in a terrorist attack. The total grant is for $118,000 and the project will be completed in 2003.

Additional Financial Information

This financial report is designed to provide MLGW's customers, investors and other interested parties with a general overview of financial position and results of operations. Questions concerning any of the information provided in this report or requests for additional information should be addressed to Manager of General Accounting, Memphis Light, Gas and Water Division, P.O. Box 430, Memphis, TN 38101, or call 901-528-4221.

Financial Statements
Report of Independent Auditors

Board of Commissioners
Memphis Light, Gas and Water Division

We have audited the accompanying financial statements of the Electric, Gas and Water divisions of Memphis Light, Gas and Water Division, a division of the City of Memphis, Tennessee, as of and for the years ended December 31, 2002 and 2001. These financial statements are the responsibility of management of Memphis Light, Gas and Water Division. 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 and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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.

As discussed in Note 1, the financial statements present only the Electric, Gas and Water divisions (the Divisions) of Memphis Light, Gas and Water Division, a division of the City of Memphis, Tennessee, and are not intended to present fairly the financial position of the City of Memphis, Tennessee, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds in conformity with accounting principles generally accepted in the United States.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Electric, Gas and Water divisions of Memphis Light, Gas and Water Division as of December 31, 2002 and 2001, and the results of operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards,* we have also issued our report dated February 28, 2003, on our consideration of the Divisions' internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Our audits were performed for the purpose of forming an opinion on the financial statements of Memphis Light, Gas and Water Division, taken as a whole. Management's discussion and analysis on pages 1 through 19 is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

Memphis, Tennessee
February 28, 2003

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Balance Sheets

December 31, 2002 and 2001 (In thousands)

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Assets						
Current assets:						
Cash and cash equivalents	**$ 46,807**	$ 50,946	**$ 40,417**	$ 23,427	**$ 15,844**	$ 17,066
Investments	**42,852**	40,598	**18,293**	8,587	**14,304**	13,629
Accounts receivable, less allowance for doubtful accounts	**56,529**	58,824	**35,817**	23,425	**8,878**	10,667
Deferred purchased power and gas cost	**23,727**	25,401	**24,598**	20,789	**—**	—
Inventories	**12,805**	13,374	**7,931**	7,548	**1,358**	1,404
Collateral held in trust for securities on loan	**18,934**	22,712	**9,449**	6,783	**7,682**	8,612
Other current assets	**895**	1,396	**2,200**	286	**—**	—
Total current assets	**202,549**	213,251	**138,705**	90,845	**48,066**	51,378
Non-current assets:						
Restricted funds:						
Construction	**9,013**	30,834	**12,086**	16,110	**9,530**	15,276
Insurance reserves - injuries and damages	**1,952**	2,628	**1,379**	808	**960**	1,026
Insurance reserves - casualties and general	**12,079**	11,620	**4,202**	4,149	**5,079**	4,878
Medical benefit	**4,229**	5,257	**2,003**	2,490	**1,187**	1,475
Customer deposits	**16,537**	12,900	**4,984**	5,391	**1,133**	963
Bond reserve and debt service	**34,941**	47,223	**—**	—	**15,527**	14,763
Total restricted funds	**78,751**	110,462	**24,654**	28,948	**33,416**	38,381
Other assets:						
Deferred charges	**—**	—	**1,813**	1,992	**—**	—
Unamortized debt expense	**—**	626	**—**	—	**—**	—
Notes receivable	**10,762**	12,265	**21,687**	—	**1,377**	1,437
Investment in Memphis Networx	**10,093**	2,889	**—**	—	**—**	—
Total other assets	**20,855**	15,780	**23,500**	1,992	**1,377**	1,437
Utility plant	**1,074,090**	1,021,466	**488,529**	481,919	**354,782**	338,809
Less accumulated depreciation	**(379,028)**	(362,136)	**(168,000)**	(157,038)	**(119,454)**	(112,047)
Utility plant, net	**695,062**	659,330	**320,529**	324,881	**235,328**	226,762
Total non-current assets	**794,668**	785,572	**368,683**	355,821	**270,121**	266,580
Total assets	**$997,217**	$ 998,823	**$507,388**	$ 446,666	**$318,187**	$ 317,958

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Liabilities						
Current liabilities:						
Accounts payable - purchased power and gas	**$ 91,171**	$ 94,622	**$ 49,900**	$ 26,806	**$ —**	$ —
Other accounts payable, accrued expenses, and deferrals	**26,503**	25,986	**23,559**	7,152	**7,634**	8,002
Notes payable	**966**	913	**—**	—	**—**	—
Collateral subject to return to borrowers	**18,934**	22,712	**9,449**	6,783	**7,682**	8,612
Total current liabilities payable from current assets	**137,574**	144,233	**82,908**	40,741	**15,316**	16,614
Current liabilities payable from restricted assets:						
Construction	**3,210**	2,331	**1,354**	1,333	**1,054**	730
Customer deposits	**6,119**	4,773	**1,844**	1,995	**419**	356
Medical benefit accrual	**4,229**	5,257	**2,090**	2,490	**1,187**	1,475
Insurance reserves - injuries and damages	**1,952**	2,628	**1,379**	808	**960**	1,026
Bonds payable	**29,450**	23,720	**—**	—	**6,730**	4,600
Total current liabilities payable from restricted assets	**44,960**	38,709	**6,667**	6,626	**10,350**	8,187
Total current liabilities	**182,534**	182,942	**89,575**	47,367	**25,666**	24,801
Non-current liabilities:						
Customer advances for construction	**8,176**	8,274	**600**	494	**9**	9
Customer deposits	**10,418**	8,127	**3,140**	3,396	**714**	607
Payable to TVA - energy conservation loans	**903**	912	**—**	—	**—**	—
Other	**7,505**	6,530	**15,735**	4,241	**1,524**	1,356
Long-term debt	**70,655**	101,776	**—**	—	**33,822**	40,487
Total non-current liabilities	**97,657**	125,619	**19,475**	8,131	**36,069**	42,459
Total liabilities	**280,191**	308,561	**109,050**	55,498	**61,735**	67,260
Net assets						
Invested in capital assets, net of related debt	**604,074**	543,900	**320,529**	324,881	**194,776**	181,675
Restricted for debt service and construction	**78,751**	110,462	**24,654**	28,948	**33,416**	38,381
Unrestricted	**34,201**	35,900	**53,155**	37,339	**28,260**	30,642
Total net assets	**717,026**	690,262	**398,338**	391,168	**256,452**	250,698
Total liabilities and net assets	**$997,217**	$ 998,823	**$507,388**	$ 446,666	**$318,187**	$ 317,958

See accompanying notes.

results

Statements of Revenues, Expenses and Changes in Net Assets

Years Ended December 31, 2002 and 2001 (In Thousands)

