PERFORMANCE DELIVERED

MLGW

Memphis Light, Gas and Water
2006 Annual Report

About MLGW

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 purchased from a variety of suppliers and 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 and approved by the Memphis City Council.

Board of Commissioners

Rick Masson, Chairman

V. Lynn Evans, Vice Chairman

Nick Clark

James Russell

Bill Taylor

2006 Executive Leadership Team

Joseph Lee, III
President and CEO

Christopher Bieber
Vice President,
Engineering

Odell Horton, Jr.
Vice President and
General Counsel

John McCullough
Vice President,
CFO and Secretary-Treasurer

Linda Peppers
Vice President and CTO

Armstead Ward
Vice President,
Human Resources

Alonzo Weaver
Vice President,
Customer Operations

Diana Veazey
Vice President,
Construction and Maintenance

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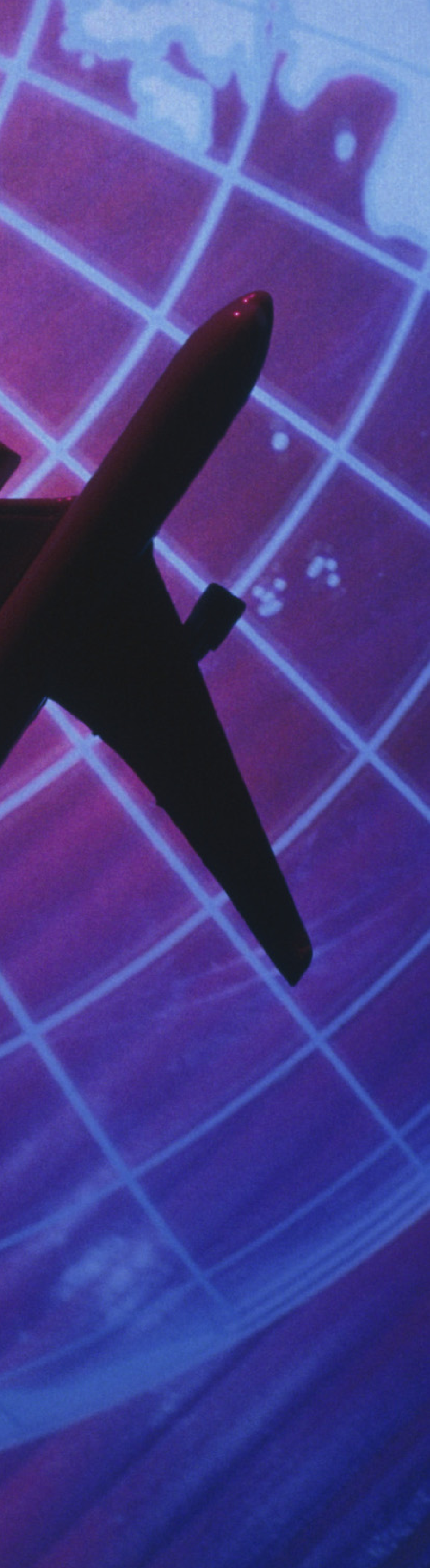

Performance Delivered

The world depends on Memphis. At the airport thousands of travelers and millions of time-sensitive packages move through our city on their way to businesses that touch the world. In East Memphis, Fortune 500® companies' headquarters are filled with decision makers that impact the lives of their customers all over the continent. Downtown, the research at St. Jude Children's Research Hospital is on the forefront of discovery in breakthrough treatments that will have a worldwide impact on keeping those we hold most dear healthy.

The world truly does rely on Memphis, and Memphis trusts MLGW to deliver a solid utility supply at the lowest cost.

But our commercial customers aren't MLGW's only focus. We also serve more than 360,000 residential customers, whose needs are just as important. In Whitehaven, five-year-old Martin doesn't know MLGW is at work for him. He just knows that when he's thirsty, there is clear, refreshing water at the tap. His parents know on cold winter days they can turn on the heat to warm up and the whole family can depend on MLGW's services to care for their family's needs. In Bartlett, Janice knows the value of MLGW. The safe and reliable service we deliver keeps her father on life support. Downtown, MLGW employees' contribution to United Way helps a shelter to house homeless men, while in Cordova, the natural gas we provide keeps the ovens fired and pizza cooking at Memphis Pizza Cafe. Memphis, its citizens and its businesses have made MLGW their source of utility providers since 1939.

A History of Performance

Although MLGW has been in existence since 1939, its parent companies started more than 100 years ago. MLGW and the services we provide have come a long way since our beginnings. The city's first utility company was the Memphis Gas Light Company, formed in 1852. It served 10,000 people and covered just three square miles. The city's water supply came from cisterns and the Wolf River.

1887 was a year of significant advancements for utility services in Memphis. Drillers unexpectedly tapped into a pure, great tasting artesian water supply lying underneath the city and The Artesian Water Company was created. That same year, a dawning, known as the "electric age," began a new electrical phenomenon of powered light, appliances and other gizmos in homes and businesses. To meet the needs of the "electric age" locally, The Memphis Light and Power Company was formed.

In 1902, the city bought the Artesian Water Company and created the Memphis Artesian Water Department, the first city-owned utility. That same year, the Memphis Light and Power Company merged with the city's only natural gas distributor. By 1917, the city's two competing gas and electric companies consolidated, eventually becoming Memphis Power and Light.

The city bought the privately owned Memphis Power and Light in 1939 and Memphis Light, Gas and Water was formed, creating what is now the largest three-service public utility in the nation.

Delivering on Expectations

Since its beginning, MLGW's foremost goal has been to provide our customers with reliable utility service at the lowest possible rates. Our customers benefit from this commitment to service, and we are constantly working to enhance the services we offer to our customers.

In 2006, the utility dedicated electric Substation 76, which serves St. Jude Children's Research Hospital and the Uptown community. The substation incorporates the most advanced technology available to ensure the research facility will have a continuous power source. The Memphis BioTech Center, currently under construction, also will benefit from this new technology. The substation also serves the growing, energy-efficient Uptown community. Among the mixed income housing in the Uptown neighborhood, there are more than 200 EcoBUILD homes, an MLGW program that ensures customers live in energy-efficient housing. EcoBUILD homes, on average, use 34 percent less electricity and 56 percent less natural gas than homes built to local codes and typical practices. Once the Uptown area is complete, it will be one of the largest green communities in the United States.

MLGW's environmental concerns extend into community safety as well. The work done by the MLGW management team is recognized nationwide as the leader in disaster preparedness planning. Prior experiences like a straight-line windstorm in 2003 and geographic standards such as Memphis' position along the New Madrid fault line have necessitated the development of extensive emergency management plans. These plans will assist us in restoring power in the fastest, safest and most orderly manner possible should there be a natural disaster. MLGW's plans are recognized nationwide, and in 2006 the utility hosted two disaster preparedness workshops for gas and electric utilities. The sharing of information allows MLGW and other large public power companies to exchange plans in order to have the best available plan should a natural disaster strike.

In 2006, MLGW received a federal grant that will enable us to seismically retrofit our Sheahan water pumping station. We understand that customers will still need the vital services we provide in the wake of an earthquake or other natural disaster. This grant will ensure that we are able to provide those life-sustaining services. This is the third grant that MLGW has received to retrofit its ten water pumping stations.

Projects like these are possible because of MLGW's thorough long-range planning and the careful control over budgetary items, both large and small. We know that our customers work hard for every dollar they earn, and we work hard to complete enhancement projects like these for the lowest possible cost and the greatest benefit to the community.

Financial Performance

Nothing we do could happen if it were not for our strong financial performance. In fact, MLGW is one of the highest-rated utilities in the financial realm. Our water division is one of the only utilities in the world to hold prestigious triple-A ratings from both Moody's Investor Services and Standard and Poor's. In addition to those financial achievements, the electric division has a AA rating from FitchRatings, Moody's Investor Services, and Standard and Poor's. These agencies say our financial performance is "stable" and "predictable." Customers see this powerful financial standing every day through lower rates and longer periods between rate increases. We are dedicated to keeping service reliable and affordable for our customers.

In 2006, MLGW completed a long-term gas pre-purchase transaction as we entered into an agreement with the Tennessee Energy Acquisition Corporation (TEAC) to purchase a portion of the Division's natural gas supply at a discounted rate that is below market index cost. As a result, MLGW customers should realize a savings of $102 million over the next 20 years.

The low-risk transaction allows us to buy a portion of our natural gas supply at a fixed discount from the market price. For the first 10 years of the agreement, about 13 percent of MLGW's natural gas needs will come from this transaction and that amount will increase to about 20 percent for the second half of the agreement. The rest of our natural gas needs will continue to be purchased through MLGW's gas purchasing strategy.

Community Performance

You can always find MLGW employees active in our community. In 2006 MLGW employees donated more than $1 million in goods and services to the community we serve. Topping our community performance is an $802,000 employee donation to United Way of the Mid-South. This donation puts MLGW employees in the top five when it comes to overall United Way donations. In addition to United Way, our employees are active in a number of volunteer activities that work to increase the energy efficiency of homes.

For example, in January, about 40 employees worked on a one-day weatherization project. They installed windows, sealed air leaks and laid attic insulation for ten customers. Through this program, MLGW is making sure that our customers' houses are as energy efficient as possible. On average, these houses are now saving four percent in their utility costs.

The winter months also saw MLGW working on an unprecedented campaign to raise money for five local charities whose funding had been depleted by Hurricane Katrina relief efforts. The Power of Five, MLGW, its suppliers and employees, along with local business and residential customers, raised more than $370,000 to support five local charities. In turn, some of the money went to assist MLGW customers struggling to pay their utility bills.

Delivering Service

Since its beginning, MLGW's primary concern has been to care for the customers it serves. Day in and day out, it is outstanding performance that our customers expect. A performance that is as well-orchestrated as a fine symphony, with more than 2,700 employees working together for a single goal: to be the best utility company for our customers.

More than 99 percent of the time, when an MLGW customer turns on one of the services we provide, it is there for them. However, with any utility, outside forces like weather can sometimes cause service interruptions. During those times, MLGW is ready to respond with dedicated crews that are the bread and butter of our business. Our crews work diligently around the clock to restore customer power in the case of an outage.

Such was the case on Sunday, June 18. While most people were celebrating Father's Day, our crews were busily responding to a power outage caused by a small tornado that ripped through one part of our service territory. Thankfully the tornado did not cause much property damage and no injuries were reported. However, the resulting power outage sent MLGW electric crews into action. Crews had to replace poles before service line could be restrung and power restored.

Occasionally the community we serve extends beyond the borders of Memphis and Shelby County. For example, when a tornado ripped apart the electric infrastructure in Newbern, Tennessee, MLGW sent crews to assist the local utility in building a new substation to serve the town. For more than a week, MLGW crews, along with others from across Tennessee, worked feverishly to restore a sense of normalcy to this devastated community.

The summer of 2006 is in the record books as one of the hottest on record. Temperatures were in the upper 90s to 100s for nearly three weeks. The intense heat put an increased demand on MLGW's electric system. The utility has already taken steps to ensure that multiple power feeds and other safeguards are placed in the system for events like these. As a result of MLGW's preparation, very few weather-related power outages were reported during this time. In cases such as these, it is the engineering before implementation that enabled us to keep power flowing while customers served by other utilities suffered multiple outages.

2006 also saw a changing of the guard in electric engineering leadership with the retirement of Clarence Wooddell. Mr. Wooddell started with MLGW in 1948, and was instrumental in designing the electric infrastructure that provides safe and reliable power to our customers today. After 58 years on the job, Mr. Wooddell hung up his hard hat and retired to spend time on his farm and have a little more time to snow ski. However, thanks to long-term succession planning, Mr. Wooddell's position was filled with a qualified, bright employee that will serve the Memphis community for years to come.

Delivering on Training

Whether it's a faster and safer way to restore an outage or enhancing customer relations skills, MLGW continues to find enhancements to both employee training and customer service. While working with tight budget constraints, utility leaders have enhanced customer interaction, and reports show customer satisfaction continues to rise. The utility is exploring new ways to employ technological advancements in customer service.

MLGW leaders recognize that no matter how excellent our service, our customers still expect fast and friendly help when they have a problem. To assist us in continually training customer service agents, the utility unveiled MLGW University in 2006. This renewed commitment to training and enhancing our employees' skills assists us in delivering the best possible service to our customers, day in and day out. Classes are available both at MLGW's Training Center and online at the employee's convenience. From improving customer interaction to safety classes to management training classes, MLGW University is dedicated to taking customer service and employee interaction to the next level for all of our stakeholders.

MLGW offers more ways for our customers to receive valuable training that can help them take control of their energy costs. Memphis Energized, a half-hour television program produced by MLGW, gives customers some how-to tips for saving energy as well as information on green power breakthroughs, an inside look at how service works at their home and the latest news and information about their hometown utility company. This innovative public service is shown more than 20 times per month on local broadcast and cable outlets, and provides a wealth of conservation information to our customers.

Future Performance

MLGW customers are noticing the service they receive. Each quarter, MLGW performs a Corporate Scorecard audit to ensure we are providing the best service to our customers. In 2006, many of the top categories saw increases in customer satisfaction. But MLGW employees do not rest on their laurels. They continue to find ways to improve customer service and interaction.

MLGW is looking to the future to ensure that we continue to provide low cost, reliable service to our customers. We continue to look into money-saving agreements like the ones we have pioneered with both our natural gas and electrical suppliers. We also pursue other opportunities to enhance our customers' utility supply.

But at the end of the day, we continue to press on with our first goal of providing uninterrupted service to our customers. Thanks in part to our work, FedEx moves millions of packages every night, St. Jude continues to make medical breakthroughs and the citizens of Memphis and Shelby County enjoy reliable service.

Take Martin, for instance. He's growing up quickly. His parents were surprised the other night when he told them he no longer needed his night light. But it's still plugged in "just in case." And Martin knows that if he hears a monster, all he has to do is to turn on the light to scare it away. MLGW is proud to help Martin in his battle. We hope he will be an MLGW customer all of his life, just as we do with all of our customers. That is why we work so hard to be not only service oriented, but also financially prudent with our resources.

Letter of Transmittal

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, 2006, 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).

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 ending December 31, 2006 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 ending December 31, 2006, are fairly presented in conformity with generally accepted accounting principles. The independent auditor's report is presented as the first component of the financial section of the 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.

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 Acts"). MLGW is an enterprise fund of the City of Memphis and 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 Acts. 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. 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 of Memphis and approved by the City Council. Under the Private Acts, the Board is responsible for the oversight of MLGW's management. The members of the Board serve staggered terms of three years each. The Board annually elects a Chairman and a Vice Chairman whose terms begin in July of each year.

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 Acts, the President supervises the operation of MLGW and its officers and employees.

Local Economy—

(Information provided by Memphis Regional Chamber Web site)—Memphis, Tennessee, located in the southwest corner of Tennessee on the Mississippi River, is the nation's 17th largest city. The 2000 Census reported a Shelby County population of 897,472, of which all households utilize some or all of MLGW's services. The Memphis Metro area provides a diverse range of employers which contribute to the overall stability of the area and to MLGW's customer base. As of 2005, government employment (15%) comprised the largest percentage of non-farm employment. Professional and business services and educational and health services each employ 12% of the workforce, followed by the retail trade and leisure and hospitality (11% each); and transportation, warehousing and utilities (10%) rounding out sectors of 10 percent or greater. More than 130 businesses have either moved or announced major expansion projects in Memphis, creating over 7,700 new jobs. In late 2006, ServiceMaster® announced it is moving its global headquarters to Memphis, making it the fourth Fortune 500® company to headquarter in Memphis. Business magazines and forecasters continually rank Memphis as one of the top places to live and work. For example, in 2006, Memphis was among the top 10 hottest cities for expansion according to Expansion Management Magazine. Entrepreneur magazine called Memphis one of the best places to start and grow a company, and the city was among the "Best Cities for Relocating Families" according to Worldwide ERC and Primacy Relocation.

Memphis is known for its expertise and growth in the healthcare industry, and MLGW has served a vital role in expanding its power infrastructure to meet the needs of the growing medical community. In 2006, MLGW dedicated a new substation that serves world-renowned St. Jude Children's Research Hospital, a leading center for research and treatment of catastrophic diseases in children. This new substation, which serves St. Jude and its surrounding neighborhood, is one of the most technologically advanced electric substations in the nation, and has built in safeguards to minimize power outages that could possibly affect the hospital's vital work. The substation will also serve a state-of-the-art biotechnology research park that is under construction. Upon completion, the biotech center is expected to add to the existing $5 billion-plus contribution that the healthcare industry generates for Shelby County's economy.

MLGW also ensures that its suburban customers receive reliable services. In 2006, the utility signed an agreement with the Town of Piperton in neighboring Fayette County to install power lines designed to increase reliability for suburban Collierville residents. By installing lines in Fayette County, MLGW saved millions of dollars and did not have to disturb customer property. The utility is currently constructing a new substation to ensure power remains reliable in this fast-growing area of Shelby County. Construction is expected to be complete by the end of 2007.

National Economy—

The continued increase in energy prices, resulting from volatility in the natural gas market and a series of rate increases imposed by MLGW's wholesale electric provider, Tennessee Valley Authority, continues to put financial pressure on MLGW customers. The Tennessee Valley Authority implemented a fuel cost adjustment system to compensate for fluctuations in the price of fuel used in the generation of electric power. 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.

