2004:

A Year of Transformation

Embarking on a New Era of Excellence

Hometown Energy • MLGW • Working for You

Memphis Light, Gas and Water
2004 Annual Report

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About Memphis Light, Gas and Water

Memphis Light, Gas and Water is the nation's largest three-service municipal utility, serving more than 420,000 customers. Since 1939, MLGW has met the utility 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 three pipeline companies, Texas Gas Transmission Corporation, CMS Trunkline Gas Company and ANR Pipeline Company. Memphis receives its water from one of the largest artesian water systems in the world.

MLGW is led by a President and a five-member Board of Commissioners who are appointed by the Mayor of Memphis.

BOARD OF COMMISSIONERS

L. R. Jalenak, Jr., Chairman
Rick Masson, Vice Chairman
Nick Clark
V. Lynn Evans
James Russell

2004 EXECUTIVE LEADERSHIP TEAM

Joseph Lee, III
President and CEO

Christopher Bieber
Vice President, Engineering

Sherry DuBose
Vice President, Customer Service and Marketing

John McCullough
Vice President, CFO and Secretary/Treasurer

Linda Peppers
Vice President and Chief Information Officer

Wade Stinson
Vice President, Construction and Maintenance

Alonzo Weaver
Vice President, Operations

J. Maxwell Williams
Vice President and General Counsel

MLGW's Vision:

To be the best utility for our customers

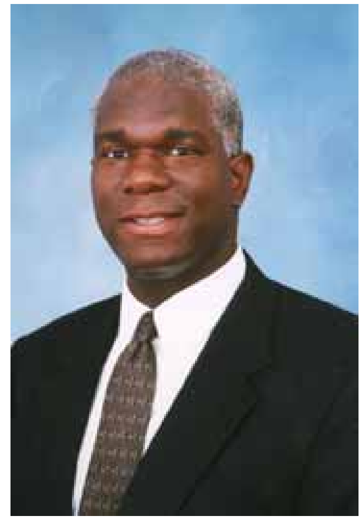
MLGW's Mission:

To provide customer-focused, reliable, safe and cost-effective utility services to the Greater Memphis community

MLGW's Values:

Customers
Safety
Trust

Letter from the President



2004 was a year of transformation at MLGW in terms of leadership, organizational structure and strategic focus. This was a particularly meaningful year for me personally as it marked the beginning of my service as President and CEO of this utility, which is a role I assumed with great excitement.

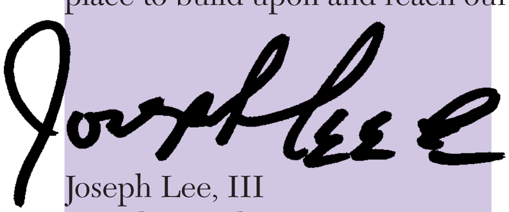
Upon joining MLGW in July 2004, I was immediately impressed by the dedication and spirit of community service portrayed by the individuals in this company. Also, the high level of expertise and professionalism was evident as I witnessed the team in action providing reliable and safe utility services to this community. I am proud to be one of the 2,800 MLGW employees working as a team to serve our customers, and as you read through the following pages, you will easily see why.

While this utility has been transformed in 2004 with an altered leadership team and organizational structure, one thing has remained the same - MLGW has remained focused and committed to our customers. This is one aspect of our business that will never change. MLGW renewed its commitment to customer service in 2004 by focusing on ways we could make it easier for customers to do business with us.

In addition to building positive relationships with our customers and other stakeholder groups, MLGW is also refocusing efforts to be financially efficient and core business focused. By keeping our costs down and focusing our resources on the utility services we provide to our customers, we are able to meet our goals of providing safe and reliable services at the best rates possible.

In 2004, we created and rolled out a new strategic plan for 2005-2010. This five-year plan was the result of extensive research and ongoing discussions with employees, elected officials, customers and other key stakeholders in this utility. We worked to identify not just their needs and expectations, but also their thoughts on how MLGW can become a more responsive organization and realize its fullest potential for the good of all our customers. The plan is a roadmap for the future that reflects a recommitment to the core values that brought MLGW to the place it is today...a valued asset to this community and a leader in the utility industry.

As we look to the future of MLGW, I am confident that we are truly embarking on a new era of excellence. MLGW has a rich tradition of service to the greater Memphis community, and we are moving forward to continue and even improve upon that tradition of excellence. The foundation is in place to build upon and reach our vision of being the best utility for our customers.



Joseph Lee, III
President and CEO

A Year of Transformation

Memphis Light, Gas and Water has a long-standing tradition of serving our community well with safe, reliable and affordable utility services. MLGW is also known as a leader in the utility industry recognized for innovative and first-rate operations. These are two roles that the 2,800 employees of MLGW accept with honor and remained committed to throughout 2004.

The beginning of 2004 was a time of leadership transition as Dr. James L. Netters became the Interim President and CEO of the utility. Having served on the MLGW Board of Commissioners since 1984, Dr. Netters planned to retire from the Board in 2004 when he was tapped to serve in this interim position. He willingly and skillfully rose to the challenge providing steady and trusted leadership during this transition period. This stability in leadership paved the way to continued stability in service to MLGW customers.

Joseph Lee, III was sworn in as the ninth President and CEO of MLGW in a special ceremony on July 1, 2004. Mayor Willie W. Herenton officiated the ceremony before a standing-room only crowd. During his remarks at the swearing in ceremony, Mr. Lee commented that the event marked the beginning of positive transformation at MLGW as all employees rededicated, refocused and recommitted themselves to the highest quality standards in service to all customers.

Another change in leadership occurred in 2004 with the retirement of four longtime, faithful members of the MLGW Board: Dr. Netters, as well as Olin Morris, Franketta Guinn and Bishop William Graves. These commissioners played a critical role in MLGW's success in recent years and were honored at a special ceremony in November for their contributions to the utility and the community.

Following Dr. Netters' retirement, L.R. Jalenak, Jr. became the chairman of the Board, and four new commissioners were appointed by the Mayor to complete the five-member body: Nick Carter, V. Lynn Evans, Rick Masson and James Russell.

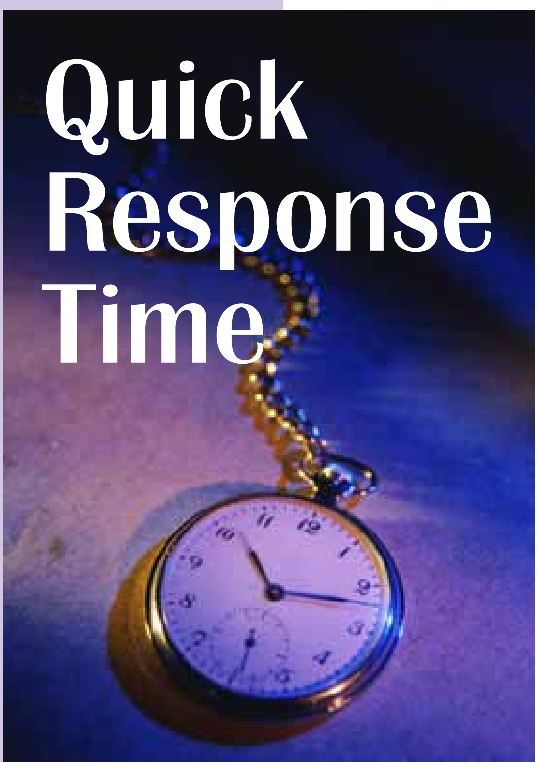
The transformation in leadership at MLGW led to a transformation in operations as well as the new leadership team jumped into action and led the utility with customer-focused and business-minded decisions supporting continued success at MLGW in the future. The organizational structure of MLGW underwent a transformation with the reduction of the senior vice presidents and a more streamlined reporting structure. This change provided cost savings and a more efficient organizational structure. In addition, MLGW began looking for ways to work more effectively by collaborating with other Divisions within the City of Memphis.

The strategic focus of MLGW was also transformed with the creation and implementation of a new five-year strategic plan. The new plan is the backbone of MLGW's strategic focus for the next five years, but it was also the driving force behind the transformation of this utility in 2004. When Mr. Lee first joined MLGW in mid-2004, he brought with him the "3-C Philosophy," which included being core business focused, coordinating and collaborating with key stakeholders and gaining cost and organizational control. These concepts guided the leadership team in 2004, and ultimately became the strategic areas of focus within the new strategic plan relating to relationships, reliability and rates.

Building Relationships

Customer/Stakeholder Focus

In 2004, MLGW adopted a new vision…to be the best utility for our customers. A variety of factors contribute to MLGW's success, but the satisfaction and safety of the customers we serve is the most valuable asset of all. MLGW is committed to building trust-filled and value-driven relationships with all customers and other key stakeholder groups.



Committed to our Customers

In keeping with our desire to provide excellent service to our customers, MLGW made great strides in customer service initiatives during 2004. MLGW has enjoyed a positive reputation for providing excellent customer service, thanks to the efforts of an internal process team and enhancements made to the Customer Care Center as a result of this team. The effort led to a tremendous improvement in wait times for customers when calling MLGW. The average customer wait time decreased from more than eight minutes in 2003 to just one minute in 2004. From April to December 2004, the average wait time was less than 10 seconds. This dramatic reduction was achieved in spite of the fact that we answered almost 200,000 more calls in 2004.

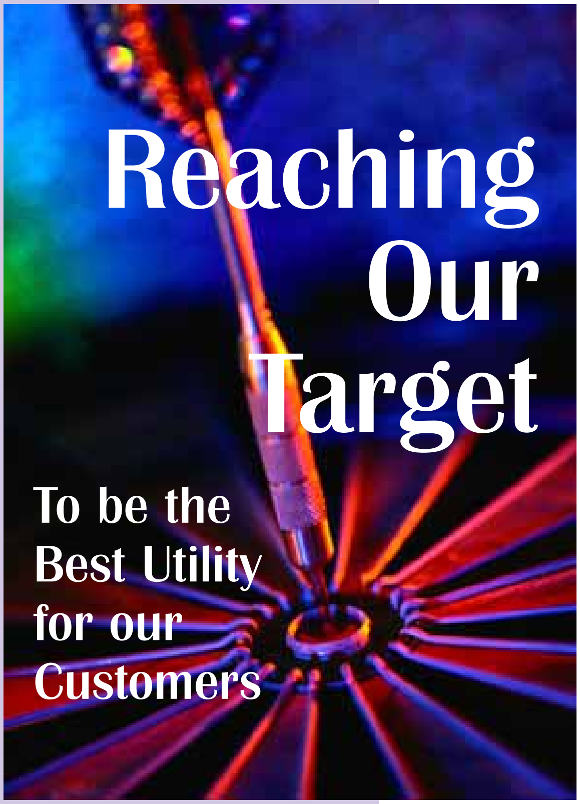
Several other enhancements are making it easier for customers to do business with MLGW. In the fall, MLGW began using an automated outbound call system to notify customers of planned service outages and remind customers of cutoffs scheduled for nonpayment or appointments scheduled with utility representatives. MLGW also enhanced online and phone payment services at the end of the year by enlisting the services of a new payment company, which offers lower fees for online and phone transactions and accepts a wider variety of credit and ATM debit cards.

A significant alteration to the organizational structure at MLGW is also enhancing customer service. The customer service division was strategically realigned as a core business function within MLGW, rather than serving as a support division, through the merger of the Operations and Customer Service divisions. In addition to reflecting a transformation of the cultural value of this important area, this organizational change creates the avenue to ensure that our operations are truly customer-focused and customer-friendly.

Committed to our Community

MLGW and its employees have long demonstrated a strong and sincere dedication to the Greater Memphis community by committing time, money and energy to numerous philanthropic efforts. This tradition of benevolence continued in 2004 with the contributions MLGW employees made to the following:

- Contributed more than $773,000 to United Way of the Mid-South
- Donated gifts to 75 Angels MLGW adopted from The Salvation Army's Angel Tree Program
- Volunteered time and donated items to the Alzheimer's Day Services' Forget-Me-Not Second Hand Sale
- Raised $16,887 for Junior Achievement during MLGW's annual Bowl-A-Thon
- Volunteered at the 16th Annual MLGW/IBEW Special Olympics Sportsfest
- Donated 724 pints of blood to LifeBlood
- Built a Habitat House in conjunction with the Junior League and Habitat for Humanity
- Raised funds and walked in WalkAmerica benefiting the March of Dimes, the American Heart Walk benefiting the American Heart Association and America's Walk for Diabetes benefiting the American Diabetes Association



- Volunteered for MLGW's Project MAX program, building wheelchair ramps for needy families

In addition to supporting the efforts of employees who volunteer for various organizations in our community, MLGW also believes strongly in giving back to the community we serve. MLGW is involved in efforts to support economic development in the Greater Memphis area by working closely with the Memphis Regional Chamber to encourage the movement of commerce into Memphis and Shelby County. MLGW also supports the growth and development of minority-, women- and locally-owned businesses through its extensive Supplier Diversity Program. Since the program's inception in 1997, MLGW has spent more than $130 million toward the growth of minority-, women- and locally-owned businesses. This program contributes to the economic growth and improvement of the MLGW customer base while simultaneously ensuring the pool of suppliers providing goods and services to MLGW reflects the tremendous diversity of the community.