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Operating revenues:						
Sales and service revenues	**$829,603**	$ 811,149	**$239,799**	$ 328,719	**$ 52,272**	$ 55,782
Other revenues	**17,619**	16,101	**15,065**	14,743	**3,987**	3,989
Total operating revenues	**847,222**	827,250	**254,864**	343,462	**56,259**	59,771
Operating expenses:						
Purchased power and gas for resale	**676,281**	658,770	**173,635**	281,199	**—**	—
Production	**—**	—	**—**	—	**10,693**	10,821
Operation	**76,442**	72,869	**47,669**	42,503	**25,637**	24,260
Maintenance	**31,613**	29,186	**9,289**	8,604	**5,532**	5,804
Depreciation	**26,427**	25,535	**10,679**	10,307	**7,125**	6,555
Payments in lieu of taxes	**27,633**	26,631	**13,357**	12,957	**1,706**	853
	838,396	812,991	**254,629**	355,570	**50,693**	48,293
Operating income (loss)	**8,826**	14,259	**235**	(12,108)	**5,566**	11,478
Non-operating revenues (expenses):						
Contributions in aid of construction	**18,679**	15,871	**1,926**	5,967	**5,451**	6,687
Reduction of plant costs recovered through contributions in aid of construction	**(18,679)**	(15,871)	**(1,926)**	(5,967)	**(5,451)**	(6,687)
Transmission credits	**21,599**	21,049	**—**	—	**—**	—
Investment and other income	**5,938**	11,928	**6,935**	8,156	**2,294**	3,858
Interest expense	**(5,281)**	(7,000)	**—**	(619)	**(2,041)**	(2,382)
Amortization	**(165)**	(216)	**—**	—	**(65)**	(130)
Telecommunications division loss	**(4,153)**	(2,032)	**—**	—	**—**	—
Total non-operating revenues	**17,938**	23,729	**6,935**	7,537	**188**	1,346
Change in net assets	**26,764**	37,988	**7,170**	(4,571)	**5,754**	12,824
Net assets, beginning of year	**690,262**	652,274	**391,168**	395,739	**250,698**	237,874
Net assets, end of year	**$717,026**	$ 690,262	**$398,338**	$ 391,168	**$256,452**	$ 250,698

See accompanying notes.

Statements of Cash Flows

Years Ended December 31, 2002 and 2001 (In Thousands)

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Cash flow from operating activities:						
Receipts from customers and users	**$890,544**	$ 887,335	**$280,923**	$ 416,427	**$ 98,922**	$ 101,439
Payments to suppliers	**(693,090)**	(685,476)	**(198,166)**	(356,524)	**(26,822)**	(30,645)
Payments to employees	**(79,026)**	(78,178)	**(42,758)**	(35,350)	**(25,221)**	(23,578)
Payments from (to) other Division funds	**(5,856)**	(23,264)	—	17,778	—	—
Payments to City and County	—	—	**(22,185)**	(22,020)	**(35,598)**	(34,047)
Payments for taxes	**(55,370)**	(52,338)	**(13,672)**	(13,240)	**(1,893)**	(1,021)
Other receipts	**8,033**	16,050	**31,670**	13,170	**5,172**	4,786
Net cash provided by operating activities	**65,235**	64,129	**35,812**	20,241	**14,560**	16,934
Cash flows from capital and related financing activities:						
Purchase and construction of utility plant	**(62,159)**	(62,250)	**(18,744)**	(31,391)	**(15,691)**	(11,228)
Proceeds from sale of land	—	—	**1,818**	17,778	—	—
Decrease (increase) in unamortized debt expense	**461**	(37)	—	—	—	339
Proceeds from issuance of long-term debt	**41,625**	—	—	—	—	18,135
Principal payments on long-term debt	**(66,963)**	(24,063)	—	—	**(4,600)**	(26,385)
Interest expense on other debt	**(802)**	(867)	—	(619)	—	—
Interest expense on bonds	**(4,479)**	(6,133)	—	—	**(2,041)**	(2,382)
Net cash used in capital and related financing activities	**(92,317)**	(93,350)	**(16,926)**	(14,232)	**(22,332)**	(21,521)
Cash flows from investing activities:						
Payments received on notes receivable	**1,503**	866	—	—	**60**	139
Investment income earned on investments	**3,340**	8,879	**3,516**	4,121	**2,200**	3,606
Net change in restricted funds	**31,711**	(12,454)	**4,294**	(16,183)	**4,965**	(119)
Net change in investments	**(2,254)**	28,395	**(9,706)**	13,791	**(675)**	5,975
Investment in Memphis Networx	**(11,357)**	(3,533)	—	—	—	—
Net cash provided by (used in) investing activities	**22,943**	22,153	**(1,896)**	1,729	**6,550**	9,601
Increase (decrease) in cash and cash equivalents	**(4,139)**	(7,068)	**16,990**	7,738	**(1,222)**	5,014
Cash and cash equivalents, beginning of year	**50,946**	58,014	**23,427**	15,689	**17,066**	12,052
Cash and cash equivalents, end of year	**$ 46,807**	$ 50,946	**$ 40,417**	$ 23,427	**$ 15,844**	$ 17,066

Statements of Cash Flows, cont.

(In Thousands)

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Reconciliation of operating income (loss) to net cash provided by operating activities:						
Operating income (loss)	**$ 8,826**	$ 14,259	**$ 235**	$ (12,108)	**$ 5,566**	$ 11,478
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:						
Depreciation of utility plant	**26,427**	25,535	**10,679**	10,307	**7,125**	6,555
Transmission credits	**21,599**	21,049	**—**	—	**—**	—
Other income	**2,598**	3,049	**3,419**	4,035	**94**	252
(Increase) decrease in assets:						
Accounts receivable	**2,295**	11,599	**(12,392)**	34,127	**1,789**	(1,942)
Deferred purchase power and gas cost	**1,674**	(5,835)	**(3,809)**	44,006	**—**	—
Inventories	**569**	(126)	**(383)**	1,100	**46**	111
Other assets	**501**	(391)	**(202)**	189	**—**	—
Increase (decrease) in liabilities:						
Accounts payable - purchased power and gas	**(3,451)**	(6,293)	**23,094**	(58,214)	**—**	—
Other accounts payable and accrued expenses	**1,396**	(1,634)	**15,002**	(5,388)	**(44)**	(60)
Customer advances for construction	**(98)**	1,196	**106**	57	**—**	—
Customer deposits	**3,637**	(440)	**(407)**	1,371	**170**	49
Insurance reserves	**(676)**	(379)	**571**	(446)	**(66)**	(266)
Medical benefit accrual	**(1,028)**	2,229	**(400)**	1,037	**(288)**	625
Payable to TVA net of notes receivable - energy conservation loans	**(9)**	47	**—**	—	**—**	—
Other	**975**	264	**299**	168	**168**	132
Total adjustments	**56,409**	49,870	**35,577**	32,349	**8,994**	5,456
Net cash provided by operating activities	**$ 65,235**	$ 64,129	**$ 35,812**	$ 20,241	**$ 14,560**	$ 16,934
Reconciliation of cash and cash equivalents per statements of cash flows to the balance sheets:						
Restricted funds	**$ 78,751**	$ 110,462	**$ 24,654**	$ 28,948	**$ 33,416**	$ 38,381
Less noncash equivalents included in restricted funds	**(11,332)**	(20,769)	**(8,689)**	(9,706)	**(7,657)**	(9,758)
Cash and cash equivalents included in restricted funds	**67,419**	89,693	**15,965**	19,242	**25,759**	28,623
Current assets - cash and cash equivalents	**46,807**	50,946	**40,417**	23,427	**15,844**	17,066
Total cash and cash equivalents	**$114,226**	$ 140,639	**$ 56,382**	$ 42,669	**$ 41,603**	$ 45,689

See accompanying notes.