Wholesale natural gas prices have tripled over a ten-year period. The Gas Division purchases its gas requirements in the open market from a variety of producers and marketers. The cost of the 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.

As part of our effort to control natural gas costs, MLGW entered into a groundbreaking agreement with the Tennessee Energy Acquisition Corporation in 2006 to purchase part of our natural gas supply at a discounted rate. This agreement enables us to save on a fixed portion of our natural gas costs for the next 20 years. Through the agreement, MLGW receives a discount from the market costs. This agreement complements a similar agreement between MLGW and TVA for the pre-purchase of power at a discounted rate. In both cases, MLGW is on the forefront of finding innovative ways to ensure customers' costs remain as low and stable as possible.

Financial Policies and Major Initiatives—

MLGW maintains a comprehensive cash flow model which assesses the growth of the separate divisions and projects 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 master plans which are then correlated with the financial plan for their respective systems. The 10-year capital plans are updated periodically during the year in order to provide the most current cash flow projections.

Among the three divisions, MLGW averages more than $100 million in capital expenditures throughout the year. In preparation for residential and industrial growth, major electric projects planned for the 10-year period include construction of three substations and one switching station in south Collierville and east Shelby County. Gas division plans include installation of approximately 17 miles of transmission mains, 200 miles of distribution mains, and eight regulator stations over the next 10 years. 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 has a five-year Strategic Plan that is committed to four specific areas which are essential to the continued vitality of the utility: cost control, core business, customer/shareholder, and co-worker capacity-building focus. MLGW works 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 recognition is extended to Watkins Uiberall, PLLC and Banks, Finley, White and Company for their efficient and timely completion of this year's audit.

Respectfully submitted,

Rick Masson	John McCullough
Chairman of the Board of Commissioners and	Vice President, CFO
Acting President and CEO	Secretary-Treasurer

2006 FINANCIALS

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 balance sheets and the related statements of revenues, expenses and changes in net assets, and cash flows of the Electric, Gas and Water divisions (the Divisions) of Memphis Light, Gas and Water Division, an enterprise fund of the City of Memphis, Tennessee, as of and for the years ended December 31, 2006 and 2005, 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.

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, 2006 and 2005, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States 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, 2006 and 2005, and the changes in their financial position and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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In accordance with *Government Auditing Standards*, we have also issued our report dated June 14, 2007, 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 considered 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 and supplementary information as shown in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The supplementary information shown as the Schedule of Additions and Retirements to Utility Plant; Schedule of Deposits and Investments; Schedule of Long Term Debt, Principal, and Interest Requirements; and Schedule of Expenditures of Federal Awards have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory section and the supplementary information shown as the Schedule of Current Utility Rates and Schedule of Insurance have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

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

Memphis, Tennessee
June 14, 2007

The following management discussion and analysis (MD&A) for Memphis Light, Gas and Water Division ("MLGW") is intended as an introduction and should be read in conjunction with the financial statements and the notes that follow this section.

Highlights

- Memphis Light, Gas and Water Division's wholesale electric supplier, the Tennessee Valley Authority ("TVA"), approved a 9.95% wholesale electric rate increase, effective with retail meters read on or after March 27, 2006. This rate increase is attributable to rising costs for coal, natural gas, and purchased power. MLGW is required by the power contract with TVA to pass wholesale increases/decreases in power costs to retail customers. The average residential bill increased approximately $6.75 per month as a result of this increase. In July of 2006, the TVA Board voted to reduce wholesale electric rates by about 4.5% and to implement a fuel cost adjustment ("FCA") mechanism. These changes became effective with retail meters read on or after September 25, 2006. The FCA will adjust effective rates up or down to reflect the forecasted difference in fuel and purchased power cost from established baseline amounts on a quarterly basis. The FCA will allow for more effective recovery of changes in fuel and purchased power costs. The 4.5% rate decrease reduced the average residential customer's monthly bill by about $3.40.

- The Gas Division's revenues and purchased gas costs were both down from 2005 due primarily to a reduction in sales and purchases volume of almost 6%. Milder winter weather contributed significantly to the decreases in sales and purchases volume. As a result of the reduction in sales volume and operating margin, the gas division recorded a loss in 2006.

- MLGW reached an agreement with the Tennessee Energy Acquisition Corporation ("TEAC") to purchase a portion of its natural gas supply at a discount below market index cost. The Division will realize a savings of approximately $102 million over the next 20 years.

Bond Ratings Reaffirmed

MLGW bond ratings remained unchanged through 2006. The Water Division holds the highest possible bond ratings--Aaa from Moody's Investors Service and AAA from Standard & Poor's. The Electric Division's AA rating was reaffirmed by Standard & Poor's and Fitch Ratings. The Gas Division currently has no debt. In issuing bond ratings, agencies typically look at financial operations, management practices, rates, and debt ratios. Higher ratings result in the ability to issue and refinance debt at lower interest costs than companies with lower ratings.

The following tables show MLGW bond ratings and debt administration for the Electric and Water Divisions in 2006:

Figure 1: Bond Ratings and Debt Administration for Electric and Water Divisions

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 *(In Thousands)*		
	Outstanding Balance	**Coverage**
Electric	$1,206,965	1.99
Water	$13,940	5.86

Overview of the Financial Statements

MLGW's financial statements 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. This report also contains required supplementary information in addition to the basic financial statements.

MLGW is an Enterprise Fund of the City of Memphis, Tennessee. MLGW's 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.

By Charter, MLGW is required to account 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 are presented fairly and consistently from year to year.

Analysis of the Electric Division's Balance Sheet

Condensed financial information comparing the Electric Division's net assets for the past three fiscal years is presented below:

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

	2006	2005	FY06 - FY05 Percentage Change	2004	FY05 - FY04 Percentage Change
Current assets (excluding restricted funds)	$ 369,196	$ 344,093	7.3%	$ 296,753	16.0%
Restricted assets	84,832	46,306	83.2%	46,297	0.0%
Other assets	16,147	19,479	-17.1%	28,244	-31.0%
Prepaid power costs - long-term	1,163,662	1,249,534	-6.9%	1,332,494	-6.2%
Utility plant	801,033	767,147	4.4%	741,683	3.4%
Total assets	2,434,870	2,426,559	0.3%	2,445,471	-0.8%
Current liabilities payable from current assets	235,512	208,168	13.1%	202,864	2.6%
Current liabilities payable from restricted assets	31,378	25,359	23.7%	26,049	-2.6%
Long-term debt	1,211,158	1,305,359	-7.2%	1,395,891	-6.5%
Non-current liabilities	22,138	23,356	-5.2%	23,158	0.9%
Total liabilities	1,500,186	1,562,242	-4.0%	1,647,962	-5.2%
Net assets:					
Invested in utility plant, net of related debt	778,989	740,054	5.3%	710,217	4.2%
Restricted	46,160	13,454	243.1%	12,996	3.5%
Unrestricted	109,535	110,809	-1.1%	74,296	49.1%
Total net assets	$ 934,684	$ 864,317	8.1%	$ 797,509	8.4%

Assets

For fiscal year 2006, total assets increased by $8.3 million, or 0.3%, compared to fiscal year 2005. Current assets increased by $25.1 million, or 7.3%, due primarily to an increase in collateral held in trust for securities on loan. A matching liability exists for this. Restricted assets also increased by $38.5 million due to an increase in funding for renewals and replacements for capital construction, and an increase in the insurance reserves- injuries and damages. Prepaid power costs decreased by $85.9 million due to amortization (see also Note 10). Other assets decreased by $3.3 million due in part to MLGW's share of operating losses experienced by Memphis Networx, and a reduction in a note receivable balance. Total assets for fiscal year 2005 decreased by $18.9 million (-0.8%) compared to the 2004 fiscal year. This decrease is mainly due to the amortization of prepaid power cost.

Capital Assets and Construction Activities

At December 31, 2006, the Electric Division had approximately $801.0 million in utility plant assets net of accumulated depreciation, an increase of 4.4% over fiscal year 2005. During 2006, the Electric Division expended $68.0 million on capital equipment purchases and construction activities, an increase of 14.7% over fiscal year 2005. Major Electric Division construction expenditures included: extensions to serve new customers ($21.0 million), substation and transmission projects ($18.8 million), and street light and leased outdoor lighting installations ($8.1 million). Other significant Electric Division capital expenditures included: purchase of transformers ($8.1 million), a mainframe system replacement projects ($5.1 million), purchase of transportation and power operated equipment ($3.1 million), and buildings and structures upgrades ($1.0 million).

The Electric Division had approximately $767.1 million in utility plant assets net of accumulated depreciation at December 31, 2005, an increase of 3.4% over fiscal year 2004. During 2005, the Electric Division expended $59.3 million on capital equipment purchases and construction activities. Major Electric Division construction expenditures included: extensions to serve new customers ($17.0 million), substation and transmission projects ($13.6 million), street light and leased outdoor lighting installations ($6.4 million), and relocation of facilities to accommodate road improvements ($1.5 million). The Electric Division equipment expenditures primarily included: purchase of communication equipment ($7.7 million which included an upgrade for radios), purchase of transformers ($3.4 million), purchase of transportation and power operated equipment ($3.2 million), mainframe system replacement project ($2.5 million), and purchase of meters and equipment ($2.1 million).

Liabilities

In 2006, total liabilities were down $62.1 million (-4.0%) compared to 2005. Long-term debt decreased from $1.3 billion in 2005 to $1.2 billion in 2006, a (-7.2%) decrease. This decrease is primarily due to the annual payment of long-term debt associated with the prepaid power transaction. This decrease is partly offset by a $33.4 million increase in current liabilities, including collateral held in trust for securities on loan, accounts payable for purchased power, insurance reserves (injuries and damages), and construction activity. Total liabilities decreased by $85.7 million (-5.2%) at December 31, 2005 compared to December 31, 2004. The primary decrease was due to the annual payment of long-term debt associated with the prepaid power transaction. Long-term debt decreased by $90.5 million in 2005. This decrease was partly offset by a $4.6 million increase in current liabilities.

Net Assets

Total net assets (total assets less total liabilities) were $934.7 million at December 31, 2006. This represents a $70.4 million or 8.1% increase in comparison to the $864.3 million of total net assets in 2005. Property, plant and construction work in progress (utility plant) accounts for 84% of these assets. Restricted net assets increased by $32.7 million, primarily due to and increase in funding for renewals and replacements for capital construction, and an increase in injuries, damages and insurance reserve. At December 31, 2005, the Electric Division's total net assets were $864.3 million, an increase of $66.8 million, or 8.4%, from $797.5 million at December 31, 2004. Over 86% of the net assets were related to utility plant.

Analysis of the Electric Division's Statement of Revenues, Expenses, and Changes in Net Assets

Condensed financial information comparing the Electric Division's revenues, expenses, and changes in net assets for the past three fiscal years is presented below:

Table 2
Electric Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2006, 2005 and 2004
(In Thousands)

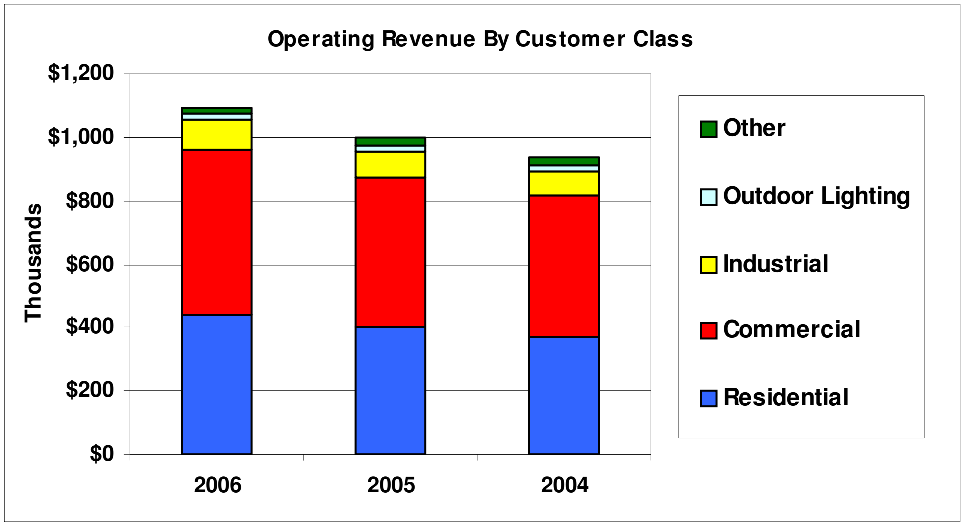
	2006	2005	FY06 - FY05 Percentage Change	2004	FY05 - FY04 Percentage Change
Revenues:					
Operating revenues	$ 1,092,979	$ 995,891	9.7%	$ 933,934	6.6%
Non-operating revenues	87,273	80,991	7.8%	78,022	3.8%
Total revenues	1,180,252	1,076,882	9.6%	1,011,956	6.4%
Expenses:					
Depreciation expense	32,645	30,971	5.4%	29,422	5.3%
Purchased power	846,441	751,055	12.7%	707,136	6.2%
Other operating expense	143,996	135,373	6.4%	133,490	1.4%
Non-operating expense	52,662	59,422	-11.4%	58,980	0.7%
Total expenses	1,075,744	976,821	10.1%	929,028	5.1%
Income (loss) before contributions in aid of construction and transfers	104,508	100,061	4.4%	82,928	20.7%
Contributions in aid of construction	22,726	18,458	23.1%	21,216	-13.0%
Reduction of plant costs recovered through contributions in aid of construction	(22,726)	(18,458)	23.1%	(21,216)	-13.0%
Transfers to City	(34,141)	(33,253)	2.7%	(29,204)	13.9%
Change in net assets	70,367	66,808	5.3%	53,724	24.4%
Beginning net assets	864,317	797,509	8.4%	743,785	7.2%
Ending net assets	$ 934,684	$ 864,317	8.1%	$ 797,509	8.4%

The change in net assets increased by $3.6 million, or 5.3%, to $70.4 million at December 31, 2006 from $66.8 million at December 31, 2005. This increase represents a growth of revenues relative to expenses. For 2005, the change in net assets increased by 24.4%, or $13.1, from $53.7 million at December 31, 2004. Sales growth of almost 5% over 2004 contributed to this gain.

Total revenues were $1.2 billion for fiscal year 2006, an increase of 9.6% over fiscal year 2005. Operating revenue was up $97.1 million from 2005 to $1.1 billion in 2006. TVA's wholesale rate adjustments effective April 1, 2006 and October 1, 2006 increased sales and service revenues by $97.9 million, with a corresponding increase in purchased power cost. Electricity sales to customers decreased (-0.3%) from 2005. This decreased sales and service revenues by $2.1 million from 2005. An increase in other revenues comprises the remaining $1.3 million variance from 2005. A $1.2 million increase in forfeited discounts and a $0.9 million increase in interdepartmental rent from property also contributed to the increase in operating revenue. Non-operating revenues increased by 7.8% in 2006 as a result of an increase in investment income.

Total revenues were $1.1 billion for fiscal year 2005, an increase of 6.4% over fiscal year 2004. Operating revenue was up $62.0 million from 2004 to $995.9 million in 2005. Electricity sales to customers were up 4.6% in 2005 from 2004, accounting for an additional $51.0 million in operating revenue. An additional $13.0 million increase in operating revenue is attributable to TVA's wholesale power rate increase of 7.5% in October 2005. Other operating revenues decreased by $2.0 million. An increase in investment income was also the source of the 3.8% increase in non-operating revenues in 2005. Figure 2 shows operating revenue by customer class for the past three fiscal years.

Figure 2: Electric Division's Operating Revenue



Total expenses increased 10.1%, growing from $976.8 million in 2005 to $1.1 billion in 2006. The increase was a result of a 12.7% increase in purchased power, a 5.4% increase in depreciation expense, and a 6.4% increase in other operating expenses. The increase was partially offset by an (-11.4%) decrease in non-operating expenses that resulted from a decrease in interest expense on long-term debt from Electric Prepay Bonds. Total expenses were $976.8 million for fiscal year 2005, an increase of 5.1% over 2004. The majority of the increase was attributed to increased wholesale purchased power costs.

In 2006, contributions in aid of construction ("CIAC") were $22.7 million; this represents an increase of $4.3 million over 2005. Contributions in aid of construction were $18.5 million in 2005, a decrease from 2004 of $2.8 million (-13.0%). CIAC were higher in 2004 than 2005 as a result of contributions received from Federal Emergency Management Agency ("FEMA") in 2004.

MLGW's transfer to the City of Memphis is based on the formula provided by the State of Tennessee Municipal Electric System Tax Equivalent Law of 1987. The formula includes a property tax equivalency calculation plus 4% of operating revenue less power costs (three-year average). Transfers to the City represent the Electric Division's in lieu of tax payment of $34.1 million in 2006. This amount represents slightly less than a $1 million increase over 2005, and is due to an increase in net plant and revenues. In 2005, transfers to the City of Memphis were $4.1 million higher than 2004. Of this, $2.4 million was due to an increase in net plant and revenues, and $1.6 million due to an increase in tax and equalization rates.

