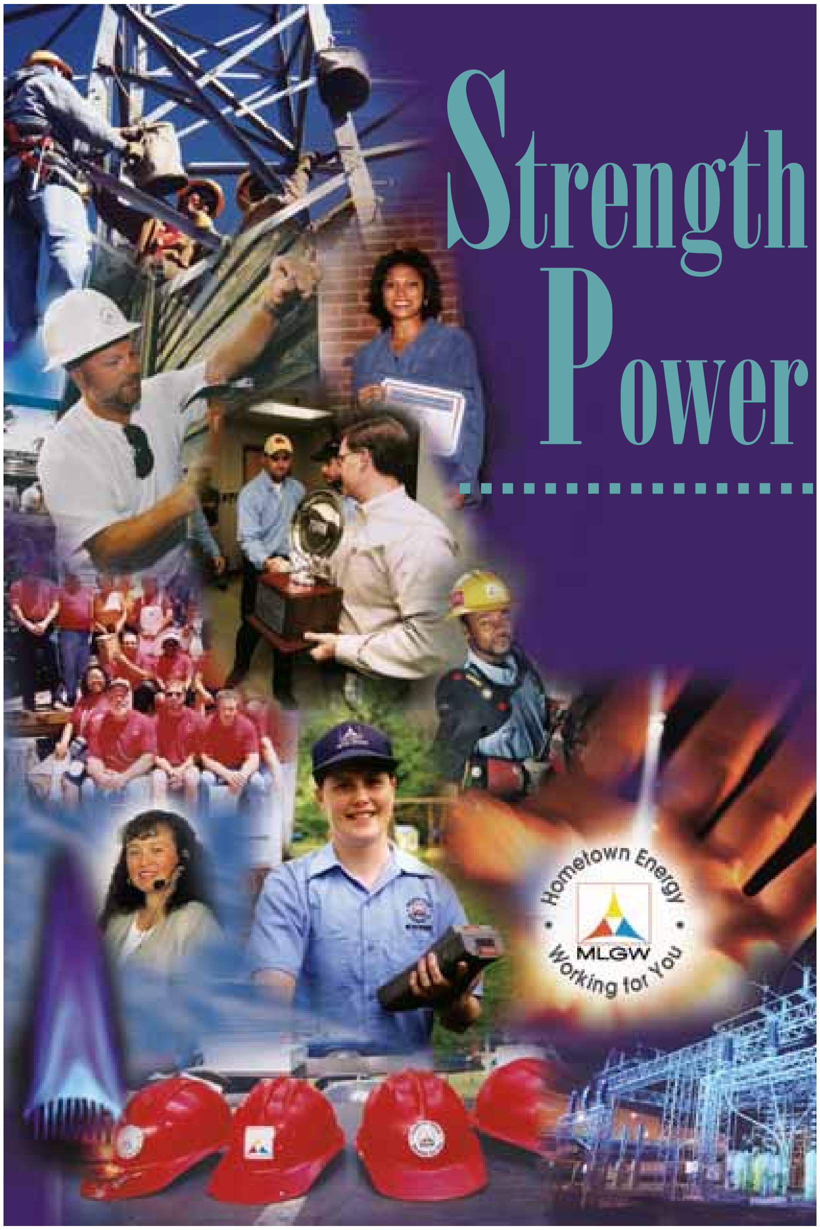
Strength for Today, Power for the Future



Memphis Light, Gas and Water Division

2003 Annual Report

Strength for today.
Power for the future.

MEMPHIS LIGHT, GAS AND WATER
2003 ANNUAL REPORT

About Memphis Light, Gas and Water

Memphis Light, Gas and Water is the nation's largest three-service municipal utility, serving 413,000 customers. Since 1939, MLGW has met the needs of Memphis and Shelby County residents by delivering reliable and affordable electricity, natural gas and water service.

Electricity is supplied to MLGW by the Tennessee Valley Authority, while natural gas is transported 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.

Board of Commissioners

Dr. James L. Netters
Chairman

L.R. Jalenak, Jr.
Vice-Chairman

Bishop William Graves
Franketta Guinn
Olin Morris

2003 Executive Management Team

Herman Morris Jr.
President & CEO

Curtis Dillihunt
Senior Vice President & CAO

John McCullough
Senior Vice President, CFO & Secretary-Treasurer

Larry Thompson
Senior Vice President & COO

Christopher Bieber
Vice President, Engineering

Sherry DuBose
Vice President, Customer Service & Marketing

Michael Magness
Vice President, Human Resources

Linda Peppers
Vice President, Chief Information Officer

Wade Stinson
Vice President, Construction & Maintenance

Alonzo Weaver
Vice President, Operations

J. Maxwell Williams
Vice President & General Counsel

Letter from the Former Interim President

2003 was a year of triumph for Memphis Light, Gas and Water. Throughout the year, MLGW demonstrated superior performance, concern and leadership for our 413,000 customers. We pioneered new ways of thinking to increase our financial stability and protect our customers from possible future wholesale price increases. We solidified our ability to respond to emergency situations when we restored power to 339,000 customers in a remarkable 13 days after a violent windstorm. Best of all, we completed the task without a lost-time injury.

Having served on the MLGW Board of Commissioners since 1984, I can truly say that the leadership and employees we have at MLGW are the best in the business. They truly care for our company, our city and the customers we serve. Their dedication enables us to continually accomplish groundbreaking successes, such as our $1.5 billion prepayment agreement with TVA, which will save our customers millions in the years to come and ensure a stable source of power as the electric industry undergoes tremendous change. When you combine such progressive thinking with the devotion of each of our employees to provide safe and reliable service at the lowest cost possible, you find a utility with the fiscal ability to operate for more than a decade without a rate increase and with some of the lowest rates in the nation while continuing to enhance system reliability and customer service operations.

2004 is a year of transition for MLGW. While we will miss Herman Morris' leadership, we look forward to the guidance of the new President and CEO, Joseph Lee, III, who shares our unwavering commitment of providing reliable utility service with low, stable rates, and shares in our vision to improve the quality of living for each of our customers. It is a change in leadership, but not in our commitment to our customers. As we look forward to the future, we know that MLGW will take our solid foundation to build a powerful future for Memphis and Shelby County, its businesses and citizenry.

Dr. James L. Netters

Dr. James Netters
Former Interim President and CEO

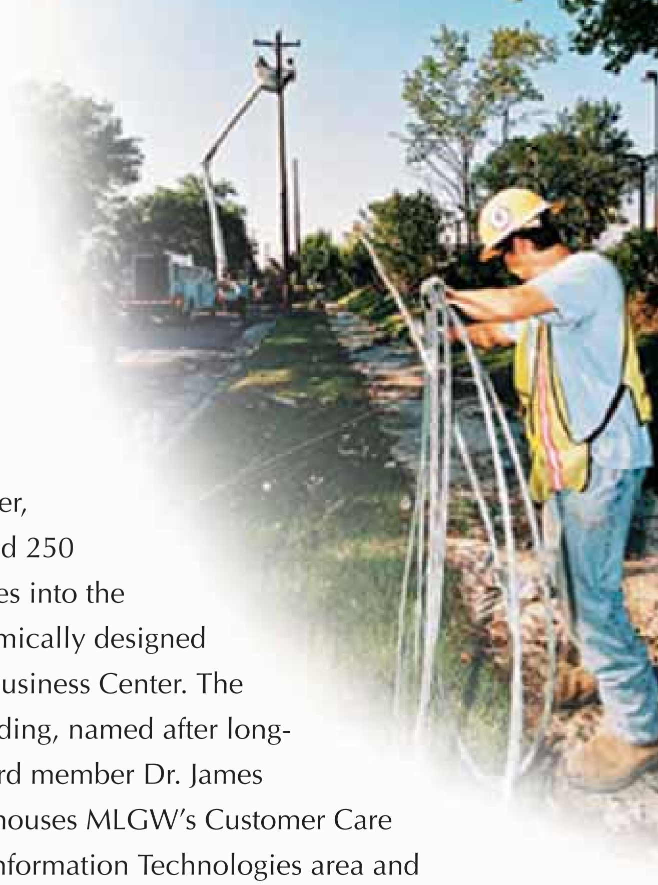
Strength for Today, Power for the Future

Powerful year

Whether it's responding to the most devastating natural disaster in recent Memphis history, authoring a groundbreaking billion dollar agreement to save our ratepayers millions each year, inaugurating a new state-of-the-art information system, or our employees giving back more than $1 million a year in goods and services to the community we serve, Memphis Light, Gas and Water and its 2,800 employees are a driving force for progress in Memphis and Shelby County. This progress builds on a strong 64-year history of providing reliable, low cost power for our 413,000 customers, and is a kind of progress that has the power to look beyond the short-term to find long-range, innovative solutions to meet the growing needs of our customers.

In 2003, MLGW's unwavering strength was evident throughout the community and the nation as we worked to ensure our customers would have a reliable, safe source of electricity, gas and water for years to come, while at the same time helping to shape national legislation that will have a positive impact on the utility industry.

The strength of customer service



Customer service is always top-of-mind at MLGW, and in 2003 we made many customer service enhancements to make it easier for our customers to do business with their Hometown Energy provider.

In January of 2003, Sherry DuBose was named Vice President of Customer Service and Marketing. DuBose brought 26 years of experience within MLGW to the helm of this important department. Under her guidance, the Customer Service areas were reorganized to streamline efficiency and MLGW underwent several major customer service enhancements.

For example, we introduced a new customer information system in May to replace our 20-year-old Legacy system. The new system consists of more than 2,500 computer system programs and affects some 650 business processes within the utility. Five years in the making, this new customer information system interfaces many company functions, thereby reducing wait times for most inquiries and offering real-time account updates for our customers by centralizing numerous operations. Our customers first noticed this new system when an easier-to-read itemized bill and new account numbers debuted in May. Under the new system, the first half of the customers' account number remains theirs, even if they move. This new information system allows customers to request service changes online, and our Customer Care Center employees now see the same bill that customers see, making communication easier. In the near future, customers will be able to view their bill online and conduct additional business with the utility through the World Wide Web.

In October, we moved 250 employees into the new seismically designed Netters Business Center. The new building, named after long-time board member Dr. James Netters, houses MLGW's Customer Care Center, Information Technologies area and other departments vital to the daily operations of the utility. The building's design protects MLGW's essential operations in case of an earthquake or other natural disaster, equipping us to be better prepared to serve our customers at all times and under all conditions. The move also enabled us to significantly expand the Customer Care Center's seating capacity and number of incoming phone lines. In addition, a new phone number, 820-7878, was introduced for starting, stopping or transferring utility service and for reporting service maintenance needs.

The combined capabilities of the new facility and the new customer information system have had a dramatic impact on our ability to respond to our customers' needs today and in the years ahead. Additional service enhancements are already in the works that will offer customers more and better information about their utility services and more options on how to receive or access that information.

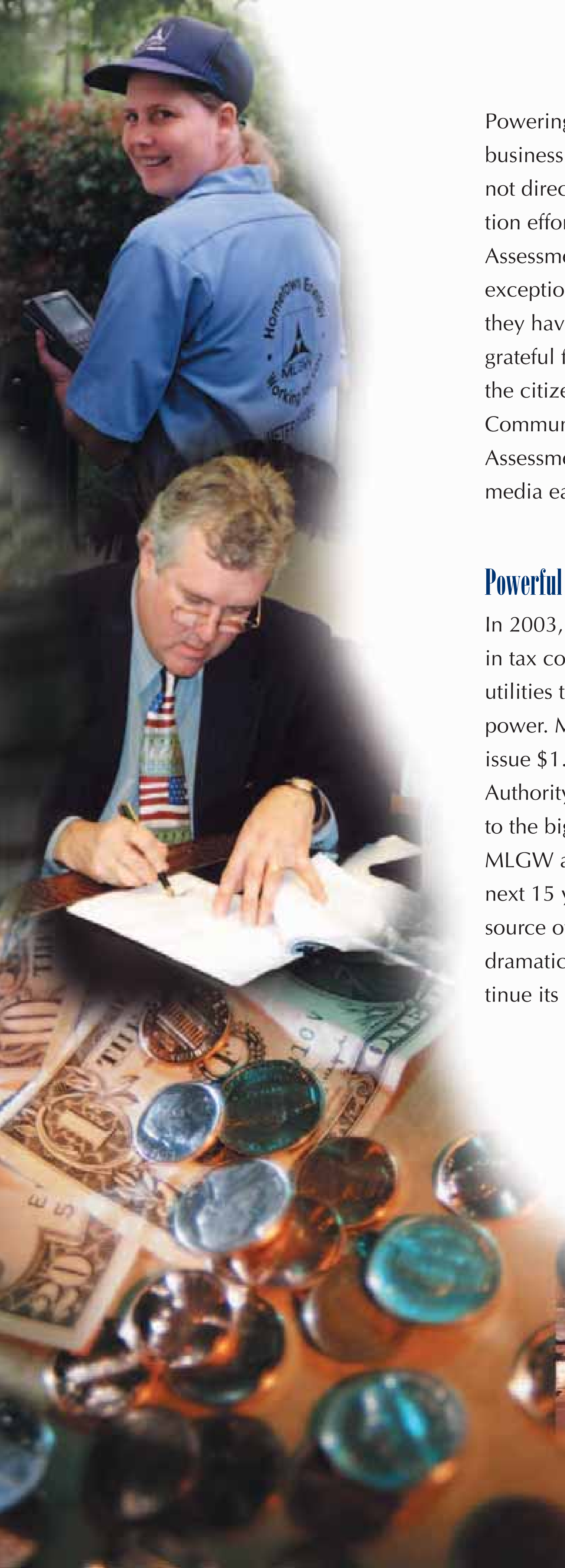
Stormy situation

Weather extremes are an expected part of MLGW's operations. We continually perform proactive preventive maintenance to keep our utility systems at peak performance throughout the year. This proactive maintenance allows us to make repairs more quickly when the system is damaged by storms or other events. Detailed response plans address numerous emergencies, and employees regularly participate in mock disaster drills to ensure they are readily able to handle any situation. MLGW crews also stay prepared for emergency response by assisting other cities in restoration efforts after disasters. For example, in May MLGW crews assisted Jackson, Tennessee utility workers after a devastating tornado ripped through the city's downtown area, killing 11 residents and leaving 75 percent of Jackson Energy Authority customers without power. MLGW's assistance enabled crews to complete the rebuilding effort with greater expedience. In 2003, MLGW also released crews to aid in the recovery effort after Hurricane Isabelle struck the East Coast in September.