Notes to Financial Statements

December 31, 2002 and 2001 (In Thousands)

1. Summary of Significant Accounting Policies

Organization

Memphis Light, Gas and Water Division ("MLGW"), a division of the City of Memphis, Tennessee (the "City"), was created by an amendment to the City Charter by Chapter 381 of the Private Acts of the General Assembly of Tennessee, adopted March 9, 1939, as amended. MLGW is managed by its President and a five member Board of Commissioners that are nominated by the City Mayor and approved by the Memphis City Council (the "Council"). MLGW, through its three distinct and financially separate divisions, provides electricity, gas and water to customers in Shelby County, Tennessee, which includes the City. MLGW's annual budget and electric, gas and water rates require the approval of the Council. MLGW must also obtain the approval of the Council before incurring certain obligations.

Basis of Presentation

The financial statements present only the Electric, Gas and Water divisions of MLGW and are not intended to present the financial position of the City and the results of the City's operations and the cash flows of the City's proprietary fund types and nonexpendable trust funds in conformity with accounting principles generally accepted in the United States.

Basis of Accounting

MLGW is required by state statute and the Charter of the City of Memphis, Tennessee, to maintain separate accounting for each division and to allocate among the divisions, on an equitable basis, joint expenses, including those related to common facilities. Each division is separately financed, and its indebtedness is repayable from its net revenues.

MLGW's accounting policies are in conformity with accounting principles generally accepted in the United States. Where applicable, the Federal Energy Regulatory Commission's (FERC) (Electric and Gas divisions) and the National Association of Regulatory Utility Commissioners' (NARUC) (Water division) Uniform Systems of Accounts are used. MLGW 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,* MLGW has elected to apply all Financial Accounting Standards Board ("FASB") statements and interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements, to MLGW's accounting and financial reporting.

The accounting policies and practices of MLGW conform to accounting principles generally accepted in the United States applicable to a proprietary fund of a government unit.

Recent Accounting Standards

In June 2001, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 143, *Accounting for Asset Retirement Obligations,* which is effective for fiscal years beginning after June 15, 2002. This Statement requires legal obligations associated with the retirement of long-lived assets to be recognized at their fair value at the time that the obligations are incurred. Upon initial recognition of a liability, that cost should be capitalized as part of the related long-lived asset and allocated to expense over the useful life of the asset. MLGW will adopt the new rules on asset retirement

Notes to Financial Statements, cont.

(In Thousands)

obligations on January 1, 2003. Currently, management does not believe that the adoption of this standard will have a material effect on MLGW's financial statements.

The FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* This Statement supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of,* and amends APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." The Statement retains the basic framework of SFAS No. 121, resolves certain implementation issues of SFAS No. 121, extends applicability to discontinued operations, and broadens the presentation of discontinued operations to include a component of an entity. MLGW adopted the provisions of SFAS 144 on January 1, 2002. The adoption of this Statement had no impact on MLGW's results of operations or financial position.

Regulatory Accounting

MLGW prepares its financial statements in accordance with the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS 71). In general, SFAS 71 recognizes that accounting for rate regulated enterprises should reflect the relationship of costs and revenues introduced by rate regulation. As a result, a regulated utility may defer recognition of a cost (a regulatory asset) or recognize an obligation (a regulatory liability) if it is probable that through the rate making process, there will be a corresponding increase or decrease in future revenues. Accordingly, MLGW has recognized certain regulatory assets and regulatory liabilities in the accompanying balance sheets. In the event operations are no longer subject to the provisions of SFAS 71 as a result of a change in regulation or the effects of competition, MLGW would be required to recognize the effects of any regulatory change in assets or liabilities in its statement of revenues and expenses.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The estimated fair value of MLGW's financial instruments has been determined by MLGW using available market information. However, considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value. Accordingly, the fair values are not necessarily indicative of the amounts that MLGW could realize in a current market exchange. The use of different market assumptions may have a material effect on the estimated fair value amounts. The carrying amounts of cash and cash equivalents, investments, restricted fund investments, accounts receivable and accounts payable are a reasonable estimate of their fair value.

The estimated fair value of long-term debt for the Electric Division and the Water Division based on quoted market prices is as follows at December 31, 2002 and 2001:

	2002	2001
Electric Division	**$103,214**	$129,718
Water Division	**42,976**	47,062

Investments

Investments are carried at their fair value. All changes in the fair value of investments are included in investment income in the accompanying statements of revenues, expenses and changes in net assets.

Accounts Receivable

At December 31, 2002 and 2001, accounts receivable and allowances for doubtful accounts were as follows:

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Accounts receivable	**$61,604**	$ 63,826	**$39,113**	$ 26,781	**$ 9,115**	$ 10,933
Allowance for doubtful accounts	**5,075**	5,002	**3,296**	3,356	**237**	266

MLGW performs a monthly analysis of outstanding trade receivables to assess the likelihood of collection. For balances on which full payment of amounts owed is not expected, MLGW records an allowance to adjust the trade receivable to MLGW's best estimate of the amount it will ultimately collect. Such allowances are netted against operating revenues. MLGW writes off receivables after 120 days of non-payment. If payment is subsequently received, the account is reinstated and the payment, relief of the receivable and revenue are recorded.

Inventories

Inventories are valued at the lower of cost or market using the average cost method.

Property

The costs of additions and replacements of units of property are capitalized. Costs include contracted work, direct labor and materials, allocable overhead and, where applicable, allowances for borrowed funds used during construction and are reduced by contributions in aid of construction. When property units are retired, original cost, plus removal cost, less salvage is charged to accumulated depreciation. The units of property adopted are closely related to those suggested by FERC for the Electric and Gas Divisions and NARUC for the Water Division, which allow for the reduction of plant cost recovered through contributions in aid of construction as opposed to recovery of costs through future regulatory rates.