Analysis of the Gas Division's Balance Sheet

Condensed financial information comparing the Gas Division's net assets for the past three fiscal years is presented below:

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

	2006	2005 As Restated	FY06 - FY05 Percentage Change	2004 As Restated	FY05 - FY04 Percentage Change
Current assets (excluding restricted funds)	$ 170,969	$ 201,367	-15.1%	$ 137,595	46.3%
Restricted assets	30,423	33,689	-9.7%	35,802	-5.9%
Other assets	15,354	16,549	-7.2%	18,262	-9.4%
Utility plant	323,338	324,562	-0.4%	322,743	0.6%
Total assets	540,084	576,167	-6.3%	514,402	12.0%
Current liabilities payable from current assets	123,764	148,265	-16.5%	95,368	55.5%
Current liabilities payable from restricted assets	7,364	6,447	14.2%	6,395	0.8%
Non-current liabilities	13,356	13,256	0.8%	14,749	-10.1%
Total liabilites	144,484	167,968	-14.0%	116,512	44.2%
Net assets					
Invested in utility plant, net of related debt	323,338	324,562	-0.4%	322,743	0.6%
Restricted	19,346	24,463	-20.9%	26,573	-7.9%
Unrestricted	52,916	59,174	-10.6%	48,574	21.8%
Total net assets	$ 395,600	$ 408,199	-3.1%	$ 397,890	2.6%

Assets

For fiscal year 2006, total assets decreased by $36.1 million (-6.3%) as compared to fiscal year 2005. This was primarily due to a $30.4 million (-15.1%) decrease in current assets. The decline in current assets is attributed, in part, to a decrease in unbilled revenues of $17.9 million, a decline in investments of $13.2 million, and changes in derivative valuations (futures, options, swaps). These declines are partially offset by increases in miscellaneous deferred debits related to derivative positions. These deferred debits are ultimately charged to gas costs through the purchased gas adjustment. Restricted assets decreased in 2006 by $3.3 million (-9.7%), primarily due to a decline of $2.9 million in futures margins deposits.

Total assets for fiscal year 2005 increased by $61.8 million, or 12.0%, compared to fiscal year 2004. This related directly to the $63.8 million increase in current assets, in part the result of an increase in unbilled revenues and higher current accounts receivable due to the rising cost of natural gas. Restricted assets decreased by $2.1 million as a result of a decline in restricted construction funds, offset partly by an increase in futures margin requirement. Also, other assets decreased by $1.7 million due to the decrease in notes receivable related to a pipeline lease.

Capital Assets and Construction Activities

The Gas Division had approximately $323.3 million in utility plant assets net of accumulated depreciation at December 31, 2006, a decrease of (-0.4%) from fiscal year 2005. During 2006, the Gas Division expended $15.6

million on capital equipment purchases and construction activities, resulting in a decrease of (-22.0%) in comparison to fiscal year 2005. The Gas Division major construction expenditures included: extensions to serve new customers ($4.3 million) and cast iron pipe replacement project ($1.5 million). A substantial portion of the Gas Division capital expenditures was also attributed to purchase of transportation and power operated equipment ($6.2 million), buildings and structures upgrades ($1.5 million), purchase of meters and equipment ($1.5 million), and customer information system development ($1.2 million).

The Gas Division had approximately $324.6 million in utility plant assets net of accumulated depreciation at December 31, 2005, an increase of 0.6% over fiscal year 2004. During 2005, the Gas Division expended $20.0 million on capital equipment purchases and construction activities. The Gas Division's major construction expenditures included: extensions to serve new customers ($4.3 million) and cast iron pipe replacement project ($1.0 million). Other Gas Division capital expenditures included: purchase of transportation and power operated equipment ($5.1 million), buildings and structures upgrades ($2.6 million), purchase of furniture and fixtures ($1.5 million), customer information system development project ($1.2 million), and purchase of meters and equipment ($0.9 million).

Liabilities

Total liabilities decreased by $23.5 million (-14.0%) at December 31, 2006 compared to December 31, 2005. Accounts payable for purchased gas decreased by $28.6 million, from $90.2 million at December 31, 2005 to $61.6 million at December 31, 2006. Other accounts payable, accrued expenses, and other deferrals decreased by $10.4 million, due primarily to a decrease in other deferred credits related to derivative positions. Liabilities related to derivative positions increased by $17.6 million.

Total liabilities increased by $51.5 million, or 44.2%, at December 31, 2005 compared to 2004. The primary increase was in current liabilities payable from current assets that consisted of a $37.0 million increase in other accounts payable, accrued expenses, and deferrals and a $24.0 million increase in purchased gas payables due to increased wholesale natural gas prices. Non-current liabilities decreased by $1.5 million as a result of the recognition of earned interest income related to the pipeline leases.

Net Assets

Total net assets (total assets less total liabilities) at December 31, 2006 were $395.6 million; this is a decrease of $12.6 million (-3.1%) from $408.2 million in 2005. Property, plant, and construction work in progress (utility plant) accounts for 82% of these assets. Restricted net assets decreased by $5.1 million, due in part to a decrease in the required margin account balance related to derivative positions. At December 31, 2005, the Gas Division's total net assets increased $10.3 million, or 2.6%, from $397.9 million at December 31, 2004. Over 81% of the nets assets were related to utility plant, which includes property, plant, and construction work in progress.

Analysis of the Gas Division's Statement of Revenues, Expenses, and Changes in Net Assets

Condensed financial information comparing the Gas Division's revenues, expenses, and changes in net assets for the past three fiscal years is presented below:

Table 4
Gas Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2006, 2005 and 2004
(In Thousands)

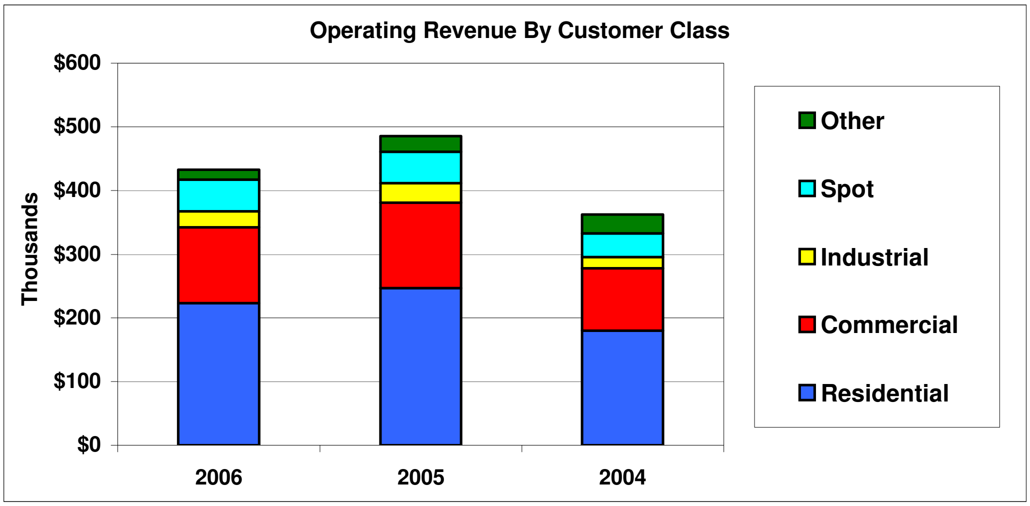
	2006	2005 As Restated	FY06 - FY05 Percentage Change	2004 As Restated	FY05 - FY04 Percentage Change
Revenues:					
Sales, service and other operating revenues	$ 429,099	$ 481,611	-10.9%	$ 360,306	33.7%
Transported gas revenue	3,831	3,828	0.1%	2,390	60.2%
Non-operating revenues	2,749	2,877	-4.4%	4,973	-42.1%
Total revenues	435,679	488,316	-10.8%	367,669	32.8%
Expenses:					
Depreciation expense	15,150	14,814	2.3%	14,803	0.1%
Purchased gas	343,761	381,036	-9.8%	283,535	34.4%
Other operating expense	73,749	69,330	6.4%	63,427	9.3%
Non-operating expense	-	-	0.0%	-	0.0%
Total expenses	432,660	465,180	-7.0%	361,765	28.6%
Income (loss) before contributions in aid of construction and transfers	3,019	23,136	-87.0%	5,904	291.9%
Contributions in aid of construction	3,506	2,518	39.2%	3,270	-23.0%
Reduction of plant costs recovered through contributions in aid of construction	(3,506)	(2,518)	39.2%	(3,270)	-23.0%
Transfers to City	(15,618)	(15,357)	1.7%	(14,395)	6.7%
Change in net assets	(12,599)	7,779	-262.0%	(8,491)	191.6%
Beginning net assets	$ 408,199	$ 397,890	2.6%	$ 412,934	-3.6%
Prior period adjustments	-	2,530	-100.0%	(6,553)	138.6%
Beginning net assets as adjusted	408,199	400,420	1.9%	406,381	-1.5%
Ending net assets	$ 395,600	$ 408,199	-3.1%	$ 397,890	2.6%

The change in net assets decreased by $20.4 million, or (-262%), to $-12.6 million at December 31, 2006 from $7.8 million at December 31, 2005. This decrease in net assets is primarily attributable to a combination of declining sales of natural gas and an increase in other operating expenses. Changes in net assets increased by $16.3 million, from $-8.5 million at December 31, 2004 to $7.8 million at December 31, 2005. This increase is due primarily to higher operating revenue from the implementation of an MLGW gas rate increase, effective December 28, 2004.

Total revenues were $435.7 million for fiscal year 2006, a decrease of (-10.8%) from fiscal year 2005. Lower wholesale gas prices and a drop in unit sales decreased sales and service revenues by $53.9 million. Sales to customers decreased (-5.3%) from 2005. This decrease was partially offset by an increase in other revenues of $1.4 million. The 4.4% decrease in 2006 non-operating revenue is attributable to a reduction in throughput of a jet fuel pipeline owned and operated by MLGW.

Total revenues were $488.3 million for fiscal year 2005, an increase of 32.8% over fiscal year 2004. The increase resulted in part from the Gas Division’s rate increase of approximately 6.1%. This added $18.7 million to sales, service and other operating revenue. Increased natural gas prices were also recovered from customers through a purchased gas adjustment, increasing revenues by $87.3 million. Gas sales to customers were up 2.9% in 2005 from 2004, accounting for an additional $10.0 million in operating revenue. Non-operating revenues decreased $2.1 million in 2005 due in part to the termination of construction contribution payments from Trunkline Gas Company pursuant to a natural gas transportation contract. Figure 3 shows the operating revenue by customer class for the past three fiscal years.

Figure 3: Gas Division’s Operating Revenue



Total expenses decreased to $432.7 million in 2006 from $465.2 million in 2005. This $32.5 million decrease can be accredited to a $37.3 million decrease in purchased gas, offset in part by an increase in other operating expenses of $4.4 million due to an increase in operations and maintenance expenses. Total expenses for fiscal year 2005 increased by 28.6% over fiscal year 2004. Purchased gas costs increased $97.5 million, or 34.4%, due largely to escalating wholesale gas prices. Additionally, other operating expenses increased by $6.0 million, or 9.3%, as a result of an increase in operations and maintenance costs.

In 2006, contributions in aid of construction increased $1.0 million, or 39.2%, to $3.5 million dollars. Contributions in aid of construction were $2.5 million in 2005, a decrease from 2004 of $0.8 million (-23.0%).

MLGW’s transfer to the City of Memphis is based on the formula provided by the State of Tennessee Municipal Gas System Tax Equivalent Law of 1987. The formula includes a property tax equivalency calculation plus 4% of operating revenue less gas costs (three-year average). Transfers to the City, which represent the Gas Division’s in lieu of tax payments, were $15.6 million in 2006. This amount represents less than a $0.3 million increase compared to 2005. Transfers to the City were $15.4 million in 2005. This amount represents a 6.7% increase over 2004. Of the $1.0 million increase in taxes over 2004, $0.2 million is attributable to increased revenues and the remaining $0.8 million is attributable to increased tax rates and equalization rates during 2005.

In 2005 and 2004, prior period adjustments and restatements were made to sales and service revenues, other accounts payable, accrued expenses, and deferrals. The adjustments made were related to the recovery of costs associated with LNG inventory. (See Note 1 – Gas Division Prior Period Adjustment and Restatement).

Analysis of the Water Division's Balance Sheet

Condensed financial information comparing the Water Division's net assets for the past three fiscal years is presented below:

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

	2006	2005	FY06 - FY05 Percentage Change	2004	FY05 - FY04 Percentage Change
Current assets (excluding restricted assets)	$ 38,933	$ 36,920	5.5%	$ 42,633	-13.4%
Restricted assets	26,628	26,109	2.0%	26,521	-1.6%
Other assets	1,223	646	89.3%	149	333.6%
Utility plant	246,078	244,492	0.6%	242,852	0.7%
Total assets	312,862	308,167	1.5%	312,155	-1.3%
Current liabilities payable from current assets	10,920	9,500	14.9%	13,048	-27.2%
Current liabilities payable from restricted assets	7,811	9,748	-19.9%	11,547	-15.6%
Long-term debt	10,796	13,721	-21.3%	19,431	-29.4%
Non-current liabilities	2,104	1,927	9.2%	1,978	-2.6%
Total liabilites	31,631	34,896	-9.4%	46,004	-24.1%
Net assets					
Invested in utility plant, net of related debt	232,307	225,001	3.2%	215,982	4.2%
Restricted	21,279	21,587	-1.4%	21,964	-1.7%
Unrestricted	27,645	26,683	3.6%	28,205	-5.4%
Total net assets	$ 281,231	$ 273,271	2.9%	$ 266,151	2.7%

Assets

Total assets for fiscal year 2006 increased to $312.9 million, an increase of $4.7 million, or 1.5%, compared to 2005. Current assets increased by $2.0 million, or 5.5%, due primarily to an increase in cash and cash equivalents and investments. Utility plant increased by $1.6 million over 2005. Total assets for fiscal year 2005 decreased by $4.0 million (-1.3%) compared to fiscal year 2004. The decrease resulted primarily from a decline in investments and current accounts receivable.

Capital Assets and Construction Activities

The Water Division had approximately $246.1 million in utility plant assets net of accumulated depreciation at December 31, 2006, an increase of 0.6% over fiscal year 2005. During 2006, the Water Division expended $11.5 million on capital equipment purchases and construction activities, which was a decrease of (-4.2%) in comparison to fiscal year 2005. The major Water Division construction expenditures included: extensions to serve new customers ($3.9 million), upgrades to the Morton Pumping Station ($2.1 million), and relocation of facilities to accommodate road improvements ($0.7 million). The Water Division equipment purchases included: purchase of data processing equipment ($1.4 million), purchase of meters ($1.1 million), and purchase of transportation and power operated equipment ($1.1 million).

The Water Division had approximately $244.5 million in utility plant assets net of accumulated depreciation at December 31, 2005, an increase of 0.7% over fiscal year 2004. During 2005, the Water Division expended $12.0 million on capital equipment purchases and construction activities. The Water Division's major construction expenditures included: extensions to serve new customers ($3.2 million), 16" main extension project from Weaver Road to Riverport ($1.1 million), seismic mitigation of buildings and equipment at Lichterman Pumping Station ($1.1 million), and seismic retrofit of wells at McCord Pumping Station ($0.6 million). The Water Division equipment purchases included: purchase of data processing equipment ($2.1 million), purchase of meters ($1.0 million), and purchase of transportation and power operated equipment ($0.7 million).

Liabilities

In 2006, total liabilities decreased by $3.3 million (-9.4%) compared to fiscal year 2005. Long-term debt decreased by $2.9 million and current liabilities payable from restricted assets decreased by $1.9 million. The decrease in current liabilities payable from restricted funds is primarily caused by the decrease in principal payments for the current portion of revenue bonds payable. These decreases are partially offset by an increase in other accounts payable of $1.1 million. Total liabilities decreased by (-24.1%) from $46.0 million at December 31, 2004 to $34.9 million at December 31, 2005. Long-term debt decreased as a result of the continued payment of principal on the existing outstanding debt. Additionally, the decrease in current liabilities payable from restricted assets was attributed to the $2.0 million decrease in principal payments for the current portion of revenue bonds payable.

Net Assets

Total net assets (total assets less total liabilities) were $281.2 million at December 31, 2006, an increase of $8.0 million in comparison to 2005. The increase is primarily due to an increase in current assets and utility plant, and a decrease in long-term debt. Property, plant, and construction work in progress (utility plant) accounts for almost 83% of these assets. At December 31, 2005, the Water Division's total net assets (total assets less total liabilities) were $273.3 million, an increase of $7.1 million, or 2.7%, from $266.2 million at December 31, 2004. Over 82% of the nets assets were related to utility plant, which includes property, plant, and construction work in progress.