Hurricanes can be one of the most brutal forces of nature. Unlike tornados, sustained winds can cause tremendous damage to an electric infrastructure. Memphis sits several hundred miles away from the nearest ocean and has never experienced the direct hit of a hurricane. However, in the early morning of July 22, hurricane-force straight-line winds in excess of 100 miles per hour struck Memphis unexpectedly and unrepentantly, damaging our city and wreaking havoc on MLGW's utility infrastructure. The storm knocked out power to 82 percent of our customers.

Like a general marching into battle, President and CEO Herman Morris Jr. activated our comprehensive emergency response plan and methodically led the men and women of MLGW through this enormous reconstruction effort. Even though several faced damage to their own homes, our employees, joined by more than a thousand utility workers from across the country, marched into the front lines and went about the task of rebuilding 70 percent of MLGW's electric infrastructure. Displaying their expertise in unsurpassed fashion, crews restored service to more than 339,000 customers in just 13 days and without a lost-time injury. Not since the ice storm of 1994, which left 275,000 customers without power, had MLGW's electric system seen such astounding damage, and the July storm left our utility infrastructure in need of much greater repair. However, lessons learned from the ice storm, as well as other less severe outage events, helped MLGW sharpen its emergency response plan to ensure our customers have service restored as quickly and safely as possible. Clearly, the restoration numbers demonstrate the plan's effectiveness. Even working to restore a significantly greater damaged electric grid, just five days after the wind storm, crews had restored power to 264,000 customers, almost the same number of customers who lost power during the ice storm of 1994. With talented and dedicated employees working 14- to 16-hour days in the field, and an exceptional and focused management team, MLGW was able to accomplish this monumental and historical restoration with paramount expediency and safety. Utilizing the continually enhanced emergency restoration plan that combines safety and customer satisfaction as top priorities, the plan directs that basic need and critical care facilities be restored first, followed by restoration according to amount of damage, and does not place priority of one area of the community above another. In all, the storm caused approximately $30 million dollars in damage to MLGW's systems, with the Federal Emergency Management Agency reimbursing MLGW for 75 percent of eligible costs.

Knowing some customers would need assistance paying for storm related damage to their homes, MLGW offered a utility repair assistance program for low-to-moderate-income customers immediately after the storm. The program offered up to $500 for repairs, with additional money available through a no-interest loan with repayment made through their utility bill.



Powering forward, MLGW assembled a blue-ribbon team of 18 business and community leaders and nine MLGW employees not directly responsible for reconstruction to assess our restoration efforts. Meeting over a three month period, the Storm Assessment Committee released a report detailing MLGW's exceptional response to this disaster. "Our conclusion is that they have done an excellent job, and we ought to be very grateful for the wonderful job MLGW did in restoring power to the citizens of Memphis," Dr. Richard Ranta, the Dean of Communications at the University of Memphis and Storm Assessment Committee member told MLGW executives and the media early in 2004.

Powerful financial foundation

In 2003, MLGW's leadership and determination led to a change in tax codes that allows MLGW and other municipal electric utilities to issue tax-free municipal bonds to pre-purchase power. MLGW asked for the tax code modification in order to issue $1.5 billion in bonds to prepay the Tennessee Valley Authority for a portion of our electric load. The agreement led to the biggest bond issuance in Tennessee history, and will save MLGW and our customers an estimated $225 million over the next 15 years. This unprecedented agreement provides a stable source of future power for our customers during a time of dramatic change in the industry and enables MLGW to continue its long-term commitment to hold the line on utility costs.

After a record-long period of providing top-notch utility service without a rate increase, and in fact, giving customers three separate rate decreases, MLGW's executive staff made the difficult decision in 2003 to approach the Memphis City Council, our rate-making body, requesting rate increases for all three services. MLGW had not increased electric rates in 11 years, gas rates for 10 years and water rates for nine years, and the increases were necessary to cover rising expenses, such as security, power supply costs and growing customer bankruptcies. However, the council postponed implementing the proposed gas increases until 2005 and reduced the amount of the electric and water increases. The approved increases will have minimal impact on our customers' monthly utility costs, raising the average bill by only $5.69 or aproximately four percent. However, this slight increase will raise much-needed revenue that will allow MLGW to continue providing unparalleled service to our 413,000 customers.

MLGW and its employees work to improve the quality of life for all of our customers. For example, our award-winning and regionally recognized Supplier Diversity program encourages locally owned , minority-owned, and women-owned businesses to do business with the utility. In just seven years, MLGW's Supplier Diversity Program has spent $150 million with these businesses, helping ensure that our pool of suppliers reflects the tremendous diversity of our community and contributing to the economic growth of our customer base.

Strengthening the community

MLGW believes in Memphis and the community we serve. The reliability and low cost of our utility service, combined with other attractive opportunities the Memphis area provides, led to more than $1.38 billion in new and expanding business investments during 2003 and created almost 8,000 new jobs in our area. MLGW works closely with the Memphis Regional Chamber to recruit and expand new businesses into Memphis and Shelby County. Some new businesses say a major influence in their relocation or expansion in Memphis is the reliability and low cost of MLGW services and the abundant availability of naturally pure water in the area.

MLGW does a lot more to promote local business growth. In early 2003, MLGW completed work on a three-year project to revitalize the Memphis Depot Business Park, installing a new utility infrastructure into the once-abandoned Memphis Defense Depot. With the improvements, the Business Park has leased more than half of its business space and has brought new jobs to Memphis and helped to revitalize the neighborhood surrounding the business park.

Our employees believe in the community we serve, and we are always ready to lend a hand to improve the quality of life for our customers. The On-Track program, for example, is recognized by others in the utility industry as going beyond the call of duty by providing our customers the financial management tools to effectively take control of their monthly income and spending. On Track enrollees participate in a year-long education program designed to eliminate debt and begin the important steps of saving money. Among other services, participants receive credit counseling assistance as well as energy efficient tips to lower their energy costs. Even though the program is still relatively young, more than 500 MLGW customers have completed the course work. Many participants say the program was a turning point in their lives, and some have gone from debt to home ownership.

Besides utility-engineered assistance programs, MLGW employees generously volunteer in the community we serve. In 2003, MLGW employees donated more than $1 million dollars in goods and services to local agencies, including a record $806,636 to United Way of the Mid-South, $22,232 to Junior Achievement and $23,726 to Plus-1, an MLGW program that helps those facing unforeseen financial hardships pay their utility bills. Our employees also donated 1,092 pints of blood to Lifeblood, and for the second year utility employees gathered to build an energy efficient Habitat for Humanity house in the River-

side community. We also spoke to dozens of community and neighborhood groups on topics ranging from energy efficiency to economic development.

A Younger Associates study completed early in 2003 shows that MLGW and its employees contribute a total of $2.15 billion each year to the local economy through sales revenue, new business growth and investment in local resources. MLGW employees are proud of our community and we do much to help improve the quality of life of our friends, neighbors and customers.

National force

As a leader in the utility industry, MLGW works to ensure the safe and reliable delivery of utilities across the country. MLGW President Herman Morris Jr. testified before congressional committees on important utility-related issues during his tenure with the utility, including two such appearances in 2003 on the issues of national gas pipeline safety and reform for MLGW's power supplier, TVA. In part as a result of Morris' testimony, the U.S. Congress passed the Pipeline Safety Act of 2003, which enacts national safety standards for the delivery of natural gas and opens government/utility communications to protect the nation's gas supply.

Emboldened environment

One of our top goals at MLGW is to educate our customers on the importance of using energy wisely so they can take control of their utility costs and preserve precious natural resources, which leads to a better environment for all of us. MLGW has comprehensive energy and environmental saving information available for our customers including brochures, interactive web pages, streaming video on simple energy efficient home improvements and much more.

To promote environmentally conscious construction practices in our community, MLGW launched the EcoBuild program in 2003. EcoBuild, which promotes energy efficient, environmentally-minded building practices in Memphis and Shelby County draws upon "green building" standards and alliances with local builders, architects, engineers and city agencies to create energy smart, more environmentally safe housing. MLGW developed EcoBuild guidelines to assist in the building of environmentally friendly housing that can reduce energy usage by up to 30 percent. This savings is achieved through construction measures such as a more efficient air conditioning system, custom-designed ductwork and the use of recycled and environmentally friendly building materials.

MLGW leads by example when it comes to environmental savings, and in 2003 launched the EcoWise program for utility employees. The program rewards employees who submit energy- and environmental-saving tips that can be implemented utility-wide, such as the reuse of paper products, with modest tokens of appreciation. In less than a year of operation, the EcoWise program has saved MLGW thousands of dollars in operational expenses. Also in 2003, the utility added an energy efficient Toyota Prius to its fleet of vehicles. The Prius, which runs on a hybrid electric and gas engine, reduces fuel emissions by 75 percent compared to even Ultra Low Emission Vehicles.

The Prius is just one part of MLGW's energy efficient vehicle fleet. The utility also utilizes compressed natural gas vehicles for some of its customer service functions. These vehicles burn clean natural gas and reduce fuel emissions, which is better for the environment.

MLGW operates hundreds of miles of right-of-way land in Shelby County. We use many of these areas to foster environmental growth. On their own time, several of our employees create wildlife habitats, cultivate food for animals and build shelters to encourage wildlife growth in our community. Our employees believe a strong eco-system will benefit Memphis and Shelby County for years to come.

Another MLGW environmental effort kept tons of scrap material out of local landfills. In 2003 alone, MLGW sold almost 2.5 million pounds of scrap to area salvage yards for recycling, saving MLGW customers $39,000 in landfill fees and generating more than $350,000 in revenue.

Recognized success

MLGW's success is recognized around town and around the nation. The utility continues to garner local, regional and national awards for its service, insight and management. In 2003, MLGW and its employees were recognized for a variety of honors including the Minority Enterprise Development's Corporation of the Year award for our continued dedication to the growth of local-, minority- and women-owned businesses. Our ability to effectively communicate important energy and environmental savings was recognized by the American Business Awards in April when the utility received the Best Communications Organization award, and our Water Quality Report, a federally mandated document that gives water customers details on the purity of Memphis water, was recognized by the Environmental Protection Agency with its 2003 Consumer Confidence Report Excellence Award for the region.

Power for the future

MLGW has a bright future filled with continued dedication to giving our customers the safest, most reliable, cost efficient service possible while steadfastly working to shape the national utility industry to benefit MLGW and utility customers nationwide. While 2004 has brought new leadership and new dynamics, one thing our customers can always count on is reliable, low-cost service from the utility that personifies Hometown Energy Working for You. As we reach our 65th birthday in 2004, MLGW will make even greater strides in customer service, continually looking for ways to invest in our community and developing visionary opportunities that will propel the utility industry while maintaining the lowest possible rates for our customers. MLGW is proud of Memphis and we look forward to continuing our tradition of excellence within the community.

Powerful performance

2003 was a groundbreaking year at MLGW. From successfully completing the task of rebuilding the majority of our electric infrastructure after a natural disaster to lobbying for legislative change to continuing our strong tradition of giving back to the customers we serve, the evidence of MLGW managers' and employees ' uncompromised performance and pioneering excellence is evident throughout Memphis and Shelby County. Our long standing tradition of excellence serves to increase the prosperity of our city and the customers we serve.

Operational achievements

One of MLGW's greatest financial achievements came to fruition in 2003, when the Tennessee Legislature and U.S. Department of Treasury enacted regulations to allow MLGW and other municipal power suppliers to issue bonds to prepay for future electric needs. The new regulations allowed MLGW to pre-purchase part of its electric needs over the next 15 years from power supplier TVA at a discounted rate. The agreement is expected to save MLGW and its customers a total of $225 million. Late in the year, the Memphis City Council approved the issuance of the bonds, enabling the transaction to take place. This is the largest bond transaction in Tennessee history.

Another achievement in 2003 was the successful completion of our largest-ever electric restoration effort. On July 22, early morning hurricane-force straight line winds leveled trees, damaged houses and knocked out 70 percent of MLGW's electric infrastructure. Within hours of the storm's passage, MLGW President & CEO Herman Morris Jr. enacted our emergency response plan and employees began the task of restoring power to more than 339,000 customers. Working around the clock and calling in more than 1,100 extra workers to complete this daunting task, we restored power in a remarkable 13 days and without a lost time injury.

After fulfilling MLGW's commitment to hold customer rates steady through 2003, utility executives made the difficult decision in 2003 to approach the Memphis City Council, our ratemaking body, and request rate increases for all three services. MLGW had gone an unprecedented 11 years without an electric rate increase, 10 years without an increase in water rates and nine years without an increase in gas rates. However, the council postponed implementing the proposed gas rate increase until 2005, and reduced the amount of the electric and water increases. In 2004, the average monthly residential utility costs will increase only $5.69, and provides much needed revenue that will allow MLGW to continue providing unparalleled service to our 413,000 customers.