Committed to the Needs of our Stakeholders

As a municipal entity, MLGW is owned by the customers we serve, and we recognize our customers as our number one stakeholders. We have also identified other key stakeholder groups that we are developing relationships with in a continuous effort to build and maintain positive and open communications with all stakeholders in this utility. In addition to our customers, MLGW also strives to communicate with and understand the needs of our employees, local elected officials, legislators, industry regulators and others.

In order to learn more about the perceptions and needs of our stakeholders, MLGW embarked on several months of gathering information in 2004. By surveying MLGW employees, local elected officials, customers and other key groups, MLGW gathered the opinions, needs and expectations of these groups, and the information provided was taken into account in the construction of a new five-year strategic plan unveiled at the end of 2004. The surveys were conducted by an independent firm to ensure reliability and provided valuable insight into areas in need of improvement and areas of satisfaction.

The local elected officials surveyed included city and county mayors, City Council members, aldermen, county commissioners and state legislators. Eighty-nine percent of respondents said they were satisfied with MLGW overall and complimented MLGW on the efficiency and responsiveness of the staff and the quality of utility services provided.

MLGW employees and the satisfaction of this key stakeholder group are a driving force behind the future success of MLGW. The employee survey results showcased the positive attitude and pride among MLGW employees. Nine out of 10 employees said they are proud to work for MLGW. In addition, 88 percent agreed that MLGW is a good organization to work for, and 90 percent said they planned to be working for MLGW a year from now.

Ensuring Reliability

Core Business Focus

MLGW is committed to delivering reliable, safe, high quality and cost-effective utility services to our customers. Maximum reliability of services is a direct result of remaining focused on the core business functions of the utility including aggressively addressing the supply and production of utility products while actively protecting and promoting the wise use of each resource. In 2004, MLGW recommitted its efforts to supporting these core business functions.

Electricity

As the anniversary of the July 2003 windstorm neared, the reliability of services was on everyone's mind. In the wake of that storm, approximately 82 percent of the entire MLGW customer base was left without power. MLGW marked the one-year anniversary of the devastating storm with a briefing of local media and City Council members at MLGW's Electric and Systems Operation facility. At the briefing, MLGW officials discussed lessons learned and provided updates on improvements made. These improvements included enhancements to the emergency response plan relating to system and damage assessment in the early stages of an emergency event and the increased ability to obtain and utilize outside assistance. These improvements translate to better preparedness in the event of a future extended outage event. In addition, MLGW created and distributed an emergency preparedness guide in conjunction with this anniversary, which offered customers valuable information on how to contact MLGW and to prepare for and weather any future outage event.

Construction began in 2004 on this substation, which will provide added reliability to the St. Jude and Uptown area of downtown.

As the largest distributor utility of the Tennessee Valley Authority (TVA), MLGW has been a longtime and vocal advocate for this community as it relates to TVA and the future reliability of electric supply. MLGW's efforts in this area were rewarded in 2004, when Congress passed legislation to significantly alter the structure of the

TVA Board of Directors. The bill, sponsored by Senators Bill Frist and Lamar Alexander, will result in TVA's governance structure being changed from three, full-time members to nine part-time members. MLGW, along with the Tennessee Valley Public Power Association, has been a strong supporter of the legislation. One element of the bill that MLGW particularly advocated was a requirement that at least seven of the nine members be residents of the TVA service territory. This new structure will benefit MLGW customers by providing greater accountability and better representation for West Tennessee.

Natural Gas

When winter temperatures arrive, reliability of natural gas used to heat our homes becomes a top-of-mind concern for MLGW customers. However, MLGW prepares for the winter heating season year-round. MLGW's aggressive gas purchasing strategy allows the utility to purchase long- and short-term on the options, futures and spot markets. This allows MLGW to secure some of the winter's projected natural gas needs ahead of the peak usage time. By October 2004, MLGW's gas storage facilities were already filled to capacity in anticipation of winter needs.

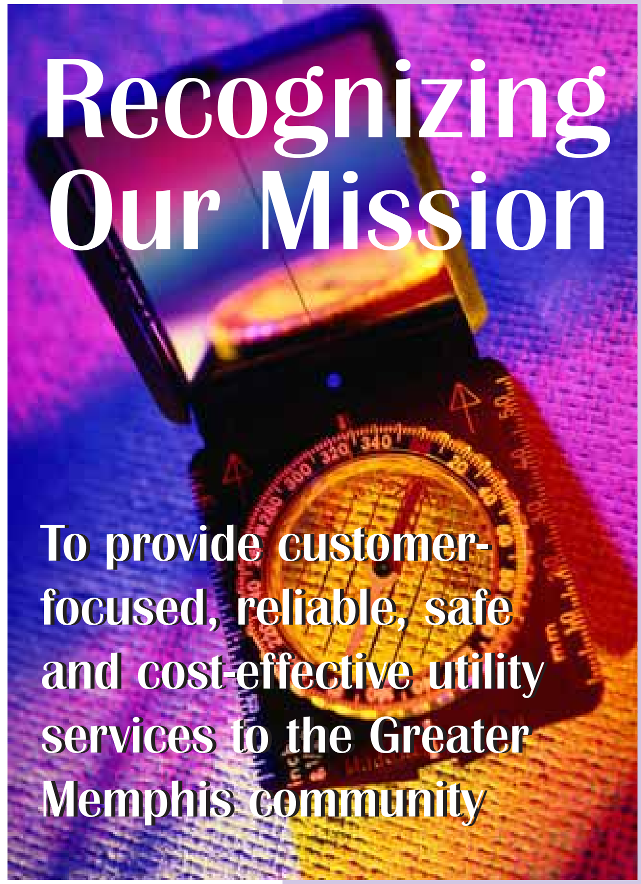
MLGW's Water Quality Assurance Laboratory conducts more than 38,000 tests each year to ensure water safety.

Also in 2004, MLGW tapped into a third natural gas transporter with the completion of a natural gas gate station in Southeast Shelby County. MLGW now has access to additional gas supplies through a connection with ANR Pipeline Co. This new connection creates cost savings for natural gas, but it also offers long-term benefits related to future reliability. In the past, MLGW has relied on natural gas from the Gulf of Mexico area, but production in that area has declined in recent years. Access to the ANR pipeline gives MLGW the ability to reach Canadian and Midwest supplies, which provides stability in the form of options for the future.

Water

The residents of Memphis and Shelby County enjoy drinking water that is among the purest in the world thanks to the natural reservoirs deep in the earth known as the Memphis Sands aquifer. While it is safe to say that Memphis has little fear of a water shortage, MLGW is committed to not taking this water source for granted by actively promoting water conservation and preservation. Maintaining safe and reliable drinking water remains a high priority for MLGW.

MLGW taps into the aquifer and delivers water to customers by way of 10 water pumping stations and more than 175 wells throughout Shelby County. In recent years, MLGW has taken steps to support water reliability in the event of an emergency. MLGW is safeguarding water reliability by adding dual electric circuit feeds into the water pumping stations and installing emergency generators. In 2004, MLGW completed an emergency generator installation and a dedicated circuit to selected wells at one of the water pumping stations, making six of the ten pumping stations now protected by emergency power generators. MLGW also obtained grant money from FEMA to make seismic improvements to two water pumping stations in 2004.



Rate Stability

Cost Control Focus

MLGW is committed to offering customers the best rates and the best value for utility services. To continue this commitment to stable and affordable rates, MLGW worked diligently in 2004 to strengthen the financial position of the utility by keeping costs down and ensuring resources are allocated to support core business functions.

Continuous efforts to save ratepayers money in 2004 were evident as MLGW leadership closely examined policies and procedures of the utility. Following this examination, potentially costly personnel policies including overly generous life insurance policies for key employees and large severance packages were eliminated. In addition, MLGW eliminated an executive tier of three Senior Vice Presidents. This organizational change resulted in substantial savings in salaries and also streamlined the management structure to better serve customers through optimum efficiency and performance.

MLGW's first rate increases in a decade went into effect in 2004. The increases, which were approved by the Memphis City Council as part of the budget in December 2003, included electric and water rate increases. Even with the increase in these two services, MLGW customers still enjoy relatively low utility costs. In fact, a study of utility bill comparisons in cities of comparable size to Memphis found MLGW rates to be among the lowest in the nation. Memphis came in a close second to El Paso, Texas, in the study, which compared the average monthly residential utility bill combining all utility services.

Environmental Stewardship

A Commitment to the Future

MLGW recognizes that environmental preservation is a necessary component for ensuring a high quality of life for generations now and in the future. With that in mind, MLGW continues to demonstrate its commitment to protecting the environment as witnessed through a number of initiatives in the past year, as well as some that will be coming to fruition in the near future.

MLGW leads by example in the area of environmental stewardship, and this commitment is evident in the educational opportunities provided to MLGW employees to learn about wise resource use at work and at home. Employee awareness programs include the EcoWise Program, which promotes the wise use of resources in the work place, as well as educational fairs held in conjunction with Earth Day in April and Energy Awareness Month in October.

MLGW added to its motor vehicle fleet in 2004 with the purchase of a second Toyota Prius. These hybrid vehicles switch between fuel and electric power, which reduces fuel consumption resulting in lower gas emissions and less dependency on foreign oil suppliers.

MLGW partnered with The Solae Company, BFI Waste Systems and CPL Systems, Inc. to improve local air quality and reduce the Solae plant's dependence on natural gas in 2004 through a renewable energy source project. Known as a landfill gas usage project, this venture puts to good use the landfill gas generated when organic waste in a municipal solid-waste landfill decomposes. Instead of burning off the landfill gas in a flare at the site, the collected gas can be used to generate electricity. Landfill gas is the only renewable energy source that, when used, directly prevents atmospheric pollution. MLGW is currently working with another customer on a similar project that should be up and running in 2005.

MLGW's EcoBUILD program, which incorporates energy and environmental measures into the design and construction of homes, continued to grow in 2004 as the construction of several EcoBUILD homes began in the Uptown development just north of downtown. When complete, Uptown will feature nearly 500 EcoBUILD homes, making it among the 10 largest "green" communities in the nation. EcoBUILD construction benefits the environment through the use of recycled materials, as well as the use of paints, stains and adhesives with very low levels of volatile organic compounds, which are often the cause of respiratory problems.

A coordinated effort between MLGW and TVA will soon allow MLGW customers to make the Green Power Switch for the good of the environment. Customers who sign up for the Green Power Switch will voluntarily pay an additional fee that will go toward advancing technology and increasing the amount of electricity generated from renewable and cleaner energy sources such as wind power, methane gas and solar power.

Commitment to Success

Recognition of Achievements

MLGW strives to be the best in all aspects of the utility business and takes this responsibility very seriously. MLGW was honored with numerous awards and recognition locally, regionally and nationally for excellence in service and operations in 2004 including the following:

- The American Business Awards honored MLGW with the "Communications Executive of the Year Award" and also named the utility a finalist in five other categories including "Best Communications Organization." Utility Communicators International bestowed similar honors on MLGW.
- MLGW received national recognition through a nomination for the "Bond Buyer's Deal of the Year Award" for its groundbreaking electric prepayment agreement with TVA.
- MLGW earned the "Spirit of Tennessee Award" from United Ways of Tennessee Association for its leadership in the 2003-2004 United Way of the Mid-South Giving Campaign.
- MLGW was selected as the recipient of the 2004 Tennessee Department of Environmental Conservation "Environmental Stewardship Award" in the category of Tennessee Energy Leadership. The award is based on voluntary initiatives, programs and projects related to environmental stewardship.
- The Mid-South Minority Business Council named MLGW "Corporation of the Year" and also named an employee of MLGW "Advocate of the Year." These honors are a direct result of MLGW's commitment to the advancement of minority- and women-owned businesses in our community.
- MLGW supports lineworker rodeo teams competing at the state and national level. These events award teams and

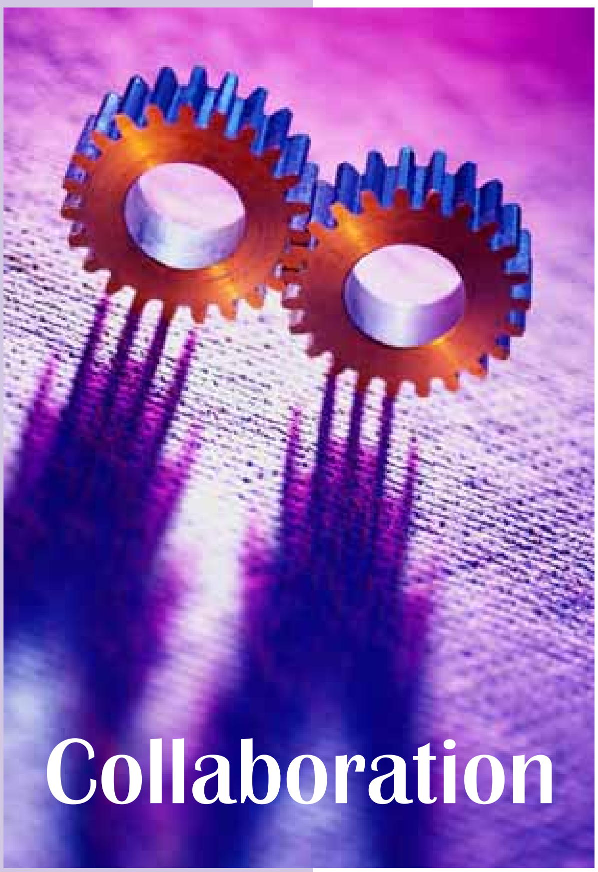
individuals who complete tasks with speed, precision and safety. MLGW teams and apprentices received high marks in 2004 at rodeo events sponsored by the American Public Power Association and the Tennessee Valley Public Power Association.