An allowance for borrowed funds used during construction is computed at actual interest rates to the extent major projects are financed by specific long-term debt. In 2002 and 2001, no construction projects were financed with specific long-term debt. Interest on other debt is not capitalized as it is recovered through current revenues.

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Notes to Financial Statements, cont.

(In Thousands)

Depreciation is computed by the straight-line method based on estimated service lives of various classes of property at rates equivalent to annual composite rates of approximately 3% for the Electric and 2% for the Gas Division and Water Divisions. Computations of the estimated service lives are the result of various depreciation studies and comparisons with industry standards.

For assets owned by one division but jointly used by more than one division, the other divisions share the costs by paying rent to the owning division to cover depreciation, interest and taxes.

Unamortized Debt Expense

Unamortized debt expense is amortized by the interest method over the lives of the applicable bond issues.

Reserves and Related Restricted Funds

The insurance reserves for injuries and damages are maintained for estimated liabilities incurred and risks assumed on claims for injuries and damages and on recurring property losses.

A medical benefit fund is maintained for a medical insurance program which serves employees and retirees. Costs and expenses for such claims and losses, as well as medical benefits, are paid from the related restricted funds and charged to the reserves as incurred. Increases in the reserves are charged to operations.

Insurance reserve funds for casualties are self-insurance reserves maintained at discretionary amounts to partially cover losses of a catastrophic nature which are not ordinarily insurable or which are not insurable on an economically feasible basis.

Construction funds are maintained for the purpose of paying the costs of certain repairs and capital additions and improvements.

Futures Contracts

The Gas Division enters into futures contracts for the purchase of gas to manage the risk of increases in the market price of gas on anticipated purchase transactions. Futures contracts are contracts for delayed delivery of gas in which the seller agrees to make delivery at a specified future date of a specified quantity at a specified price. Open futures contracts for the purchase of gas are reported at market, based on the contract price, in the balance sheet. Gains or losses on futures contracts are included in deferred purchased gas costs until they are charged to gas costs through the purchased gas adjustment. Gains or losses on futures contracts entered into on behalf of specified customers are charged to that specific customer.

Net Assets

Net assets are classified into three components - invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

- Invested in capital assets, net of related debt - This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds is not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

- Restricted - This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
- Unrestricted net assets - This component of net assets consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

Revenues

Revenues are recognized at the time of the monthly cycle billings to customers. Revenues are not accrued for power, gas and water delivered but unbilled at the end of a fiscal period.

Non-operating revenues include transmission credits, which are fees paid by Tennessee Valley Authority (TVA) for its use of the Electric Division's power transmission facilities in supplying power to MLGW.

Concentration of Credit Risk

MLGW's financial instruments that are potentially exposed to concentrations of credit risk consist of trade receivables. MLGW's trade receivables result primarily from its operations and include wholesale, commercial, industrial and government customers in the Memphis, Tennessee, geographic area. As a general policy, customer deposits are required for receivables unless or until the customer has established good credit history. Customers' financial condition and credit worthiness are evaluated regularly. Trade receivable credit losses were not material in 2002 or 2001.

Management of MLGW does not believe that it has a significant credit risk on its derivative instruments, which are transacted through the New York Mercantile Exchange or with counterparties meeting established collateral and credit criteria.

Customer Deposits

Customers that do not have adequate credit history are required to make a utility deposit before services are provided. Deposits are refunded after the earlier of 36 months or disconnection of service.

Deferred Purchased Power and Gas Cost

The purchased power and gas cost applicable to power and gas delivered to customers but not yet billed at fiscal year end is deferred until the associated revenues are recognized.

MLGW has a contract under which the Gas Division is required to refill gas used from storage tanks during the winter. Purchases of gas to refill the tanks usually occur during months of non-peak gas demand, primarily during the summer. Estimated costs to refill the tanks are accrued and charged to purchased gas operating expense as usage occurs based on the gas futures market price for the month that MLGW expects to purchase the gas to refill the tanks. This liability is included in accounts payable - purchased gas in the accompanying Gas Division balance sheets.

Notes to Financial Statements, cont.

(In Thousands)

Statements of Cash Flows

MLGW considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Reclassifications

Certain amounts in the 2001 financial statements have been reclassified to conform to the 2002 presentation.

Related Parties

MLGW conducts business with its related parties as "arm's length" transactions. Major related party entities include the City of Memphis Government and Memphis Networx. Generally, MLGW provides utility and related services to these parties and receives payments in the same manner as other customers. The amounts are considered immaterial to MLGW. The only free service provided is, under the City charter, free water for public purposes such as, fire hydrants and street sprinkling.

2. Deposits and Investments

MLGW has a cash management program that provides for the investment of excess cash balances in short-term investments and the investment of debt service funds in instruments maturing as the related debt matures. The policy is authorized by the Charter of the City of Memphis, Tennessee, the Board of Commissioners of MLGW, and as set forth in the bond resolutions of each division. Restricted funds, cash, cash equivalents and investments consist of the following at December 31, 2002 and 2001:

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Restricted funds:						
Common account	**$23,044**	$ 45,082	**$17,667**	$ 21,067	**$15,569**	$ 21,180
Mutual funds	**34,941**	47,223	**—**	—	**15,527**	14,763
Commercial paper	**12,266**	16,057	**6,987**	7,881	**2,320**	2,438
Certificates of deposit	**8,500**	2,100	**—**	—	**—**	—
Total restricted funds	**$78,751**	$110,462	**$24,654**	$ 28,948	**$33,416**	$ 38,381
Cash and cash equivalents:						
Common account	**$44,281**	$ 47,524	**$18,902**	$ 10,052	**$14,782**	$ 15,954
Mutual funds	**2,370**	3,223	**—**	—	**1,062**	1,112
Cash	**156**	199	**21,515**	13,375	**—**	—
Total cash and cash equivalents	**$46,807**	$ 50,946	**$40,417**	$ 23,427	**$15,844**	$ 17,066
Investments - common account	**$42,852**	$ 40,598	**$18,293**	$ 8,587	**$14,304**	$ 13,629

The common account consists of commingled funds held by safekeeping agents on behalf of MLGW and the income is allocated to the divisions based on each division's prorated share of the common fund. As of December 31, 2002 and 2001, the common account consisted of the following:

	2002	2001
Common account:		
Commercial paper	**$ 83,744**	$101,235
Mutual funds	**13,745**	9,808
U.S. Treasury notes	**350**	350
U.S. Government agencies	**92,462**	83,401
Corporate bonds	**7,366**	10,411
Certificates of deposit	**3,100**	11,500
Asset-backed securities	**7,625**	5,300
Accrued interest receivable	**1,302**	1,668
	$209,694	$223,673

Investments are categorized into three credit risk categories by GASB Statement No. 3. All of MLGW's investments (excluding mutual funds) meet the requirements of the first category, defined by GASB to include investments that are insured or registered or securities held by MLGW or its agent in MLGW's name. Mutual funds are not categorized, as they are not evidenced by securities that exist in physical or book entry form.