Customer service achievements also prevailed in 2003. In May, the utility replaced its 20-year-old customer information system with a Windows® based system. Affecting more than 650 business processes, this new customer information system enables our customer service advisors greater access to customer accounts, allowing for immediate account updates and a faster response time for customer requests. In October, the Customer Care Center along with several other departments moved to the seismically resistant Netters Business Center in East Memphis. The new building allowed for increased phone line capacity and the addition of a new phone number for starting, stopping and transferring service as well as completing service maintenance requests. These new additions, combined with others in 2004, will give our customers greater access to their utility company and allow us to serve them more efficiently.

Energy for the community

Thanks in part to MLGW's unwavering commitment to the continued growth and development of our region, the Memphis area saw more than $1.38 billion in new business and business expansion in 2003. By working closely with the Memphis Regional Chamber to attract companies to and expand present companies located in our community, nearly 8,000 new jobs were created in the midst of an uncertain nationwide economy. Working with the Chamber, MLGW creates packages tailored to each prospective company to attract and retain their business.

MLGW works to have the providers and the products we buy resemble the diversity of the customers we serve. MLGW's Supplier Diversity Program works to ensure that local small-, minority- and women-owned businesses have the opportunity to provide products and services to us. In the program's seven years of operation, MLGW has spent $150 million with these businesses, ensuring the utility gets quality products and competitive rates and aiding in the growth of local small businesses.

Just as we are sensitive to opportunities to help our local economy stay on track, we work to do the same for customers who are struggling financially. One such program, On Track, has assisted more than 500 MLGW customers reach a turning point in their lives by providing debt counseling assistance that has enabled them to begin saving money and improved their quality of life. The program also teaches participants energy conservation and how to build a budget.

In addition, MLGW employees are actively involved in the Memphis community, donating more than $1 million in goods and services annually. In 2003, MLGW employees donated a record $806,636 to United Way of the Mid-South, $22,232 to Junior Achievement and $23,726 to Plus-1, an MLGW program that helps those facing unforeseen financial hardship to pay their utility bills. Also in 2003, MLGW employees built their second energy-efficient Habitat for Humanity home in the Uptown Memphis area and donated 1,092 pints of blood to Lifeblood, the most of any company in the area. MLGW employees are truly committed to improving the quality of life of its customers.

Environmental Concern

MLGW is concerned about the environment, and works to foster a safe environment for generations to come. For instance, in 2003, MLGW added a hybrid electric/gasoline car to its fleet, which also includes a number of clean burning compressed natural gas vehicles. Another environmental concern keeps tons of scrap material out of local landfills. In 2003, MLGW sold 1,231 tons of scrap materials like iron to local salvage yards. In addition to saving valuable landfill space, MLGW saved $39,000 in landfill fees. The utility also launched the EcoBuild program in 2003, which will make energy savings a top priority in planning and constructing new houses in our community.

Powering Forward

MLGW has a bright future rich with continued dedication to providing reliable utility service to our customers at some of the lowest combined rates in the nation. While 2004 brings new leadership and new dynamics to our utility, our customers can rest assured that their service will not be compromised. MLGW is proud of Memphis, and we look forward to continuing our long tradition of excellence in the community and in the utility industry.

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, accounts separately 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

- MLGW was instrumental in amending IRS regulation 26 CFR Part 1 pertaining to the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. This amendment allows for municipal electric utilities such as MLGW to utilize tax-exempt financing to secure prepaid electricity to be used for resale to retail electric customers who are located in the service territory.
- MLGW recorded the largest municipal bond issue in history in the State of Tennessee with the issuance of $1.4 billion Subordinate Revenue Bonds Series 2003A and 2003B (Auction Rate Securities) to prepay for electricity with TVA. This issue was a direct result of the amending of the IRS regulation previously discussed.
- The most devastating wind storm in the history of MLGW hit the City on July 22, 2003, causing extensive damage to MLGW's systems, particularly the Electric System.
- Memphis City Council approved rate increases for the Electric and Water Divisions.
- Net assets increased in all three divisions; the Electric Division increased by $26.8 million, the Gas Division by $14.6 million, and the Water Division by $2.7 million.
- MLGW incurred a combined total expense of $44.7 million for payment in lieu of taxes to the City of Memphis to support critical city services, up 4.8 percent from 2002.

MLGW Negotiated Prepaid Electricity Contract with TVA, the first for TVA Distributors

After two years of negotiations with the Tennessee Valley Authority and simultaneous efforts to change IRS regulations, MLGW entered into a 15-year contract with TVA to prepay a portion of electric capacity needs. As a part of the arrangement, TVA received an up-front payment of $1.5 billion from MLGW and MLGW in turn secured for the next 15 years a lower-cost supply of electric power and mitigated significantly its supply risk for its core retail customer base. Savings over the life of the agreement are projected to be in excess of $225 million. The ensuing bond issue to fund the prepayment, which closed on December 9, 2003, was the largest recorded in the State of Tennessee's history. Please see additional information in Notes 1, 7, and 10 of the accompanying financial statements.

Summer Storm Strikes Service Territory

On July 22, 2003, the MLGW service territory was struck by a line of thunderstorms producing up to 102 mph winds bringing with them the most widespread and intense destruction ever experienced by MLGW. Damage to the electric system infrastructure caused a loss of power to approximately 339,000 or 82 percent of our customers. Within the electric system, approximately 1,760 of 2,036 megawatts of electric load was lost, 41 of 56 substations were impacted, and massive damage occurred to distribution circuits, poles, and transformers. Within the water system, 8 of 10 pumping stations were off or compromised, power and communications lost to 86 percent of the wells, and 200,000 customers impacted. The gas division was the least harmed with uprooted trees damaging certain pipelines and loss of telemetry communications with remote locations.

The emergency restoration extended over a 13 day period with most customers back on during that time. MLGW supported its staff with 340 contracted tree trimmers, 79 utility linemen assisting from other municipalities, and over 500 linemen and electrical workers from six different contractors. Total estimated cost of the storm is approximately $30 million.

With Shelby County being declared a major disaster on July 29, MLGW applied for FEMA (Federal Emergency Management Agency) funding in the amount of $26.4 million. Total expected reimbursement is approximately $20.0 million, or 75 percent of eligible costs. All work will be completed in 2004.

In advance of the FEMA reimbursement, MLGW secured a $15 million revenue anticipation note. The note was repaid in February 2004. Please see additional information in Note 14 of the accompanying financial statements.

MLGW Labor Agreement

2003 was the second year of a three-year contract with IBEW Local No. 1288 which represents approximately 1,800 non-supervisory employees throughout MLGW. Negotiations for the 2005 fiscal year contract will begin mid-year 2004.

Electric Division Highlights

Operating Highlights

As indicated in Table 1 below, the Electric Division's total assets increased $1.5 billion, primarily due to non-current prepaid power costs of $1.4 billion and current prepaid power costs of $63.8 million. MLGW changed its accounting policy in 2003 to recognize revenues when earned rather than billed. The change resulted in a $17.1 million increase in current assets from 2002 to 2003. The rate increase secured for 2004 comprised $1.9 million of the accounting change. 2002 was not restated; however, a cumulative effect was recorded in 2003 in the Statement of Revenues, Expenses, and Changes in Net Assets.

Table 1
Electric Division Condensed Balance Sheets
December 31
(In Thousands)

	2003	2002
Current and other assets	$ 291,467	$ 302,155
Prepaid power costs	1,495,643	-
Capital assets	715,535	695,062
Total assets	2,502,645	997,217
Current liabilities payable from current assets	230,172	136,018
Current liabilities payable from restricted assets	20,974	46,516
Non-current liabilities	1,507,714	97,657
Total liabilities	1,758,860	280,191
Net assets:		
Invested in capital assets, net of related debt	679,848	604,074
Restricted	13,119	53,637
Unrestricted	50,818	59,315
Total net assets	$ 743,785	$ 717,026

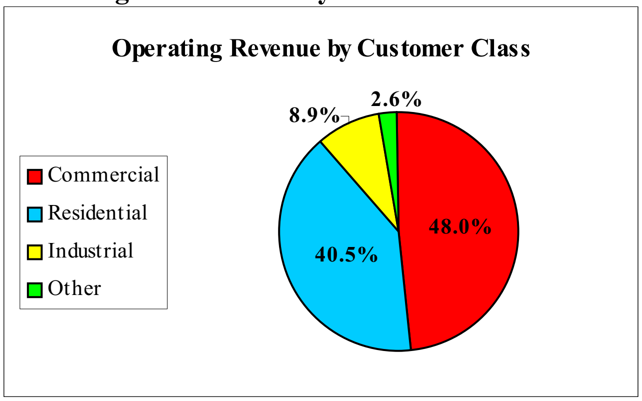
At December 31, 2003, over 91 percent of the net assets were related to capital assets, which included property, plant and equipment. Restricted funds comprised $13.1 million, and an additional $50.8 million of the net assets was in unrestricted funding, which can be used for on-going operations of the electric system.

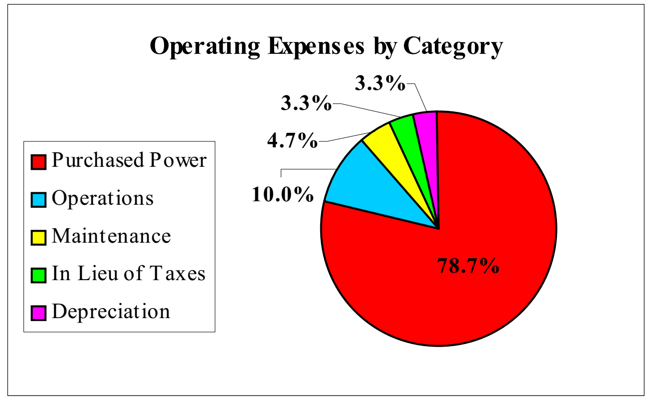
Table 2
Electric Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2003 and 2002
(In Thousands)

	2003	2002
Revenues:		
Operating revenues	$ 848,430	$ 847,222
Non-operating revenues	34,884	27,537
Total revenues	883,314	874,759
Expenses:		
Depreciation expense	27,622	26,427
Purchased power	669,358	676,281
Other operating expense	153,169	135,688
Non operating expense	12,176	9,599
Total expenses	862,325	847,995
Income before contributions in aid of construction	20,989	26,764
Contributions in aid of construction	31,768	18,679
Reduction of plant costs recovered through contributions in aid of construction	(31,768)	(18,679)
Changes in net assets	20,989	26,764
Beginning net assets	717,026	690,262
Cumulative effect of change in accounting principle	5,770	-
Beginning net assets as adjusted	722,796	690,262
Ending net assets	$ 743,785	$ 717,026

Total net assets increased $26.8 million with $9.1 million of the increase due to the effects of the change in accounting principle. The remaining increase of $17.6 million is due primarily to an increase in net utility plant. Operating revenues of the Electric Division totaled $848.4 million and were derived principally from the retail sales of electricity to an average of 412,817 customers. As depicted in Figure 1, commercial and residential customers comprise 88.5 percent of total sales revenue. Operating revenues were up slightly from 2002 revenues of $847.2 million primarily due to the effect of the change in accounting principle which increased revenue $11.4 million from 2002. Power costs in 2003 were $669.4 million, down 1.0 percent from 2002. The change in accounting principle increased power costs $8.0 million from 2002. Net of the change in accounting principle, operating revenues and power costs were down due to a decline in retail sales.

Figure 1: Electric Division
Percentage of Each Utility Dollar





Contributing factors to the decrease in kWh sales and power costs include decreases in both the cooling degree days (12.6 percent) and heating degree days (6.1 percent). The decrease in Electric Division revenues by customer class in 2003 is attributable to the residential customer class.

Adjusted net write-offs of $3.1 million declined back to a rate equivalent to the pre-gas crisis period of 2000. During the peak year 2001, adjusted net-write offs hit a 10-year high of $3.8 million. Working with customers to prevent bankruptcies and delinquent payments remains a top priority of management. MLGW also continued the policy implemented in late 2002 per the direction of the Memphis City Council to discontinue cutoffs annually during the high utility usage period of mid-December to mid-January.

Non-operating revenues of $34.9 million were up $7.3 million from the prior year due to a $4.0 million prepay credit related to the issuance of the 2003 Electric Bonds and $3.8 million related to the Summer Storm to record FEMA reimbursement.

Operating expenses of $850.1 million were up $11.8 million from the prior year expenses of $838.4 million. As shown in Figure 1, power costs accounted for almost 79 percent of MLGW operating expenses. Although power costs were down $6.9 million from the previous year, these reductions were offset by $7.8 million in storm costs. Almost $7 million of the $7.8 million is located in maintenance expense, with the remainder in operations expense. Depreciation expense increased $1.2 million in 2003. Other increases included $1.7 million in injuries and damages, and $3 million in employee pensions and benefits. In addition, $1.7 million of miscellaneous accounts receivable greater than one year old were written off, along with over $900 thousand of additional inter-company charges recorded relating to the Electric Division's use of the new customer information system.

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 implemented both a rate change and a rate adjustment effective October 1, 2003. Both were passed through to MLGW customers. This was TVA's first rate change since October 1997. The rate change increased power cost for non-manufacturing customers and manufacturing customers with demands less than 1,000 kilowatts. For manufacturing customers with demands greater than 1,000 kilowatts, the rate change introduced new rates which decreased their power cost.

The October TVA rate adjustment increased power cost for all customer classes. The combined retail effects of the rate change and adjustment varied by customer class, with the approximate increase being 5.9 percent for residential customers and 7.5 percent for non-manufacturing general service customers. The effect for manufacturing general service customers was a 1.9 percent rate decrease.

In October, MLGW received City Council approval to issue $1.5 billion of bonds to finance the prepayment of a portion of the electric power supplied by TVA. Under the terms of the supplemental contract, TVA will provide the prepaid capacity in equal monthly segments. By acquiring the prepaid capacity from TVA, the Electric Division has secured for the next 15 years a lower-cost supply of electric power and has mitigated significantly its supply risk for its core retail customer base. Estimated savings for MLGW are $225 million, or about $15 million a year over the life of the contract.