Moving Forward

The Spirit of Collaboration

2004 was surely a year marked by transformation at MLGW that was in part made possible by the spirit of collaboration permeating throughout the utility. Collaboration became the driving force internally among MLGW employees and continued into relationships with the community we serve.

The spirit of collaboration was evident as labor contract negotiations began between IBEW Local 1288 and MLGW management in the fall. After much deliberation among the negotiation team members and an exhibited willingness to work for the common good of MLGW and its customers, an agreement was reached and approved by vote of union membership in October.



Collaboration was also the theme in 2004 as MLGW leadership began looking for ways to work with the City of Memphis to create economies of scale, potential cost savings or operational efficiencies to benefit MLGW customers both now and in the future.

And now, as we move forward into 2005, the efforts of the previous year will continue to shine in our ability to serve our customers. After carefully thought out changes to the organization and the reallocation of funds to support customer service and other core business functions, MLGW presented its 2005 budget to the Memphis City Council and received swift approval. The 2005 budget includes projected operating expenses of $255 million and calls for no new rate increases. In addition, $111 million is budgeted to complete capital improvement projects such as adding electric transmission lines to improve reliability and pipeline enhancements. These upcoming capital improvements will prove beneficial to our customers as we strive to deliver reliable and safe utility services to this community.

A New Strategic Focus

Framework for Excellence

As 2004 was drawing to a close, MLGW was embarking on the road to a new era of excellence with the unveiling of a new 2005-2010 strategic plan for the utility. This plan provides a roadmap for the future success of MLGW and was the result of many months of information gathering from key stakeholders and close examination of MLGW's internal structure and processes.

This five-year strategic plan outlines how MLGW will build on the strong foundation already in place to become the best utility for our customers by following a strategic framework for operational excellence. The framework for excellence focuses on six key areas of operation: public trust, human resources, utility supply, technology and physical resources, reliability and financial control.

While 2004 brought new leadership and new dynamics to MLGW, our commitment to providing the best services in the safest and most affordable way has not changed. As we continue on the path we are taking into a new era of excellence, you can count on MLGW to continue our commitment to meeting our customers' utility needs. We will continue making strides in customer service superiority and maintaining the most affordable rates possible for our customers. MLGW is honored to be a part of the Greater Memphis community and will continue to serve this community proudly on our quest to being the best utility for our customers.

To The Board of Commissioners and Valued Stakeholders:

We are pleased to submit the Annual Report of Memphis Light, Gas and Water Division (MLGW) for the fiscal year ended December 31, 2004, as required by the Charter Provisions of the City of Memphis (City) creating the Memphis Light, Gas and Water Division. This report has been prepared in conformity with generally accepted accounting principles (GAAP), under the rules and regulations of the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB). MLGW is also subject to the federally mandated Single Audit, and the findings for internal controls and compliance are herein presented.

Responsibility for the accuracy and presentation of the information provided is the full responsibility of the management of MLGW. Disclosures necessary to assist the reader in the understanding of the financial statements have been included.

MLGW's financial statements have been audited by Watkins Uiberall, PLLC and Banks, Finley, White and Company, licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of MLGW for the fiscal year ended December 31, 2004 are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditors concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that MLGW's financial statements for the fiscal year ended December 31, 2004, are fairly presented in conformity with generally accepted accounting principles (GAAP). The independent auditor's report is presented as the first component of the financial section of the report.

The independent audit of the financial statements of MLGW was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are available in MLGW's separately issued Single Audit Report.

Generally accepted accounting principles require that management provide a narrative introduction, overview and analysis to accompany the basic financial statements in the form of a Management Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. MLGW's MD&A can be found immediately following the report of the independent auditors.

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Profile of the Government—MLGW was created by an amendment to the City Charter by Chapter 381 of the Private Acts of the General Assembly of Tennessee, adopted March 9, 1939, as amended (the "Private Act"). MLGW operates three separate utilities, as divisions, providing electricity and gas in the City and Shelby County. Water service is provided by MLGW in the City and, together with other municipal systems, in Shelby County. Each division operates as a separate entity for accounting and financial purposes in accordance with the Private Act. For economic reasons, activities common to all three divisions are administered jointly and costs are prorated monthly among the divisions. A 1981 amendment to the City Charter permits the establishment of additional divisions to provide other energy services.

MLGW controls the administration of its activities and business affairs. It operates independently, manages its own finances and is responsible for obligations incurred in such operations, including indebtedness payable from operations of the Division. MLGW must have the approval of the City Council before incurring certain obligations, including purchasing real estate and exercising the right of eminent domain; also the annual budget is subject to approval by the City Council.

MLGW is managed by a Board, which consists of five members nominated by the Mayor and approved by the City Council. Under the Private Act, the Board is responsible for doing all things necessary to supply the Division's service area with electricity, gas and water. The members of the Board serve staggered terms of three years each. The Board elects annually Chairman and Vice Chairman whose terms begin June 1 of each year. The Chairman, Vice Chairman and Board Members continue to serve until a new Chairman, Vice Chairman or Board Member is approved.

The daily operation of MLGW is managed by the President and Chief Executive Officer, who is nominated for a five-year term by the Mayor and approved by the City Council. Under the Private Act, the President generally supervises the operation of MLGW and all of its officers and employees.

Local Economy—(Information provided by Memphis Regional Chamber Website)—Memphis, Tennessee, located in the southwest corner of Tennessee on the Mississippi River, is the nation's 18th largest city. The 2000 Census reported a Shelby County population of 897,472, of which, all households utilize MLGW's services. The Memphis Metro area provides a diverse range of employers which contributes to the overall stability of the area and to MLGW's customer base. As of 2003, government employment (14%) comprised the largest percentage of non-farm employment, followed by professional and business services, educational and health services and retail trade (each adding 12% respectively), and transportation, warehousing and utilities (11%) rounding out sectors greater than 10 percent. Nineteen major companies announced relocations to Memphis and 123 existing businesses announced expansions in 2003. Expansion Management magazine also listed Memphis as the fifth of "50 Hottest Cities" for relocating or expanding.

Memphis is also known for its expertise and growth in the healthcare industry. St. Jude Children's Research Hospital is one of the world's renowned centers for research and treatment of catastrophic diseases in children. St. Jude announced a billion-dollar expansion, which will double the facility's size;

MLGW's partnership has been critical through the addition of a new substation to support the growth of the St. Jude facility and surrounding area. A state-of-the-art biotechnology research park which will add to the existing $5 billion plus contribution of the healthcare industry to Shelby County's economy is also being built.

National Economy—High energy prices (particularly natural gas) continue to put financial pressure on MLGW customers. Wholesale natural gas prices have tripled over a ten-year period and continue to rise. MLGW continues to implement strategies and plans to help shape the direction of federal and state electric restructuring to ensure continued access to reliable, low-cost electricity supplies.

Financial Policies and Major Initiatives—MLGW maintains a comprehensive cash flow model which assesses the growth of the separate divisions and determines future rate increase requirements. MLGW also incorporates a 10-year capital financial plan in its budgeting process. MLGW's Electric, Gas and Water Engineering Departments develop detailed technical master plans for their respective systems which are then correlated with the financial plan. The 10-year capital plans are updated periodically during the year in order to provide the most current possible cash flow projections.

Among the three divisions, MLGW averages more than $100 million in capital expenditures throughout the year. Major electric projects planned for the 10-year period include construction of South Collierville and East Shelby County substations needed to provide for expected residential and industrial growth in these areas. Gas division plans include installation of approximately 17 miles of transmission main, 202 miles of distribution main, and 8 regulator stations over the next 10 years, and the Water division plans for the continuation of seismic retrofit to pumping facilities and the construction of an additional plant in the projected growth area of Northeast Shelby County.

MLGW also has a formal five-year Strategic Plan that is committed to the vision of being the best utility for our customers. MLGW will also work with the City of Memphis, TVA, and other stakeholders when possible to streamline costs through collaborative efforts.

Acknowledgements—The preparation of this report was made possible by the overall dedication of MLGW's Finance Division. We would like to express our appreciation to all members of the Finance Division who assisted and contributed to the preparation of this report. Special thanks must also be given to Watkins Uiberall, PLLC and Banks, Finley, White and Company for their efficient and timely completion of this year's audit.

Respectfully submitted,

Joseph Lee, III
President and CEO

John McCullough
Vice President, CFO and Secretary-Treasurer

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WATKINS UIBERALL

Watkins Uiberall, PLLC
Certified Public Accountants & Financial Advisors
Independent Member of BKR International

BANKS, FINLEY, WHITE, & CO.
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

To the Board of Commissioners and Management
Memphis Light, Gas and Water Division
Memphis, Tennessee

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 year ended December 31, 2004, as listed in the table of contents. These financial statements are the responsibility of the Divisions' management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Memphis Light, Gas and Water Division as of and for the year ended December 31, 2003, were audited by other auditors whose report dated July 30, 2004 expressed an unqualified opinion on those statements.

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

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 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, 2004, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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, 2004, and the changes in their financial position and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 4, 2005 on our consideration of the Divisions' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. 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 audit.

Management's Discussion and Analysis as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. 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.

Our audit was conducted for the purpose of forming an opinion on the financial statements of each of the Divisions. The introductory section is not a required part of the basic financial statements. The introductory section has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

Watkins Uiberall, PLLC
Banks, Finley, White & Co.

Memphis, Tennessee
May 4, 2005

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

- In June 2004, Joseph Lee, III was confirmed as the ninth President and CEO of MLGW. Mr. Lee began his tenure developing a new strategic plan and reorganizing the management structure at MLGW.
- The Board of Commissioners welcomed new members including: Rick Masson, Jim Russell, V. Lynn Evans and Nick Clark. Mr. L.R. Jalenak will continue to serve on the board as Chairman until his term expires on June 30, 2005.
- Bond Ratings were reaffirmed for the Electric and Water Divisions by Standard & Poor's.
- The savings related to the prepaid electric bond transaction were approximately $13.0 million in 2004.
- A new pipeline connection was made to ANR Pipeline. This will allow MLGW to gain access to additional gas supplies.
- Net assets in the Electric Division increased by $53.7 million and in the Water Division by $7.0 million, primarily due to the rate increases that took effect in the January 2004 revenue month. Net assets in the Gas Division decreased by $7.8 million; the Gas Division rate increase was delayed until the January 2005 revenue month.
- MLGW incurred a combined total expense of $46.8 million for payment in lieu of taxes to the City of Memphis to support critical city services, up 4.6 percent from 2003.
- Management negotiated a one year extension on the labor contract with IBEW Local 1288.

New Strategic Plan

President Joseph Lee unveiled his new strategic plan in late 2004. The strategic plan outlined the foundation in which we intend to build upon to reach our vision of being the best utility for our customers. At the heart of the plan are three primary goals:

(1) **Customer/Stakeholder focus**: Establish a trust-filled and value-driven relation with all customers, key stakeholders and employees through performance excellence, open communication and active partnerships.
(2) **Core business focus**: Deliver reliable, safe, high quality and cost-effective utility services.
(3) **Cost-control focus**: Strengthen the financial position of MLGW and ensure that we continue to offer our customers the best rates and best value.

By clearly focusing on the "Three C's", MLGW will provide customer-focused, reliable, safe and cost-effective utility services to the Greater Memphis Community. The strategic plan will be effective 2005-2010.

Bond Ratings Reaffirmed

MLGW Bond Ratings			
	S&P	Moody's	Fitch
Electric			
2002 Revenue Bonds	AA	Aa3	AA
2003A and 2003B	AA	Aa3	AA
Water	AAA	Aaa	

Debt Administration		
	Outstanding Balance	Coverage
Electric	$1,356,140	1.95
Water	$27,150	3.28

In 2004, MLGW's Water Division AAA bond rating was reaffirmed from Standard & Poor's after an annual review of financial management practices. The Electric Division's AA rating was also reaffirmed (see above chart for all bond ratings). MLGW remains the only municipal utility in the nation to hold a AAA rating from Standard & Poor's and a Aaa rating from Moody's Investors Service. To provide bond ratings, agencies typically look at financial operations, management practices, rates and debt ratio. Higher ratings also result in the ability to buy and refinance bonds at much lower rates than companies with lower ratings.

MLGW Prepaid Bond Transaction Yields Savings and Recognition

In late 2003, 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. In turn, MLGW 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 in 2004 were approximately $13.0 million, with total projected savings in excess of $225 million over the life of the agreement. 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.