Analysis of the Water Division's Statement of Revenues, Expenses, and Changes in Net Assets

Condensed financial information comparing the Water Division's revenues, expenses, and changes in net assets for the past three fiscal years is presented below:

Table 6
Water Division
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended December 31, 2006, 2005 and 2004
(In Thousands)

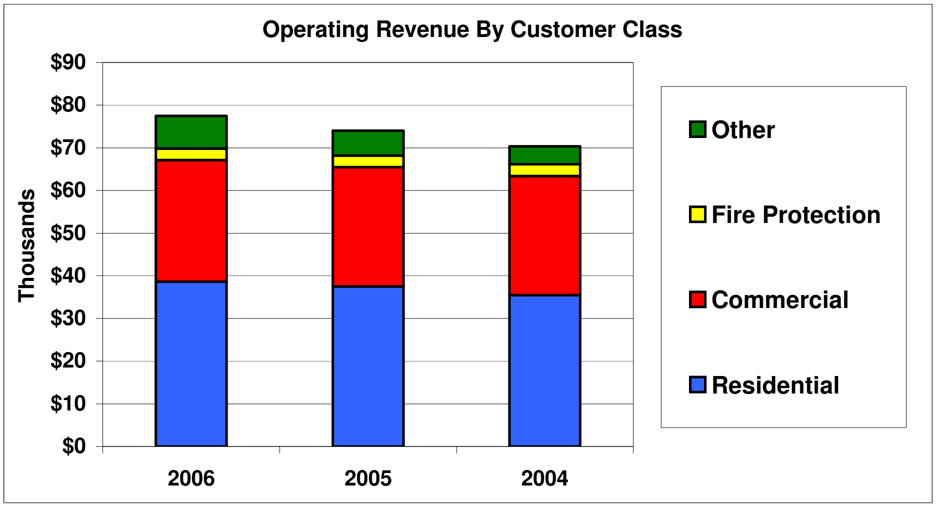
	2006	2005	FY06 - FY05 Percentage Change	2004	FY05 - FY04 Percentage Change
Revenues:					
Operating revenues	$ 77,474	$ 74,020	4.7%	$ 70,365	5.2%
Non-operating revenues	2,085	1,259	65.6%	637	97.6%
Total Revenues	79,559	75,279	5.7%	71,002	6.0%
Expenses:					
Depreciation expense	9,798	9,493	3.2%	7,797	21.8%
Other operating expense	58,606	55,158	6.3%	52,289	5.5%
Non-operating expense	695	1,008	-31.1%	1,397	-27.8%
Total Expenses	69,099	65,659	5.2%	61,483	6.8%
Income (loss) before contributions in aid of construction and transfers	10,460	9,620	8.7%	9,519	1.1%
Contributions in aid of construction	5,068	6,106	-17.0%	9,833	-37.9%
Reduction of plant costs recovered through contributions in aid of construction	(5,068)	(6,106)	-17.0%	(9,833)	-37.9%
Transfers to City	(2,500)	(2,500)	0.0%	(2,500)	0.0%
Change in net assets	7,960	7,120	11.8%	7,019	1.4%
Beginning net assets	273,271	266,151	2.7%	259,132	2.7%
Ending net assets	$ 281,231	$ 273,271	2.9%	$ 266,151	2.7%

The change in net assets increased by 11.8%, or $0.9 million, from $7.1 million in 2005 to $8.0 million in 2006, representing growth in revenues relative to expenses. The change in net assets increased slightly by 1.4% at December 31, 2005 compared to 2004, reflecting similar growth rates in revenues and expenses.

Total revenues were $79.6 million for fiscal year 2006, an increase of $4.3 million, or 5.7%, over fiscal year 2005. Water sales increased 2.2% from 2005. The sales increase contributed $1.6 million to the increase in sales and service revenues. Interest income from sinking funds and interdepartmental rent from water property (property owned by the water division and rented to the other divisions) contributed $2.7 million to the increase in total revenue.

In 2005, total revenues were $75.3 million, an increase of 6.0% over fiscal year 2004. Water sales to customers were up 3.6% in 2005 from 2004, accounting for an additional $2.2 million in operating revenue. Revenue from water property rentals contributed $1.7 million to the increase in operating revenue. There was a $0.6 million increase to non-operating revenue in 2005 due to an increase in investment income. Figure 4 shows operating revenue by customer class for the past three fiscal years.

Figure 4: Water Division's Operating Revenue



Total expenses for the Water Division in 2006 were $69.1 million, representing a $3.4 million, or 5.2%, increase over 2005. This is attributable primarily to increases in operating expenses (production and distribution) of $3.4 million. Depreciation expense increases of $0.3 million were offset by a decrease of $0.3 million in non-operating expenses. Total expenses were $65.7 million for fiscal year 2005, an increase of 6.8% over fiscal year 2004. The primary increase was due to a $2.9 million increase in other operating expenses as a result of an increase in production, operations, and maintenance costs.

For fiscal year 2006, contributions in aid of construction decreased by $1.0 million to $5.1 million. Contributions in aid of construction were $6.1 million in 2005; this is a decrease of $3.7 million (-37.9%) due to the completion of a state highway project and the receipt of federal award funds.

Transfers to the City are per an agreement with the City of Memphis to provide payments in the amount of $2.5 million per year. The agreement is effective through the year 2028.

Additional Financial Information

This discussion is designed to provide MLGW's customers, investors, and other interested parties with a general overview of the 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 the Manager of General Accounting, Memphis Light, Gas and Water Division, P.O. Box 430, Memphis, TN 38101, or call 901-528-4221.

BALANCE SHEETS
(Dollars in Thousands)
DECEMBER 31, 2006 AND 2005

	Electric Division		Gas Division		Water Division	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
				As Restated		
Assets						
Current assets:						
Cash and cash equivalents	**$ 73,364**	$ 70,092	**$ 16,618**	$ 14,850	**$ 13,555**	$ 11,043
Investments	**41,102**	41,235	**162**	13,344	**7,616**	6,508
Derivative Financial Instruments	–	–	–	10,617	–	–
Restricted funds - current	**63,624**	25,359	**22,298**	26,552	**10,616**	10,717
Accounts receivable, less allowance for doubtful accounts	**61,381**	63,691	**46,745**	48,775	**9,391**	12,030
Unbilled revenues	**57,839**	52,776	**50,037**	67,913	**3,494**	3,297
Prepaid power cost	**85,872**	82,961	–	–	–	–
Unrecovered purchased gas cost	–	–	–	16,668	–	–
Inventories	**16,935**	16,986	**14,422**	14,961	**2,198**	1,722
Collateral held in trust for securities on loan	**29,326**	13,982	**3,216**	6,314	**2,679**	2,320
Other current assets	**3,377**	2,370	**39,769**	7,925	–	–
Total current assets	**432,820**	369,452	**193,267**	227,919	**49,549**	47,637
Non-current assets:						
Restricted funds:						
Futures margin deposits	–	–	**5,304**	8,198	–	–
Construction	**37,372**	2,198	**11,253**	13,136	**4,370**	1,748
Insurance reserves - injuries and damages	**5,915**	2,012	**1,273**	1,044	**1,408**	1,015
Insurance reserves - casualties and general	**13,913**	13,454	**4,411**	4,359	**5,886**	5,684
Medical benefit	**4,322**	4,856	**2,303**	2,430	**1,213**	1,363
Customer deposits	**11,958**	12,283	**5,879**	4,522	**841**	891
Bond reserve and debt service	**11,352**	11,503	–	–	**12,910**	15,408
Total restricted funds	**84,832**	46,306	**30,423**	33,689	**26,628**	26,109
Less restricted funds - current	**(63,624)**	(25,359)	**(22,298)**	(26,552)	**(10,616)**	(10,717)
Restricted funds – non-current	**21,208**	20,947	**8,125**	7,137	**16,012**	15,392
Other assets:						
Prepaid power cost – long term	**1,163,662**	1,249,534	–	–	–	–
Prepayments In Lieu of Taxes	**1,456**	–	**517**	–	–	–
Unamortized debt expense	**9,214**	10,638	–	–	–	–
Notes receivable	**4,105**	5,630	**14,837**	16,549	**1,223**	646
Investment in Memphis Networx	**1,372**	3,211	–	–	–	–
Total other assets	**1,179,809**	1,269,013	**15,354**	16,549	**1,223**	646
Utility plant	**1,255,828**	1,198,403	**549,912**	535,626	**396,659**	389,584
Less accumulated depreciation	**(454,795)**	(431,256)	**(226,574)**	(211,064)	**(150,581)**	(145,092)
Utility plant, net	**801,033**	767,147	**323,338**	324,562	**246,078**	244,492
Total non-current assets	**2,002,050**	2,057,107	**346,817**	348,248	**263,313**	260,530
Total assets	**$ 2,434,870**	$ 2,426,559	**$ 540,084**	$ 576,167	**$ 312,862**	$ 308,167

See accompanying notes.

BALANCE SHEETS
(Dollars in Thousands)
DECEMBER 31, 2006 AND 2005
(Continued)

	Electric Division		Gas Division		Water Division	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
				As Restated		
Liabilities						
Current liabilities:						
Accounts payable - purchased power and gas	**$ 93,708**	$ 88,890	**$ 61,630**	$ 90,200	**$ –**	$ –
Other accounts payable, accrued expenses, and deferrals	**37,869**	34,386	**41,364**	51,751	**8,241**	7,180
Derivative Financial Instruments	**–**	–	**17,554**	–	**–**	–
Bonds and notes payable	**74,609**	70,910	**–**	–	**–**	–
Collateral subject to return to borrowers	**29,326**	13,982	**3,216**	6,314	**2,679**	2,320
Total current liabilities payable from current assets	**235,512**	208,168	**123,764**	148,265	**10,920**	9,500
Current liabilities payable from restricted assets:						
Construction	**5,125**	2,198	**1,623**	1,229	**1,565**	778
Customer deposits	**4,664**	4,790	**2,164**	1,744	**328**	348
Medical benefit accrual	**4,322**	4,856	**2,304**	2,430	**1,213**	1,363
Insurance reserves - injuries and damages	**5,915**	2,012	**1,273**	1,044	**1,408**	1,015
Bonds payable – accrued interest	**4,593**	4,941	**–**	–	**322**	474
Bonds payable – principal	**6,759**	6,562	**–**	–	**2,975**	5,770
Total current liabilities payable from restricted assets	**31,378**	25,359	**7,364**	6,447	**7,811**	9,748
Total current liabilities	**266,890**	233,527	**131,128**	154,712	**18,731**	19,248
Non-current liabilities:						
Customer advances for construction	**7,876**	8,972	**587**	554	**–**	–
Customer deposits	**7,294**	7,493	**3,715**	2,778	**513**	544
Other	**6,968**	6,891	**9,054**	9,924	**1,591**	1,383
Long-term debt	**1,211,158**	1,305,359	**–**	–	**10,796**	13,721
Total non-current liabilities	**1,233,296**	1,328,715	**13,356**	13,256	**12,900**	15,648
Total liabilities	**1,500,186**	1,562,242	**144,484**	167,968	**31,631**	34,896
Net assets						
Invested in capital assets, net of related debt	**778,989**	740,054	**323,338**	324,562	**232,307**	225,001
Restricted for debt service and construction	**46,160**	13,454	**19,346**	24,463	**21,279**	21,587
Unrestricted	**109,535**	110,809	**52,916**	59,174	**27,645**	26,683
Total net assets	**934,684**	864,317	**395,600**	408,199	**281,231**	273,271
Total liabilities and net assets	**$ 2,434,870**	$ 2,426,559	**$ 540,084**	$ 576,167	**$ 312,862**	$ 308,167

See accompanying notes.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
(Dollars in Thousands)
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

	Electric Division		Gas Division		Water Division	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
				As Restated		
Operating revenues:						
Sales and service revenues	**$1,070,137**	$ 974,380	**$ 413,593**	$ 467,474	**$ 69,337**	$ 67,732
Transported gas revenue	**–**	–	**3,831**	3,828	**–**	–
Other revenues	**22,842**	21,511	**15,506**	14,137	**8,137**	6,288
Total operating revenues	**1,092,979**	995,891	**432,930**	485,439	**77,474**	74,020
Operating expenses:						
Purchased power and gas for resale	**846,441**	751,055	**343,761**	381,036	**–**	–
Production	**–**	–	**–**	–	**13,974**	12,875
Operation	**104,535**	96,115	**62,532**	59,464	**37,572**	35,754
Maintenance	**38,854**	38,744	**11,001**	9,673	**7,060**	6,529
Depreciation	**32,645**	30,971	**15,150**	14,814	**9,798**	9,493
Payments in lieu of taxes	**607**	514	**216**	193	**–**	–
	1,023,082	917,399	**432,660**	465,180	**68,404**	64,651
Operating income (loss)	**69,897**	78,492	**270**	20,259	**9,070**	9,369
Non-operating revenues (expenses):						
Contributions in aid of construction	**22,726**	18,458	**3,506**	2,518	**5,068**	6,106
Reduction of plant costs recovered through contributions in aid of construction	**(22,726)**	(18,458)	**(3,506)**	(2,518)	**(5,068)**	(6,106)
Transmission credits	**23,767**	23,023	**–**	–	**–**	–
Investment and other income	**63,506**	57,968	**2,749**	2,877	**2,085**	1,259
Interest expense	**(50,737)**	(53,174)	**–**	–	**(695)**	(1,008)
Telecommunications division loss	**(1,925)**	(6,248)	**–**	–	**–**	–
Total non-operating revenues (expenses)	**34,611**	21,569	**2,749**	2,877	**1,390**	251
Income before transfers	**104,508**	100,061	**3,019**	23,136	**10,460**	9,620
Transfer out	**(34,141)**	(33,253)	**(15,618)**	(15,357)	**(2,500)**	(2,500)
Change in net assets	**$ 70,367**	$ 66,808	**$ (12,599)**	$ 7,779	**$ 7,960**	$ 7,120
Net assets, beginning of year	**$ 864,317**	$ 797,509	**$ 408,199**	$ 397,890	**$ 273,271**	$ 266,151
Prior Period Adjustment	**–**	–	**–**	2,530	**–**	–
Net assets, beginning of year as adjusted	**864,317**	797,509	**408,199**	400,420	**273,271**	266,151
Change in net assets	**70,367**	66,808	**(12,599)**	7,779	**7,960**	7,120
Net assets, end of year	**$ 934,684**	$ 864,317	**$ 395,600**	$ 408,199	**$ 281,231**	$ 273,271

See accompanying notes.

STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

	Electric Division		Gas Division		Water Division	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
				As Restated		
Cash flow from operating activities:						
Receipts from customers and users	**$ 1,110,495**	$ 1,001,904	**$ 478,065**	$ 484,512	**$ 81,990**	$ 77,302
Receipts from federal grants	–	–	–	–	–	–
Payments to suppliers	**(749,298)**	(656,557)	**(430,853)**	(419,196)	**(34,155)**	(31,430)
Payments to employees	**(82,622)**	(78,216)	**(35,443)**	(34,295)	**(25,272)**	(25,756)
Payments from (to) other Division funds	**(5,050)**	(4,868)	**2,904**	4,119	**2,146**	749
Payments for taxes	**(1,682)**	(461)	**(785)**	(193)	–	–
Other receipts	**704**	717	**22**	7	–	38
Net cash provided (used) by operating activities	**272,547**	262,519	**13,910**	34,954	**24,709**	20,903
Cash flows from noncapital financing activities:						
Transfers to City	**(34,141)**	(33,253)	**(15,618)**	(15,357)	**(2,500)**	(2,500)
Decrease (increase) in unamortized debt expense	–	12	–	–	–	–
Principal payments on long-term debt	**(71,170)**	(67,975)	–	–	–	–
Interest expense on bonds	**(60,588)**	(62,910)	–	–	–	–
Net cash provided (used) by noncapital financing activities	**(165,899)**	(164,126)	**(15,618)**	(15,357)	**(2,500)**	(2,500)
Cash flows from capital and related financing activities:						
Purchase and construction of utility plant	**(93,636)**	(79,598)	**(20,488)**	(22,054)	**(18,213)**	(17,811)
Contributions in aid of construction	**22,726**	18,458	**3,506**	2,518	**5,068**	6,106
Receipts from federal grants	–	–	–	–	–	2,000
Principal payments on long-term debt	**(6,303)**	(6,064)	–	–	**(5,770)**	(7,440)
Interest expense on debt	**(1,530)**	(1,780)	–	–	**(796)**	(1,141)
Net cash provided (used) by capital and related financing activities	**(78,743)**	(68,984)	**(16,982)**	(19,536)	**(19,711)**	(18,286)
Cash flows from investing activities:						
Sales and maturities of investments	**27,900**	27,812	**22,986**	11,092	**4,852**	6,247
Purchase of investments	**(41,795)**	(29,848)	**(9,025)**	(13,535)	**(7,024)**	(6,145)
Payments received on notes receivable	**1,899**	1,708	**1,712**	1,713	**346**	513
Issuance of notes receivable	–	–	–	–	**(923)**	–
Investment income earned on investments	**11,776**	5,202	**2,297**	2,359	**2,219**	1,071
Investment in Memphis Networx	**84**	67	–	–	–	–
Net cash provided (used) by investing activities	**(136)**	4,941	**17,970**	1,629	**(530)**	1,686
Increase (decrease) in cash and cash equivalents	**27,770**	34,350	**(720)**	1,690	**1,967**	1,803
Cash and cash equivalents, beginning of year	**109,848**	75,498	**41,668**	39,978	**34,020**	32,217
Cash and cash equivalents, end of year	**$ 137,618**	$ 109,848	**$ 40,948**	$ 41,668	**$ 35,987**	$ 34,020

See accompanying notes.

STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005
(Continued)

	Electric Division		Gas Division		Water Division	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
				As Restated		
Reconciliation of operating income (loss) to net cash provided (used) by operating activities:						
Operating income (loss)	**$ 69,897**	$ 78,492	**$ 270**	$ 20,259	**$ 9,070**	$ 9,369
Adjustments to reconcile operating income (loss)						
Net cash provided by operating activities:						
Depreciation of utility plant	**37,025**	33,241	**18,443**	17,717	**11,465**	10,065
Transmission credits	**23,767**	23,023	–	–	–	–
Prepay power credits	**49,156**	50,840	–	–	–	–
Other income	**2,137**	1,363	**214**	518	**112**	188
(Increase) decrease in assets:						
Accounts receivable	**2,310**	(7,458)	**2,030**	(24,110)	**2,639**	1,475
Unbilled revenues	**(5,063)**	(6,747)	**17,876**	(13,033)	**(197)**	44
Prepaid power cost	**82,961**	80,404	–	–	–	–
Prepayments – In Lieu of Taxes	**(1,456)**	–	**(517)**	–	–	
Deferred purchase power and gas cost	–	–	**16,668**	(6,682)	–	–
Inventories	**51**	(793)	**539**	(5,244)	**(476)**	(13)
Other assets	**(908)**	2,766	**(3,673)**	2,192	–	–
Increase (decrease) in liabilities:						
Accounts payable - purchased power and gas	**4,818**	14,328	**(28,570)**	23,905	–	–
Other accounts payable and accrued expenses	**5,314**	(5,513)	**(9,960)**	21,239	**1,696**	(174)
Customer deposits	**(325)**	393	**1,357**	(99)	**(51)**	155
Insurance reserves	**3,903**	(697)	**229**	(9)	**393**	171
Medical benefit accrual	**(534)**	(830)	**(126)**	(264)	**(150)**	(233)
Other	**(506)**	(293)	**(870)**	(1,435)	**208**	(144)
Total adjustments	**202,650**	184,027	**13,640**	14,695	**15,639**	11,534
Net cash provided (used) by operating activities	**$ 272,547**	$ 262,519	**$ 13,910**	$ 34,954	**$ 24,709**	$ 20,903
Reconciliation of cash and cash equivalents per statements of cash flows to the balance sheets:						
Restricted funds	**$ 84,832**	$ 46,306	**$ 30,423**	$ 33,689	**$ 26,628**	$ 26,109
Less investments included in restricted funds	**(20,578)**	(6,550)	**(6,093)**	(6,871)	**(4,196)**	(3,132)
Cash and cash equivalents included in restricted funds	**64,254**	39,756	**24,330**	26,818	**22,432**	22,977
Current assets - cash and cash equivalents	**73,364**	70,092	**16,618**	14,850	**13,555**	11,043
Total cash and cash equivalents	**$ 137,618**	$ 109,848	**$ 40,948**	$ 41,668	**$ 35,987**	$ 34,020

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.

1. Summary of Significant Accounting Policies (continued)

Basis of Accounting (continued)

Under Governmental Accounting Standards Board ("GASB") Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* MLGW has elected to apply all Financial Accounting Standards Board ("FASB") statements and interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements, to MLGW's accounting and financial reporting.

Recent Accounting Standards

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*, respectively. Other Postemployment Benefits (OPEB) are benefits, other than pension, received by employees (e.g., medical, life insurance). 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 was required to adopt GASB Statements No. 43 and 45 for financial statements beginning after December 15, 2005 and 2006, respectively. In 2007, MLGW will establish an OPEB plan and implement GASB Statements No. 43 and 45.

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 adopted this statement on January 1, 2006. Because MLGW is a qualifying entity under FASB Statement 71, MLGW Board actions have the same effect as enabling legislation for the restriction of assets.

In December 2004, FASB issued Statement No. 153, *Exchanges of Nonmonetary Assets- an amendment of APB Opinion No 29.* The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. This statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of this statement have an effective date for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. MLGW implemented this statement in 2006.

GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* in November 2006. This statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations which are obligations to address current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. The requirements of this statement are effective for financial statements for periods beginning after December 15, 2007. MLGW has not elected early implementation of this statement, and does not believe it will have a material effect on the financial statements.

1. Summary of Significant Accounting Policies (continued)

Gas Division Prior Period Adjustment and Restatement

A prior period adjustment was made to the net assets, beginning of the year balance, in the Gas Division's Statement of Revenues, Expenses and Changes in Net Assets for 2005. Also, a restatement was made to sales and service revenues (revenue) and other accounts payable, accrued expenses, and deferrals (liability) for 2005. These adjustments are related to the Liquefied Natural Gas (LNG) inventory. MLGW owns and operates two LNG plants for the storage of natural gas. Typically, these facilities are refilled during periods of relatively low gas consumption and gas is withdrawn from storage and injected into the gas distribution system for use by customers during high demand periods.

In 2005, MLGW made a prior period adjustment and restatement of 2004 to recognize the liability associated with the recovery of costs for LNG inventory. Because the recovery was only partial, the liability was overstated in 2005 and prior years. To correct the revenue and overstated liability, a 2006 prior period adjustment was made to increase net assets at the beginning of 2005 by $2,530. A restatement was also made to increase sales and service revenues by $1,814 for 2005 and decrease the liability in other accounts payable, accrued expenses, and deferrals by $4,344 ($2,530 + $1,814).

(Dollars in Thousands)

1. Summary of Significant Accounting Policies (continued)

Regulatory Accounting

MLGW prepares its financial statements in accordance with the provisions of Statement of Financial Accounting Standards 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:

		2006	2005 As Restated
Assets			
Gas Division	Deferred loss on futures/swaps	**$ 36,693**	$ 5,627
Gas Division	Unrecovered purchased gas cost	**0**	16,668
Liabilities			
Gas Division	Deferred gains-gas futures/swaps	**$ 0**	$ 16,096
Gas Division	Deferred credits-PGA/storage	**28,741**	23,006

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 is as follows as of December 31, 2006 and 2005:

	2006	**2005**
Electric Division	**$1,273,719**	$1,361,284
Water Division	**14,270**	20,240

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, 2006 and 2005, accounts receivable and allowances for doubtful accounts were as follows:

	Electric Division		**Gas Division**		**Water Division**	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
Accounts receivable	**$ 71,347**	$ 72,473	**$ 48,266**	$ 50,489	**$ 10,312**	$ 12,963
Less: Allowance for doubtful accounts	**(9,966)**	(8,782)	**(1,521)**	(1,714)	**(921)**	(933)
TOTAL	**$ 61,381**	$ 63,691	**$ 46,745**	$ 48,775	**$ 9,391**	$ 12,030

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.

(Dollars in Thousands)

1. Summary of Significant Accounting Policies (continued)

Accounts Receivable (continued)

MLGW's policy is to write off trade receivables after 120 days of non-payment. The bad debt expense amounts netted against operating revenues are as follows:

	2006	2005
Electric	**$ 7,283**	$ 6,233
Gas	**4,342**	2,738
Water	**915**	753

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. MLGW's derivatives transactions are mostly conducted directly or indirectly with the New York Mercantile Exchange ("NYMEX"). Using NYMEX largely minimizes MLGW's exposure to credit risk for such transactions.

Prepaid Power Cost

Electric Division prepaid power cost represents the unamortized amount of prepaid power under the prepaid electricity agreement signed with Tennessee Valley Authority ("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 is sufficient to meet the debt service requirements and yield approximately $13,000 in annual power cost savings. 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 2006 and 2005, 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% for each division. 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, in lieu of taxes, and transfers.

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 MLGW 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. Restricted funds are first used for expenses when available, with the exception of the insurance reserve fund for casualties which is used at the discretion of management, depending on the severity of the catastrophe and the availability of funds.

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.

1. Summary of Significant Accounting Policies (continued)

Reserves and Related Restricted Funds (continued)

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

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's 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, Options and Swap Contracts

The Gas Division enters into futures contracts, swaps, and options on futures contracts to manage the risk of volatility in the market price of gas on anticipated purchase transactions. Open futures, swaps, and option contracts as of December 31, 2006 and 2005, are reported at market values of ($16,024) and $9,324 respectively. Notional values of the open futures as of December 31, 2006 and 2005 were $49,378 and $36,996, respectively. Margin account balances with MLGW's New York Mercantile Exchange clearing member as of December 31, 2006 and 2005, were $21,635 and $405, respectively.

Because MLGW prepares its statements in accordance with Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation,* gains or losses on futures contracts and swaps and option costs 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)

Futures, Options and Swap Contracts (continued)

Deferred gains (losses) at year end associated with recording derivatives at fair market value were ($16,024) and $9,324 for the years ending 2006 and 2005, respectively. Deferred costs at year end associated with gains (losses) on closed positions for the years ending 2006 and 2005 were ($20,669) and $1,145 respectively.

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 net assets – 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 records 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 for its use of the Electric Division's power transmission facilities in supplying power to MLGW.

1. Summary of Significant Accounting Policies (continued)

Revenues and Expenses (continued)

Operating expenses include the cost of purchased power and gas, water production costs, operation and maintenance 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 $49,156 and $50,840 for the years ended December 31, 2006 and 2005, respectively.

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 2005 financial statements have been reclassified to conform to the 2006 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. For the years ending 2006 and 2005, receivables from related parties for utility construction, pole rentals and utility related services excluding utility bills were $3,745 and $2,889. 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 $2,078 and $1,740 for 2006 and 2005, respectively.

(Dollars in Thousands)

2. Deposits and Investments

On January 1 2005, MLGW adopted the provision of GASB Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3*. This statement establishes and modifies disclosure requirements for state and local governments related to deposit and investment risks. As of December 31, 2006, the bank balances of MLGW cash deposits were fully insured or collaterized with securities held by MLGW or its agent in MLGW's name. MLGW had the following investments:

Investment	**Fair Value**	**Maturities < 1 year**	**Maturities 1 to 5 years**
U.S. Treasuries	$ 26,221	$ -	$ 26,221
Federal Agency (Fixed Rate)	26,500	4,515	21,985
Federal Agency (Callable)	7,035	1,184	5,851
Commercial Paper (Rated AA or higher)	157,257	157,257	-
Corporate Bonds/Notes	8,067	1,097	6,970
Certificates of Deposit	3,800	3,800	-
Tennessee LGIP and Mutual Funds	26,701	26,701	-
Asset – Backed Securities	11,909	72	11,837
TOTAL	**$ 267,490**	**$ 194,626**	**$ 72,864**

Credit Risk

MLGW's general investment policy is to apply the Prudent Investor rule which states: Investments shall be made with judgment and care, under circumstances then prevailing which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Repurchase Agreements have a term to maturity of no greater than ninety (90) days and commercial paper maturity is no greater than two hundred-seventy (270) days. If the corporation has senior long term debt it must have a minimum rating of "AA" or equivalent and a short-term debt minimum rating of "A" or equivalent as provided by a majority of the rating services that rate the issuer. Municipal obligations are rated in either of the two highest rating categories by a nationally recognized statistical rating agency. Asset-backed securities are defined as debt securities that have specifically pledged collateral. Each holding shall be rated "Aaa" by Moody's Investors Services or "AAA" by Standard & Poor's and shall have an average maturity life of three years or less.

(Dollars in Thousands)

2. Deposits and Investments (continued)

Concentration of Credit Risk

MLGW's charter specifies that the Board of Commissioners shall be able to make such investments as authorized by state law and as it deems proper. The following securities shall be permitted investments and such portfolio shall be diversified by security type and institution:

U.S. Treasuries	100% maximum
Federal Agency (fixed rate)	100% maximum
Federal Agency (callable)	50% maximum
Repurchase Agreements	50% maximum
Commercial Paper (rated AA or higher)	90% maximum
Bankers' Acceptances (rated AA or higher)	60% maximum
Corporate Notes (medium term)	15% maximum
Certificates of Deposit	20% maximum
Municipal Obligations	20% maximum
Tennessee LGIP and Mutual Funds	40% maximum
Asset – Backed Securities	50% maximum

MLGW's portfolio will be further diversified to limit the exposure to any one issuer. No more than 10% of the portfolio will be invested in the securities of any single issuer except U.S. Government obligations with a maximum percentage of 100%. Furthermore, MLGW is prohibited from investing in the following securities: (1) purchases on margin or short sales; (2) investment in reverse repurchase agreements; and (3) "exotic" derivatives such as range notes, dual index notes, inverse floating rate notes and deleveraged notes, or notes linked to lagging indices or to long-term indices.

Interest Rate Risk

MLGW's investment policy does not limit investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. However, the portfolio shall be managed to accomplish the following hierarchy of investment objectives: (1) preservation of principal, (2) maintenance of liquidity; and (3) maximize return (within the context and parameters set forth in 1 and 2). Those responsible for the day-to-day management of the portfolio will routinely monitor the contents of the portfolio, the available markets and the relative values of competing instruments, and will adjust the portfolio as necessary to meet the investment objectives. Further, no investment will have a maturity of greater than five (5) years from date of purchase, except U.S. Treasury Securities which shall have a maturity not to exceed ten (10) years.

(Dollars in Thousands)

2. Deposits and Investments (continued)

Custodial Credit Risk

MLGW has authorized The Northern Trust Company ("the 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% of the market value of borrowed securities, or at least 105% if the borrowed securities and collateral are denominated in different currencies. The borrower is required to deliver additional collateral when necessary so that the total collateral held by the Agent for all loans to the borrower will at least equal the market value of the securities without a borrower default. The Agent shall issue a safekeeping receipt to MLGW listing the specific instrument, rate, maturity and other pertinent information. On a monthly basis, the Agent will also provide reports which list all securities held for MLGW, the book value of holdings and the market value as of month-end. Appropriate MLGW officials and representatives of the Agent responsible for, or in any manner involved with, the safekeeping and custody process of MLGW shall be bonded in such a fashion as to protect MLGW from losses from malfeasance and misfeasance. In addition, MLGW will not deposit funds through third parties or money brokers.

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, 2006 and 2005:

	Electric Division		**Gas Division**		**Water Division**	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
Restricted funds:						
Common account	**$ 57,200**	$ 17,664	**$ 16,938**	$ 18,539	**$ 11,663**	$ 8,446
Cash and cash equivalents	**27,632**	28,642	**13,485**	15,150	**14,965**	17,663
Total restricted funds	**$ 84,832**	$ 46,306	**$ 30,423**	$ 33,689	**$ 26,628**	$ 26,109
Cash and cash equivalents:						
Common account	**$ 73,147**	$ 69,968	**$ 288**	$ 22,643	**$ 13,555**	$ 11,043
Cash	**217**	124	**16,330**	(7,793)	**–**	–
Total cash and cash equivalents	**$ 73,364**	$ 70,092	**$ 16,618**	$ 14,850	**$ 13,555**	$ 11,043
Investments:						
Investments – common account	**$ 41,102**	$ 41,235	**$ 162**	$ 23,961	**$ 7,616**	$ 6,508

(Dollars in Thousands)

3. Long-Term Receivables

The Electric Division has an unsecured note receivable from a government agency, which amounted to $5,440 and $6,676 as of December 31, 2006 and 2005, respectively. Interest is earned at a fixed rate of 7.723% 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:

2007	$ 1,335
2008	1,442
2009	1,557
2010	1,106
	$ 5,440

The government agency note receivable is included in notes receivable in the accompanying 2006 Electric Division balance sheet, except for the current portion of $1,335, which is included in other current assets.

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

2007	$ 1,712
2008	1,712
2009	1,712
2010	1,712
2011	1,712
Thereafter	7,989
	$ 16,549

The Valero lease receivable is included in notes receivable in the accompanying 2006 Gas Division's balance sheet, except for the current portion of $1,712, which is included in other current assets.