MLGW requested City Council approval of a rate increase to be effective with meter readings on and after December 30, 2003. This is the first increase for operating expenses in MLGW's Electric Rate Schedules since January 1, 1993. The actual increase varied by customer class, with a composite average of 4.7 percent. These rate increases were required due to the effects of inflation on general operating expenses, health insurance costs, facility security, increases in uncollectibles, depletion of cash reserves, increases of in lieu of tax payments, and capital expenditures for system improvements. This rate increase is estimated to produce an annual increase in revenues of $40.3 million during the calendar year 2004.

Changes in Capital Assets

Construction Activities

During 2003, the Electric Division expended $45.3 million on construction activities. Major Electric Division capital projects included completion of a new substation needed for downtown network growth ($1.7 million), purchase of transportation and communication equipment ($3.6 million), street lighting installations ($4.0 million), revenue extensions to serve new customers ($14.8 million), distribution system improvements ($1.6 million), purchase of transformers ($5.2 million), and improvements to the Netters Business Operations Center ($6.7 million). The Netters Business Operations Center was occupied by the customer call center and critical customer service operations in October 2003. As a result, more than 100 incoming telephone lines were added to the new Customer Care Center to better assist customers.

Capital Assets

The Electric Division's investment in capital assets as of December 31, 2003 was $715.5 million, net of accumulated depreciation. This includes $76.3 million in Transmission plant (up $2.6 million from 2002). The 3.5 percent increase resulted from the construction of transmission lines in the effort to tie several substations together.

Distribution plant, net of depreciation, had an ending balance of $531.1 million, a $33.7 million increase (representing a 6.8 percent rise from the previous year). $13.8 million of the increase can be attributed to the storm of July 22nd, net of FEMA contributions and retirements, and $5.3 million to the purchase of line transformers and meters.

General plant, net of depreciation, had an ending balance of $43.9 million, an increase of $3.7 million (a 9.2 percent increase over the previous year). The increase is mainly associated with the purchase of miscellaneous equipment such as communication and power operated equipment.

Major plant additions from construction work in progress include the expansion of the fiber optic cable system for communication and protective relaying, streetlights for portions of Shelby County that were annexed, and the purchase of meters and transformers.

Debt Administration

The Electric Division's long-term debt is notably increased from prior years due to the issuance of $1.4 billion of bonds for the prepayment of electricity. Note that the prepayment debt does not adversely impact the financial position of the Electric Division as the annual expense for debt service is a substitution for a part of power costs.

MLGW will actually save approximately $15 million per year. Under the Prepay arrangement, the Electric Division has a corresponding prepay asset for power receivable from TVA. MLGW also defeased $25 million of Series 1992 revenue refunding bonds. The only remaining debt other than the Prepay financing is Series 2002 revenue refunding bonds in the amount of $37 million with seven years remaining. Please see additional information in Note 7 of the accompanying financial statements.

MLGW's Electric Division Bond Covenants require that for Series 2002 Bonds, the ratio of net revenues available for debt service to the amount of principal and interest for any fiscal year (coverage) must be not less than 1.20. For Series 2003 A & B Bonds, the ratio of net revenues to the amount of principal and interest for any fiscal year for Junior Lien Revenue Obligations must not be less than 100%. The composite coverage as of December 31, 2003, was 3.07.

Current credit ratings from Moody's Investors Service are Aa3 on all debt. Standard and Poor's current rating on Series 2002 senior lien debt is AA and AA- on the Subordinate Revenue Bonds Series 2003A and 2003B. FitchRatings issued AA rating on all outstanding debt.

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 percent of operating revenue less power costs (three year average). The 2003 Electric Division in lieu of tax payments paid by MLGW was $28.2 million. This amount represents a 1.9 percent increase over 2002.

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 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.

MLGW's gross investment in Memphis Networx through 2003 has been $25.0 million. MLGW is authorized for a total investment amount up to $32 million. MLGW's share of Memphis Networx losses in 2003 was $4.5 million and the cumulative net investment in Memphis Networx was $11.3 million at December 31, 2003. MLGW expects to invest approximately $6 million in Memphis Networx in 2004. 2003 was the first full year for Networx to market its services. During the year, Memphis Networx acquired some very significant customers who use the various services offered including data center development, transport services, Ethernet services, fiber optic network construction, and internet services. 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. Please see additional information in Note 9 of the accompanying financial statements.

Gas Division Highlights

Operating Highlights

As shown in Table 3, the Gas Division's total assets of $507.0 million exceeded total liabilities by $412.9 million, up $14.6 million from 2002, $6.2 million of which relates to increases in utility plant and $8.4 million relates to the change in accounting principle to accrue earned but unbilled revenue. Current and other assets increased by $3.2 million due also to the accounting change. Non-current liabilities decreased $3.6 million from 2002, of which $1.8 million was due to an early payment of a long-term receivable by an industrial customer and $1.4 million was due to the reclassification of the current portion of unearned income related to a direct financing lease with The Premcor Refining Group, Inc. (formerly Williams Refining and Marketing, LLC).

Table 3
Gas Division Condensed Balance Sheets
December 31
(In Thousands)

	2003	2002
Current and other assets	$ 180,272	$ 177,053
Capital assets	326,757	320,529
Total assets	507,029	497,582
Current liabilities payable from current assets	72,117	73,102
Current liabilities payable from restricted assets	6,074	6,667
Non-current liabilities	15,904	19,475
Total liabilities	94,095	99,244
Net assets:		
Invested in capital assets, net of related debt	326,757	320,529
Restricted	23,780	16,558
Unrestricted	62,397	61,251
Total net assets	$ 412,934	$ 398,338

At December 31, 2003, almost 80 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $23.8 million of the net assets and the remaining $62.4 million was in unrestricted asset accounts used for on-going operations of the gas system.

Table 4
Gas Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2003 and 2002
(In Thousands)

	2003	2002
Revenues:		
Sales, service and other operating revenues	$ 338,520	$ 246,653
Transported gas revenue	14,379	8,211
Non-operating revenues	3,177	6,935
Total revenues	356,076	261,799
Expenses:		
Depreciation expense	12,591	10,679
Purchased gas	260,102	173,635
Other operating expense	74,011	70,315
Non operating expense	-	-
Total expenses	346,704	254,629
Income before contributions in aid of construction	9,372	7,170
Contributions in aid of construction	2,483	1,926
Reduction of plant costs recovered through contributions in aid of construction	(2,483)	(1,926)
Changes in net assets	9,372	7,170
Beginning net assets	398,338	391,168
Cumulative effect of change in accounting principle	5,224	-
Beginning net assets as adjusted	403,562	391,168
Ending net assets	$ 412,934	$ 398,338

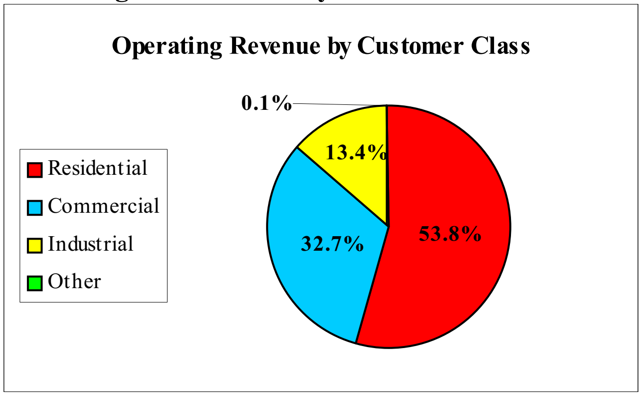
Operating revenues were up 38.5 percent from 2002 due mainly to higher winter wholesale gas prices. The effect of the change in accounting principle increased operating revenues $12.0 million from 2002. Gas costs in 2003 amounted to $260.1 million, up 49.8 percent from 2002. The effect of change in accounting principle increased gas costs $10.9 million from 2002. Net of the change in accounting principle, operating revenue and gas cost were up due to an increase in wholesale natural gas cost.

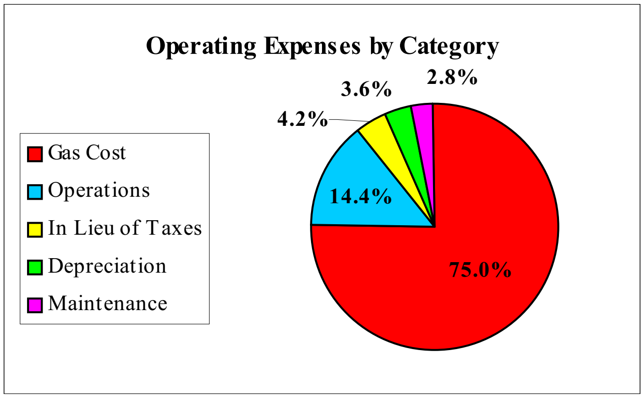
Sales decreased by about 9.8 percent due in part to a 6.1% decrease in heating degree days.

Operating revenues of the Gas Division totaled $352.9 million and were derived principally from the retail sale of gas to an average of 308,662 customers and transportation of gas to an average of 15 customers. As indicated in Figure 2, residential customers account for 53.8 percent of total sales revenue.

Adjustments for uncollectibles, which are deducted from gross operating revenues, amounted to $574.5 thousand during 2003, down from $2.0 million in 2002. The Division had been carrying a larger reserve balance due to the extremely high gas costs of 2001; therefore, an adjustment was made to more accurately reflect aged receivables.

Figure 2: Gas Division
Percentage of Each Utility Dollar





Total operating expenses of $346.7 million were up $92.1 million from 2002, due mainly to the increase in wholesale gas costs coupled with the change in accounting principle.

Rates

The Gas Division purchases its gas requirements on the open market from a variety of producers and marketers. 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.

Natural gas is delivered to MLGW 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. A connection to ANR Pipeline Company is scheduled to be completed by November 1, 2004. This connection will provide MLGW access to an additional interstate pipeline and the ability to transport 60,000 MMBtu/day of natural gas.

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.

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).

MLGW requested City Council approval of a 6.3 percent gas rate increase effective with Cycle 1 meter readings on or after December 30, 2003. This rate increase was required due to the effects of inflation on general operating expenses, health insurance costs, facility security, reduced cash reserves, increases on in lieu of tax payments, and capital expenditures for system improvements. This will be the first increase for operating expenses in MLGW's Gas Rate Schedules since April 1, 1994.

The City Council approved the rate increase, but delayed the effective date. The new Retail Gas Rate Schedules will become effective with Cycle 1 meter readings for the January 2005 revenue month.

Changes in Capital Assets

Construction Activities

During 2003, the Gas Division expended $21.8 million in construction costs. Included in the construction costs were cast iron system retrofits ($3.0 million) and revenue extensions ($4.2 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. Due to budget constraints and the delay of the gas rate increase, work on the cast iron system was slowed in 2003. To date, 206 miles of cast iron main have been replaced (64 percent complete). In May 2003, the new customer information system (CIS) was implemented. Costs charged to construction in 2003 were $6.3 million and the total cost of the new system is $34.0 million. The new system's software has allowed Division users to readily access more information and serve our customers with greater efficiency. Along with the implementation of CIS, customer bills were also redesigned based on customer feedback. The Electric and Water Divisions will share the cost of the CIS with the Gas Division through the payment of rents to the Gas Division.

Capital Assets

The Gas Division's investment in capital assets as of December 31, 2003 was $326.8 million, net of accumulated depreciation. This includes production, distribution, general plant, construction work in progress, non-utility plant and plant held for future uses. The overall increase in capital assets for 2003 was 1.9 percent.

Major additions to plant from work in progress were the replacement of cast iron mains. Other major additions were from purchases of land and meters, transportation equipment, and power operated equipment. A large percentage of the increase in gas capital assets can be attributed to the purchase and installation of the Customer Information System which resulted in a 76.3 percent increase in General Plant.

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 2003, the Gas Division paid in lieu of tax payments of almost $14.5 million, which represents an 8.4 percent increase over 2002, mainly due to the overall increase in operating revenue less gas costs along with property tax increases levied by certain local municipalities.

Water Division Highlights

Operating Highlights

As depicted in Table 5, the Water Division's total assets exceeded total liabilities by over $259.1 million**.** Current and other assets decreased $6.8 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 $7.0 million reduction in long-term debt. Almost 79 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $24.2 million of the net assets and the remaining $31.6 million was in unrestricted asset accounts used for on-going operations of the water system.