In October 2004, MLGW's prepaid bond transaction was nominated for "The Bond Buyer Deal of the Year". The MLGW bond agreement with TVA was the first electric prepayment transaction completed under new U.S. Treasury Department regulations, thereby setting the precedent for all future electric prepay transactions. This historic transaction was also recognized by both the *Wall Street Journal* and the *Dow Jones News*. *The Bond Buyer's* annual "Deal of the Year Award" honors municipal bond industry deals that represent innovation and distinctiveness and can serve as a model for future financing arrangements across the country.

Third Gas Pipeline

A new contract with ANR Pipelines Company took effect in November 2004 and is projected to save MLGW approximately $400 thousand per year in gas costs. With this third pipeline, MLGW gains an additional source of gas and access to different production areas, including Canada, the Gulf Region and the Midwest. The contract with ANR will provide MGLW greater leverage in negotiating gas contracts. The additional pipeline will also help protect customers from fluctuating prices in the gas market.

MLGW Labor Agreement

MLGW management and IBEW Local 1288 agreed on a new one-year memorandum that serves as an extension to the previous agreement which expired December 31, 2004. The new agreement took effect on January 1, 2005. Negotiations for a new labor agreement will begin again in mid-year 2005.

Electric Division Highlights

Operating Highlights

As indicated in Table 1 below, the Electric Division's total assets exceeded total liabilities by $797.5 million, up $53.7 million from 2003. Current and other assets decreased slightly and capital assets increased $26.1 million (please see discussion of construction activities and capital assets for further information).

Total liabilities decreased $110.9 million due to several factors including $74.0 million debt retirement payments, $14.1 million relating to the decreased value of the unamortized debt premium for the prepaid bonds, and $15.0 million reduction in notes payable related to the payment in 2004 of a short term loan that was acquired in 2003 to cover storm expenses.

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

	2004	2003
Current, restricted and other assets	$ 290,889	$ 291,467
Prepaid power costs	1,412,899	1,495,643
Capital assets	741,683	715,535
Total assets	2,445,471	2,502,645
Current liabilities payable from current assets	202,864	230,172
Current liabilities payable from restricted assets	26,049	20,974
Prepaid power liabilities (non-current)	1,395,891	1,483,290
Non-current liabilities	23,158	24,424
Total liabilities	1,647,962	1,758,860
Net assets:		
Invested in capital assets, net of related debt	710,217	679,848
Restricted	12,996	13,119
Unrestricted	74,296	50,818
Total net assets	$ 797,509	$ 743,785

At December 31, 2004, over 89 percent of the net assets were related to capital assets, which included property, plant and equipment. Restricted funds comprised $13.0 million, and an additional $74.3 million of the net assets remained 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, 2004 and 2003
(In Thousands)

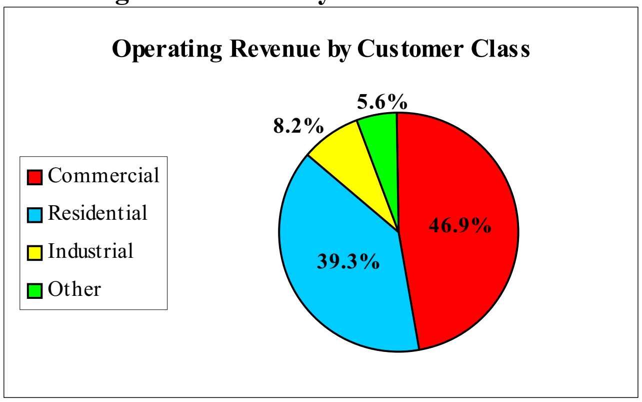
	2004	2003
Revenues:		
Operating revenues	$ 933,934	$ 848,430
Non-operating revenues	78,022	34,304
Total revenues	1,011,956	882,734
Expenses:		
Depreciation expense	29,422	27,622
Purchased power	707,136	669,358
Other operating expense	162,694	153,169
Non-operating expense	58,980	11,596
Total expenses	958,232	861,745
Income (loss) before contributions in aid of construction	53,724	20,989
Contributions in aid of construction	21,216	31,768
Reduction of plant costs recovered through contributions in aid of construction	(21,216)	(31,768)
Changes in net assets	53,724	20,989
Beginning net assets	743,785	717,026
Cumulative effect of change in accounting principle	-	5,770
Beginning net assets as adjusted	743,785	722,796
Ending net assets	$ 797,509	$ 743,785

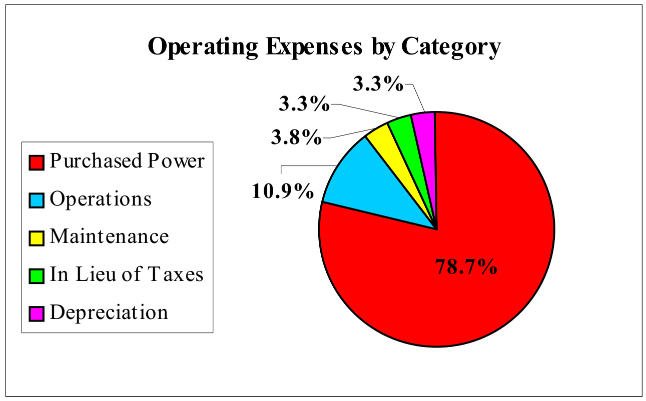
Operating revenues of the Electric Division totaled $933.9 million and were derived principally from the retail sales of electricity to an average of 416,455 customers. As depicted in Figure 1, commercial and residential customers comprise 86.2 percent of total sales revenue. Operating revenues were up 10.1 percent from 2003 revenues of $848.4 million. Power costs in 2004 were $707.1 million, up 5.6 percent from 2003. The increase in operating revenues can be attributed to the Electric Division's rate increase, effective in the January revenue month and the TVA rate increase effective in October 2003. The MLGW rate increase generated $40.3 million and the TVA rate increase generated $45.4 million in 2004. Also, there was a slight increase in the number of electric customers in 2004 which impacted sales and purchased power from the prior year.

Non-operating revenues of $78.0 million were up $43.7 million from the prior year. The increase is mainly due to a $46.0 million increase in amortization of the prepaid power cost.

Operating expenses of $899.3 million were up $49.2 million from the prior year expenses of $850.1 million. As shown in Figure 1, power costs accounted for almost 79 percent of MLGW operating expenses. Approximately $37.8 million of the increase can be attributed to power cost and the remaining increase can be attributed to the $12.9 million increase in Administrative and General Expense. Power costs were impacted by TVA's October 2003 "pass-through" rate increase. In 2004, this rate increase amounted to $45.4 million in increased power costs to MLGW. The large increase in Administrative and General (A&G) expense is related to a $1.5 million increase in injuries and damages pertaining to a rare accident that severely injured an employee and an increase of $8.9 million relating to employee pensions and benefits.

Figure 1: Electric Division
Percentage of Each Utility Dollar





Adjustments for uncollectibles, which are deducted from gross operating revenues, amounted to $6.2 million, an increase of over $2.6 million from 2003. Contributing to the large increase in write-offs was residential and commercial bankruptcies, which increased $3.5 million from 2003. Working with customers to prevent bankruptcies and delinquent payments remains a top priority of management.

Non-operating expenses increased $47.4 million from 2003 due mainly to interest expense on the Electric Prepaid Bonds.

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, 2002 and 2003. On November 19, 2003 MLGW entered into a Supplement to the Power Contract ("Supplement") with TVA under which MLGW made a prepayment of $1.5 billion to TVA for capacity and related energy. The bond issue to fund the prepayment was the largest recorded in the State of Tennessee's history. Under the terms of the supplemental contract, TVA will provide the prepaid capacity in equal monthly segments over a 15 year period. 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. Prepay savings for 2004 are approximately $13.0 million.

Beginning in January, electric bills included the electric rate increase which was effective December 30, 2003. This was the first increase for operating expenses in MLGW's Electric Rate Schedules since January 1, 1993. The increase was 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. The actual increase varied by customer class, with a composite average of 4.7 percent. In 2004, sales revenues increased by $82.0 million. Approximately $40.3 million of this revenue increase can be attributed to MLGW's rate increase. The remaining $45.4 million increase is the pass-through of TVA's October 2003 electric wholesale rate increase (a nine month difference from 2004 to 2003), and also an increase in sales driven by warmer weather. Current MLGW plans call for no electric rate increases in 2005.

Rate options available to Electric Division customers include firm, seasonal, time-of-day, and interruptible service rates. Interruptible rate programs provide large commercial and industrial customers with the potential for reduced rates, along with the right for TVA to interrupt service as needed. Surveys conducted annually of electric rates in large U.S. cities show the Electric Division's rates are some of the most competitive in the nation.

Changes in Capital Assets

Construction Activities

During 2004, the Electric Division expended $55.9 million on construction activities. Major Electric Division capital projects included: substation improvements needed to handle increased capacity for the downtown St. Jude Children's Research Hospital campus extension project ($6.2 million), other substation projects ($1.1 million), purchase of transportation and communication equipment ($4.7 million), street lighting installations ($6.2 million), extensions to serve new customers ($14.3 million), purchase of meters and equipment ($2.3 million), replacement of feeder cables ($2.1 million), and purchase of transformers ($5.0 million).

Capital Assets

The Electric Division's investment in capital assets as of December 31, 2004 was $741.7 million, net of accumulated depreciation. This includes $77.7 million in Transmission plant (up $1.4 million from 2003) and $532.3 million in Distribution plant (up $1.2 million from 2003).

General plant, net of depreciation, had an ending balance of $50.4 million, an increase of $6.5 million or 14.8 percent increase over the previous year. The increase is mainly associated with the purchase of miscellaneous equipment such as transportation and power operated equipment.

Major plant additions from construction work in progress include the completion of the Rev. James L. Netters Business Center and the purchase of meters and transformers.

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 2004 Electric Division in lieu of tax payments paid by MLGW was $29.7 million. This amount represents a 5.5 percent increase over 2003.

Other Significant Items

Windstorm Highlights

In July 2003, a wind storm hit the MLGW service territory causing power to be lost to approximately 339,000 customers or 82 percent of our electric customers. Shelby County was declared a major disaster by FEMA (Federal Emergency Management Agency), and funding was supplied for 75 percent of eligible costs relating to storm restoration. Total eligible expenses reported to FEMA due to the 2003 Windstorm were $24.7 million. Most of these expenses or capital outlays and associated contributions in aid were accrued on MLGW's 2003 financials. The receipt of the actual cash reimbursement from FEMA of $18.7 million did not occur until final inspection was completed, invoices were paid, and projects were closed by FEMA in 2004.

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 2004 has been $28.6 million. MLGW is authorized for a total investment amount up to $32 million. MLGW's share of Memphis Networx losses recorded in 2004 was $5.4 million and the cumulative net investment in Memphis Networx was $9.4 million at December 31, 2004. During 2004, Memphis Networx continued to expand its customer base for 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 $514.4 million exceeded total liabilities by $405.1 million, a $7.8 million decrease from 2003. The $4.0 million decrease in capital assets was related to an increase in depreciation and other factors (see further discussion in capital asset section). Current and other assets increased by $11.4 million due to an increase in unrecovered purchased gas cost at year end 2004. Non-current liabilities decreased $1.2 million from 2003, due to a decrease in the deferred credit for a pipeline lease.

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

	2004	2003
Current, restricted and other assets	$ 191,659	$ 180,272
Capital assets	322,743	326,757
Total assets	514,402	507,029
Current liabilities payable from current assets	88,166	72,117
Current liabilities payable from restricted assets	6,395	6,074
Non-current liabilities	14,749	15,904
Total liabilities	109,310	94,095
Net assets:		
Invested in capital assets, net of related debt	322,743	326,757
Restricted	26,573	23,780
Unrestricted	55,776	62,397
Total net assets	$ 405,092	$ 412,934

At December 31, 2004, almost 80 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $26.6 million of the net assets and the remaining $55.8 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, 2004 and 2003
(In Thousands)

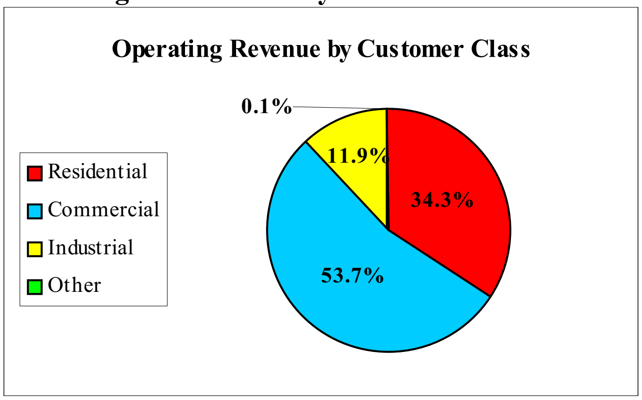
	2004	2003
Revenues:		
Sales, service and other operating revenues	$ 360,955	$ 338,520
Transported gas revenue	2,390	14,379
Non-operating revenues	4,973	3,177
Total revenues	368,318	356,076
Expenses:		
Depreciation expense	14,803	12,591
Purchased gas	283,535	260,102
Other operating expense	77,822	74,011
Non-operating expense	-	-
Total expenses	376,160	346,704
Income (loss) before contributions in aid of construction	(7,842)	9,372
Contributions in aid of construction	3,270	2,483
Reduction of plant costs recovered through contributions in aid of construction	(3,270)	(2,483)
Changes in net assets	(7,842)	9,372
Beginning net assets	412,934	398,338
Cumulative effect of change in accounting principle	-	5,224
Beginning net assets as adjusted	412,934	403,562
Ending net assets	$ 405,092	$ 412,934

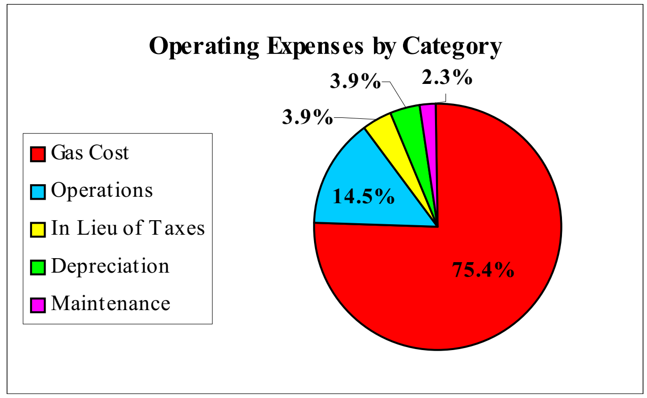
Operating revenues were up 3.0 percent from 2003 due mainly to higher winter wholesale gas prices and a 1.3 percent increase in the number of gas customers. Gas costs in 2004 amounted to $283.5 million, up 9.0 percent from 2003.