At December 31, 2002 and 2001, the bank balances of MLGW cash deposits were fully insured or collateralized with securities held by MLGW or its agent in MLGW's name.

Construction, bond reserve and debt service funds of the Electric and Water Divisions are restricted under the respective bond indentures. Construction restricted funds of the Gas Division currently have no external restrictions but represent funds management has designated as restricted for Gas Division construction expenditures.

Securities Lending Transactions

MLGW has authorized The Northern Trust Company ("Agent") to enter into, on behalf of MLGW, securities lending transactions—loans of securities to broker-dealers and other entities for collateral with a simultaneous agreement to return the collateral for the same securities in the future. Initial collateral, consisting of cash and securities, levels must be at least 102% of the market value of borrowed securities, or at least 105% if the borrowed securities and collateral are denominated in different currencies. The borrower is required to deliver additional collateral when necessary so that the total collateral held by the Agent for all loans to the borrower will at least equal the market value of the securities without a borrower default. Collateral held in trust for securities on loan included in the 2002 and 2001 statements of net assets consists of cash collateral. At December 31, 2002 and 2001, MLGW has no credit risk exposure to borrowers because the amounts MLGW owes to the borrowers exceed the amounts the borrowers owe MLGW. The Agent is required to indemnify MLGW if the borrowers fail to return the securities to MLGW.

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Notes to Financial Statements, cont.

(In Thousands)

Investments held by broker-dealers under securities loans consist of the following:

	Fair Value	
	2002	2001
U.S. Government fixed	**$ 35,989**	$ 22,633
U.S. Government agencies	**12,857**	20,885
U.S. Corporate bonds	**—**	1,043
Total	**$ 48,846**	$ 44,561

All term loans have a matched collateral investment. Of the cash collateral received for open loans, 20% must be invested on an overnight basis and no more than 40% of the collateral investments may be invested in instruments which have a maturity exceeding 97 days.

The net income recognized from securitized loan activity is recorded in other income on the statements of revenues, expenses, and changes in net assets. The net amount of income recognized is $91 and $66 at December 31, 2002 and 2001, respectively. This income is pro-rated monthly to the three divisions based on each Division's share of the joint investment pool.

3. Long-Term Receivables

The Electric Division has an unsecured note receivable from a government agency which amounted to $9,861 and $10,769 as of December 31, 2002 and 2001, respectively. Interest is earned at a rate of 7.7% per annum. The note provides for monthly payments of principal and interest and has a maturity date of November 1, 2010. The note receivable secures an Electric Division note payable (see Note 7).

Scheduled maturities of the note receivable are as follows for the years ending December 31:

2003	$ 981
2004	1,060
2005	1,144
2006	1,236
2007	1,335
Thereafter	4,105
	$ 9,861

In 2002, MLGW and Williams Energy Services ("Williams") entered into an agreement, whereby MLGW would provide for the construction of two pipelines and lease them to Williams for the purpose of transporting crude oil and refinery products. The lease provides for monthly payments of principal and interest and has an initial term of 15 years, ending on October 1, 2016.

Scheduled lease payments receivable are as follows for the years ending December 31:

2003	$ 1,712
2004	1,712
2005	1,712
2006	1,712
2007	1,712
Thereafter	14,839
	$ 23,399

The Williams lease receivable is included in notes receivable in the accompanying 2002 Gas Division balance sheet, except for the current portion of $1,712, which is included in other current assets. Deferred income of $1,426 (current portion) and $11,375 (non-current portion) is included in other accounts payable, accrued expenses and deferrals and other non-current liabilities, respectively, in the accompanying 2002 Gas Division balance sheet.

4. Utility Plant

Utility plant activity for the years ended December 31, 2002 and 2001 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2002:				
Electric Division				
Capital assets not being depreciated:				
Land	**$ 23,633**	**$ 488**	**$ —**	**$ 24,121**
Construction in progress	**49,383**	**61,190**	**(44,705)**	**65,868**
Total capital assets not being depreciated	**73,016**	**61,678**	**(44,705)**	**89,989**
Capital assets being depreciated:				
Structures and improvements	**26,593**	**2,245**	**(3)**	**28,835**
Transmission and distribution plant equipment	**858,161**	**36,917**	**(8,206)**	**886,872**
General plant equipment	**63,696**	**6,873**	**(2,175)**	**68,394**
Total capital assets being depreciated	**948,450**	**46,035**	**(10,384)**	**984,101**
Less accumulated depreciation	**(362,136)**	**(29,380)**	**12,488**	**(379,028)**
Total capital assets being depreciated, net	**586,314**	**16,655**	**2,104**	**605,073**
Total capital assets, net	**$659,330**	**$ 78,333**	**$(42,601)**	**$695,062**

results

Notes to Financial Statements, cont.

(In Thousands)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2002:				
Gas Division				
Capital assets not being depreciated:				
Land	$ 7,431	$ —	$ (363)	$ 7,068
Construction in progress	46,037	21,645	(23,705)	43,977
Plant held for future use	212	—	—	212
Total capital assets not being depreciated	53,680	21,645	(24,068)	51,257
Capital assets being depreciated:				
Structures and improvements	45,308	718	(1,453)	44,573
Processing and distribution plant equipment	333,117	13,111	(689)	345,539
General plant equipment	46,722	2,223	(1,985)	46,960
Non-utility plant equipment	3,092	—	(2,892)	200
Total capital assets being depreciated	428,239	16,052	(7,019)	437,272
Less accumulated depreciation	(157,038)	(15,226)	4,264	(168,000)
Total capital assets being depreciated, net	271,201	826	(2,755)	269,272
Total capital assets, net	$324,881	$22,471	$(26,823)	$320,529
Water Division				
Capital assets not being depreciated:				
Land	$ 3,093	$ 1	$ —	$ 3,094
Construction in progress	31,742	16,226	(16,539)	31,429
Total capital assets not being depreciated	34,835	16,227	(16,539)	34,523
Capital assets being depreciated:				
Structures and improvements	37,004	105	—	37,109
Pumping, transmission and distribution plant equipment	245,941	12,610	(770)	257,781
General plant equipment	37,892	3,824	(449)	41,267
Total capital assets being depreciated	320,837	16,539	(1,219)	336,157
Less accumulated depreciation	(112,047)	(8,754)	1,347	(119,454)
Less acquisition adjustment	(16,863)	—	965	(15,898)
Total capital assets being depreciated, net	191,927	7,785	1,093	200,805
Total capital assets, net	$226,762	$24,012	$(15,446)	$235,328