Table 5
Water Division Condensed Balance Sheets
December 31
(In Thousands)

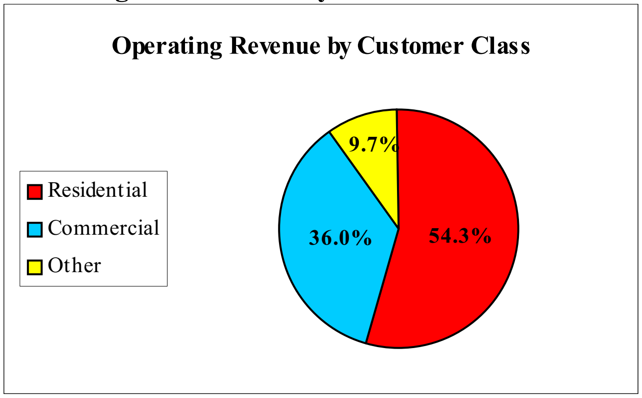
	2003	2002
Current and other assets	$ 76,086	$ 82,859
Capital assets	237,177	235,328
Total assets	313,263	318,187
Current liabilities payable from current assets	13,462	14,295
Current liabilities payable from restricted assets	11,679	11,371
Non-current liabilities	28,990	36,069
Total liabilities	54,131	61,735
Net assets:		
Invested in capital assets, net of related debt	203,289	194,776
Restricted	24,253	29,123
Unrestricted	31,590	32,553
Total net assets	$ 259,132	$ 256,452

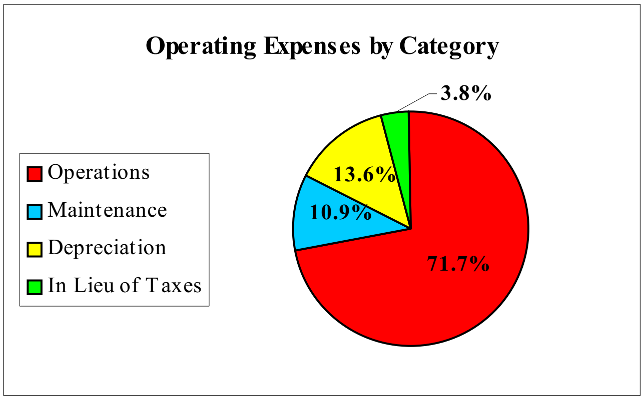
Table 6
Water Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2003 and 2002
(In Thousands)

	2003	2002
Revenues:		
Operating revenues	$ 55,812	$ 56,259
Nonoperating revenues	2,383	2,294
Total revenues	58,195	58,553
Expenses:		
Depreciation expense	7,479	7,125
Other operating expense	47,720	43,568
Non operating expense	1,763	2,106
Total expenses	56,962	52,799
Income before contributions in aid of construction	1,233	5,754
Contributions in aid of construction	4,174	5,451
Reduction of plant costs recovered through contributions in aid of construction	(4,174)	(5,451)
Changes in net assets	1,233	5,754
Beginning net assets	256,452	250,698
Cumulative effect of change in accounting principle	1,447	-
Beginning net assets as adjusted	257,899	250,698
Ending net assets	$ 259,132	$ 256,452

Net assets for the Water Division increased by almost $2.7 million in 2003 as shown in Table 6, due to the effect of the change in accounting principle of $3.1 million, relating to accruing earned but unbilled revenues. The rate increase secured for 2004 comprised $754 thousand of the accounting change. For the twelve months ending December 31, 2003, operating revenues of the Water Division totaled $55.8 million and were derived principally from the sale of water to an average of 248,917 customers. Figure 3 depicts the breakdown of Water Division revenues, of which 54.3 percent are derived from residential customers. Operating revenues were down 0.8 percent from 2002. The effect of the change in accounting principle increased 2003 operating revenues by $1.7 million.

Figure 3: Water Division
Percentage of Each Utility Dollar





Total operating expense of $55.2 million increased in 2003 by $4.5 million. Almost $400,000 of the difference was due to the final increase in the three year escalation factor of the Water Division payment in lieu of tax to the City of Memphis. Operations expenses also increased by $2.8 million due to increases in inter-company rents primarily related to new customer information system, employee pensions and benefits, and customer contracts and orders.

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 the MLGW Charter to furnish to the City free, sufficient water for public purposes such as fire hydrants and Memphis City Schools.

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. 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 received a 3.0 percent rate decrease annually each July 1 from 1999 through 2003. On July 1, 2003, the last SCBPU decrease was implemented and the water rates for these customers are now equal to the Division's county water rates.

MLGW requested City Council approval of a 28.6 percent water rate increase effective with meter readings on or after December 30, 2003. This rate increase was required due to the effects of inflation on general operating expenses, health insurance costs, facility security, increases in uncollectibles, reduced cash reserves, increases on in lieu of tax payments, and capital expenditures for system improvements. This is the first increase for operating expenses in MLGW's Water Rate Schedules since January 6, 1995. The rate increase is projected to produce an annual increase in revenues of $15.5 million for water during the calendar year 2004. The City Council approved an amended rate increase which averaged 27.5 percent across customer classes.

Changes in Capital Assets

Construction Activities

The Water Division expended $13.3 million in construction activities during 2003. Major projects for 2003 included capital improvements for various pumping stations ($1.5 million), purchase of data processing equipment and ($6.1 million), and revenue extension to serve customers ($2.6 million).

The Water Division is currently in the construction phase of a $3.5 million seismic mitigation grant for the Lichterman and McCord pumping stations. The 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 2003 exceeded $61 thousand.

Capital Assets

The Water Division's investment in capital assets as of December 31, 2003 was $237.2 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 2003 was 0.79 percent.

Major additions to plant include the purchase of well lots, wells and mains, the upgrade of Lichterman Instrumentation System, and the purchase of meters and computer equipment, including but not limited to an e-mail management system, an Ethernet printing system, and mainframe equipment, which will be rented to the Electric and Gas Divisions on a customer split basis.

Debt Administration

The Water Division's long-term debt, comprised of revenue bonds, decreased $6.9 million during 2003 due to scheduled repayments. The current outstanding balance is $26.6 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 the amount of principal and interest for each fiscal year (coverage) must be not less than 1.20. Coverage as of December 31, 2003, was 1.46. The coverage will increase in 2004 as a result of a water rate increase effective with meters read on or after December 30, 2003, projected to generate $15.5 million in 2004.

Payment In Lieu of Taxes

As of July 1, 2001, MLGW entered into an agreement with the City of Memphis requiring the Water Division 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 paid out of the General Reserve Fund of the Water Division. The Water Division's tax liability for MLGW's fiscal year ending December 31, 2003, increased to $2.1 million because of the split year and will stabilize at $2.5 million in 2004 for the remainder of the contract.

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.

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Report of Independent Auditors

Board of Commissioners and Management
Memphis Light, Gas and Water Division

We have audited the accompanying financial statements of the Electric, Gas and Water divisions (the Divisions) of Memphis Light, Gas and Water Division, an enterprise fund of the City of Memphis, Tennessee, as of and for the years ended December 31, 2003 and 2002, as listed in the table of contents. These financial statements are the responsibility of management of Memphis Light, Gas and Water Division. Our responsibility is to express opinions 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 opinions.

As discussed in Note 1, the financial statements of the Electric, Gas and Water divisions of Memphis Light, Gas and Water Division, are intended to present the financial position and the changes in financial position and cash flows of only that portion of the Memphis Light, Gas and Water Division that is attributable to the transactions of the Electric, Gas and Water divisions. They do not purport to, and do not present fairly the financial position of the Memphis Light, Gas and Water Division as of December 31, 2003 and 2002, and the changes in its financial position and its cash flows for the years then ended 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, 2003 and 2002, and the changes in their financial position and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

As described in Note 1 to the financial statements, in 2003 the Divisions changed their method for accounting for unbilled revenues.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 30, 2004, on our consideration of the Divisions' internal control over financial reporting and on our tests of their compliance with certain provisions of laws, regulations, contracts, and grants. 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.

Management's Discussion and Analysis on pages M-1 through M-15 are not required parts 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 required supplementary information. However, we did not audit the information and express no opinion on it. The information presented on pages 1-15 is additional information and has not been subjected to the auditing procedures applied in the audits of the financial statements, and accordingly, we express no opinion on it.

Ernst & Young LLP

July 30, 2004

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(Thousands of Dollars)

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Assets						
Current assets:						
Cash and cash equivalents	**$ 37,235**	$ 44,437	**$ 18,999**	$ 23,726	**$ 14,563**	$ 14,782
Investments	**37,453**	42,852	**17,779**	22,596	**14,698**	14,304
Restricted funds - current	**20,974**	52,319	**25,601**	19,023	**14,711**	19,847
Accounts receivable, less allowance for doubtful accounts	**53,194**	56,529	**25,492**	35,817	**6,002**	8,878
Unbilled revenues	**40,890**	–	**41,535**	–	**3,127**	–
Prepaid power cost	**63,843**	–	–	–	–	–
Deferred purchased power and gas cost	–	23,727	**3,032**	24,598	–	–
Inventories	**16,677**	12,805	**9,095**	7,931	**1,334**	1,358
Collateral held in trust for securities on loan	**10,230**	18,934	**8,454**	9,449	**5,716**	7,682
Other current assets	**18,258**	895	**2,215**	2,200	–	–
Total current assets	**298,754**	252,498	**152,202**	145,340	**60,151**	66,851
Non-current assets:						
Restricted funds:						
Futures margin deposits	–	–	**7,862**	1,711	–	–
Construction	**1,861**	9,013	**12,724**	12,086	**4,230**	9,530
Insurance reserves - injuries and damages	**1,977**	1,952	**1,179**	1,379	**840**	960
Insurance reserves - casualties and general	**12,537**	12,079	**4,254**	4,202	**5,281**	5,079
Medical benefit	**4,944**	4,229	**2,342**	2,003	**1,388**	1,187
Customer deposits	**13,910**	16,537	**4,083**	4,984	**879**	1,133
Bond reserve and debt service	**7,627**	37,311	–	–	**16,788**	16,589
Total restricted funds	**42,856**	81,121	**32,444**	26,365	**29,406**	34,478
Less restricted funds - current	**(20,974)**	(52,319)	**(25,601)**	(19,023)	**(14,711)**	(19,847)
Restricted funds – non-current	**21,882**	28,802	**6,843**	7,342	**14,695**	14,631
Other assets:						
Prepaid power cost – long term	**1,431,800**	–	–	–	–	–
Deferred charges	–	–	**1,253**	2,684	–	–
Unamortized debt expense	**13,576**	–	–	–	–	–
Notes receivable	**9,778**	10,762	**19,974**	21,687	**1,240**	1,377
Investment in Memphis Networx	**11,320**	10,093	–	–	–	–
Total other assets	**1,466,474**	20,855	**21,227**	24,371	**1,240**	1,377
Utility plant	**1,113,658**	1,074,090	**507,672**	488,529	**364,735**	354,782
Less accumulated depreciation	**(398,123)**	(379,028)	**(180,915)**	(168,000)	**(127,558)**	(119,454)
Utility plant, net	**715,535**	695,062	**326,757**	320,529	**237,177**	235,328
Total non-current assets	**2,203,891**	744,719	**354,827**	352,242	**253,112**	251,336
Total assets	**$ 2,502,645**	$ 997,217	**$ 507,029**	$ 497,582	**$ 313,263**	$ 318,187

See accompanying notes.

(Thousands of Dollars)

	Electric Division		Gas Division		Water Division	
	2003	2002	2003	2002	2003	2002
Liabilities						
Current liabilities:						
Accounts payable - purchased power and gas	**$ 83,697**	$ 91,171	**$ 43,648**	$ 40,094	**$ –**	$ –
Other accounts payable, accrued expenses, and deferrals	**47,597**	24,947	**20,015**	23,559	**7,746**	6,613
Bonds and notes payable	**88,648**	966	**–**	–	**–**	–
Collateral subject to return to borrowers	**10,230**	18,934	**8,454**	9,449	**5,716**	7,682
Total current liabilities payable from current assets	**230,172**	136,018	**72,117**	73,102	**13,462**	14,295
Current liabilities payable from restricted assets:						
Construction	**1,861**	3,210	**1,060**	1,354	**1,197**	1,054
Customer deposits	**5,147**	6,119	**1,493**	1,844	**325**	419
Medical benefit accrual	**4,944**	4,229	**2,342**	2,090	**1,388**	1,187
Insurance reserves - injuries and damages	**1,977**	1,952	**1,179**	1,379	**840**	960
Bonds payable – accrued interest	**6,656**	1,556	**–**	–	**849**	1,021
Bonds payable – principal	**389**	29,450	**–**	–	**7,080**	6,730
Total current liabilities payable from restricted assets	**20,974**	46,516	**6,074**	6,667	**11,679**	11,371
Total current liabilities	**251,146**	182,534	**78,191**	79,769	**25,141**	25,666
Non-current liabilities:						
Customer advances for construction	**8,145**	8,176	**603**	600	**9**	9
Customer deposits	**8,763**	10,418	**2,590**	3,140	**554**	714
Other	**7,516**	8,408	**12,711**	15,735	**1,619**	1,524
Long-term debt	**1,362,020**	69,512	**–**	–	**26,553**	33,461
Unamortized debt premium	**121,270**	1,143	**–**	–	**255**	361
Total non-current liabilities	**1,507,714**	97,657	**15,904**	19,475	**28,990**	36,069
Total liabilities	**1,758,860**	280,191	**94,095**	99,244	**54,131**	61,735
Net assets						
Invested in capital assets, net of related debt	**679,848**	604,074	**326,757**	320,529	**203,289**	194,776
Restricted for debt service and construction	**13,119**	53,637	**23,780**	16,558	**24,253**	29,123
Unrestricted	**50,818**	59,315	**62,397**	61,251	**31,590**	32,553
Total net assets	**743,785**	717,026	**412,934**	398,338	**259,132**	256,452
Total liabilities and net assets	**$ 2,502,645**	$ 997,217	**$ 507,029**	$ 497,582	**$ 313,263**	$ 318,187

See accompanying notes.