Operating revenues of the Gas Division totaled $363.3 million and were derived principally from the retail sale of gas to an average of 312,627 customers and transportation of gas to an average of 15 customers. As indicated in Figure 2, residential customers account for 53.7 percent and commercial customers account for 34.3 percent of total sales revenue.

Adjustments for uncollectibles, which are deducted from gross operating revenues, amounted to $2.4 million during 2004, up $1.8 million from 2003. High gas prices during 2004 and an increase in the number of bankruptcies caused adjusted net write-offs in the Gas Division to increase 21.0 percent in 2004.

Figure 2: Gas Division
Percentage of Each Utility Dollar





Total operating and non-operating expenses of $376.2 million were up $29.5 million from 2003, due mainly to the increase in purchased gas costs of $23.4 million over 2003 and $2.2 million related mainly to additional depreciation for the CIS (Customer Information System) which was put into service in December 2003.

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 three interstate pipelines, Texas Gas Transmission, ANR 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 was completed in November 2004. This connection provides 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 meter readings on or after December 30, 2003. The City Council approved this rate increase, but delayed implementation for one year. MLGW implemented the gas rate increase effective with meters read on or after December 28, 2004. This will be the first increase for operating expenses in MLGW's Gas Rate Schedules since April 1, 1994. Current MLGW plans call for no additional gas rate increases in 2005.

Changes in Capital Assets

Construction Activities

During 2004, the Gas Division expended $13.4 million in construction costs. Construction spending in the Gas Division was slowed due to the delay in the gas rate increase. Included in the construction costs were cast iron system retrofits ($1.7 million), purchase transportation, tool and equipment ($1.6 million), improvements to buildings and structures ($1.2 million), and extensions to serve new customers ($3.4 million). The retrofit of the cast iron system project, which began in 1991 and was requested by the Tennessee Regulatory Authority, provides for replacement of 320 miles of old cast iron main that requires excessive maintenance. The expenditures for this program cover replacing approximately 72,000 feet of cast iron main per year. To date, 216 miles of cast iron main have been replaced (68 percent complete).

Capital Assets

The Gas Division's investment in capital assets as of December 31, 2004 was $322.7 million, net of accumulated depreciation. This includes production, distribution, general plant, construction work in progress, non-utility plant and plant held for future use. The overall decrease in capital assets for 2004 was 1.2 percent. This decrease is a result of accruing more depreciation expense and retiring more capital assets than adding additions to Gas plant in 2004.

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 2004, the Gas Division paid in lieu of tax payments of $14.6 million compared to $14.5 million in 2003.

Water Division Highlights

Operating Highlights

As depicted in Table 5, the Water Division's total assets exceeded total liabilities by over $266.2 million, an increase of $7.0 million from 2003**.** Current and other assets decreased $6.8 million, with almost half of the decrease associated to construction activities drawing down the construction fund. Non-current liabilities also decreased $7.6 million due to reduction in long-term debt of $7.3 million.

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

	2004	2003
Current, restricted and other assets	$ 69,303	$ 76,086
Capital assets	242,852	237,177
Total assets	312,155	313,263
Current liabilities payable from current assets	13,048	13,462
Current liabilities payable from restricted assets	11,547	11,679
Non-current liabilities	21,409	28,990
Total liabilities	46,004	54,131
Net assets:		
Invested in capital assets, net of related debt	215,982	203,289
Restricted	21,964	24,253
Unrestricted	28,205	31,590
Total net assets	$ 266,151	$ 259,132

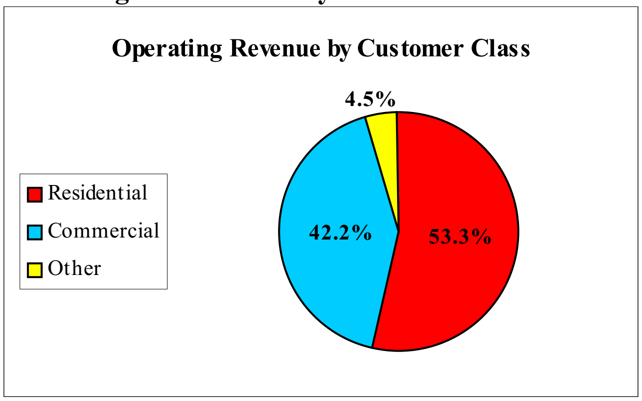
Over 81 percent of the net assets were related to capital assets, which included property, plant, and equipment. Restricted funds comprised $22.0 million of the net assets and the remaining $28.2 million was in unrestricted asset accounts used for on-going operations of the water system.

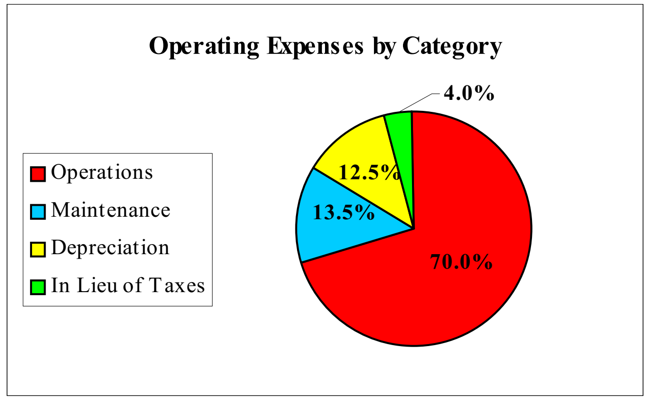
Table 6
Water Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2004 and 2003
(In Thousands)

	2004	2003
Revenues:		
Operating revenues	$ 70,365	$ 55,812
Non-operating revenues	637	2,383
Total revenues	71,002	58,195
Expenses:		
Depreciation expense	7,797	7,479
Other operating expense	54,789	47,720
Non-operating expense	1,397	1,763
Total expenses	63,983	56,962
Income (loss) before contributions in aid of construction	7,019	1,233
Contributions in aid of construction	9,833	4,174
Reduction of plant costs recovered through contributions in aid of construction	(9,833)	(4,174)
Changes in net assets	7,019	1,233
Beginning net assets	259,132	256,452
Cumulative effect of change in accounting principle	-	1,447
Beginning net assets as adjusted	259,132	257,899
Ending net assets	$ 266,151	$ 259,132

Net assets for the Water Division increased by $7.0 million in 2004, as shown in Table 6, due to a 26.4 percent increase in sales and service revenue. For the twelve months ending December 31, 2004, operating revenues of the Water Division totaled $70.4 million and were derived principally from the sale of water to an average of 249,877 customers. Figure 3 depicts the breakdown of Water Division revenues, of which 53.3 percent were derived from residential customers. Operating revenues were up 26.1 percent from 2003, due to the Water Division rate increase which took effect in the January revenue month and generated approximately $13.9 million during 2004.

Figure 3: Water Division
Percentage of Each Utility Dollar





Total operating expense of $62.6 million increased in 2004 by $7.4 million. Almost $0.4 million 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. Operation expenses also increased by $3.1 million due to increases in employee pensions and benefits and $0.6 million due to an increase in fuel and power used for pumping water.

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.

Beginning in January, water bills included the water rate increase which was effective December 30, 2003. The rate increase averaged 27.5 percent across customer classes. This was the first increase for operating expenses in MLGW's Water Rate Schedules since January 6, 1995. The rate increase was required due to the effects of inflationary pressures over the last ten years. In 2004, revenue increased by $13.9 million and is attributed to this rate increase. Current MLGW plans call for no water rate increases in 2005.

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. Current MLGW plans call for no water rate increases in 2005.

Changes in Capital Assets

Construction Activities

The Water Division expended $13.7 million in construction activities during 2004. Major projects for 2004 included distribution work at I-40/I-240 ($3.9 million), purchase of data processing equipment ($3.8 million), and extensions to serve new customers ($2.8 million). The Water Division is also in the construction phase of two seismic mitigation projects at McCord Pumping Station ($2.1 million) and Lichterman Pumping Station ($1.8 million).

Capital Assets

The Water Division's investment in capital assets as of December 31, 2004 was $242.9 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 2004 was 2.4 percent.

Major additions to plant include the purchase of well lots, wells and mains, emergency generators, and the purchase of meters and computer equipment, (including but not limited to the enhancement of the corporate network system, data warehouse system, and document imaging system) which will be rented to both the Electric and Gas Divisions.

Payment In Lieu of Taxes

The Water Division, through an agreement with the City of Memphis, pays to the City a payment in lieu of taxes in the amount of $2.5 million per year. The agreement is effective through the year 2028. This payment is paid out of the General Reserve Fund of the Water Division.

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.

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, restricted 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

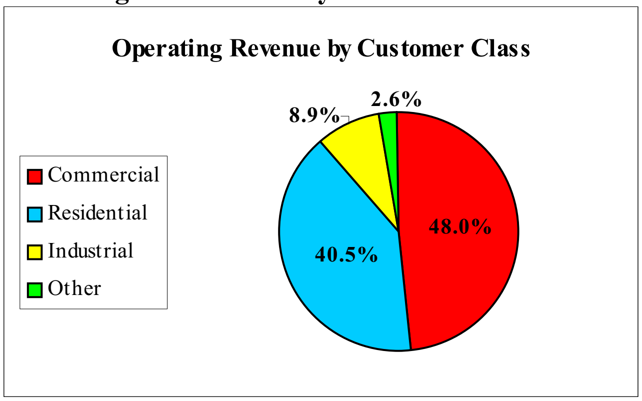
At December 31, 2003, over 91 percent of the net assets were related to capital assets, which included property, plant and equipment. Restricted funds comprised $13.1 million, and an additional $50.8 million of the net assets was in unrestricted funding, which can be used for on-going operations of the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

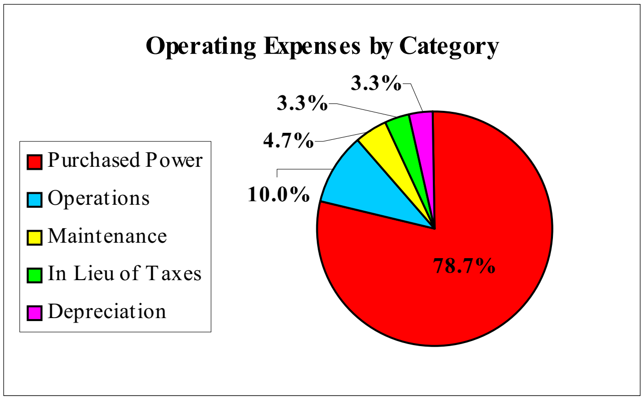
Table 2
Electric Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2003 and 2002
(In Thousands)

	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, restricted 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

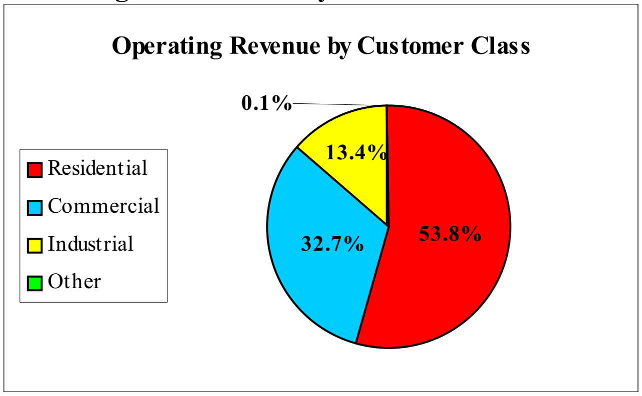
Operating revenues were up 38.5 percent from 2002 due mainly to higher winter wholesale gas prices. The effect of the change in accounting principle increased operating revenues $12.0 million from 2002. Gas costs in 2003 amounted to $260.1 million, up 49.8 percent from 2002. The effect of change in accounting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

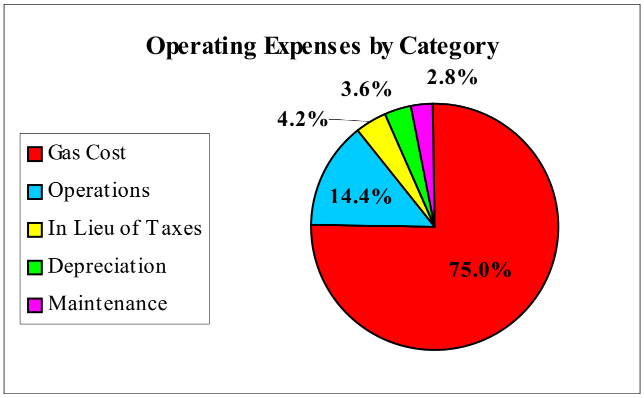
Sales decreased by about 9.8 percent due in part to a 6.1% decrease in heating degree days.