(Dollars in Thousands)

4. Utility Plant

Utility plant activity for the years ended December 31, 2006 and 2005 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2006				
Electric Division				
Capital assets not being depreciated:				
Land	$ 27,509	$ 651	$ –	$ 28,160
Construction in progress	58,996	–	(3,806)	55,190
Total capital assets not being depreciated	86,505	651	(3,806)	83,350
Capital assets being depreciated:				
Structures and improvements	47,514	1,405	(60)	48,859
Transmission and distribution plant equipment	980,237	54,990	(7,837)	1,027,390
General plant equipment	84,147	14,729	(2,647)	96,229
Total capital assets being depreciated	1,111,898	71,124	(10,544)	1,172,478
Less accumulated depreciation	(431,256)	(36,960)	13,421	(454,795)
Total capital assets being depreciated, net	680,642	34,164	2,877	717,683
Total capital assets, net	$ 767,147	$ 34,815	$ (929)	$ 801,033
Gas Division				
Capital assets not being depreciated:				
Land	$ 7,584	$ –	$ –	$ 7,584
Construction in progress	21,498	–	(9,278)	12,220
Plant held for future use	212	–	–	212
Total capital assets not being depreciated	29,294	–	(9,278)	20,016
Capital assets being depreciated:				
Structures and improvements	48,736	3,761	(226)	52,271
Processing and distribution plant equipment	372,524	9,598	(431)	381,690
General plant equipment	84,872	12,968	(2,106)	95,735
Non-utility plant equipment	200	–	–	200
Total capital assets being depreciated	506,332	26,327	(2,763)	529,896
Less accumulated depreciation	(211,064)	(18,714)	3,204	(226,574)
Total capital assets being depreciated, net	295,268	7,613	441	303,322
Total capital assets, net	$ 324,562	$ 7,613	$ (8,837)	$ 323,338

(Dollars in Thousands)

4. Utility Plant (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2006				
Water Division				
Capital assets not being depreciated:				
Land	**$ 3,211**	**$ 36**	**$ –**	**$ 3,247**
Construction in progress	**18,135**	**11,534**	**(18,220)**	**11,449**
Total capital assets not being depreciated	**21,346**	**11,570**	**(18,220)**	**14,696**
Capital assets being depreciated:				
Structures and improvements	**43,523**	**2,997**	**(317)**	**46,203**
Pumping, transmission and distribution plant equipment	**277,949**	**7,871**	**(1,223)**	**284,597**
General plant equipment	**59,773**	**7,315**	**(3,882)**	**63,206**
Total capital assets being depreciated	**381,245**	**18,183**	**(5,422)**	**394,006**
Less accumulated depreciation	**(145,092)**	**(11,464)**	**5,975**	**(150,581)**
Less acquisition adjustment	**(13,007)**	**–**	**964**	**(12,043)**
Total capital assets being depreciated, net	**223,146**	**6,719**	**1,517**	**231,382**
Total capital assets, net	**$ 244,492**	**$ 18,289**	**$ (16,703)**	**$ 246,078**

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2005				
Electric Division				
Capital assets not being depreciated:				
Land	$ 27,229	$ 2,715	$ (2,435)	$ 27,509
Construction in progress	63,504	59,425	(63,933)	58,996
Total capital assets not being depreciated	90,733	62,140	(66,368)	86,505
Capital assets being depreciated:				
Structures and improvements	39,586	8,170	(242)	47,514
Transmission and distribution plant equipment	948,073	39,567	(7,403)	980,237
General plant equipment	79,052	13,480	(8,385)	84,147
Total capital assets being depreciated	1,066,711	61,217	(16,030)	1,111,898
Less accumulated depreciation	(415,761)	(33,240)	17,745	(431,256)
Total capital assets being depreciated, net	650,950	27,977	1,715	680,642
Total capital assets, net	$ 741,683	$ 90,117	$ (64,653)	$ 767,147

(Dollars in Thousands)

4. Utility Plant (continued)

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2005				
Gas Division				
Capital assets not being depreciated:				
Land	$ 7,601	$ (17)	$ 0	$ 7,584
Construction in progress	16,188	19,950	(14,640)	21,498
Plant held for future use	212	0	0	212
Total capital assets not being depreciated	24,001	19,933	(14,640)	29,294
Capital assets being depreciated:				
Structures and improvements	47,214	1,627	(105)	48,736
Processing and distribution plant equipment	365,040	8,234	(750)	372,524
General plant equipment	83,080	4,797	(3,005)	84,872
Non-utility plant equipment	200	0	0	200
Total capital assets being depreciated	495,534	14,658	(3,860)	506,332
Less accumulated depreciation	(196,792)	(17,717)	3,445	(211,064)
Total capital assets being depreciated, net	298,742	(3,059)	(415)	295,268
Total capital assets, net	$ 322,743	$ 16,874	$ (15,055)	$ 324,562

	Beginning Balance	Increases	Decreases	Ending Balance
Water Division				
Capital assets not being depreciated:				
Land	$ 3,215	$ (4)	$ 0	$ 3,211
Construction in progress	19,640	11,561	(13,066)	18,135
Total capital assets not being depreciated	22,855	11,557	(13,066)	21,346
Capital assets being depreciated:				
Structures and improvements	40,951	2,573	(1)	43,523
Pumping, transmission and distribution plant equipment	272,832	5,595	(478)	277,949
General plant equipment	55,778	4,903	(908)	59,773
Total capital assets being depreciated	369,561	13,071	(1,387)	381,245
Less accumulated depreciation	(135,593)	(11,029)	1,530	(145,092)
Less acquisition adjustment	(13,971)	0	964	(13,007)
Total capital assets being depreciated, net	219,997	2,042	1,107	223,146
Total capital assets, net	$ 242,852	$ 13,599	$ (11,959)	$ 244,492

(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 2007 are estimated as follows (unaudited):

Electric Division	$ 67,533
Gas Division	17,451
Water Division	19,716

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

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, 2006 and 2005:

	2006	**2005**
Retirees and beneficiaries receiving benefits	**2,493**	2,443
Terminated plan members entitled to but not yet receiving benefits	**19**	18
Active plan members	**2,600**	2,672
	5,112	5,133

(Dollars in Thousands)

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% 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, MLGW's 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% of plan assets.

Contributions

MLGW's contribution is based on an annual actuarial study and is approved by the Board and City Council. The annual contribution is shared by the employee and MLGW according to MLGW Board policy.

Due to favorable long-term actual investment performance, past contributions have resulted in a net pension asset or surplus contribution which allows for flexibility in the annual contribution made.

The employee's share of the actual contribution has remained at 8% of payroll while MLGW's share is generally above the minimum 8% of payroll required by the Pension resolution. MLGW also funds the 8% employee contribution on behalf of the president and vice presidents.

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
2006	$ 11,129	$ 11,129	100%	$ 19,512	$ 19,630	101%
2005	11,576	11,576	100%	18,683	19,204	103%
2004	10,711	10,711	100%	18,241	16,133	88%

5. Employee Retirement System (continued)

Actuarial Methods and Assumptions

As of December 31, 2006 and 2005, the Pension Plan valuation dates, the asset valuation method used by the actuary 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% per year compounded annually, (b) projected salary increases ranging from 4.50% to 8.16% per year compounded annually, and (c) pensioner cost of living adjustments of 1.05% – 2.63% 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. The actuarial value of assets was estimated at December 31, 2006 to be $1,207,012; the actuarial value as of December 31, 2005 was $1,126,577.

6. Deferred Compensation and Other Post-Employment 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-employment major medical and life insurance benefits available to all employee groups as a continuation of those benefits that were available prior to retirement. Currently, 2,493 retirees and beneficiaries are eligible for post-employment 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-employment benefits are provided for through the insurance reserves for employee benefits to the extent recovered through current revenues.

(Dollars in Thousands)

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

MLGW has established a grantor trust to accumulate funds that will be used to partially pay future post-employment medical benefits for all three divisions. The value of assets in the trust as of December 31, 2006 and 2005 was $64,309 (unaudited) and $54,216 (audited), respectively, and are not included in the accompanying balance sheets.

Post-employment benefit costs for the years ended December 31, 2006 and 2005 are as follows:

	Electric Division		Gas Division		Water Division	
	2006	2005	**2006**	2005	**2006**	2005
Premium payments	**$ 11,135**	$ 10,898	**$ 5,275**	$ 5,162	**$ 3,126**	$ 3,059

7. Debt

Long-term debt as of December 31, 2006 and 2005 consists of the following:

	Interest Rates	2006	2005
Electric Division:			
Electric System Revenue Bonds:			
Series 2002, due serially 2003-2010	3.00-5.00%	**$ 22,140**	$ 27,230
Series 2003A, due serially 2004-2018	2.00-5.00%	**1,084,825**	1,155,995
Series 2003B, due 2017-2018	Variable	**100,000**	100,000
Premium on revenue bonds		**80,290**	93,324
Unamortized deferred cost on bond refunding		**(467)**	(668)
Total		**1,286,788**	1,375,881
Note payable with bank, due serially through 2010	7.58%	**5,737**	6,950
		1,292,525	1,382,831
Less: current portion of bonds and notes payable		**(81,368)**	(77,472)
		$ 1,211,157	$ 1,305,359
Water Division:			
Revenue Refunding Bonds:			
Series 1992, due serially 1993-2006	3.35-6.00%	**$ 0**	$ 2,920
Series 1998, due serially 2000-2012	3.30-5.25%	**8,670**	9,910
Series 2001, due serially 2002-2009	4.00-5.00%	**5,270**	6,880
Premium on revenue bonds		**64**	114
Unamortized deferred cost on bond refunding		**(233)**	(333)
		13,771	19,491
Less: current portion of bonds and notes payable		**(2,975)**	(5,770)
		$ 10,796	$ 13,721

(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, 2006, are as follows:

	Electric Division		Water Division	
	Principal	Interest	Principal	Interest
2007	$ 81,343	$ 57,453	$ 2,975	$ 579
2008	85,260	53,531	3,100	446
2009	89,366	49,326	3,235	311
2010	93,848	44,923	1,465	205
2011	90,420	37,848	1,540	126
2012-2018	772,465	146,441	1,625	43
Total	$ 1,212,702	$ 389,522	$ 13,940	$ 1,710

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%. 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, 2006 for the Series 2003B-1, 2003B-2, and 2003B-3 revenue bonds were 3.79%, 3.44 % and 3.45%, 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 2002, the Electric Division issued $41,625 in revenue bonds to refund $41,905 of Series 1993 revenue bonds. An additional $4,270 of the 1993 revenue bonds was not refunded, but was repaid on January 1, 2003. The refunding was undertaken to reduce total future debt service payments. The reacquisition price exceeded the net carrying value of the old debt by $462. This amount is netted against the carrying value of the new debt and is being amortized over the life of the new debt, which was shorter than the life of the refunded debt.

7. Debt (continued)

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 not be 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, 2006, was 1.99.

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, 2006, was 5.86.

(Dollars in Thousands)

7. Debt (continued)

Long-term debt activity for the years ended December 31, 2006 and 2005 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Year ended December 31, 2006:				
Electric Division				
Bonds and note payable:				
Revenue bonds	**$ 1,283,225**	**$ –**	**$ (76,260)**	**$ 1,206,965**
Premium on revenue bonds	**93,324**	**–**	**(13,034)**	**80,290**
Notes payable	**6,950**	**–**	**(1,213)**	**5,737**
Less deferred amounts:				
For issuance discounts and on refunding	**(668)**	**–**	**201**	**(467)**
Total bonds and note payable	**$ 1,382,831**	**$ –**	**$ (90,306)**	**$ 1,292,525**
Water Division				
Bonds payable:				
Revenue bonds	**$ 19,710**	**$ –**	**$ (5,770)**	**$ 13,940**
Premium on revenue bonds	**114**	**–**	**(50)**	**64**
Less deferred amounts:				
For issuance discounts and on refunding	**(333)**	**–**	**100**	**(233)**
Total bonds payable	**$ 19,491**	**$ –**	**$ (5,720)**	**$ 13,771**
Year ended December 31, 2005:				
Electric Division				
Bonds and note payable:				
Revenue bonds	$ 1,356,140	$ –	$ (72,915)	$ 1,283,225
Premium on revenue bonds	107,133	–	(13,809)	93,324
Note payable	8,074	–	(1,124)	6,950
Less deferred amounts:				
For issuance discounts and on refunding	(1,417)	–	749	(668)
Total bonds and note payable	$ 1,469,930	$ –	$ (87,099)	$ 1,382,831
Water Division				
Bonds payable:				
Revenue bonds	$ 27,150	$ –	$ (7,440)	$ 19,710
Premium on revenue bonds	172	–	(58)	114
Less deferred amounts:				
For issuance discounts and on refunding	(451)	–	118	(333)
Total bonds payable	$ 26,871	$ –	$ (7,380)	$ 19,491

(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 MLGW's 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, 2006 and 2005 are as follows:

	Medical Benefits			Injuries and Damages		
	Electric Division	Gas Division	Water Division	Electric Division	Gas Division	Water Division
Balance – December 31, 2004	$ 5,686	$ 2,694	$ 1,596	$ 2,709	$ 1,053	$ 844
Payments	(24,893)	(11,791)	(6,988)	(1,759)	(773)	(559)
Incurred claims expense	24,063	11,527	6,755	1,062	764	730
Balance – December 31, 2005	4,856	2,430	1,363	2,012	1,044	1,015
Payments	**(25,595)**	**(12,124)**	**(7,184)**	**(1,242)**	**(742)**	**(698)**
Incurred claims expense	**25,061**	**11,997**	**7,034**	**5,145**	**971**	**1,091**
Balance – December 31, 2006	**$ 4,322**	**$ 2,303**	**$ 1,213**	**$ 5,915**	**$ 1,273**	**$ 1,408**

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.

On August 9, 2001, the Tennessee Regulatory Authority (TRA) issued a final order approving the Company's amended and restated operating agreement (dated November 29, 2000) 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.

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 (TRA) approval are to be shared equally by the members. Per the Operating Agreement, allocations of net operating income or loss and distributions are based on cumulative members' contributions, accumulated members' equity (loss), and the sharing ratios.

9. Telecommunications Division (continued)

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 and voting interest. On the contribution date, the sharing ratio of net operating income or loss and distributions is adjusted to reflect the increased capital contribution.

On December 30, 2004, a Note and Warrant Purchase Agreement was entered into between Memphis Networx, LLC; Memphis Broadband, LLC; and MLGW. This agreement specified 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 were secured by a first lien security interest in all assets of the Company and provided for the issuance of warrants, representing, in the aggregate, the right to purchase up to 750,000 units of the Company or an additional 7.5% share in the Company in the event the bridge loan was 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, such loan to bear interest at 8% per annum. Funding of $500 was made on April 25, 2005, and additional funding of $150 was made on May 18, 2005. All of the bridge loans were repaid in full on June 27, 2005.

On June 21, 2005, Memphis Broadband and MLGW entered into a Capital Contribution Allowance Agreement. Under this agreement, Memphis Broadband agreed to provide a guaranty for a loan by the Company of $4,916. The sharing ratios were adjusted from 83.73% and 16.27% for MLGW and Memphis Broadband, respectively to 56.14% and 43.86% for MLGW and Memphis Broadband, respectively. The Capital Contribution Agreement of April 1, 2002, was also terminated.

In March 2006, also pursuant to provisions in the June 21, 2005 agreement, Memphis Broadband provided additional loan guaranties for the Company in the amount of $2,085. The sharing ratios were adjusted from 56.14% and 43.86% for MLGW and Memphis Broadband, respectively to 49.25% and 50.75% for MLGW and Memphis Broadband, respectively.

In June 2007, an agreement was reached to sell Memphis Networx to Communications Infrastructure Investments Holdco, Inc., pending approval by MLGW's Board and the Tennessee Regulatory Authority. This transaction may result in an additional loss for 2007.

(Dollars in Thousands)

9. Telecommunications Division (continued)

Condensed results of operations of the Company for the years ended December 31, 2006 and 2005 are as follows:

	2006	2005
	(unaudited)	
Operating revenue	$ 5,513	$ 3,925
Operating expense	(8,556)	(7,620)
Net loss	$ (3,043)	$ (3,695)

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:

	2006	2005
Share of the Company's loss	$ 1,531	$ 3,695
Investment reduction – Equity Transfer to Memphis Broadband per June 21, 2005 Capital Contribution Agreement	308	2,508
General and administrative expenses	85	67
Total Telecommunications Division loss	$ 1,924	$ 6,270

The Telecommunications Division's investment in the Company of $1,372 and $3,211 as of December 31, 2006 and 2005, respectively, is included in other non-current assets in the accompanying balance sheets of the Electric Division.

10. Energy Supplies

The 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 (Debt).

10. Energy Supplies (continued)

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 from multiple suppliers on multiple pipelines in order to minimize operational and performance risk. MLGW has some short term purchase commitments which are normally for one year or less. MLGW and the Tennessee Energy Acquisition Corporation ("TEAC") entered into a 20 year long term gas purchase contract with volume commitments for the period. Public Energy Authority of Kentucky, Inc. ("PEAK") and MLGW entered into a 5 year term gas purchase contract with volume commitments for the period. Both TEAC and PEAK deals are paid monthly after the gas is received by MLGW for its customers, and therefore these deals present no increased cash flow risk compared to normal physical gas purchases.

11. Rates

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

TVA implemented a rate adjustment effective October 1, 2005, increasing the cost of wholesale power purchased by MLGW by approximately 7.5%. MLGW implemented changes to its retail rate schedules effective with meters read on or after September 26, 2005, to recover the increased cost of wholesale power from its retail customers. The retail effects of the rate adjustment varied by customer class, with the approximate increases being 5.6% for residential customers, 6.2% for commercial customers and 6.8% for industrial customers.

TVA implemented a rate adjustment effective with the April 2006 revenue month, increasing the cost of wholesale power purchased by MLGW by approximately 9.95%. MLGW implemented changes to its retail rate schedules effective with meters read on or after March 27, 2006 to recover the increased cost of wholesale power from its retail customers. The retail effects of the rate adjustment varied by customer class, with the approximate increases being 7.6% for residential customers, 8.4% for commercial customers and 9.2% for industrial customers.

TVA implemented a second adjustment within the year that became effective with the October 2006 revenue month, decreasing the cost of wholesale power purchased by MLGW by approximately 4.5%. MLGW implemented changes to its retail rate schedules effective with meters read on or after September 25, 2006 to reduce the recovery of wholesale power costs from its retail customers. The retail effects of the decrease varied by customer class, with the approximate decreases being 3.5% for residential, 3.9% for commercial customer and 4.2% for industrial customers.

11. Rates (continued)

In addition to the October 1, 2006 wholesale power cost decrease, TVA implemented a Fuel Cost Adjustor (FCA). The FCA is a variable wholesale energy rate that can fluctuate each quarter with TVA's fuel and purchased power costs. The FCA affects energy (per kilowatt-hour) charges for all customers who are not on interruptible rate schedules.

MLGW implemented a gas rate increase of approximately 6.2% 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, increases in uncollectibles, depletion of cash reserves, increases of in lieu of tax payments, and capital expenditures for system improvements.