(Dollars in Thousands)

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Operating revenues:						
Sales and service revenues	**$ 828,421**	$ 829,603	**$ 327,417**	$ 239,799	**$ 51,879**	$ 52,272
Transported gas revenue	**–**	–	**14,379**	8,211	**–**	–
Other revenues	**20,009**	17,619	**11,103**	6,854	**3,933**	3,987
Total operating revenues	**848,430**	847,222	**352,899**	254,864	**55,812**	56,259
Operating expenses:						
Purchased power and gas for resale	**669,358**	676,281	**260,102**	173,635	**–**	–
Production	**–**	–	**–**	–	**11,110**	10,693
Operation	**84,774**	76,442	**49,987**	47,669	**28,466**	25,637
Maintenance	**40,238**	31,613	**9,539**	9,289	**6,041**	5,532
Depreciation	**27,622**	26,427	**12,591**	10,679	**7,479**	7,125
Payments in lieu of taxes	**28,157**	27,633	**14,485**	13,357	**2,103**	1,706
	850,149	838,396	**346,704**	254,629	**55,199**	50,693
Operating income (loss)	**(1,719)**	8,826	**6,195**	235	**613**	5,566
Non-operating revenues (expenses):						
Contributions in aid of construction	**31,768**	18,679	**2,483**	1,926	**4,174**	5,451
Reduction of plant costs recovered through contributions in aid of construction	**(31,768)**	(18,679)	**(2,483)**	(1,926)	**(4,174)**	(5,451)
Transmission credits	**22,164**	21,599	**–**	–	**–**	–
Investment and other income	**12,140**	5,938	**3,177**	6,935	**2,383**	2,294
Interest expense	**(7,551)**	(5,281)	**–**	–	**(1,697)**	(2,041)
Amortization of debt premium (expense)	**580**	(165)	**–**	–	**(66)**	(65)
Telecommunications division loss	**(4,625)**	(4,153)	**–**	–	**–**	–
Total non-operating revenues	**22,708**	17,938	**3,177**	6,935	**620**	188
Change in net assets	**$ 20,989**	$ 26,764	**$ 9,372**	$ 7,170	**$ 1,233**	$ 5,754
Net assets, beginning of year	**$ 717,026**	$ 690,262	**$ 398,338**	$ 391,168	**$ 256,452**	$ 250,698
Cumulative effect of change in accounting principle	**5,770**	–	**5,224**	–	**1,447**	–
Net assets, beginning of year as adjusted	**722,796**	690,262	**403,562**	391,168	**257,899**	250,698
Change in net assets	**20,989**	26,764	**9,372**	7,170	**1,233**	5,754
Net assets, end of year	**$ 743,785**	$ 717,026	**$ 412,934**	$ 398,338	**$ 259,132**	$ 256,452

See accompanying notes.

(Dollars in Thousands)

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Cash flow from operating activities:						
Receipts from customers and users	**$ 877,031**	$ 890,544	**$ 390,312**	$ 280,923	**$ 96,254**	$ 98,922
Payments to suppliers	**(684,622)**	(693,090)	**(312,007)**	(198,166)	**(27,168)**	(26,822)
Payment to TVA – prepaid power	**(1,500,000)**					
Payments to employees	**(91,353)**	(79,026)	**(37,608)**	(42,758)	**(26,135)**	(25,221)
Payments from (to) other Division funds	**(3,742)**	(5,856)	**102**	–	**3,640**	–
Payments to City and County	**–**	–	**(22,055)**	(22,185)	**(32,684)**	(35,598)
Payments for taxes	**(56,834)**	(55,370)	**(14,843)**	(13,672)	**(1,918)**	(1,893)
Other receipts	**11,884**	8,033	**11,741**	26,694	**551**	5,172
Net cash provided by (used in) operating activities	**(1,447,636)**	65,235	**15,642**	30,836	**12,540**	14,560
Cash flows from noncapital financing activities:						
Debt issuance expense	**(13,700)**	–	**–**	–	**–**	–
Proceeds from issuance of long-term debt	**1,513,417**	–	**–**	–	**–**	–
Interest expense on bonds	**(4,021)**	–	**–**	–	–	–
Net cash provided by noncapital financing activities	**1,495,696**	–	**–**	–	**–**	–
Cash flows from capital and related financing activities:						
Purchase and construction of utility plant	**(50,576)**	(62,159)	**(21,959)**	(18,744)	**(9,853)**	(15,691)
Proceeds from sale of land	–	–	–	1,818	**–**	–
Increase in unamortized debt expense	**41**	461	–	–	**–**	–
Proceeds from issuance of note payable	**15,000**	–	–	–	**–**	–
Proceeds from issuance of long-term debt	–	41,625	–	–	**–**	–
Principal payments on long-term debt	**(30,416)**	(66,963)	–	–	**(6,730)**	(4,600)
Defeasance of debt	**(26,082)**	–	–	–	**–**	–
Interest expense on other debt	**(731)**	(802)	–	–	**–**	–
Interest expense on bonds	**(2,799)**	(4,479)	–	–	**(1,697)**	(2,041)
Net cash used in capital and related financing activities	**(95,563)**	(92,317)	**(21,959)**	(16,926)	**(18,280)**	(22,332)
Cash flows from investing activities:						
Payments received on notes receivable	**984**	1,503	**1,713**	–	**137**	60
Investment income earned on investments	**1,393**	3,340	**1,139**	3,516	**706**	2,200
Net change in restricted funds	**3,107**	9,437	**(431)**	1,017	**2,458**	2,101
Net change in investments	**5,399**	(2,254)	**4,817**	(14,009)	**(394)**	(675)
Investment in Memphis Networx	**(5,740)**	(11,357)	**–**	–	**–**	–
Net cash provided by (used in) investing activities	**5,143**	669	**7,238**	(9,476)	**2,907**	3,686
Increase (decrease) in cash and cash equivalents	**(42,360)**	(26,413)	**921**	4,434	**(2,833)**	(4,086)
Cash and cash equivalents, beginning of year	**114,226**	140,639	**41,402**	36,968	**41,603**	45,689
Cash and cash equivalents, end of year	**$ 71,866**	$ 114,226	**$ 42,323**	$ 41,402	**$ 38,770**	$ 41,603

(Dollars in Thousands)

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:						
Operating income (loss)	**$ (1,719)**	$ 8,826	**$ 6,195**	$ 235	**$ 613**	$ 5,566
Adjustments to reconcile operating income (loss) Net cash provided by operating activities:						
Depreciation of utility plant	**30,103**	26,427	**15,731**	10,679	**8,004**	7,125
Transmission credits	**22,164**	21,599	**–**	–	**–**	–
Other income	**10,747**	2,598	**2,038**	3,419	**1,677**	94
(Increase) decrease in assets:						
Accounts receivable	**(13,965)**	2,295	**10,325**	(12,392)	**2,876**	1,789
Unbilled revenues, net of cumulative effect of change in accounting principle	**(11,393)**	–	**(12,022)**	–	**(1,679)**	–
Prepaid power cost	**(1,495,643)**	–	**–**	–	**–**	–
Deferred purchase power and gas cost	**–**	1,674	**(2,722)**	(3,809)	**–**	–
Inventories	**(3,872)**	569	**(1,164)**	(383)	**24**	46
Other assets	**(63)**	501	**1,416**	(202)	**–**	–
Increase (decrease) in liabilities:						
Accounts payable - purchased power and gas	**(7,474)**	(3,451)	**3,554**	18,989	**–**	–
Other accounts payable and accrued expenses	**26,400**	1,396	**(3,838)**	15,002	**1,103**	(44)
Customer deposits	**(2,627)**	3,637	**(901)**	(407)	**(254)**	170
Insurance reserves	**25**	(676)	**(200)**	571	**(120)**	(66)
Medical benefit accrual	**715**	(1,028)	**252**	(400)	**201**	(288)
Other	**(1,034)**	868	**(3,022)**	(466)	**95**	168
Total adjustments	**(1,445,917)**	56,409	**9,447**	30,601	**11,927**	8,994
Net cash provided by (used in) operating activities	**$(1,447,636)**	$ 65,235	**$ 15,642**	$ 30,836	**$ 12,540**	$ 14,560
Reconciliation of cash and cash equivalents per statements of cash flows to the balance sheets:						
Restricted funds	**$ 42,856**	$ 81,121	**$ 32,444**	$ 26,365	**$ 29,406**	$ 34,478
Less noncash equivalents included in restricted funds	**(8,225)**	(11,332)	**(9,120)**	(8,689)	**(5,199)**	(7,657)
Cash and cash equivalents included in restricted funds	**34,631**	69,789	**23,324**	17,676	**24,207**	26,821
Current assets - cash and cash equivalents	**37,235**	44,437	**18,999**	23,726	**14,563**	14,782
Total cash and cash equivalents	**$ 71,866**	$ 114,226	**$ 42,323**	$ 41,402	**$ 38,770**	$ 41,603

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 (the "Charter"), 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 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 in conformity with accounting principles generally accepted in the United States applicable to a proprietary fund of a government unit. The accompanying financial statements present the separate financial position, results of operations, and the cash flows of each of the three divisions--Electric, Gas and Water—(the Divisions) of MLGW, but do not present the financial position, results of operations, and the cash flows of MLGW, an enterprise fund of the City of Memphis. Accordingly, the accompanying disclosures relate separately to the Divisions, as applicable, and not collectively to MLGW. Unless expressly stated, each disclosure, including references to "MLGW" herein, applies solely to each of the separate divisions on a departmental basis. These statements 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 funds, nor do they represent the financial position, results of operations, or cash flows of MLGW's Retirement and Pension System discussed in Note 5 and the Trust for Retiree Medical and Life Insurance Benefits discussed in Note 6.

Basis of Accounting

MLGW is required by state statute and the Charter 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. MLGW utilizes direct cost methods where applicable. For expenses not directly charged to a specific division, internally developed cost allocation methods are used based on the function performed. 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 with the exception of the Electric Division's investment in Memphis Networx, which is regulated by the Tennessee Regulatory Authority (TRA). See Note 9.

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

1. Summary of Significant Accounting Policies (continued)

Recent Accounting Standards

and interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements, to MLGW's accounting and financial reporting.

In March 2003, GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3.* This statement addresses investment risks to deposits and investments of state and local governments that may have a potential to result in losses. The new disclosure requirements will provide the public with better information about the risks that could potentially impact a government's ability to provide services and pay its debts. The provisions of this statement are effective for financial statements for periods beginning after June 15, 2004.

GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* The statement requires governments to report the effect of a capital asset impairment in their financial statements when it occurs. This statement also clarifies and establishes accounting requirements for insurance recoveries. MLGW will adopt the provision for impairment of capital assets and insurance recoveries on January 1, 2005. Currently, management does not believe that the adoption of this standard will have a material effect on MLGW's financial statements.

MLGW adopted the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligation*, on January 1, 2003. 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 has concluded that it does not have any legal obligations which require accrual under SFAS No. 143.

Change in Accounting Principle

In 2003, MLGW performed an analysis of its revenue recognition practices and began recording revenues and the associated cost of purchased power and gas related to volumes delivered but not yet billed. Recording unbilled revenues changed the timing of revenue recognition from the cycle-billing method to the accrual method which is based on when the service is provided. Prior to 2003, MLGW recognized revenues from meters read on a monthly cycle basis and deferred the cost of purchased power and gas for volumes delivered but not yet billed. The effects of the change in revenue recognition methods increased net assets by $3,362, $1,040, and $1,680 in the Electric, Gas and Water Divisions, respectively, for the year ended December 31, 2003 and are reflected in the accompanying statement of revenues, expenses and changes in net assets. The cumulative effects of the change resulting from years prior to January 1, 2003 were increases of $5,770, $5,224 and $1,447 in the Electric, Gas, and Water Divisions, respectively, and are treated as adjustments to beginning net assets in the accompanying statements of revenues, expenses and changes in net assets.

(Dollars in Thousands) (Continued)

1. Summary of Significant Accounting Policies (continued)

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. The following are the regulatory assets and liabilities included on the balance sheets:

		2003	2002
Assets			
Electric Division	Deferred purchased power	**$ –**	$ 23,727
Gas Division	Deferred loss on futures contracts	**1,341**	875
Gas Division	Unrecovered purchased gas cost	**3,032**	24,598
Liabilities			
Gas Division	Deferred gains-gas futures	**$ 5,598**	$ 7,234
Gas Division	Deferred credits-PGA/storage	**4,389**	6,802

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, the 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.

(Dollars in Thousands)

1. Summary of Significant Accounting Policies (continued)

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, investments, restricted fund investments, accounts receivable and accounts payable are a reasonable estimate of their fair values. The estimated fair values of MLGW's other financial instruments have been determined by MLGW using available market information. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the fair values are not necessarily indicative of the amounts that 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 estimated fair value of long-term debt for the Electric Division and the Water Division based on quoted market prices are as follows as of December 31, 2003 and 2002:

	2003	**2002**
Electric Division	**$1,576,440**	$ 103,214
Water Division	**36,397**	42,976

Investments

Investments are carried at their fair value based on quoted market prices. See Note 2. 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

As of December 31, 2003 and 2002, accounts receivable and allowances for doubtful accounts were as follows:

	Electric Division		**Gas Division**		**Water Division**	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Accounts receivable	**$ 59,958**	$ 61,604	**$ 27,802**	$ 39,113	**$ 6,719**	$ 9,115
Allowance for doubtful accounts	**6,764**	5,075	**2,310**	3,296	**717**	237

(Dollars in Thousands)

1. Summary of Significant Accounting Policies (continued)

Accounts Receivable (continued)

MLGW performs a monthly analysis of outstanding trade receivables to assess the likelihood of collection. For aged receivable balances, 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 trade receivables after 120 days of non-payment. The bad debt expense amounts netted against operating revenues are as follows:

	2003	2002
Electric	**$ 3,552**	$ 3,718
Gas	**574**	2,023
Water	**657**	358

Concentration of Credit Risk

MLGW's financial instruments that are potentially exposed to concentrations of credit risk primarily consist of trade receivables. MLGW's trade receivables result 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.

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 counter parties meeting established collateral and credit criteria.

Prepaid Power Cost

Electric Division prepaid power cost represents the unamortized amount of prepaid power under the prepaid electricity agreement signed with TVA on November 19, 2003. See Note 10. Under the prepay agreement, MLGW issued revenue bonds with a face value of $1,392,170 and a premium of $121,247 to make an upfront payment of $1,500,000 to TVA. Under the terms of the agreement, MLGW receives a fixed discount on the monthly power purchased for the fifteen year term of the agreement. The total fixed discount under the agreement approximates the debt service requirements of the associated prepay debt. The monthly fixed discount is allocated to prepaid power cost and other income under the interest method based on the debt service requirements of the associated debt.