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)

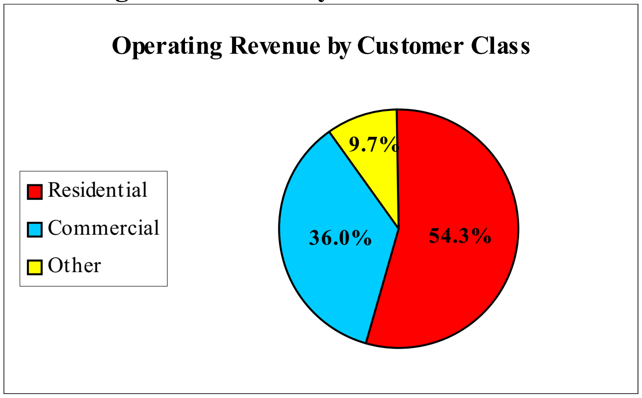
	2003	2002
Current, restricted and other assets	$ 76,086	$ 82,859
Capital assets	237,177	235,328
Total assets	313,263	318,187
Current liabilities payable from current assets	13,462	14,295
Current liabilities payable from restricted assets	11,679	11,371
Non-current liabilities	28,990	36,069
Total liabilities	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

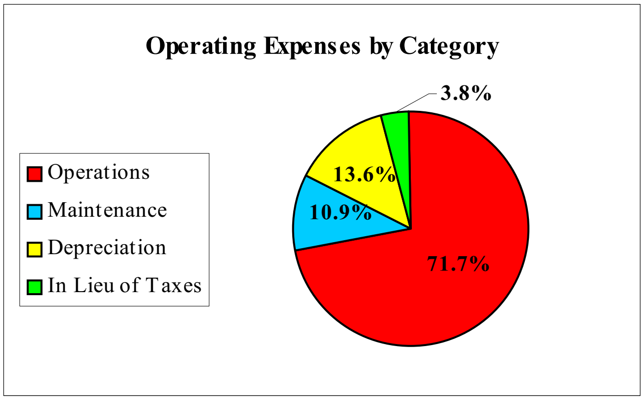
Table 6
Water Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2003 and 2002
(In Thousands)

	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.

(Thousands of Dollars)

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Assets						
Current assets:						
Cash and cash equivalents	**$ 37,778**	$ 37,235	**$ 15,258**	$ 18,999	**$ 9,251**	$ 14,563
Investments	**36,636**	37,453	**3,083**	17,779	**9,005**	14,698
Restricted funds - current	**26,051**	20,974	**28,661**	25,601	**11,717**	14,711
Accounts receivable, less allowance for doubtful accounts	**56,233**	53,194	**24,665**	25,492	**13,505**	6,002
Unbilled revenues	**46,029**	40,890	**54,880**	41,535	**3,341**	3,127
Prepaid power cost	**80,405**	81,946	–	–	**–**	–
Unrecovered purchased gas cost	–	–	**9,986**	3,032	**–**	–
Inventories	**16,193**	16,677	**9,717**	9,095	**1,709**	1,334
Collateral held in trust for securities on loan	**20,242**	10,230	**9,889**	8,454	**5,822**	5,716
Other current assets	**3,237**	18,258	**10,117**	3,468	**–**	–
Total current assets	**322,804**	316,857	**166,256**	153,455	**54,350**	60,151
Non-current assets:						
Restricted funds:						
Futures margin deposits	–	–	**6,020**	7,862	–	–
Construction	**1,686**	1,861	**17,109**	12,724	**882**	4,230
Insurance reserves - injuries and damages	**2,709**	1,977	**1,053**	1,179	**844**	840
Insurance reserves - casualties and general	**12,996**	12,537	**4,306**	4,254	**5,482**	5,281
Medical benefit	**5,686**	4,944	**2,694**	2,342	**1,596**	1,388
Customer deposits	**11,890**	13,910	**4,620**	4,083	**737**	879
Bond reserve and debt service	**11,330**	7,627	–	–	**16,980**	16,788
Total restricted funds	**46,297**	42,856	**35,802**	32,444	**26,521**	29,406
Less restricted funds - current	**(26,051)**	(20,974)	**(28,661)**	(25,601)	**(11,717)**	(14,711)
Restricted funds – non-current	**20,246**	21,882	**7,141**	6,843	**14,804**	14,695
Other assets:						
Prepaid power cost – long term	**1,332,494**	1,413,697	**–**	–	**–**	–
Unamortized debt expense	**12,153**	13,576	**–**	–	**–**	–
Notes receivable	**6,676**	9,778	**18,262**	19,974	**149**	1,240
Investment in Memphis Networx	**9,415**	11,320	**–**	–	**–**	–
Total other assets	**1,360,738**	1,448,371	**18,262**	19,974	**149**	1,240
Utility plant	**1,157,444**	1,113,658	**519,535**	507,672	**378,445**	364,735
Less accumulated depreciation	**(415,761)**	(398,123)	**(196,792)**	(180,915)	**(135,593)**	(127,558)
Utility plant, net	**741,683**	715,535	**322,743**	326,757	**242,852**	237,177
Total non-current assets	**2,102,421**	2,185,788	**348,146**	353,574	**257,805**	253,112
Total assets	**$ 2,445,471**	$ 2,502,645	**$ 514,402**	$ 507,029	**$ 312,155**	$ 313,263

See accompanying notes.

(Thousands of Dollars)

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Liabilities						
Current liabilities:						
Accounts payable - purchased power and gas	**$ 74,562**	$ 83,697	**$ 66,295**	$ 43,648	**$ –**	$ –
Other accounts payable, accrued expenses, and deferrals	**40,176**	47,597	**11,982**	20,015	**7,226**	7,746
Bonds and notes payable	**67,884**	88,648	**–**	–	**–**	–
Collateral subject to return to borrowers	**20,242**	10,230	**9,889**	8,454	**5,822**	5,716
Total current liabilities payable from current assets	**202,864**	230,172	**88,166**	72,117	**13,048**	13,462
Current liabilities payable from restricted assets:						
Construction	**1,686**	1,861	**862**	1,060	**713**	1,197
Customer deposits	**4,637**	5,147	**1,786**	1,493	**287**	325
Medical benefit accrual	**5,686**	4,944	**2,694**	2,342	**1,596**	1,388
Insurance reserves - injuries and damages	**2,709**	1,977	**1,053**	1,179	**844**	840
Bonds payable – accrued interest	**5,176**	6,656	**–**	–	**667**	849
Bonds payable - principal	**6,155**	389	**–**	–	**7,440**	7,080
Total current liabilities payable from restricted assets	**26,049**	20,974	**6,395**	6,074	**11,547**	11,679
Total current liabilities	**228,913**	251,146	**94,561**	78,191	**24,595**	25,141
Non-current liabilities:						
Customer advances for construction	**8,530**	8,145	**571**	603	**–**	9
Customer deposits	**7,253**	8,763	**2,835**	2,590	**450**	554
Other	**7,375**	7,516	**11,343**	12,711	**1,528**	1,619
Long-term debt	**1,395,891**	1,483,290	**–**	–	**19,431**	26,808
Total non-current liabilities	**1,419,049**	1,507,714	**14,749**	15,904	**21,409**	28,990
Total liabilities	**1,647,962**	1,758,860	**109,310**	94,095	**46,004**	54,131
Net assets						
Invested in capital assets, net of related debt	**710,217**	679,848	**322,743**	326,757	**215,982**	203,289
Restricted for debt service and construction	**12,996**	13,119	**26,573**	23,780	**21,964**	24,253
Unrestricted	**74,296**	50,818	**55,776**	62,397	**28,205**	31,590
Total net assets	**797,509**	743,785	**405,092**	412,934	**266,151**	259,132
Total liabilities and net assets	**$ 2,445,471**	$ 2,502,645	**$ 514,402**	$ 507,029	**$ 312,155**	$ 313,263

See accompanying notes.

(Dollars in Thousands)

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Operating revenues:						
Sales and service revenues	**$ 910,426**	$ 828,421	**$ 349,477**	$ 327,417	**$ 65,550**	$ 51,879
Transported gas revenue	**–**	–	**2,390**	14,379	**–**	–
Other revenues	**23,508**	20,009	**11,478**	11,103	**4,815**	3,933
Total operating revenues	**933,934**	848,430	**363,345**	352,899	**70,365**	55,812
Operating expenses:						
Purchased power and gas for resale	**707,136**	669,358	**283,535**	260,102	**–**	–
Production	**–**	–	**–**	–	**11,914**	11,110
Operation	**98,575**	84,774	**54,764**	49,987	**34,791**	28,466
Maintenance	**34,424**	40,238	**8,467**	9,539	**5,584**	6,041
Depreciation	**29,422**	27,622	**14,803**	12,591	**7,797**	7,479
Payments in lieu of taxes	**29,695**	28,157	**14,591**	14,485	**2,500**	2,103
	899,252	850,149	**376,160**	346,704	**62,586**	55,199
Operating income (loss)	**34,682**	(1,719)	**(12,815)**	6,195	**7,779**	613
Non-operating revenues (expenses):						
Contributions in aid of construction	**21,216**	31,768	**3,270**	2,483	**9,833**	4,174
Reduction of plant costs recovered through contributions in aid of construction	**(21,216)**	(31,768)	**(3,270)**	(2,483)	**(9,833)**	(4,174)
Transmission credits	**22,562**	22,164	**–**	–	**–**	–
Investment and other income	**55,460**	12,140	**4,973**	3,177	**637**	2,383
Interest expense	**(53,439)**	(6,971)	**–**	–	**(1,397)**	(1,763)
Telecommunications division loss	**(5,541)**	(4,625)	**–**	–	**–**	–
Total non-operating revenues	**19,042**	22,708	**4,973**	3,177	**(760)**	620
Change in net assets	**$ 53,724**	$ 20,989	**$ (7,842)**	$ 9,372	**$ 7,019**	$ 1,233
Net assets, beginning of year	**$ 743,785**	$ 717,026	**$ 412,934**	$ 398,338	**$ 259,132**	$ 256,452
Cumulative effect of change in accounting principle	**–**	5,770	**–**	5,224	**–**	1,447
Net assets, beginning of year as adjusted	**743,785**	722,796	**412,934**	403,562	**259,132**	257,899
Change in net assets	**53,724**	20,989	**(7,842)**	9,372	**7,019**	1,233
Net assets, end of year	**$ 797,509**	$ 743,785	**$ 405,092**	$ 412,934	**$ 266,151**	$ 259,132

See accompanying notes.