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2001:				
Electric Division				
Capital assets not being depreciated:				
Land	$ 5,176	$ 18,457	$ —	$ 23,633
Construction in progress	41,114	44,935	(36,666)	49,383
Total capital assets not being depreciated	46,290	63,392	(36,666)	73,016
Capital assets being depreciated:				
Structures and improvements	25,974	619	—	26,593
Transmission and distribution plant equipment	833,933	31,131	(6,903)	858,161
General plant equipment	60,999	4,237	(1,540)	63,696
Total capital assets being depreciated	920,906	35,987	(8,443)	948,450
Less accumulated depreciation	(344,581)	(27,625)	10,070	(362,136)
Total capital assets being depreciated, net	576,325	8,362	1,627	586,314
Total capital assets, net	$622,615	$ 71,754	$ (35,039)	$ 659,330
Gas Division				
Capital assets not being depreciated:				
Land	$ 25,195	$ 14	$ (17,778)	$ 7,431
Construction in progress	32,191	34,557	(20,711)	46,037
Plant held for future use	212	—	—	212
Total capital assets not being depreciated	57,598	34,571	(38,489)	53,680
Capital assets being depreciated:				
Structures and improvements	44,573	941	(206)	45,308
Processing and distribution plant equipment	318,524	15,654	(1,061)	333,117
General plant equipment	43,807	4,116	(1,201)	46,722
Non-utility plant equipment	3,092	—	—	3,092
Total capital assets being depreciated	409,996	20,711	(2,468)	428,239
Less accumulated depreciation	(146,019)	(13,060)	2,041	(157,038)
Total capital assets being depreciated, net	263,977	7,651	(427)	271,201
Total capital assets, net	$321,575	$ 42,222	$ (38,916)	$ 324,881

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Notes to Financial Statements, cont.

(In Thousands)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2001:				
Water Division				
Capital assets not being depreciated:				
Land	$ 3,076	$ 17	$ —	$ 3,093
Construction in progress	27,089	11,920	(7,267)	31,742
Total capital assets not being depreciated	30,165	11,937	(7,267)	34,835
Capital assets being depreciated:				
Structures and improvements	35,095	1,909	—	37,004
Pumping, transmission and distribution plant equipment	242,402	3,950	(411)	245,941
General plant equipment	36,687	1,393	(188)	37,892
Total capital assets being depreciated	314,184	7,252	(599)	320,837
Less accumulated depreciation	(104,435)	(7,999)	387	(112,047)
Less acquisition adjustment	(17,825)	—	962	(16,863)
Total capital assets being depreciated, net	191,924	(747)	750	191,927
Total capital assets, net	$222,089	$ 11,190	$ (6,517)	$ 226,762

Total net capital asset changes include additions to construction in progress, transfers to or from other accounts, depreciation and amortization and the effects of sales, retirements, and contribution in aid of construction.

MLGW's planned construction program expenditures for 2003 are estimated as follows (unaudited):

Electric Division	$65,962
Gas Division	24,463
Water Division	19,792

In June 1999, the Water Division purchased the Shelby County Water Distribution System and related assets from Shelby County, Tennessee. The difference between the purchase price and the net book value of the assets acquired (the "acquisition adjustment") is being amortized over twenty years by the Water Division. Under the purchase agreement, MLGW agreed to decrease the water rates for the acquired customers by 3 percent per year through the year 2003 and committed to expenditures of at least $15 million over the next twenty years to upgrade and extend the acquired water system. As of December 31, 2002, expenditures of $5.1 million have been spent for the construction commitment.

5. Employee Retirement System

Plan Description

The Memphis Light, Gas and Water Division Pension Board is the administrator of a single-employer retirement system established by MLGW to provide retirement benefits for its employees. Prior to July 1, 1988, the retirement system included two contributory defined benefit plans (the "1948 Plan" and the "1978 Plan"). The 1948 Plan and the 1978 Plan were amended and superseded as of July 1, 1988. All employees who were members of the 1948 Plan and the 1978 Plan automatically became members of the amended, restated and consolidated Memphis Light, Gas and Water Division Retirement and Pension System (the "MLGW Pension Plan"). MLGW issues separate audited financial statements for the retirement system as of and for its fiscal year ended December 31. The financial statements may be obtained by writing to the MLGW Pension Plan, P.O. Box 430, Memphis, Tennessee 38101-0430.

The MLGW Pension Plan covers full time employees and appointed officials of MLGW. Membership consisted of the following at December 31, 2002 and 2001:

	2002	2001
Retirees and beneficiaries receiving benefits	2,368	2,372
Terminated plan members entitled to but not yet receiving benefits	30	32
Active plan members	2,666	2,631
	5,064	5,035

The MLGW Pension Plan provides retirement, disability and death benefits to participants and their beneficiaries. The MLGW Pension Plan also provides for a cost of living adjustment beginning at age 56 for retired, disabled and surviving spouses on a graded scale up to 5% per annum based on the Department of Labor's consumer price index.

Basis of Accounting

The financial statements of the MLGW Pension Plan are prepared using the accrual basis of accounting. Contributions are recognized in the period in which the contributions are due. Benefits and refunds are recognized when due and payable in accordance with the terms of the MLGW Pension Plan.

Method Used to Value Investments

All investments of the MLGW Pension Plan are reported at fair value by the plan. Short-term investments are reported at cost, which approximates fair value. All other investments are valued based upon quoted market prices except for investments in certain limited partnerships, which are valued at estimated fair value based on amounts derived from the partnerships' financial statements. For certain investments consisting of corporate bonds and notes that do not have an established fair value, MLGWs' treasury management department has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings. The MLGW Pension Plan has no investment in any one organization that represents more than 5 percent of plan assets.

Notes to Financial Statements, cont.

(In Thousands)

Contributions

Substantially all members under the MLGW Pension Plan are required to contribute 8% of the benefit compensation to the MLGW Pension Plan. Such amounts are withheld from employee compensation each pay period. MLGW funds the required 8% employee contributions on behalf of certain employees. During 2002 and 2001, MLGW was required to contribute 8% of the benefit compensation of all active participants. Investment costs of the MLGW Pension Plan are financed through investment earnings. Other administrative costs are included in the annual required contribution amount.

Actuarial Methods and Assumptions

At December 31, 2002 and 2001, the Pension Plan valuation dates, the asset valuation method used is the five-year weighted index method. The aggregate actuarial cost method is used in determining the funding requirements. Significant actuarial assumptions include (a) a rate of return on the investment of present and future assets of 8.0 percent per year compounded annually, (b) projected salary increases of 5.0 percent per year compounded annually, and (c) pensioner cost of living adjustments of 1.05 - 2.63 percent compounded annually.

Schedule of Funding Progress

The aggregate cost method does not identify or separately amortize unfunded actuarial liabilities. These liabilities are amortized through the normal cost. Under the aggregate cost method, the actuarial accrued liability equals the actuarial value of assets. At December 31, 2002 and 2001, the actuarial value of assets was $1,014,967 and $ 1,028,496, respectively.