MLGW retail natural gas rates are adjusted monthly for the Purchased Gas Adjustment (PGA) rider. MLGW gas rate schedules have a projected price of natural gas and related gas storage and transportation. In addition, a (PGA) is applied to customer bills to reflect the difference between the actual cost of gas, storage and transportation in a given month and the projected levels built into the base rate schedules.

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. However, there is no counterparty financial risk for contracts transacted through NYMEX.

MLGW pays a transfer to the City and in lieu of taxes to 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 a transfer to the City for the Water Division based upon an agreement with the City which calls for a payment of $2,500 for each of the fiscal years 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 discussions of MLGW's power contract with TVA and gas purchase commitments.

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. Transfers to City

MLGW makes a transfer to the City of Memphis. Prior to 2005, the transfer to the city was classified as a payment in lieu of tax to the City of Memphis. The change was made to comply with GASB requirements. Each division has its own basis of calculating these transfers.

The Electric Division transfer is based on the formula provided by the State of Tennessee Municipal Electric System Tax Equivalent Law of 1987. The formula includes a property tax equivalency calculation plus 4 % of operating revenue less power costs (three year average).

The Gas Division transfer is 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% of operating revenue less gas costs (three year average).

The Water Division, through an agreement with the City of Memphis, transfers a payment in the amount of $2,500 per year. The agreement is effective through the year 2028.

15. Federal Grant Contributions

During 2006, the Tennessee Emergency Management Agency (TEMA) State Hazard Mitigation Officer completed the closeout compliance review of two outstanding grant projects. In June 2006, the MLGW Water Seismic Retrofit project was finalized with the remaining subgrantee administration funds being applied against an overpayment reimbursement by MLGW to the State of Tennessee. In December 2006, $46 of the $537 accounts receivable balance for the MLGW Lichterman-McCord Hazard Mitigation project was received. The final payment for this project is expected to be received in 2007.

SCHEDULE OF ADDITIONS AND RETIREMENTS TO UTILITY PLANT
(Dollars in Thousands)
DECEMBER 31, 2006

	Electric Division	Gas Division	Water Division
Utility plant in service, December 31, 2005	$ 1,124,064	$ 513,650	$ 371,449
Additions	71,775	26,327	18,220
Retirements	(10,544)	(2,763)	(4,457)
Utility plant in service, December 31, 2006	$ 1,185,295	$ 537,214	$ 385,212

Note: Utility plant in service balances exclude amounts for construction work in process, non-utility property and land held for future use.

(Dollars in Thousands)

	ACCRUAL YIELD	MATURITY DATE	FAIR VALUE
COMMERCIAL PAPER			
	5.221	01/02/2007	$ 1,594
	5.275	01/02/2007	2,538
	5.240	01/02/2007	3,288
	5.242	01/02/2007	2,987
	5.241	01/02/2007	1,992
	5.222	01/02/2007	5,975
	5.227	01/02/2007	7,560
	5.202	01/02/2007	5,975
	5.257	01/02/2007	9,948
	5.261	01/02/2007	2,988
	5.258	01/12/2007	3,488
	5.250	01/16/2007	2,486
	5.214	01/16/2007	1,989
	5.241	01/22/2007	6,561
	5.240	01/22/2007	3,580
	5.242	01/22/2007	2,187
	5.275	01/22/2007	1,987
	5.229	01/12/2007	4,683
	5.250	01/22/2007	3,579
	5.258	01/25/2007	1,890
	5.298	01/25/2007	3,382
	5.262	01/25/2007	1,292
	5.261	01/25/2007	5,169
	5.242	01/25/2007	10,954
	5.228	02/02/2007	10,941
	5.227	02/02/2007	8,555
	5.258	02/02/2007	10,941
	5.226	02/02/2007	4,278
	5.220	01/22/2007	3,079
	5.259	02/09/2007	1,985
	5.236	01/16/2007	1,887
	5.246	01/16/2007	1,787
	5.035	01/16/2007	1,092
	5.250	01/22/2007	1,885
	5.264	01/25/2007	1,341
	5.264	01/25/2007	1,093
	5.275	02/02/2007	1,291
	5.285	02/02/2007	1,788
	5.260	02/09/2007	1,985
	5.264	02/15/2007	1,983
	5.304	02/15/2007	1,884
	5.242	02/20/2007	1,389

(Dollars in Thousands)

		ACCRUAL YIELD	MATURITY DATE	FAIR VALUE
	Total Commercial Paper			$ 157,256
CERTIFICATE OF DEPOSIT				
	Sun Trust Bank	5.240	02/09/2007	$ 3,800
	Total Certificate of Deposit			$ 3,800
MUTUAL FUNDS				
	Northern Institutional Diversified Assets			$ 2,439
	Federated Treas Obligations FD 398			24,262
	Total Mutual Funds			$ 26,701
CASH				25,738
TOTAL CASH AND CASH EQUIVALENTS				$ 213,495
TREASURY NOTES				
		(0.086)	07/31/2008	$ 501
	Total Treasury Notes			$ 501
U. S. GOVERNMENT BONDS				
		3.500	11/15/2009	$ 1,548
		3.875	05/15/2010	1,462
		3.000	02/15/2009	1,928
		4.750	11/15/2008	1,398
		4.375	12/15/2010	1,631
		5.125	06/30/2008	95
		4.875	07/31/2011	2,518
		4.500	09/30/2011	743
		4.875	10/31/2008	971
		4.875	04/30/2008	1,998
		4.625	11/30/2008	832
		4.500	11/30/2011	991
		4.875	08/15/2009	752
		4.875	10/31/2008	2,021
		3.000	02/15/2008	954
		3.250	08/15/2008	1,122
		4.625	09/30/2008	1,514
		4.500	02/15/2009	745
		4.625	11/15/2009	1,246
		4.875	05/31/2008	1,249
	Total U.S. Government Bonds			$ 25,718

(Dollars in Thousands)

	ACCRUAL YIELD	MATURITY DATE	FAIR VALUE
U.S. GOVERNMENT AGENCIES			
	4.250	07/15/2009	$ 983
	3.250	01/15/2008	1,471
	3.875	02/15/2010	969
	12.250	12/15/2008	283
	5.800	01/14/2008	50
	3.680	06/26/2008	34
	3.240	02/26/2007	499
	3.625	04/22/2009	970
	3.625	05/19/2008	147
	4.000	02/20/2009	171
	4.125	04/27/2007	199
	4.200	05/19/2010	682
	4.250	06/30/2008	247
	4.350	03/10/2010	147
	4.560	04/11/2008	139
	5.670	02/26/2009	81
	5.865	09/02/2008	10
	5.750	05/15/2008	202
	6.050	05/27/2008	56
	2.465	05/11/2007	248
	5.545	02/17/2009	15
	5.940	08/28/2008	101
	4.000	02/20/2009	245
	3.375	10/15/2007	986
	5.125	06/13/2008	500
	4.750	08/17/2007	997
	4.000	10/27/2008	83
	3.750	07/16/2008	591
	4.400	07/28/2008	183
	5.420	09/23/2008	10
	5.425	09/24/2008	50
	5.890	06/30/2008	30
	5.900	03/26/2009	507
	5.930	03/03/2008	101
	6.060	05/21/2008	25
	3.500	07/30/2008	269
	6.135	02/15/2011	209
	2.050	01/02/2007	1,000
	4.000	12/03/2007	198

(Dollars in Thousands)

	ACCRUAL YIELD	MATURITY DATE	FAIR VALUE
U. S. GOVERNMENT AGENCIES (cont.)			
	3.000	11/18/2009	$ 494
	4.850	12/01/2009	158
	4.250	03/28/2008	494
	6.700	06/19/2007	252
	2.560	03/02/2007	199
	4.750	12/15/2010	467
	6.000	06/29/2010	1,002
	2.625	09/17/2007	363
	3.000	12/17/2007	490
	4.250	10/10/2008	2,073
	4.125	02/15/2008	988
	4.000	06/13/2008	788
	4.625	12/19/2008	1,241
	4.000	12/15/2009	1,266
	3.875	06/15/2008	590
	5.125	04/18/2008	1,000
	5.250	05/21/2009	528
	2.500	06/15/2008	723
	3.250	08/15/2008	972
	5.250	01/15/2009	603
	6.625	09/15/2009	260
	4.875	04/15/2009	499
	5.550	05/04/2009	1,000
Total U.S. Government Agencies			$ 30,138
CORPORATE BONDS			
Citigroup Inc Global	3.500	02/01/2008	$ 982
Fleet Natl Bank	5.750	01/15/2009	808
Gen Elec Cap Corp	4.125	03/04/2008	988
Walmart Stores Inc	6.875	08/10/2009	1,042
Franchise Fin Corp	7.070	01/15/2008	335
Gen Elec Cap Corp	4.800	05/30/2008	644
Natl Cy Bk Clev	3.375	10/15/2007	256
Premark Intl Inc	6.875	11/15/2008	514
PVTPL CMO 3M	5.620	07/15/2009	124
World Svgs Bk FSB	4.125	03/10/2008	491
Fleet Boston Finl	4.200	11/30/2007	841
Walmart Stores Inc	6.875	08/10/2009	1,042
Total Corporate Bonds			$ 8,067

(Dollars in Thousands)

ASSET-BACKED SECURITIES

Banc of Amer Secs	4.080	04/18/2010	$ 984
Bk One Auto	2.430	03/20/2010	637
BMW Veh	2.670	03/25/2008	15
Cap Auto Receivables	5.040	05/17/2010	947
Carmax Auto	4.910	01/18/2011	994
Caterpillar Finl Asset	3.130	01/25/2009	306
Caterpillar Finl TR	5.570	05/25/2010	1,006
Citibank Cr Card	5.300	05/20/2011	1,005
Honda Auto Receivables	2.790	03/16/2009	595
John Deere	5.380	07/15/2010	1,003
MBNA Cr Card	4.300	02/15/2011	987
Nissan Auto Lease	4.700	10/15/2008	997
Toyota Auto Receivables	2.790	01/15/2010	697
USAA Auto Owner	3.900	07/15/2009	675
Volkswagen Auto Lease	3.940	10/20/2010	990
Walmart Store Inc	7.490	06/21/2007	71
Total Asset-Backed Securities			$ 11,909

GOVERNMENT MORTGAGE BACKED SECURITIES

	ACCRUAL YIELD	MATURITY DATE	FAIR VALUE
FHLMC	4.500	10/01/2007	$ 104
FHLMC Gold	5.000	08/01/2007	65
FHLMC Gold	5.000	12/01/2007	99
FHLMC Gold	5.000	01/01/2008	102
FNMA Pool	5.500	09/01/2008	75
FNMA Pool	5.500	10/01/2008	205
FNMA Pool	5.500	01/01/2009	412
FNMA Pool	5.500	05/01/2009	56
FNMA Pool	5.500	06/01/2009	79
FNMA Pool	5.500	09/01/2009	21
FNMA Pool	5.500	12/01/2009	17
FNMA Pool	5.500	06/01/2008	106
FHLMC	3.500	07/01/2008	214
FHLMC Gold	3.500	08/01/2008	450
FNMA Pool	4.000	06/01/2010	1,395
Total Government Mortgage Backed Securities			$ 3,400

FAIR VALUE OF FUTURES	$ (17,554)
ACCRUED INTEREST	$ 1,058
TOTAL CASH AND INVESTMENTS	$ 276,732

SCHEDULE OF LONG TERM DEBT,
PRINCIPAL AND INTEREST REQUIREMENTS
(Dollars in Thousands)
DECEMBER 31, 2006

	Series 2002		Series 2003A		Series 2003B	
	Principal	**Interest**	**Principal**	**Interest**	**Principal**	**Interest**
Electric Division:						
2007	$ 5,240	$ 904	$ 74,795	$ 53,699	$	$ 2,460
2008	5,410	734	78,440	50,050		2,460
2009	5,635	518	82,210	46,171		2,460
2010	5,855	295	86,495	42,110		2,460
2011			90,420	37,848		2,460
2012			95,190	33,414		2,460
2013			99,700	28,677		2,460
2014			104,675	23,817		2,460
2015			109,905	18,584		2,460
2016			115,270	13,110		2,460
2017			88,075	7,347	33,000	2,255
2018			59,650	2,966	67,000	1,511
Total	$ 22,140	$ 2,451	$1,084,825	$ 357,793	$ 100,000	$ 28,366

	Note Payable – Bank	
	Principal	**Interest**
Electric Division:		
2007	$ 1,308	$ 390
2008	1,410	287
2009	1,521	177
2010	1,498	58
Total	$ 5,737	$ 912

SCHEDULE OF LONG TERM DEBT,
PRINCIPAL AND INTEREST REQUIREMENTS
(Dollars in Thousands)
DECEMBER 31, 2006
(Continued)

	Series 1998		Series 2001	
	Principal	**Interest**	**Principal**	**Interest**
Water Division:				
2007	$ 1,285	$ 388	$ 1,690	$ 191
2008	1,350	329	1,750	117
2009	1,405	272	1,830	39
2010	1,465	205		
2011	1,540	126		
2012	1,625	43		
Total	$ 8,670	$ 1,363	$ 5,270	$ 347

Electric Division Rate Class	Base Charge	Customers
<u>Residential</u>	Effective meters read on or after September 25, 2006.	365,193
Customer charge:	$11.20 per month, less hydro allocation credit: $1.71	
Energy charge:	First 2,000 kWh per month at 6.844 cents per kWh; Additional kWh per month at 7.698 cents per kWh	
<u>General Service – Schedule GSA</u>	Effective meters read on or after September 25, 2006. If (a) the higher of (i) the customer's currently effective contract demand, if any, or (ii) its highest billing demand during the latest twelve-month period is not more than 50 kW, and (b) customer's monthly energy taking for any month during such period does not exceed 15,000 kWh:	44,237
Customer charge:	$15.52 per delivery point per month	
Energy charge:	7.891 cents per kWh If (a) the higher of (i) the customer's currently effective contract demand or (ii) its highest billing demand during the latest twelve-month period is greater than 50kW but not more than 1,000 kW, or (b) if the customer's billing demand is less than 50kW and its energy takings for any month during such period exceed 15,000 kWh.	
Customer charge:	$53.42 per delivery point per month	
Demand charge:	First 50kW of billing demand per month, no demand charge Excess over 50kW of billing demand per month, at $11.92 per kW	
Energy charge:	First 15,000 kWh per month at 8.475 cents per kWh Additional kWh per month at 3.939 cents per kWh If the higher of the customer's currently effective contract demand or its highest billing demand during the latest twelve-month period is greater than 1.000 kW.	
Customer charge:	$191.84 per delivery point per month	
Demand charge:	First 1,000 kW of billing demand per month, at $11.44 per kW Excess over 1,000 kW of billing demand per month, at $13.09 per kW, plus an additional $13.09 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds the higher of 2,500 kW or its contract demand	
Energy charge:	4.239 cents per kWh per month The above rates are subject to adjustment under the Provisions of the TVA Fuel Cost and Purchased Power Adjustment Rider.	

Electric Division Rate Class (cont.)	**Base Charge**	**Customers**
General Service – Schedule GSB	Effective meters read on or after September 25, 2006.	15
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$13.41 per kW of billing demand per month, plus an additional $13.41 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	First 620 hours use of metered demand per month at 3.554 cents per kWh Additional kWh per month at 2.901 cents per kWh The above rates are subject to adjustment under the Provisions of the TVA Fuel Cost and Purchased Power Adjustment Rider.	
General Service – Schedule GSC	Effective meters read on or after September 25, 2006.	1
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$12.88 per kW of billing demand per month, plus an additional $12.88 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	First 620 hours use of metered demand per month at 3.554 cents per kWh Additional kWh per month at 2.901 cents per kWh	
General Service – Schedule GSD	Effective meters read on or after September 25, 2006.	0
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$15.48 per kW of billing demand per month, plus an additional $15.48 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	2.783 cents per kWh per month	
Manufacturing – Schedule MSB	Effective meters read on or after September 25, 2006. If the customer's metered demand for the month is not more than 5,000 kW:	11
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$11.52 per kW of billing demand per month, plus an additional $11.52 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	

Electric Division Rate Class (cont.)	Base Charge	Customers
Energy charge:	First 620 hours use of metered demand per month at 3.010 cents per kWh Additional kWh per month at 2.456 cents per kWh If the customer's metered demand for the month is greater than 5,000 kW:	
Customer charge:	$1,500.00 per delivery point per month	
Demand charge:	$10.95 per kW billing demand per month, plus an additional $10.95 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	First 620 hours use of metered demand per month at 2.861 cents per kWh Additional kWh per month at 2.336 cents per kWh The above rates are subject to adjustment under the Provisions of the TVA Fuel Cost and Purchased Power Adjustment Rider.	
<u>Manufacturing – Schedule MSC</u>	Effective meters read on or after September 25, 2006.	2
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$10.42 per kW of billing demand per month, plus an additional $10.42 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	First 620 hours use of metered demand per month at 2.861 cents per kWh Additional kWh per month at 2.336 cents per kWh	
<u>Manufacturing – Schedule MSD</u>	Effective meters read on or after September 25, 2006.	3
Customer charge:	$1,500 per delivery point per month	
Demand charge:	$12.51 per kW of billing demand per month, plus an additional $12.51 per kW per month for each kW, if any, of the amount by which the customer's billing demand exceeds its contract demand	
Energy charge:	2.250 cents per kWh per month The above rates are subject to adjustment under the Provisions of the TVA Fuel Cost and Purchased Power Adjustment Rider.	
<u>Outdoor Lighting</u>	Effective meters read on or after September 25, 2006. Part A – Charges for street and park lighting systems, traffic signal systems, and athletic field lighting installations.	16,996
Energy charge:	5.299 cents per kWh per month The above rates are subject to adjustment under the Provisions of the TVA Fuel Cost and Purchased Power Adjustment Rider.	