Inventories

Inventories, consisting primarily of materials and supplies inventory and stored natural gas, are valued at the lower of cost or market using the average cost method.

1. Summary of Significant Accounting Policies (continued)

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 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 2003 and 2002, no construction projects were financed with specific long-term debt. Interest on other debt is not capitalized as it is recovered through current revenues.

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 percent for the Electric Division and 2 percent 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/Premium

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

Reserves and Related Restricted Funds

Certain of MLGW's assets are restricted for specific purposes. Legal and contractual agreements restrict amounts for debt service, refund of customer deposits, futures margin requirements, and capital improvements while Board of Commissioners enacted provisions restrict funds for self-insurance and additional capital improvements.

The Gas Division maintains a cash margin account with its futures clearing member. The clearing member requires that a minimum cash margin be maintained based on the value of the Gas Division's outstanding futures positions. The minimum cash margin requirements are considered restricted and are reflected in restricted assets in the accompanying balance sheets. The amounts of cash in excess of the minimum cash margin requirement are included in cash and cash equivalents.

Construction funds are maintained for the purpose of paying certain repairs and capital additions and improvements. The respective bond resolutions of the Electric, Gas and Water Divisions provide for a certain level of funding for future construction. Additional construction funds are periodically authorized by the Board of Commissioners.

1. Summary of Significant Accounting Policies (continued)

Reserves and Related Restricted Funds (continued)

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. The insurance reserves for casualties are maintained at discretionary amounts to partially cover losses of a catastrophic nature which are not ordinarily insurable or which are not insurable on an economical basis. Since MLGW is self-insured for these liabilities, the Board of Commissioners has authorized the restriction of assets equal to the computed reserves.

Medical benefit reserves are maintained for MLGW's medical insurance program, which serves employees and retirees. The medical benefit reserves represent the estimated costs incurred but not yet paid for in providing medical benefits to employees and retirees which are not insured by third party providers. Since MLGW is self-insured for these costs, the Board of Commissioners has authorized the restriction of assets equal to the computed reserves.

Customer deposit funds are maintained for the future repayment of deposits collected from customers without adequate credit history in accordance with MLGW policy and the respective customer service agreement.

Bond reserve and debt service funds are restricted under the terms of the respective bond indentures to pay current bond principal and interest as they become due.

Futures Contracts

The Gas Division enters into futures contracts and options on futures contracts to manage the risk of volatility in the market price of gas on anticipated purchase transactions. Open futures and option contracts as of December 31, 2003 and 2002, are reported at market values of $4,178 and $4,303, respectively. Notional values of the open futures as of December 31, 2003 and 2002 were $37,012 and $9,806, respectively. Margin account balances with MLGW's New York Mercantile Exchange clearing member as of December 31, 2003 and 2002, are $13,385 and $6,535, respectively. 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.

1. Summary of Significant Accounting Policies (continued)

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 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 and Expenses

Revenues are recognized when earned in 2003 and when billed in 2002 and prior years. Customer meters are read and bills are rendered monthly. MLGW recorded an estimate for unbilled revenues earned from the dates its customers were last billed to the end of the month. The amounts of unbilled revenues at December 31, 2003 were $40,890, $41,535 and $3,127 for the Electric, Gas and Water Divisions, respectively.

MLGW distinguishes operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with an enterprise fund's principal operations. The principal operating revenues of MLGW consist of electric, gas and water sales and related activities. Non-operating revenues consist of transmission credits, the non-power cost portion of the prepaid electricity discount, investment income and other ancillary activities. Transmission credits are fees paid by Tennessee Valley Authority (TVA) for its use of the Electric Division's power transmission facilities in supplying power to MLGW. Operating expenses include the cost of purchased power and gas, water production costs, administrative expenses, depreciation on capital assets and payments in lieu of taxes. Expenses not meeting this definition are reported as non-operating expenses.

1. Summary of Significant Accounting Policies (continued)

Customer Deposits

Customers that do not have adequate credit history are required to make a utility deposit before services are provided. Deposits are refunded or applied toward the customer's bill after a 36 month good pay status. Deposits are allocated to the Electric, Gas and Water Divisions based upon each division's percentage of total sales revenue of the previous year end.

Statements of Cash Flows

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

Reclassifications

Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 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 only free service provided to the City, under the Charter, is water for public purposes, such as Memphis City Schools and fire hydrants. The free water provided to the City is estimated to be $1,142 and $1,363 for 2003 and 2002, respectively, and neither revenues nor expenses for free water are recorded in the accompanying statements of revenues, expenses and changes in net assets.

(Dollars in Thousands)

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, the MLGW Board of Commissioners, and as set forth in the bond resolutions of each division. Restricted funds, cash, cash equivalents and investments consisted of the following as of December 31, 2003 and 2002:

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Restricted funds:						
Common account	**$ 16,376**	$ 23,044	**$ 15,172**	$ 17,667	**$ 10,351**	$ 15,569
Mutual funds	**7,627**	37,311	**–**	–	**16,788**	16,589
Cash			**7,862**	1,711		
Commercial paper	**15,992**	12,266	**8,435**	6,987	**1,923**	2,320
Certificates of deposit	**2,861**	8,500	**975**	–	**344**	–
Total restricted funds	**$ 42,856**	$ 81,121	**$ 32,444**	$ 26,365	**$ 29,406**	$ 34,478
Cash and cash equivalents:						
Common account	**$ 37,108**	$ 44,281	**$ 13,477**	$ 18,902	**$ 14,563**	$ 14,782
Cash	**127**	156	**5,522**	4,824	**–**	–
Total cash and cash equivalents	**$ 37,235**	$ 44,437	**$ 18,999**	$ 23,726	**$ 14,563**	$ 14,782
Investments:						
Common account	**$ 37,453**	$ 42,852	**$ 13,601**	$ 18,293	**$ 14,698**	$ 14,304
Fair value of futures contracts	**–**	–	**4,178**	4,303	**–**	–
Investments – common account	**$ 37,453**	$ 42,852	**$ 17,779**	$ 22,596	**$ 14,698**	$ 14,304

(Dollars in Thousands)

2. Deposits and Investments (continued)

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, 2003 and 2002, the common account consisted of the following:

	2003	2002
Common account:		
Commercial paper	**$ 64,577**	$ 83,744
Mutual funds	**2,268**	12,136
U.S. Treasury bonds	**350**	350
U.S. Government agencies	**39,764**	92,462
U.S. Government bonds	**19,758**	-
Corporate bonds	**10,471**	7,366
Certificates of deposit	**3,800**	3,100
Asset-backed securities	**12,695**	7,625
Bank repurchase agreement	**4,300**	-
Government mortgage-backed securities	**5,838**	-
Accrued interest receivable	**829**	1,302
Cash	**8,149**	1,609
	$ 172,799	$ 209,694

Investments are categorized into three credit risk categories in accordance with 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.

As of December 31, 2003 and 2002, the bank balances of MLGW cash deposits were fully insured or collateralized with securities held by MLGW or its agent in MLGW's name.

MLGW has authorized The Northern Trust Company ("Agent") to enter into, on behalf of MLGW, securities lending transactions comprised of 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 percent of the market value of borrowed securities, or at least 105 percent 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 2003 and 2002 statements of net assets consists of cash collateral. As of December 31, 2003 and 2002, MLGW has no credit risk exposure to borrowers because the amounts MLGW owes to the borrowers exceed the

(Dollars in Thousands) (Continued)

2. Deposits and Investments (continued)

amounts the borrowers owe MLGW. The Agent is required to indemnify MLGW if the borrowers fail to return the securities to MLGW.

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

	Fair Value	
	2003	**2002**
U.S. Government bonds or notes	**$ 18,851**	$ 35,989
U.S. Government agencies	**9,003**	12,857
U.S. Corporate bonds or notes	**1,431**	–
Total	**$ 29,285**	$ 48,846

All term loans have a matched collateral investment. Of the cash collateral received for open loans, 20 percent must be invested on an overnight basis and no more than 40 percent 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 $61 and $91 for the years ending December 31, 2003 and 2002, 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 $8,880 and $9,861 as of December 31, 2003 and 2002, respectively. Interest is earned at a fixed rate of 7.723 percent 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:

2004	$ 1,060
2005	1,144
2006	1,236
2007	1,335
2008	1,442
Thereafter	2,663
	$ 8,880

In 2002, MLGW and The Premcor Refining Group, Inc. ("Premcor") (formerly Williams Refining and Marketing, LLC) entered into an agreement, whereby MLGW would provide for the construction of two

(Dollars in Thousands)

3. Long-Term Receivables (continued)

pipelines and lease them to Premcor 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:

2004	$ 1,712
2005	1,712
2006	1,712
2007	1,712
2008	1,712
Thereafter	13,126
	$ 21,686

The Premcor lease receivable is included in notes receivable in the accompanying 2003 Gas Division balance sheet, except for the current portion of $1,712, which is included in other current assets. Deferred income of $1,384 (current portion) and $9,991 (non-current portion) is included in other accounts payable, accrued expenses and deferrals and other non-current liabilities, respectively, in the accompanying 2003 Gas Division balance sheet.

(Dollars in Thousands)

4. Utility Plant

Utility plant activity for the years ended December 31, 2003 and 2002 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2003				
Electric Division				
Capital assets not being depreciated:				
Land	$ 24,121	$ 111	$ –	$ 24,232
Construction in progress	65,868	45,337	(64,787)	46,418
Total capital assets not being depreciated	89,989	45,448	(64,787)	70,650
Capital assets being depreciated:				
Structures and improvements	28,835	2,291	(3)	31,123
Transmission and distribution plant equipment	886,872	56,025	(6,896)	936,001
General plant equipment	68,394	8,925	(1,435)	75,884
Total capital assets being depreciated	984,101	67,241	(8,334)	1,043,008
Less accumulated depreciation	(379,028)	(30,543)	11,448	(398,123)
Total capital assets being depreciated, net	605,073	36,698	3,114	644,885
Total capital assets, net	$ 695,062	$ 82,146	$ (61,673)	$ 715,535
Gas Division				
Capital assets not being depreciated:				
Land	$ 7,068	$ 533	$ –	$ 7,601
Construction in progress	43,977	21,830	(49,147)	16,660
Plant held for future use	212	–	–	212
Total capital assets not being depreciated	51,257	22,363	(49,147)	24,473
Capital assets being depreciated:				
Structures and improvements	44,573	1,367	(95)	45,845
Processing and distribution plant equipment	345,539	10,351	(780)	355,110
General plant equipment	46,960	36,897	(1,813)	82,044
Non-utility plant equipment	200	–	–	200
Total capital assets being depreciated	437,272	48,615	(2,688)	483,199
Less accumulated depreciation	(168,000)	(14,042)	1,127	(180,915)
Total capital assets being depreciated, net	269,272	34,573	(1,561)	302,284
Total capital assets, net	$ 320,529	$ 56,936	$ (50,708)	$ 326,757

(Dollars in Thousands) (Continued)

4. Utility Plant (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2003				
Water Division				
Capital assets not being depreciated:				
Land	**$ 3,094**	**$ 121**	**$ –**	**$ 3,215**
Construction in progress	**31,429**	**13,345**	**(13,176)**	**31,598**
Total capital assets not being depreciated	**34,523**	**13,466**	**(13,176)**	**34,813**
Capital assets being depreciated:				
Structures and improvements	**37,109**	**288**	**(37)**	**37,360**
Pumping, transmission and distribution plant equipment	**257,781**	**6,962**	**(490)**	**264,253**
General plant equipment	**41,267**	**2,275**	**(299)**	**43,243**
Total capital assets being depreciated	**336,157**	**9,525**	**(826)**	**344,856**
Less accumulated depreciation	**(119,454)**	**(9,153)**	**1,049**	**(127,558)**
Less acquisition adjustment	**(15,898)**	**–**	**964**	**(14,934)**
Total capital assets being depreciated, net	**200,805**	**372**	**1,187**	**202,364**
Total capital assets, net	**$ 235,328**	**$ 13,838**	**$ (11,989)**	**$ 237,177**
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

(Dollars in Thousands)

4. Utility Plant (continued)

	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

	Beginning Balance	Increases	Decreases	Ending Balance
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

(Dollars in Thousands) (Continued)

4. Utility Plant (continued)

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 2004 are estimated as follows (unaudited):

Electric Division	$ 57,807
Gas Division	16,933
Water Division	17,746

In June 1999, the Water Division purchased the Shelby County Water Distribution System and related assets from Shelby County, Tennessee. The difference of the dollar amount 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 $15,000 over the next twenty years to upgrade and extend the acquired water system. As of December 31, 2003, expenditures of approximately $6,000 have been spent towards 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 through the 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 as of December 31, 2003 and 2002:

	2003	**2002**
Retirees and beneficiaries receiving benefits	**2,366**	2,368
Terminated plan members entitled to but not yet receiving benefits	**23**	30
Active plan members	**2,651**	2,666
	5,040	5,064

5. Employee Retirement System (continued)

Plan Description (continued)

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 retirees, disabled retirees and surviving spouses on a graded scale up to 5 percent per annum based on the Department of Labor's consumer price index.

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.

Contributions

Substantially all members under the MLGW Pension Plan are required to contribute 8 percent of their compensation to the MLGW Pension Plan. Such amounts are withheld from employee compensation each pay period. MLGW funds the required 8 percent employee contributions on behalf of certain executive employees. During 2003 and 2002, MLGW was required under the Pension Plan to contribute 8 percent of the benefit compensation of all active participants. MLGW's required contribution was based on an actuarial study and approved by the Board of Commissioners. Investment costs of the MLGW Pension Plan are financed through investment earnings.