Schedule of Contributions from all Sources

Employee and employer contributions for the past three years are shown below:

Plan Year	Annual Required Employee Contribution	Percentage Contributed	Annual Required Employer Contribution	Percentage Contributed
2002	$ 9,933	100%	$ 9,855	100%
2001	9,299	100%	9,588	100%
2000	8,641	100%	10,760	100%

6. Deferred Compensation and Other Post-Retirement Benefits

MLGW offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all MLGW employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

During 1997, the plan was amended to meet the requirements of Internal Revenue Code Section 457. The Amended 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 Amended 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 MLGW's balance sheets.

MLGW has post-retirement major medical and life insurance benefits available to all employee groups as a continuation of those benefits that were available prior to retirement. Currently 2,398 retirees and beneficiaries are eligible for post-retirement benefits. Life insurance premiums are paid monthly and medical coverage is paid as claims are filed through the medical benefit fund (a restricted fund). The costs of future post-retirement benefits are provided for through the insurance reserves for employee benefits to the extent recovered through current revenues. MLGW has established a grantor trust to accumulate funds that will be used to pay future post retirement medical benefits. The value of assets in fund at December 31, 2002 and 2001 was $45,840 and $65,583, respectively.

Post-retirement benefit costs for the years ended December 31, 2002 and 2001 are as follows:

	Electric Division		Gas Division		Water Division	
	2002	2001	**2002**	2001	**2002**	2001
Premium payments	**$ 7,650**	$ 7,149	**$ 3,624**	$ 3,386	**$ 2,148**	$ 2,007
Paid from grantor trust	**(5,301)**	(6,156)	**(2,511)**	(2,916)	**(1,488)**	(1,728)
Net costs	**$ 2,349**	$ 993	**$ 1,113**	$ 470	**$ 660**	$ 279

7. Debt

Long-term debt at December 31, 2002 and 2001 consists of the following:

	Interest Rates	2002	2001
Electric Division:			
Electric System Revenue Bonds:			
Series 1992, due serially 1993-2006	3.35-6.00%	**$45,535**	$ 65,160
Series 1993, due serially 1997-2011	3.60-5.00%	**4,270**	50,270
Series 2002, due serially 2003-2010	3.00-5.00%	**41,625**	—
Total		**91,430**	115,430
Note payable with bank, due serially through 2010	7.58%	**10,083**	10,979
		101,513	126,409
Less: current portion of bonds and note payable		**(30,416)**	(24,633)
Unamortized deferred amount on bond refunding		**(442)**	—
		$70,655	$101,776
Water Division:			
Revenue Refunding Bonds:			
Series 1992, due serially 1993-2006	3.35-6.00%	**$10,725**	$ 13,050
Series 1992-A, due serially 1994-2003	3.00-5.50%	**1,000**	1,950
Series 1998, due serially 2000-2012	3.30-5.25%	**12,340**	12,425
Series 2001, due serially 2002-2009	4.00-5.00%	**16,895**	18,135
		40,960	45,560
Less: current portion of bonds payable		**(6,730)**	(4,600)
Unamortized deferred amount on bond refunding		**(408)**	(473)
		$33,822	$ 40,487

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Notes to Financial Statements, cont.

(In Thousands)

Principal payments on bonds are due annually on January 1 or December 1. Debt service requirements, including note payable with bank, at December 31, 2002, are as follows:

	Electric Division		Water Division	
	Principal	Interest	Principal	Interest
2003	$ 30,416	$ 5,375	$ 6,730	$ 1,869
2004	15,907	3,179	7,080	1,516
2005	13,351	2,438	7,440	1,142
2006	14,026	1,751	5,770	795
2007	6,573	1,269	2,975	579
2008-2012	21,240	1,986	10,965	1,131
Total	$ 101,513	$ 15,998	$ 40,960	$ 7,032

MLGW, at its option, may redeem bonds prior to maturity at premiums and prices specified in the indentures.

Bonds are secured by the pledge of the respective division's revenues, by funds established by the bond resolutions and, in certain circumstances, proceeds from the sale of certain division assets.

During 2002, the Electric Division issued $41,625 in revenue bonds to refund $41,905 of Series 1993 revenue bonds. An additional $4,270 of the 1993 revenue bonds was not refunded, but was repaid on January 1, 2003. The refunding was undertaken to reduce total future debt service payments. The reacquisition price exceeded the net carrying value of the old debt by $462. This amount is netted against the carrying value of the new debt and is being amortized over the life of the new debt, which was shorter than the life of the refunded debt. This bond issue netted a savings of approximately $2,200.

During 2001, MLGW obtained a 90-day bridge loan of $50,000 to assist in funding gas costs prior to the receipt of customer revenue. The loan was repaid prior to December 31, 2001.

During 2001, the Water Division issued $18,135 in revenue bonds to refund the $18,135 of Series 1993 revenue bonds. The refunding was undertaken to reduce total future debt service payments. The reacquisition price exceeded the net carrying amount of the old debt by $338. This amount is being netted against the new debt and amortized over the refunded debt's life, which is shorter than the new debt. This bond issue netted a savings of approximately $800.

Long-term debt activity for the years ended December 31, 2002 and 2001 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2002:				
Electric Division				
Bonds and note payable:				
Revenue bonds	**$115,430**	**$ 41,625**	**$(65,625)**	**$ 91,430**
Note payable	**10,979**	**—**	**(896)**	**10,083**
Less deferred amounts:				
For issuance discounts and on refunding	**—**	**—**	**(442)**	**(442)**
Total bonds and note payable	**$126,409**	**$ 41,625**	**$(66,963)**	**$101,071**
Water Division				
Bonds payable:				
Revenue bonds	**$ 45,560**	**$ —**	**$ (4,600)**	**$ 40,960**
Less deferred amounts:				
For issuance discounts and on refunding	**(473)**	**—**	**65**	**(408)**
Total bonds payable	**$ 45,087**	**$ —**	**$ (4,535)**	**$ 40,552**
Year ended December 31, 2001:				
Electric Division				
Bonds and note payable:				
Revenue bonds	$137,775	$ —	$ (22,345)	$115,430
Note payable	11,810	—	(831)	10,979
Total bonds and note payable	$149,585	$ —	$ (23,176)	$126,409
Water Division				
Bonds payable:				
Revenue bonds	$ 53,810	$ 18,135	$ (26,385)	$ 45,560
Less deferred amounts:				
For issuance discounts and on refunding	(729)	—	256	(473)
Total bonds payable	$ 53,081	$ 18,135	$ (26,129)	$ 45,087

Notes to Financial Statements, cont.

(In Thousands)

8. Insurance Reserves for Medical Benefits and Injuries and Damages

MLGW is self-insured for health and medical benefits and for injuries and damages including workers compensation and general liability claims. MLGW has established insurance reserves for the estimated liabilities, including an accrual for incurred but not reported claims, resulting from medical benefits, injuries and damages claims. The medical benefits reserve and the costs and charges to the reserve are allocated to each division based on a standard administrative and general cost allocation.