(Dollars in Thousands)

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Cash flow from operating activities:						
Receipts from customers and users	**$ 949,178**	$ 848,382	**$ 344,277**	$ 368,257	**$ 73,046**	$ 63,570
Receipts from federal grants	**3,875**	–	**–**	–	**–**	–
Payments to suppliers	**(634,783)**	(684,622)	**(297,448)**	(312,007)	**(37,107)**	(27,168)
Payment to TVA – prepaid power	**–**	(1,500,000)	**–**	–	**–**	–
Payments to employees	**(79,997)**	(91,996)	**(34,273)**	(37,966)	**(24,456)**	(26,347)
Payments from (to) other Division funds	**(3,732)**	(3,742)	**5,280**	102	**(1,548)**	3,640
Payments for taxes	**(29,651)**	(28,157)	**(14,593)**	(14,485)	**(2,897)**	(1,706)
Other receipts	**2,623**	11,884	**1,424**	11,741	**10**	551
Net cash provided by (used in) operating activities	**207,513**	(1,448,251)	**4,667**	15,642	**7,048**	12,540
Cash flows from noncapital financing activities:						
Decrease (increase) in unamortized debt expense	**(112)**	(13,700)	**–**	–	**–**	–
Increase (decrease) in unamortized debt premium	**–**	121,247	**–**	–	**–**	–
Proceeds from issuance of long-term debt	**–**	1,392,170	**–**	–	**–**	–
Principal payments on long-term debt	**(68,200)**	–	**–**	–	**–**	–
Interest expense on bonds	**(68,603)**	(4,021)	**–**	–	–	–
Net cash provided by noncapital financing activities	**(136,915)**	1,495,696	**–**	–	**–**	–
Cash flows from capital and related financing activities:						
Purchase and construction of utility plant	**(79,827)**	(68,691)	**(16,662)**	(24,442)	**(21,275)**	(14,027)
Contributions in aid of construction	**20,081**	18,115	**3,270**	2,483	**7,296**	4,174
Receipts from federal grants	**14,789**	–	–	–	**–**	–
Increase in unamortized debt expense	**–**	41	–	–	**–**	–
Proceeds from issuance of note payable	**–**	15,000	–	–	**–**	–
Principal payments on long-term debt	**(20,837)**	(30,416)	–	–	**(7,080)**	(6,730)
Defeasance of debt	**–**	(26,082)	–	–	**–**	–
Interest expense on debt	**(2,124)**	(3,530)	–	–	**(1,516)**	(1,697)
Net cash used in capital and related financing activities	**(67,918)**	(95,563)	**(13,392)**	(21,959)	**(22,575)**	(18,280)
Cash flows from investing activities:						
Sales and maturities of investments	**32,703**	53,451	**16,619**	41,136	**15,707**	24,843
Purchase of investments	**(32,238)**	(44,945)	**(12,785)**	(36,750)	**(8,370)**	(22,779)
Payments received on notes receivable	**2,020**	1,711	**1,712**	1,713	**1,091**	137
Investment income earned on investments	**2,103**	1,393	**834**	1,139	**546**	706
Investment in Memphis Networx	**(3,636)**	(5,852)	**–**	–	**–**	–
Net cash provided by (used in) investing activities	**952**	5,758	**6,380**	7,238	**8,974**	2,907
Increase (decrease) in cash and cash equivalents	**3,632**	(42,360)	**(2,345)**	921	**(6,553)**	(2,833)
Cash and cash equivalents, beginning of year	**71,866**	114,226	**42,323**	41,402	**38,770**	41,603
Cash and cash equivalents, end of year	**$ 75,498**	$ 71,866	**$ 39,978**	$ 42,323	**$ 32,217**	$ 38,770

See accompanying notes.

(Dollars in Thousands) (Continued)

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:						
Operating income (loss)	**$ 34,682**	$ (1,719)	**$ (12,815)**	$ 6,195	**$ 7,779**	$ 613
Adjustments to reconcile operating income (loss)						
Net cash provided by operating activities:						
Depreciation of utility plant	**33,598**	30,103	**17,406**	15,731	**8,304**	8,004
Transmission credits	**22,562**	22,164	**–**	–	**–**	–
Prepay power credits	**49,957**	4,021	**–**	–	**–**	–
Other income	**2,751**	5,999	**4,140**	2,038	**91**	1,677
(Increase) decrease in assets:						
Accounts receivable	**(3,039)**	(13,965)	**827**	10,325	**(7,503)**	2,876
Unbilled revenues, net of cumulative effect of change in accounting principle	**(5,139)**	(11,393)	**(13,345)**	(12,022)	**(214)**	(1,679)
Prepaid power cost	**82,744**	(1,495,643)	**–**	–	**–**	–
Deferred purchase power and gas cost	**–**	–	**(6,954)**	(2,722)	**–**	–
Inventories	**484**	(3,872)	**(622)**	(1,164)	**(375)**	24
Other assets	**1,170**	(63)	**(6,649)**	1,416	**–**	–
Increase (decrease) in liabilities:						
Accounts payable - purchased power and gas	**(9,135)**	(7,474)	**22,647**	3,554	**–**	–
Other accounts payable and accrued expenses	**(2,543)**	26,400	**668**	(3,838)	**(1,186)**	1,103
Customer deposits	**(2,020)**	(2,627)	**538**	(901)	**(142)**	(254)
Insurance reserves	**732**	25	**(126)**	(200)	**4**	(120)
Medical benefit accrual	**742**	715	**352**	252	**208**	201
Other	**(33)**	(922)	**(1,400)**	(3,022)	**82**	95
Total adjustments	**172,831**	(1,446,532)	**17,482**	9,447	**(731)**	11,927
Net cash provided by (used in) operating activities	**$ 207,513**	$(1,448,251)	**$ 4,667**	$ 15,642	**$ 7,048**	$ 12,540
Reconciliation of cash and cash equivalents per statements of cash flows to the balance sheets:						
Restricted funds	**$ 46,297**	$ 42,856	**$ 35,802**	$ 32,444	**$ 26,521**	$ 29,406
Less investments included in restricted funds	**(8,577)**	(8,225)	**(11,082)**	(9,120)	**(3,555)**	(5,199)
Cash and cash equivalents included in restricted funds	**37,720**	34,631	**24,720**	23,324	**22,966**	24,207
Current assets - cash and cash equivalents	**37,778**	37,235	**15,258**	18,999	**9,251**	14,563
Total cash and cash equivalents	**$ 75,498**	$ 71,866	**$ 39,978**	$ 42,323	**$ 32,217**	$ 38,770

See accompanying notes.

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)

Basis of Accounting (continued)

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

Recent Accounting Standards

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* in November 2003. 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.

In April and June 2004, GASB issued Statement No. 43 *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45 *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension*, which is referred to as other postemployment benefits (OPEB), respectively. OPEB are benefits, other than pension, received by employee (i.e. life insurance) that should be reported as employee compensation. GASB 43 establishes uniform financial reporting standards for OPEB plans. GASB 45 attempts to match the cost of OPEB with the period in which service is rendered and report such benefit. MLGW is required to adopt GASB Statements No. 43 and 45 for financial statements beginning after December 15, 2005 and 2006, respectively. MLGW has not elected early implementation of these statements nor has the financial impact been evaluated.

GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation—an amendment of GASB No. 34 in December 2004.* The statement clarifies the definition of a legally enforceable enabling legislation restriction on net assets. MLGW will adopt this statement on January 1, 2006. Management does not believe this statement will have a material effect on the financial statements.

(Dollars in Thousands)

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:

		2004	2003
Assets			
Gas Division	Deferred loss on futures contracts	**$ 7,860**	$ 1,341
Gas Division	Unrecovered purchased gas cost	**9,986**	3,032
Liabilities			
Gas Division	Deferred gains-gas futures	**$ –**	$ 5,598
Gas Division	Deferred credits-PGA/storage	**2,979**	4,389

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, 2004 and 2003:

	2004	**2003**
Electric Division	**$1,469,214**	$1,576,440
Water Division	**28,362**	36,348

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, 2004 and 2003, accounts receivable and allowances for doubtful accounts were as follows:

	Electric Division		**Gas Division**		**Water Division**	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Accounts receivable	**$ 63,804**	$ 59,958	**$ 26,683**	$ 27,802	**$ 14,404**	$ 6,719
Allowance for doubtful accounts	**7,571**	6,764	**2,018**	2,310	**899**	717

(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:

	2004	2003
Electric	**$ 6,236**	$ 3,552
Gas	**2,378**	574
Water	**846**	657

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 2004 and 2003, 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 and Gas Divisions and 2 percent for the 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.

Bond Premiums, Discounts and Issuance Costs

Bond premiums and discounts, as well as issuance costs, are deferred and amortized by the interest method over the lives of the applicable bond issues. Long term debt is reported net of the applicable bond premium or discount. Bond issue costs are reported as deferred charges and amortized over the term of the related debt.

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

1. Summary of Significant Accounting Policies (continued)

Reserves and Related Restricted Funds (continued)

certain level of funding for future construction. Additional construction funds are periodically authorized by the Board of Commissioners.

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, 2004 and 2003, are reported at market values of ($3,608) and $4,178, respectively. Notional values of the open futures as of December 31, 2004 and 2003 were $47,860 and $37,012, respectively. Margin account balances with MLGW's New York Mercantile Exchange clearing member as of December 31, 2004 and 2003, are $14,402 and $13,385, 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. 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.

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.

Investment and other income includes prepay credit income related to the prepaid power agreement with TVA of $49,957 and $4,021 for the years ended December 31, 2004 and 2003, respectively.

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 maturities of three months or less when purchased to be cash equivalents.

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform to the 2004 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 $2,164 and $1,142 for 2004 and 2003, respectively.

(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, 2004 and 2003:

	Electric Division		Gas Division		Water Division	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Restricted funds:						
Common account	**$ 17,391**	$ 16,376	**$ 22,469**	$ 15,172	**$ 7,208**	$ 10,351
Cash and cash equivalents	**28,906**	26,480	**13,333**	17,272	**19,313**	19,055
Total restricted funds	**$ 46,297**	$ 42,856	**$ 35,802**	$ 32,444	**$ 26,521**	$ 29,406
Cash and cash equivalents:						
Common account	**$ 37,643**	$ 37,108	**$ 6,875**	$ 13,477	**$ 9,251**	$ 14,563
Cash	**135**	127	**8,383**	5,522	**–**	–
Total cash and cash equivalents	**$ 37,778**	$ 37,235	**$ 15,258**	$ 18,999	**$ 9,251**	$ 14,563
Investments:						
Common account	**$ 36,636**	$ 37,453	**$ 6,691**	$ 13,601	**$ 9,005**	$ 14,698
Fair value of futures contracts	**–**	–	**(3,608)**	4,178	**–**	–
Investments – common account	**$ 36,636**	$ 37,453	**$ 3,083**	$ 17,779	**$ 9,005**	$ 14,698

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, 2004 and 2003, the common account consisted of the following:

	2004	**2003**
Cash and cash equivalents	**$ 77,313**	$ 78,794
U.S. Government agencies	**33,700**	39,764
U.S. Government bonds	**20,300**	20,108
Asset-backed securities	**11,491**	12,695
Corporate bonds	**5,467**	10,471
Government mortgage-backed securities	**4,287**	5,838
Bank repurchase agreement	**–**	4,300
Accrued interest receivable	**611**	829
	$ 153,169	$ 172,799

(Dollars in Thousands) (Continued)

2. Deposits and Investments (continued)

Investments are categorized into three credit risk categories in accordance with GASB Statement No. 3. All of MLGW's investments 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.

As of December 31, 2004 and 2003, 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 2004 and 2003 statements of net assets consists of cash collateral. As of December 31, 2004 and 2003, MLGW has no credit risk exposure to borrowers because the amounts MLGW owes to the borrowers exceed the amounts the borrowers owe MLGW. The Agent is required to indemnify MLGW if the borrowers fail to return the securities to MLGW.

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

	Fair Value	
	2004	**2003**
U.S. Government bonds or notes	**$ 19,721**	$ 18,851
U.S. Government agencies	**14,406**	9,003
U.S. Corporate bonds or notes	**1,135**	1,431
Total	**$ 35,262**	$ 29,285

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 $39 and $61 for the years ending December 31, 2004 and 2003, respectively. This income is pro-rated monthly to the three divisions based on each Division's share of the joint investment pool.

(Dollars in Thousands) (Continued)

3. Long-Term Receivables

The Electric Division has an unsecured note receivable from a government agency, which amounted to $7,820 and $8,880 as of December 31, 2004 and 2003, 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:

2005	$ 1,144
2006	1,236
2007	1,335
2008	1,442
2009	1,557
Thereafter	1,106
	$ 7,820

The government agency note receivable is included in notes receivable in the accompanying 2004 Electric Division balance sheet, except for the current portion of $1,144, which is included in other current assets.

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 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:

2005	$ 1,712
2006	1,712
2007	1,712
2008	1,712
2009	1,712
Thereafter	11,414
	$ 19,974

The Premcor lease receivable is included in notes receivable in the accompanying 2004 Gas Division balance sheet, except for the current portion of $1,712, which is included in other current assets. Deferred income of $1,337 (current portion) and $8,653 (non-current portion) is included in other accounts payable, accrued expenses and deferrals and other non-current liabilities, respectively, in the accompanying 2004 Gas Division balance sheet.