Actuarial Methods and Assumptions

As of December 31, 2003 and 2002, 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 ranging from 4.50 to 8.16 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. As of December 31, 2003 and 2002, the actuarial value of assets was $1,037,872 and $1,014,967, respectively.

(Dollars in Thousands)

5. Employee Retirement System (continued)

Schedule of Contributions from all Sources

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

Plan Year	Annual Required Employee Contribution	Actual Contribution	Percentage Contributed	Annual Required Employer Contribution	Actual Contribution	Percentage Contributed
2003	$ 10,476	$ 10,476	100%	$ 15,890	$ 10,696	67%
2002	9,933	9,933	100%	9,855	9,855	100%
2001	9,299	9,299	100%	9,588	9,588	100%

The variance between the 2003 annual required employer contribution and actual contribution will be funded in 2004.

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, 2,389 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 partially pay future post retirement medical benefits for all three divisions. The value of assets in the trust as of December 31, 2003 and 2002 was $46,433 and $45,840, respectively, and are not included in the accompanying balance sheets.

(Dollars in Thousands)

6. Deferred Compensation and Other Post-Retirement Benefits (continued)

Post-retirement benefit costs for the years ended December 31, 2003 and 2002 are as follows:

	Electric Division		Gas Division		Water Division	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Premium payments	**$ 8,652**	$ 7,650	**$ 4,098**	$ 3,624	**$ 2,428**	$ 2,148
Paid from unconsolidated grantor trust	**(5,301)**	(5,301)	**(2,511)**	(2,511)	**(1,488)**	(1,488)
Net costs charged to operations	**$ 3,351**	$ 2,349	**$ 1,587**	$ 1,113	**$ 940**	$ 660

7. Debt

Long-term debt as of December 31, 2003 and 2002 consists of the following:

	Interest Rates	2003	2002
Electric Division:			
Electric System Revenue Bonds:			
Series 1992, defeased in 2003	3.35-6.00%	**$ –**	$ 45,535
Series 1993, refunded in 2002	3.60-5.00%	**–**	4,270
Series 2002, due serially 2003-2010	3.00-5.00%	**36,965**	41,625
Series 2003A, due serially 2004-2018	2.00-5.00%	**1,292,170**	–
Series 2003B, due 2017-2018	Variable	**100,000**	–
Total		**1,429,135**	91,430
Note payable with bank, due serially through 2010	7.58%	**9,117**	10,083
Note payable with bank, due February 2004	1.55%	**15,000**	–
		1,453,252	101,513
Less: current portion of bonds and notes payable		**(89,037)**	(30,416)
Unamortized deferred cost on bond refunding		**(2,195)**	(1,585)
		$ 1,362,020	$ 69,512
Water Division:			
Revenue Refunding Bonds:			
Series 1992, due serially 1993-2006	3.35-6.00%	**$ 8,270**	$ 10,725
Series 1992-A, partially refunded in 2001	3.00-5.50%	**–**	1,000
Series 1998, due serially 2000-2012	3.30-5.25%	**12,250**	12,340
Series 2001, due serially 2002-2009	4.00-5.00%	**13,710**	16,895
		34,230	40,960
Less: current portion of bonds payable		**(7,080)**	(6,730)
Unamortized deferred cost on bond refunding		**(597)**	(769)
		$ 26,553	$ 33,461

(Dollars in Thousands)

7. Debt (continued)

Principal payments on bonds are due annually on January 1 or December 1. Debt service requirements, including notes payable, as of December 31, 2003, are as follows:

	Electric Division		Water Division	
	Principal	Interest	Principal	Interest
2004	$ 89,037	$ 70,228	$ 7,080	$ 1,516
2005	74,039	63,363	7,440	1,141
2006	77,473	59,817	5,770	795
2007	81,343	56,058	2,975	579
2008	85,260	52,136	3,100	446
2009-2018	1,046,100	265,280	7,865	685
Total	$ 1,453,252	$ 566,882	$ 34,230	$ 5,162

MLGW, at its option, may redeem bonds prior to maturity at premiums and prices specified in the indentures. The Series 2003A and Series 2003B bonds are subject to mandatory redemption upon early termination of the Supplement to the Power Contract ("Supplement") with TVA as discussed in Note 10.

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 2003, the Electric Division issued $1,292,170 of Series 2003A and $100,000 of Series 2003B revenue bonds to prepay future power purchases from TVA under the Supplement. See Note 10. The Series 2003A revenue bonds bear interest at annual fixed rates ranging from 2.00 to 5.00 percent. The Series 2003B revenue bonds are auction rate securities and bear interest for 35-day auction periods. The auction period rate as of December 31, 2003 for the Series 2003B revenue bonds was 1.05 percent.

During 2003, the Electric Division deposited $26,658 with an escrow agent to satisfy the future principal and interest requirements of the remaining $25,015 of Series 1992 refunding bonds. The escrowed funds plus future interest are sufficient to meet the debt service requirements of the Series 1992 bonds and the bonds are considered to be defeased. Therefore, the liability for such bonds has been removed from the accounts of the Electric Division. The difference between the reacquisition price and the net carrying amount of the old debt of $1,067 is reflected as a decrease to bonds payable and is being charged to operations over the original life of the defeased bonds.

During 2003, the Electric Division obtained a short-term loan of $15,000 to assist with the cost of storm related expenditures. The loan, plus interest accruing at 1.55 percent, was repaid on February 15, 2004. See Note 14 for additional storm information.

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

7. Debt (continued)

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.

MLGW's Electric Division bond covenants require that for Series 2002 Bonds, the ratio of net revenues available for debt service to maximum amount of principal and interest for any fiscal year ("electric coverage") must be not less than 1.25. For Series 2003 A & B Bonds, the ratio of net revenues to maximum amount of principal and interest for any fiscal year must not be less than 1.00. The composite electric coverage as of December 31, 2003, was 3.07.

The Water 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 ("water coverage") must not be less than 1.20. Water coverage as of December 31, 2003 was 1.27.

(Dollars in Thousands)

7. Debt (continued)

Long-term debt activity for the years ended December 31, 2003 and 2002 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2003:				
Electric Division				
Bonds and note payable:				
Revenue bonds	**$ 91,430**	**$ 1,392,170**	**$ (54,465)**	**$1,429,135**
Notes payable	**10,083**	**15,000**	**(966)**	**24,117**
Less deferred amounts:				
For issuance discounts and on refunding	**(1,585)**	**(1,026)**	**416**	**(2,195)**
Total bonds and note payable	**$ 99,928**	**$ 1,406,144**	**$ 55,015)**	**$1,451,057**
Water Division				
Bonds payable:				
Revenue bonds	**$ 40,960**	**$ –**	**$ (6,730)**	**$ 34,230**
Less deferred amounts:				
For issuance discounts and on refunding	**(769)**	**–**	**172**	**(597)**
Total bonds payable	**$ 40,191**	**$ –**	**$ (6,558)**	**$ 33,633**
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	–	–	(1,585)	(1,585)
Total bonds and note payable	$ 126,409	$ 41,625	$ (68,106)	$ 99,928
Water Division				
Bonds payable:				
Revenue bonds	$ 45,560	$ –	$ (4,600)	$ 40,960
Less deferred amounts:				
For issuance discounts and on refunding	(957)	–	188	(769)
Total bonds payable	$ 44,603	$ –	$ (4,412)	$ 40,191

(Dollars 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 and injuries and damages claims as established by a third party administrator and the MLGW legal department. 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, 2003 and 2002 are as follows:

	Medical Benefits			Injuries and Damages		
	Electric Division	**Gas Division**	**Water Division**	**Electric Division**	**Gas Division**	**Water Division**
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
Payments	**(19,953)**	**(9,451)**	**(5,601)**	**(1,876)**	**(950)**	**(570)**
Incurred claims expense	**20,668**	**9,703**	**5,802**	**1,901**	**750**	**450**
Balance – December 31, 2003	**$ 4,944**	**$ 2,342**	**$ 1,388**	**$ 1,977**	**$ 1,179**	**$ 840**

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, MLGW has continued to provide periodic investments of capital as requested by Memphis Networx, with a respective increase in ownership percentage to approximately 82 percent. 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. Voting interest rights and board membership have shifted to reflect MLGW's increased ownership interest. The current carrying value of Memphis Networx, reflecting total investment and allocated losses since inception is $11,320.

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

(Dollars in Thousands)

9. Telecommunications Division (continued)

from the previously approved $20,000 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 $32,000.

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 $11,200, which is equal to both members' required capital contributions. In 2003, MLGW contributed $5,740, which is equal to both members' required capital contributions. As of December 31, 2003 and 2002, the Telecommunications Division's ownership interest in the Company was approximately 82 and 78 percent, respectively.

Condensed results of operations of the Company for the years ended December 31, 2003 and 2002 are as follows:

	2003	**2002**
	(unaudited)	
Operating revenue	**$ 675**	$ 125
Operating expense	**(6,194)**	(5,248)
Net loss	**$ (5,519)**	$ (5,123)

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:

	2003	**2002**
Share of the Company's loss	**$ 4,513**	$ 3,996
General and administrative expenses	**112**	157
Total Telecommunications Division loss	**$ 4,625**	$ 4,153

The Telecommunications Division's investment in the Company of $11,320 and $10,093 as of December 31, 2003 and 2002, respectively, is included in other non-current assets in the accompanying balance sheets of the Electric Division.

10. Energy Supplies

The Tennessee Valley Authority (TVA) currently supplies all of MLGW's electric power requirements pursuant to a power contract. On November 19, 2003, MLGW entered into a Supplement to the Power Contract ("Supplement") with TVA under which MLGW made a prepayment of $1,500,000 to TVA for capacity and related energy. In exchange for the prepayment and a commitment by MLGW to purchase a minimum amount of electric power from TVA over the term of the Supplement (15 years), TVA will supply a specified amount of electricity over the term and provide a fixed credit to its wholesale power rates otherwise in effect. To finance the prepayment, MLGW issued the Series 2003A and Series 2003B Bonds. See Note 7.

Under the terms of the TVA power contract, MLGW may terminate its supply arrangement with TVA upon five years' prior written notice. TVA may terminate on not less than ten years' prior written notice. However, such notice of termination cannot be given by either party before November 19, 2013, under the terms of the Supplement.

MLGW purchases gas supplies directly from producers and marketers. MLGW has no minimum purchase commitments under these agreements.

11. Rates

Electric, gas and water rates are established by MLGW and rate changes are subject to approval by the City Council of Memphis, Tennessee. The City Council has approved mechanisms for pass-through of wholesale electric rate changes from TVA and natural gas price changes from suppliers without requiring additional specific approval.

TVA implemented both a rate change and a rate adjustment effective October 1, 2003, impacting the cost of wholesale power purchased by MLGW. The rate change increased power cost for non-manufacturing customers and manufacturing customers with demands less than 1,000 kilowatts and decreased power cost for manufacturing customers greater than 1,000 kilowatts. The rate adjustment, increased power cost for all customer classes. MLGW implemented changes to its retail rate schedules effective with meters read on or after September 30, 2003 to recover the increased cost of wholesale power from its retail customers. The combined retail effects of the rate change and adjustment varied by customer class, with the approximate increases being 5.9 percent for residential customers, 7.5 percent for commercial customers and 7.9 percent for industrial customers and a 1.9 percent decrease for both commercial manufacturing and industrial manufacturing customers.

MLGW implemented rate increases of approximately 4.7 percent for electric, and 27.5 percent for water effective with meters read on or after December 30, 2003. These rate increases are due to the effects of inflation on general operating expenses, employee health insurance costs, facility security, increases in uncollectibles, depletion of cash reserves, increases of in lieu of tax payments, and capital expenditures for system improvements. The total proposed revenue increases due to the rate increases are estimated to be $40,300 for the Electric Division and $15,500 for the Water Division in calendar year 2004.

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 fair value of the open futures contracts.

MLGW pays in lieu of taxes to the City of Memphis and the incorporated towns of Shelby County for the Electric and Gas Divisions based on the Tennessee Municipal Electric and Gas System Tax Equivalent Laws of 1987. MLGW pays an in lieu of tax payment to the City of Memphis for the Water Division based upon an agreement with the City which calls for a payment of $2,103 in 2003 and $2,500 for each of the fiscal years 2004 through 2028.

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.

See Note 10 for discussion of MLGW's power contract with TVA.

13. Self-Insurance

MLGW is self-insured under the Tennessee Governmental Tort Liability Act. This coverage applies to all tort actions arising in the State of Tennessee. Various liability limits are in force as established by the act. The current limits of liability for actions arising on or after July 1, 2002 are $250 per person and $600 for two or more persons per accident.

14. Windstorm 2003

On July 22, 2003, a severe storm caused damage to MLGW's electric, gas, and water distribution systems. As of December 31, 2003, the total expenditures related to the storm were $27,335. Of these costs, $26,383 (97 percent) was in the Electric Division, including a $18,583 addition to Electric plant for capital asset replacements and $7,800 in Electric Division operating and maintenance expenses in 2003. MLGW has been approved to receive compensation from the Federal Emergency Management Agency (FEMA) totaling 75 percent of eligible expenses, which is estimated to be approximately $20,000. Total estimated dollars receivable from FEMA as reimbursement for these costs as of December 31, 2003 is $17,300 and is included in other current assets in the accompanying balance sheets. Of this amount, $13,700 was accounted for as a contribution in aid of construction in the Electric Division and $3,400 as Electric miscellaneous non-operating income. Subsequent to December 31, 2003, FEMA reimbursed MLGW $10,070. The financial impact of the storm on the Gas and Water Divisions was not significant.

15. Federal Grant Contributions

MLGW has received federal grant contributions in the amount of $78 and $711 for the years 2003 and 2002, respectively, excluding the FEMA storm damage award discussed in Note 14.

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