Electric Division Rate Class (cont.)	**Base Charge**	**Customers**
Outdoor Lighting Facilities charge:	The annual facility charge shall be 9.84% of the installed cost to the Division's electric system of the facility devoted to street and park lighting service specified in this Part A. Such installed cost shall be recomputed on July 1 of each year, or more often if substantial changes in the facilities are made. Each month, one-twelfth of the then total annual facility charge shall be billed to the customer. If any part of the facilities has not been provided at the electric system's expense or if the installed cost of any portion thereof is reflected on the books of another municipality or agency or department, the annual facility charge shall be adjusted to reflect properly the remaining cost to be borne by the electric system.	

Traffic signal systems and athletic field lighting installations shall be provided, owned, and maintained by and at the expense for the customer, except as Division may agree otherwise in accordance with the provisions of the paragraph next following in this section. The facilities necessary to provide service to such systems and installations shall be provided by and at the expense of Division's electric system, and the annual facility charge provided for first above in this section shall apply to the installed cost of such facilities.

When so authorized by policy duly adopted by Division's governing board, traffic signal systems and athletic field lighting installations may be provided, owned and maintained by Division's electric system for the customer's benefit. In such cases Division may require reimbursement from the customer for a portion of the initial installed cost of any such system or installation and shall require payment by the customer of a facility charge sufficient to cover all of Division's costs (except reimbursed costs), including appropriate overheads, of providing, owning, and maintaining such system or installation; provided that, for athletic field lighting installations, such facility charge shall in no case be less than 12% per year of such costs. Said facility charge will be in addition to the annual facility charge on the facilities necessary to provide service to such system or installation as provided for in the preceding paragraph.

Part B – Charges for outdoor lighting for individual customers – charges per fixture per month

(a) Type of fixture	**Watts**	**Lamp Size (Lumens)**	**Rated (kWh)**	**Charge**
Mercury Vapor or Incandescent	175	7,650	70	$2.95
	250	10,400	98	3.49
	400	19,100	155	4.42
	700	33,600	266	5.96
	1,000	47,500	378	7.59
Metal Halide	175	8,300	70	2.95
	250	14,000	98	3.49
	400	22,600	155	4.42
	1,000	88,000	378	7.59

Electric Division Rate Class (cont.)	Base Charge				Customers
High Pressure Sodium	50	3,285	22	4.19	
	100	8,550	42	4.48	
	150	14,400	63	4.61	
	200	18,900	82	5.01	
	250	23,000	105	5.30	
	400	45,000	165	6.29	
	1,000	126,000	385	10.05	

Gas Division Rate Class	Base Charge	Customers
Residential G-1 & G-3	Effective December 28, 2004 Schedule G-1 is available for domestic use to residential customers in individual private residences or other individual dwelling units situated within the corporate limits of the City of Memphis, Tennessee. Schedule G-3 is available for domestic use to residential customers in individual private residences or other individual dwelling units situated outside the corporate limits of the City of Memphis, Tennessee.	296,178
Service charge:	$ 7.00 per month plus	
Commodity charge:	All gas consumed: $0.7192 per Ccf per month, plus The above rates are subject to adjustment under the provisions of the Purchased Gas Adjustment Rider.	
Minimum bill:	$7.00 per meter per month	
Small General Service G-7	Effective December 28, 2004 This rate schedule is available for gas service to all gas customers except residential	22,413
Service charge:	$18.00 per month plus,	
Commodity charge:	All gas consumed: $0.7198 per Ccf per month, plus The above rates are subject to adjustment under the provisions of the Purchased Gas Adjustment Rider.	
Minimum bill:	The minimum monthly bill shall be $.6539 for each Ccf of the higher of: (1) The maximum daily demand during the preceding eleven months, or (2) The daily contract demand, but in no case less than $18.00.	
Large General Service Firm on-peak G-8 and G-9	Effective December 28, 2004 This rate schedule is available for gas service to all customers contracting for not less than 100 Ccf of maximum daily demand.	505

Gas Division Rate Class (cont.)	Base Charge	Customers
Demand charge:	$0.609 Ccf per month of contract demand or maximum daily demand during the twelve (12) months ending with the billing month, whichever is higher, plus First 200,000 Ccf per month @ $0.5698 Ccf Excess over 200,000 Ccf per month @ $0.5015 Ccf, plus The above rates are subject to adjustment under the provisions of the Purchased Gas Adjustment Rider.	
Minimum bill:	The minimum bill shall be $.9035 for Ccf of the higher of: (1) the maximum Daily Demand during the twelve (12) months ending with the billing month, or (2) the Daily Contract Demand. Sales and transportation usage is combined when calculating the minimum bill.	
<u>Large General Service Interruptible Off-peak G-10 and G-12</u>	Effective December 28, 2004 This rate schedule is available for gas service to all customers contracting for not less than 1,500 Ccf of maximum daily demand and providing all or other alternate fuel facilities approved by the Division as being adequate in design and capacity.	35
Service charge:	$301.42 per month, plus First 200,000 Ccf per month @ $0.5513 Ccf Excess over 200,000 Ccf per month @ $0.5015 per Ccf, plus The above rates are subject to adjustment under the provisions of the Purchased Gas Adjustment Rider.	
Minimum bill:	The minimum monthly bill shall be $.3496 for each Ccf of the higher of (1) the maximum daily demand during the twelve months ending with the billing month, or (2) the daily contract demand, but in no event less than $301.42.	
<u>General Service Seasonal Off-peak G-17</u>	Effective December 28, 2004 Schedule G-17 is available for gas service from April 1 through October 31 of any year to all customers contracting for not less than 250 Ccf of maximum daily demand and providing oil or other alternative fuel facilities approved by the Division as being adequate in design and capacity.	0
Monthly rate:	(Ccf equals 100 cubic feet)	
All gas consumed:	$0.6158 per Ccf, plus The above rates are subject to adjustment under the provisions of the Purchased Gas Adjustment Rider.	

Gas Division Rate Class (cont.)	**Base Charge**	**Customers**
Minimum bill:	The minimum monthly bill shall be $0.3661 for each Ccf of the higher of: (1) the maximum daily demand during the preceding eleven (11) months, or (2) the daily contract demand, but in no case less than $217.47	
Schedule PGA: Purchase Gas Adjustment Rider	Effective November 4, 1996 All retail rates for natural gas may be adjusted for changes in MLGW's cost of gas, storage, and transportation at the discretion of MLGW. Adjustments may be made on a monthly basis using an estimate of future costs and adjusting for actual costs incurred.	

Water Division Rate Class	**Base Charge**	**Customers**
Residential – Inside City Rate	Effective meters read on or after December 30, 2003 For water furnished to premises entirely within the corporate limits of the City of Memphis	186,662
Commodity charge:	All water consumed: $1.1406 per Ccf per month	
Minimum bill:	The minimum monthly bill shall be determined by the size of the meter installed, as follows: 5/8" meter $ 4.81 3/4" meter 6.94 1" meter 12.33 1-1/2" meter 27.74 2" meter 49.32	
Residential – Outside City Rate	Effective meters read on or after December 30, 2003 For water furnished to premises outside the corporate limits of the City of Memphis	20,542
Commodity charge:	All water consumed: $1.7750 per Ccf per month	
Minimum bill:	The minimum monthly bill shall be determined by the size of the meter installed, as follows: 5/8" meter $ 6.70 3/4" meter 9.64 1" meter 17.16 1-1/2" meter 38.60 2" meter 68.61	
General Service – Inside City Rate	Effective meters read on or after December 30, 2003 For water service to all customers within the corporate limits of the City of Memphis, except residential customers	18,986
Commodity charge:	Water consumed per month:	

Water Division Rate Class (cont.)	Base Charge		Customers
	First 30 Ccf	$1.4558 per Ccf	
	Next 70 Ccf	$1.2353 per Ccf	
	Next 100 Ccf	$0.9412 per Ccf	
	Next 400 Ccf	$0.7866 per Ccf	
	Next 5,400 Ccf	$0.6044 per Ccf	
	Excess over 6,000 Ccf	$0.6323 per Ccf	
Minimum bill:	The minimum monthly bill shall be determined by the size of the meter installed, as follows:		
	5/8" meter	$9.23	
	3/4" meter	10.75	
	1" meter	18.44	
	1-1/2" meter	36.90	
	2" meter	76.91	
	3" meter	153.77	
	4" meter	229.95	
	6" meter	290.89	
	8" meter	351.85	
	10" meter	728.85	
	12" meter	1,016.99	
	14" meter	1,398.37	
	Battery of 2-2" meters	153.77	
	Battery of 3-2" meters	229.95	
General Service – Outside City Rate	Effective meters read on or after December 30, 2003 For water service to all customers outside the corporate limits of the City of Memphis, except residential customers		744
Commodity charge:	Water consumed per month:		
	First 30 Ccf	$2.1784 per Ccf	
	Next 70 Ccf	$1.8341 per Ccf	
	Next 100 Ccf	$1.3998 per Ccf	
	Next 400 Ccf	$1.1753 per Ccf	
	Next 5,400 Ccf	$0.9179 per Ccf	
	Excess over 6,000 Ccf	$0.9583 per Ccf	

Water Division Rate Class (cont.)	Base Charge	Customers
Minimum bill:	The minimum monthly bill shall be determined by the size of the meter installed, as follows:	

5/8" meter	$14.10
3/4" meter	16.46
1" meter	28.21
1-1/2" meter	56.41
2" meter	117.54
3" meter	235.12
4" meter	351.38
6" meter	444.52
8" meter	537.65
10" meter	1,113.75
12" meter	1,554.06
14" meter	2,135.38
Battery of 2-2" meters	235.12
Battery of 3-2" meters	351.38

<u>Residential – Shelby County Water Distribution System</u>

Effective meters read on or after December 30, 2003 — Customers: 23,170

For water service within the area served by the Shelby County Water Distribution System at the time of its acquisition on June 30, 1999, for domestic uses to residential customers in individual private residences or other individual dwelling places.

Monthly rate: All water consumed $1.7750 per Ccf per month

Minimum bill: The minimum monthly bill shall be determined by the size of the meter installed, as follows:

5/8" meter	$6.70
3/4" meter	9.64
1" meter	17.16
	38.60
1-1/2" meter	68.61
2" meter	

Residential customers shall be served through a single meter not larger than 2” in size.

<u>Commercial - Industrial – Shelby County Water Distribution System</u>

Effective meters read on or after December 30, 2003 — Customers: 623

For water service within the area served by the Shelby County Water Distribution System at the time of its acquisition on June 30, 1999, for all customers except residential customers using service exclusive for domestic use.

Water Division Rate Class (cont.)	Base Charge	Customers

Monthly rate:

Water consumed per month:

First 30 Ccf	$2.1784 per Ccf
Next 70 Ccf	$1.8341 per Ccf
Next 100 Ccf	$1.3998 per Ccf
Next 400 Ccf	$1.1753 per Ccf
Next 5,400 Ccf	$0.9179 per Ccf
Excess over 6000 Ccf	$0.9583 per Ccf

Minimum bill:

The minimum monthly bill shall be determined by the size of the meter installed, as follows:

5/8" meter	$14.10
3/4" meter	16.46
1" meter	28.21
1-1/2" meter	56.41
2" meter	117.54
3" meter	235.12
4" meter	351.38
6" meter	444.52
	537.65
8" meter	1,113.75
	1,554.06
10" meter	2,135.38
12" meter	
14" meter	

SCHEDULE OF INSURANCE
(Thousands of Dollars)
FOR DECEMBER 31, 2006

Type of Coverage	Amount of Coverage
Property	$500,000
Boiler and Machinery	100,000
LNG Plants	100,000
Crime	1,000
Travel Accident	1,000

WATKINS UIBERALL
Watkins Uiberall, PLLC
Certified Public Accountants & Financial Advisors
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BANKS, FINLEY, WHITE & CO.
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

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

We have audited the 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, 2006, and have issued our report thereon dated June 14, 2007. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Divisions' internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Divisions' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Divisions' internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency or combination of control deficiencies, that adversely affects the Divisions' ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Divisions' financial statements that is more than inconsequential will not be prevented or detected by the

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Divisions' internal control. We consider the deficiencies described in the accompanying schedule of findings and responses to be significant deficiencies in internal control over financial reporting. They are shown as 2006-1, 2006-2, and 2006-3.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Divisions' internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider item 2006-3 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Divisions' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Divisions' response to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the Divisions' response and accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Audit Committee, Board of Commissioners, management, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Watkins Uiberall, PLLC
Banks, Finley, White

Memphis, Tennessee
June 14, 2007

SCHEDULE OF FINDINGS AND RESPONSES

Finding 2006-1 - Records of Materials Received Report

There are old outstanding items on the Record of Materials Received (RMR) report dating back as early as 2003. This report lists inventory items that have been received but have yet to hit the accounts payable listing. When invoices are received they are matched to the items on the RMR report, removed from the report, and placed into accounts payable. This transaction debits inventory and credits accounts payable. At year-end, the RMR report did not accurately reflect inventory received and not yet processed for payment. Since all inventory is adjusted through a clearing account and ultimately the clearing account is adjusted to zero, expense had to be recognized for errors on the report.

We recommend the RMR report be adjusted to include the date of the RMR receipt date. The system should also be adjusted to kick out RMRs aged beyond a certain time such as 90 days. Items over 90 days would then be investigated for accuracy.

Management's response:

Management agrees with this recommendation and will work with Information Services to implement the required modifications.

Finding 2006-2 - Unused Sick Liability

The unused sick leave liability is recorded for all employees not eligible for retirement who have accrued sick leave in excess of 100 days and for all employees eligible for sick leave regardless of the number of sick days accrued. Employees not yet eligible for retirement may sell unused sick days back to MLGW at 42% pay for all unused sick days in excess of 100 days. Employees not eligible for retirement with unused sick leave in excess of 100 days are being accrued at 100% of the 42% pay. However, not all these employees will ultimately retire and earn the benefit. This accrued amount would, therefore, be over-accrued for this class. However, employees who do not have 100 days of unused sick leave are not accrued even though they may ultimately retire.

We recommend that an actuary be used to calculate unused sick leave for employees not yet eligible to retire, which would create a more accurate picture of the true liability for unused sick leave for financial statement purposes as well as a more steady change in the liability.

Management's response:

Management will evaluate the use of an actuary for purposes of accruing unused sick leave liability.

Finding 2006-3 Prior Period Adjustment

A prior period adjustment was made during the year for $4,343,673 for income incorrectly deferred related to the LNG storage tank. It was determined by management that too much income had been deferred related to advance collections from customers to fill the storage tank. This prior-period adjustment affected the financial statements in two ways. It restated the January 1, 2005 beginning net assets and restated earnings for 2005. The January 1, 2005 net assets were increased by $2,530,158. Income in 2005 was increased $1,813,515.

Because the LNG tank was drained in 2007, the balance in the account is currently zero.

Management's response:

Additional levels of internal review will be instituted for transactions involving gas revenue and costs due to the number and complexity of these transactions. In addition, the advance collection of gas costs for storage injection has been discontinued by management.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2006
(Dollars in Thousands)

Federal Grantor/Pass-Through Grantor	CFDA Number	Contract Number	Beginning (Accrued) Deferred	Cash Receipts	Expenditures	Overpayment Refund Due by MLGW	Net Payment Made by MLGW to TEMA	Ending (Accrued) Deferred
Federal Awards								
FEMA	97.039	GR-02-14575-00*	$ (18)	$ -	$ -	$ 132	$ (114)	$ -
FEMA	97.039	GG-01-13847-00	$ (537)	$ 46	$ -	$ -	$ -	$ (492)
Total Federal Awards			$ (555)	$ 46	$ -	$ 132	$ (114)	$ (492)

See accompanying notes to schedule of expenditures of federal awards.

*Note: In December 2005, State of Tennessee Hazard Mitigation representatives performed the closeout audit on FEMA Contract #GR-02-14575-00. Shortly thereafter, the determination was made that the federal share payments exceeded the project expenditures eligible for reimbursement by $132. As a result, the 2005 Ending (Accrued) subgrantee administration portion balance of ($22), due MLGW, was reduced to ($18), as reflected on the 2006 Beginning (Accrued) amount shown on the above schedule. In June 2006, MLGW applied the remaining subgrantee administration funds of ($18) against the $132 in overpayments, and reimbursed the State of Tennessee a net payment of $114.

General

The accompanying schedule of Expenditures of Federal Awards (the Schedule) presents the grant activity of the federal award programs of the Electric, Gas and Water divisions of Memphis Light, Gas and Water Division, an enterprise fund of the City of Memphis, Tennessee, for the year ended December 31, 2006. The schedule is prepared on the accrual basis of accounting and is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations.* MLGW generally follows the Federal Energy Regulatory Commission's Uniform System of Accounts prescribed for Public Utilities.


MLGW