(Dollars in Thousands)

4. Utility Plant

Utility plant activity for the years ended December 31, 2004 and 2003 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2004				
Electric Division				
Capital assets not being depreciated:				
Land	$ 24,232	$ 2,997	$ –	$ 27,229
Construction in progress	46,418	55,852	(38,766)	63,504
Total capital assets not being depreciated	70,650	58,849	(38,766)	90,733
Capital assets being depreciated:				
Structures and improvements	31,123	8,560	(97)	39,586
Transmission and distribution plant equipment	936,001	23,564	(11,492)	948,073
General plant equipment	75,884	3,645	(477)	79,052
Total capital assets being depreciated	1,043,008	35,769	(12,066)	1,066,711
Less accumulated depreciation	(398,123)	(33,598)	15,960	(415,761)
Total capital assets being depreciated, net	644,885	2,171	3,894	650,950
Total capital assets, net	$ 715,535	$ 61,020	$ (34,872)	$ 741,683
Gas Division				
Capital assets not being depreciated:				
Land	$ 7,601	$ –	$ –	$ 7,601
Construction in progress	16,660	13,368	(13,840)	16,188
Plant held for future use	212	–	–	212
Total capital assets not being depreciated	24,473	13,368	(13,840)	24,001
Capital assets being depreciated:				
Structures and improvements	45,845	1,480	(111)	47,214
Processing and distribution plant equipment	355,110	10,777	(847)	365,040
General plant equipment	82,044	1,582	(546)	83,080
Non-utility plant equipment	200	–	–	200
Total capital assets being depreciated	483,199	13,839	(1,504)	495,534
Less accumulated depreciation	(180,915)	(16,561)	684	(196,792)
Total capital assets being depreciated, net	302,284	(2,722)	(820)	298,742
Total capital assets, net	$ 326,757	$ 10,646	$ (14,660)	$ 322,743

(Dollars in Thousands)

4. Utility Plant (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2004				
Water Division				
Capital assets not being depreciated:				
Land	**$ 3,215**	**$ –**	**$ –**	**$ 3,215**
Construction in progress	**31,598**	**13,706**	**(25,664)**	**19,640**
Total capital assets not being depreciated	**34,813**	**13,706**	**(25,664)**	**22,855**
Capital assets being depreciated:				
Structures and improvements	**37,360**	**3,815**	**(224)**	**40,951**
Pumping, transmission and distribution plant equipment	**264,253**	**9,303**	**(724)**	**272,832**
General plant equipment	**43,243**	**12,546**	**(11)**	**55,778**
Total capital assets being depreciated	**344,856**	**25,664**	**(959)**	**369,561**
Less accumulated depreciation	**(127,558)**	**(11,163)**	**3,128**	**(135,593)**
Less acquisition adjustment	**(14,934)**	**–**	**963**	**(13,971)**
Total capital assets being depreciated, net	**202,364**	**14,501**	**3,132**	**219,997**
Total capital assets, net	**$ 237,177**	**$ 28,207**	**$ (22,532)**	**$ 242,852**
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

(Dollars in Thousands)

4. Utility Plant (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2003				
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

	Beginning Balance	Increases	Decreases	Ending Balance
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

(Dollars in Thousands)

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 2005 are estimated as follows (unaudited):

Electric Division	$ 68,512
Gas Division	26,556
Water Division	16,266

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, 2004, expenditures of approximately $6,900 have been spent for the construction commitment.

5. Employee Retirement System

Plan Description

The Memphis Light, Gas and Water Division Pension Board is the administrator of a single-employer retirement system established by MLGW to provide retirement benefits for its employees 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, 2004 and 2003:

	2004	**2003**
Retirees and beneficiaries receiving benefits	**2,401**	2,366
Terminated plan members entitled to but not yet receiving benefits	**21**	23
Active plan members	**2,653**	2,651
	5,075	5,040

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 2004 and 2003, 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, 2004 and 2003, 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, 2004 and 2003, the actuarial value of assets was $1,082,324 and $1,037,872, 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
2004	$ 10,711	$ 10,711	100%	$ 18,241	$ 16,133	88%
2003	10,476	10,476	100%	15,890	10,696	67%
2002	9,933	9,933	100%	9,855	9,855	100%

6. Deferred Compensation and Other Post-Retirement Benefits

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

During 1997, the plan was amended to meet the requirements of Internal Revenue Code Section 457. The Amended Plan provides that assets or income of the Plan shall be used for the exclusive purpose of providing benefits for participants and their beneficiaries or defraying reasonable expenses of administration of the Plan. Since the assets of the Amended Plan are held in custodial and annuity accounts for the exclusive benefit of Plan participants, the related assets of the Plan are not reflected on MLGW’s balance sheets.

MLGW has post-retirement major medical and life insurance benefits available to all employee groups as a continuation of those benefits that were available prior to retirement. Currently, 2,401 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, 2004 and 2003 was $55,948 and $46,433, 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, 2004 and 2003 are as follows:

	Electric Division		Gas Division		Water Division	
	2004	2003	**2004**	2003	**2004**	2003
Premium payments	**$ 10,237**	$ 8,652	**$ 4,849**	$ 4,098	**$ 2,874**	$ 2,428
Paid from unconsolidated grantor trust	**–**	(5,301)	**–**	(2,511)	**–**	(1,488)
Net costs charged to operations	**$ 10,237**	$ 3,351	**$ 4,849**	$ 1,587	**$ 2,874**	$ 940

7. Debt

Long-term debt as of December 31, 2004 and 2003 consists of the following:

	Interest Rates	2004	2003
Electric Division:			
Electric System Revenue Bonds:			
Series 2002, due serially 2003-2010	3.00-5.00%	**$ 32,170**	$ 36,965
Series 2003A, due serially 2004-2018	2.00-5.00%	**1,223,970**	1,292,170
Series 2003B, due 2017-2018	Variable	**100,000**	100,000
Premium on revenue bonds		**107,133**	121,270
Unamortized deferred cost on bond refunding		**(1,417)**	(2,195)
Total		**1,461,856**	1,548,210
Note payable with bank, due serially through 2010	7.58%	**8,074**	9,117
Note payable with bank, due February 2004	1.55%	**–**	15,000
		1,469,930	1,572,327
Less: current portion of bonds payable		**(74,039)**	(89,037)
		$ 1,395,891	$ 1,483,290
Water Division:			
Revenue Refunding Bonds:			
Series 1992, due serially 1993-2006	3.35-6.00%	**$ 5,670**	$ 8,270
Series 1998, due serially 2000-2012	3.30-5.25%	**11,100**	12,250
Series 2001, due serially 2002-2009	4.00-5.00%	**10,380**	13,710
Premium on revenue bonds		**172**	255
Unamortized deferred cost on bond refunding		**(451)**	(597)
		26,871	33,888
Less: current portion of bonds payable		**(7,440)**	(7,080)
		$ 19,431	$ 26,808

(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, 2004, are as follows:

	Electric Division		Water Division	
	Principal	Interest	Principal	Interest
2005	$ 74,039	$ 64,163	$ 7,440	$ 1,141
2006	77,473	60,617	5,770	795
2007	81,343	56,858	2,975	579
2008	85,260	52,936	3,100	446
2009	89,366	48,731	3,235	311
2010-2018	956,733	224,230	4,630	374
Total	$ 1,364,214	$ 507,535	$ 27,150	$ 3,646

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, 2004 for the Series 2003B-1, 2003B-2, and 2003B-3 revenue bonds were 1.75 percent, 1.92 percent and 1.80 percent, respectively.

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, 2004, was 1.95.

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, 2004 was 3.28.

(Dollars in Thousands)

7. Debt (continued)

Long-term debt activity for the years ended December 31, 2004 and 2003 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2004:				
Electric Division				
Bonds and note payable:				
Revenue bonds	**$ 1,429,135**	**$ –**	**$ (72,995)**	**$ 1,356,140**
Premium on revenue bonds	**121,270**	**–**	**(14,137)**	**107,133**
Notes payable	**24,117**	**–**	**(16,043)**	**8,074**
Less deferred amounts:				
For issuance discounts and on refunding	**(2,195)**	**–**	**778**	**(1,417)**
Total bonds and note payable	**$ 1,572,327**	**$ –**	**$ (102,397)**	**$ 1,469,930**
Water Division				
Bonds payable:				
Revenue bonds	**$ 34,230**	**$ –**	**$ (7,080)**	**$ 27,150**
Premium on revenue bonds	**255**	**–**	**(83)**	**172**
Less deferred amounts:				
For issuance discounts and on refunding	**(597)**	**–**	**146**	**(451)**
Total bonds payable	**$ 33,888**	**$ –**	**$ (7,017)**	**$ 26,871**
Year ended December 31, 2003:				
Electric Division				
Bonds and note payable:				
Revenue bonds	$ 91,430	$ 1,392,170	$ (54,465)	$ 1,429,135
Premium on revenue bonds	1,143	121,247	(1,120)	121,270
Note 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	$ 101,071	$ 1,527,391	$ (56,135)	$ 1,572,327
Water Division				
Bonds payable:				
Revenue bonds	$ 40,960	$ –	$ (6,730)	$ 34,230
Premium on revenue bonds	361	–	(106)	255
Less deferred amounts:				
For issuance discounts and on refunding	(769)	–	172	(597)
Total bonds payable	$ 40,552	$ –	$ (6,664)	$ 33,888

(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, 2004 and 2003 are as follows:

	Medical Benefits			**Injuries and Damages**		
	Electric Division	**Gas Division**	**Water Division**	**Electric Division**	**Gas Division**	**Water Division**
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
Payments	**(22,793)**	**(10,797)**	**(6,398)**	**(2,628)**	**(729)**	**(513)**
Incurred claims expense	**23,535**	**11,149**	**6,606**	**3,360**	**603**	**517**
Balance – December 31, 2004	**$ 5,686**	**$ 2,694**	**$ 1,596**	**$ 2,709**	**$ 1,053**	**$ 844**

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. MLGW's share of capital contributions was approximately 84 and 82 percent at December 31, 2004 and 2003, respectively. 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. Under the terms of the Company's operating agreement, MLGW's share of net operating losses for 2004 and 2003 was 100 percent. In 2004, MLGW's investment in the Company was reduced by $1,551 to properly reflect its prior years' share of net operating losses. The current carrying value of Memphis Networx, reflecting total investment and allocated losses since inception is $9,415 or 100 percent of the accumulated members' equity of the Company.

(Dollars in Thousands)

9. Telecommunications Division (continued)

On August 9, 2001, the TRA issued a final order approving the Company's amended and restated operating agreement and granting a certificate of public convenience and necessity for the State of Tennessee. In addition, MLGW received approval from the State Comptroller's office to release funds from the previously approved $20,000 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 or increase its ownership percentage. On the contribution date, the sharing ratio of net operating income or loss and distributions is adjusted to reflect the increased capital contribution. MLGW contributed $3,532 and $5,740 in 2004 and 2003, respectively, which was equal to both members' required capital contributions.

On December 30, 2004, a Note and Warrant Purchase Agreement was entered into between Memphis Networx, LLC; Memphis Broadband, LLC; and MLGW. This agreement specifies that Memphis Broadband and MLGW will provide bridge loan financing to the Company in an amount up to $375 each, for a total of $750. Promissory notes were issued bearing interest at 8% per annum, due and payable on or before July 1, 2005. The promissory notes are secured by a first lien security interest in all assets of the Company and provide for the issuance of warrants, representing, in the aggregate, the right to purchase up to 750,000 units of the Company or additional 7.5% share in the Company in the event the bridge loan is not paid on or before July 1, 2005. MLGW funded its portion of the bridge loan on January 7, 2005.

On April 7, 2005, MLGW agreed to provide an additional ninety-day bridge loan of up to $750 to Memphis Networx. The loan will bear interest at 8% per annum.

Condensed results of operations of the Company for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
	(unaudited)	
Operating revenue	**$ 3,572**	$ 678
Operating expense	**(7,458)**	(6,202)
Net loss	**$ (3,886)**	$ (5,524)

(Dollars in Thousands) (Continued)

9. Telecommunications Division (continued)

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:

	2004	2003
Share of the Company's loss	**$ 3,886**	$ 4,513
Investment reduction	**1,551**	−
General and administrative expenses	**104**	112
Total Telecommunications Division loss	**$ 5,541**	$ 4,625

The Telecommunications Division's investment in the Company of $9,415 and $11,320 as of December 31, 2004 and 2003, 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 1 (Prepaid Power Cost) and 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.

11. Rates (continued)

MLGW implemented a gas rate increase of approximately 6.2 percent effective with meters read on or after December 28, 2004. The increase was approved in the 2004 Budget process, but was delayed for one year at the direction of the Memphis City Council. This was the first gas rate increase (except for pass-through of purchased gas costs) since April 1994. The rate increase is due to the effects of inflation on general operating expenses, employee health insurance costs, facility security, increase in uncollectibles, depletion of cash reserves, increases of in lieu of tax payments, and capital expenditures for system improvements. Total revenue increases due to this rate increase are estimated to be $19,128 for the Gas Division in calendar year 2005.

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. The Tennessee Governmental Tort Liability Act applies to all tort actions against MLGW arising in the State of Tennessee and establishes limits of liability. The current limits of liability for actions arising on or after July 1, 2002 for personal injuries are $250 per person and $600 for two or more persons per accident. Property damages are limited to $85 per accident.

14. Windstorm 2003

On July 22, 2003, a severe storm caused damage to MLGW's electric, gas, and water distribution systems. MLGW was approved to receive to receive compensation from the Federal Emergency Management Agency (FEMA) totaling 75 percent of eligible expenses, which were estimated to be approximately $20,000. Of the reimbursement received, $1,100 and $13,700 were accounted for as contributions in aid of construction for 2004 and 2003, respectively. Additional amounts of $500 and $3,400 were included in Electric Division non-operating income for 2004 and 2003, respectively. Although almost all of the expenses for this restoration effort occurred in 2003, complete reimbursement

14. Windstorm 2003 (continued)

did not occur until after all projects were closed in 2004. MLGW received a partial payment of $10,100 in January 2004, based upon estimated costs. Another payment for $8,600, based upon the remainder of actual costs, was received in November 2004. This $18,700 from FEMA is considered final payment by FEMA to MLGW for the disaster.

15. Federal Grant Contributions

In addition to the FEMA grant discussed in Note 14, MLGW earned $2,500 in federal grant contributions in 2004. The $2,500 receivable in federal grants earned is included in other current assets in the accompanying 2004 Water Division balance sheet. The grant contributions earned were recorded as contributions in aid of construction in the Water Division.

Memphis Light, Gas and Water

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