The changes in the self-insurance reserves for medical benefits and injuries and damages for the years ended December 31, 2002 and 2001 are as follows:

	Medical Benefits			Injuries and Damages		
	Electric Division	Gas Division	Water Division	Electric Division	Gas Division	Water Division
Balance - December 31, 2000	$ 3,028	$ 1,453	$ 850	$ 3,007	$ 1,254	$1,292
Payments	(14,429)	(6,835)	(4,050)	(1,891)	(594)	(604)
Incurred claims expense	16,658	7,872	4,675	1,512	148	338
Balance - December 31, 2001	5,257	2,490	1,475	2,628	808	1,026
Payments	**(17,747)**	**(8,406)**	**(4,982)**	**(1,686)**	**(914)**	**(506)**
Incurred claims expense	**16,719**	**8,006**	**4,694**	**1,010**	**1,485**	**440**
Balance - December 31, 2002	**$ 4,229**	**$2,090**	**$1,187**	**$1,952**	**$1,379**	**$ 960**

9. Telecommunications Division

Memphis Networx, LLC (the Company) was organized under the Tennessee Limited Liability Act on November 8, 1999, to provide telecommunications services through the installation of broadband fiber optic cable in the Memphis, Tennessee, area. The Company is a joint venture between the Telecommunications Division of MLGW's Electric Division and Memphis Broadband, LLC, a Delaware limited liability company.

Under the terms of the Company's operating agreement, capital contributions and costs incurred by the Company prior to its formation and through the date of Tennessee Regulatory Authority (TRA) approval are to be shared equally by the members. Subsequent to TRA approval, each of the members were to contribute capital to the Company such that contributed members' equity equals 53% for MLGW and 47% for Memphis Broadband LLC; however, as of December 31, 2002, this true-up had not occurred. Allocations of net operating income or loss and distributions are based on cumulative members' contributions, accumulated members' equity (loss), and the ratio of contributed members' equity. Each member has a 50% voting interest in the Company.

Effective April 1, 2002, MLGW entered into a capital contribution agreement with Memphis Broadband, LLC. The agreement established planned monthly capital contributions through 2004 for both members. The agreement also amended the operating agreement to allow one member to contribute the required capital on behalf of the other member. If a member makes such a disproportionate contribution, the agreement allows the contributing member to charge the other member interest on the disproportionate contribution. On the contribution date, the sharing ratio of net operating income or loss and distributions is adjusted to reflect the increased capital contribution. In

2002, MLGW contributed capital to the Company of $11.2 million, which is equal to both members' required capital contributions. As of December 31, 2002, the Telecommunications Division's ownership interest in the Company was approximately 78%.

On August 9, 2001, the TRA issued a final order approving the Company's amended and restated operating agreement and granting a certificate of public convenience and necessity for the State of Tennessee. In addition, MLGW received approval from the State Comptroller's office to release funds from the previously approved $20 million loan from the Electric Division to the Telecommunications Division. In the third quarter of 2002, MLGW's Board of Commissioners, at the request of management, increased the approved level of investment in the Company to $32 million, and MLGW expects to fund $10 million of that amount in 2003.

Condensed results of operations of the Company for the years ended December 31, 2002 and 2001 are as follows:

	2002	2001
	(unaudited)	
Operating revenue	**$ 125**	$ 1
Operating expense	**(5,248)**	(3,538)
Net loss	**$ (5,123)**	$ (3,537)

The equity method of accounting is used for the Telecommunications Division's investment in the Company since the Telecommunications Division has significant influence over operating and financial policies but does not have control over policy and operations. Telecommunications Division results for the years ended December 31 are as follows:

	2002	2001
Share of the Company's loss	**$ 3,996**	$ 1,768
General and administrative expenses	**157**	264
Total Telecommunications Division loss	**$ 4,153**	$ 2,032

The Telecommunications Division's investment in the Company of $10,093 and $2,889 at December 31, 2002 and 2001, respectively, is included in other non-current assets in the accompanying balance sheets of the Electric Division.

10. Energy Supplies

MLGW is committed to purchase all of its power from TVA under a contract, subject to termination by MLGW at any time upon not less than five years' prior written notice or by TVA on not less than ten years' prior written notice provided; however, that the earliest date on which either party may provide such notice was October 1, 2002. MLGW purchases gas supplies directly from producers and marketers. In addition, MLGW has transportation agreements with Texas Gas Transmission Corporation and Trunkline Gas Company. MLGW has no minimum purchase commitments under these agreements.

Notes to Financial Statements, cont.

(In Thousands)

11. Rates

Electric, gas and water rates are established by MLGW and are subject to approval by the City Council of Memphis, Tennessee, except for pass-through changes in electric rates from TVA and gas cost changes from suppliers. Electric rates to retail customers are established in coordination with TVA.

12. Commitments and Contingencies

The Gas Division has contracts and swap agreements, from which risks arise from the possible inability of counter parties to meet the terms of their contracts and from movements in gas prices. The Gas Division's exposure to credit loss in the event of nonperformance by the other party is represented by the contractual notional amount of the financial instrument. Open futures contracts at December 31, 2002 and 2001, are a net liability of $13,266 and $5,701, respectively, and are included in other accounts payable, accrued expenses and deferrals in the accompanying Gas Division balance sheets.

Under the Charter of the City of Memphis, the City is entitled to dividends (6% annual rate for the Electric Division and the Gas Division and 3% for the Water division) based upon accumulated net revenues, as defined in the bond resolutions, but not to exceed one-half of the annual net revenues, as defined in the bond resolution, for the Electric Division and the Gas Division, unless approved by MLGW's Board of Commissioners. Under the power contract signed with TVA and under the 1958 Basic Bond Resolution of the Water Division, the City of Memphis has waived its rights to dividends from the Electric Division and the Water Division. Payments in lieu of taxes and dividends to the City of Memphis are also limited by laws established by the State of Tennessee.

MLGW is party to various legal proceedings incidental to its business. In the opinion of management, MLGW's liability, if any, in all pending litigation or other proceedings, taken as a whole after consideration of amounts accrued, insurance coverage, or other indemnification arrangements, will not have a material adverse effect on its financial position or results of operations.

13. Self-Insurance

MLGW is self-insured under the Tennessee Governmental Tort Liability Act. This coverage applies to all tort liability coverage and holds harmless commissioners, officers, and general counsel making decisions as authorized by the Board of Commissioner's policies. Various liability limits are in force as established by the act except as increased by resolution of the Board of Commissioners. The more significant coverage relates to gas leaks, gas explosions and electrical shocks with maximum limits of $130 per person and $350 for two or more persons per accident.

results

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