

**HOUSTON INDUSTRIES INCORPORATED**  
**d/b/a RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

cost trend rate assumptions were decreased by 1%, the accumulated postretirement benefit obligation as of December 31, 1998 would be decreased by approximately 4.3%. The annual effect of the 1% decrease on the total of the service and interest costs would be a decrease of 4.6%.

In 1998, the Company's board of directors approved an amendment, effective January 1, 1999, which created an account balance based on credited service at December 31, 1998. Under the new plan, each participant has an account, for recordkeeping purposes only, to which a \$750 credit is allocated annually. This account balance vests after 5 years of service after age 50. At retirement the account balance can be used to purchase medical benefits. It may not be taken as cash.

The purpose of the plan change is to continue to provide uniform retiree medical benefits across all employee groups, which are competitive both within the utility industry as well as with other companies within the United States.

The Company will continue to reflect the costs of the retiree medical plan according to the provisions of SFAS No. 106 as amended by SFAS No. 132. As a result of the January 1, 1999 amendment, which is reflected in the December 31, 1998 disclosure, the Company's benefit obligation increased \$99 million. The plan amendment had no impact on 1998 expense.

The actuarial loss is due to changes in certain actuarial assumptions.

*(e) Postemployment Benefits.*

The Company records postemployment benefits based on SFAS No. 112, "Employer's Accounting for Postemployment Benefits," which requires the recognition of a liability for benefits provided to former or inactive employees, their beneficiaries and covered dependents, after employment but before retirement (primarily health care and life insurance benefits for participants in the long-term disability plan). Net postemployment benefit costs were not material in 1998, 1997 and 1996.

**(11) Income Taxes**

The Company records income taxes under SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109), which, among other things, (i) requires that the liability method be used in computing deferred taxes on all temporary differences between book and tax bases of assets other than nondeductible goodwill; (ii) requires that deferred tax liabilities and assets be adjusted for an enacted change in tax laws or rates; and (iii) prohibits net-of-tax accounting and reporting. SFAS No. 109 requires that regulated enterprises recognize such adjustments as regulatory assets or liabilities if it is probable that such amounts will be recovered from or returned to customers in future rates.

The Company's current and deferred components of income tax expense (benefit) are as follows:

	Year Ended December 31,		
	1998	1997	1996
	(Thousands of Dollars)		
Current.....	\$ 439,322	\$ 199,011	\$ 150,658
Deferred.....	(469,754)	7,363	49,507
Income taxes.....	<u>\$ (30,432)</u>	<u>\$ 206,374</u>	<u>\$ 200,165</u>

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The Company's effective income tax rates are lower than statutory corporate rates for each year as follows:

	Year Ended December 31,		
	1998	1997	1996
	(Thousands of Dollars)		
Income (loss) before income taxes.....	\$ (171,524)	\$ 627,484	\$ 605,109
Preferred dividends of subsidiary .....		2,255	22,563
Total .....	(171,524)	629,739	627,672
Statutory rate .....	35%	35%	35%
Income taxes at statutory rate .....	(60,033)	220,409	219,685
Net addition (reduction) in taxes resulting from:			
State income taxes, net of federal income tax benefit.....	16,853	(9)	
Amortization of investment tax credit .....	(20,123)	(19,777)	(18,404)
Excess deferred taxes.....	(4,011)	(5,570)	(4,331)
Difference between book and tax depreciation for which deferred taxes have not been normalized .....	37,069	27,466	22,638
Equity dividend exclusion.....	(980)	(5,075)	(10,194)
Equity income - foreign affiliates.....	(23,241)	(17,011)	(5,936)
Goodwill .....	18,049	7,242	
Other - net .....	5,985	(1,301)	(3,293)
Total .....	29,601	(14,035)	(19,520)
Income taxes.....	\$ (30,432)	\$ 206,374	\$ 200,165
Effective rate .....	17.7%	32.8%	31.9%

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Following are the Company's tax effects of temporary differences attributable to continuing operations resulting in deferred tax assets and liabilities:

	December 31,	
	1998	1997
	(Thousands of Dollars)	
<b>Deferred Tax Assets:</b>		
Alternative minimum tax credit carryforwards .....	\$ 39,893	\$ 60,669
Employee benefits .....	154,746	145,794
Disallowed plant cost - net .....	56,219	22,378
ACES .....	454,165	42,491
State operating loss carryforwards .....	23,178	29,515
Deferred state income taxes .....	14,455	14,460
Other .....	92,659	69,235
Valuation allowance .....	(8,591)	(6,353)
Total deferred tax assets - net .....	<u>\$ 826,724</u>	<u>378,189</u>
<b>Deferred Tax Liabilities:</b>		
Depreciation .....	\$ 2,106,860	\$ 2,115,717
Deferred plant costs - net .....	147,278	186,472
Regulatory tax asset - net .....	418,339	356,509
Capitalized taxes, employee benefits and removal costs .....	60,099	46,584
Gain on sale of cable television subsidiary .....	222,942	222,942
Deferred state income taxes .....	70,000	70,000
Deferred gas costs .....	13,663	34,113
Loss on reacquired debt .....	44,077	39,503
Other .....	107,502	99,130
Total deferred tax liabilities .....	<u>3,190,760</u>	<u>3,170,970</u>
Accumulated deferred income taxes - net .....	<u>\$ 2,364,036</u>	<u>\$ 2,792,781</u>

*Tax Refund Case.* In July 1990, the Company paid approximately \$104.5 million to the Internal Revenue Service (IRS) following an IRS audit of Former Parent's 1983 and 1984 federal income tax returns. In November 1991, Former Parent filed a refund suit in the U.S. Court of Federal Claims seeking the return of \$52.1 million of tax and \$36.3 million of accrued interest, plus interest on both of those amounts accruing after July 1990. The major contested issue in the refund case involved the IRS allegation that certain amounts related to the over-recovery of fuel costs should have been included as taxable income in 1983 and 1984 even though the Company had an obligation to refund the over-recoveries to its ratepayers.

In September 1997, the United States Court of Appeals upheld a lower court ruling that the Company (as successor corporation to Former Parent) was due a refund of federal income taxes assessed on fuel over-recoveries during 1983 and 1984 that subsequently were refunded to Electric Operations' customers.

In February 1998, the Company received a refund of approximately \$142 million in taxes and interest paid by Former Parent in July 1990, including interest accrued since 1990 in the amount of approximately \$57 million. After giving effect to the Company's deferred recognition of the 1990 tax payment and payment of federal income taxes due on the accrued interest on the refund, the refund had the effect of increasing the Company's earnings in the fourth quarter of 1997 by \$37 million (after-tax).

*Tax Attribute Carryforwards.* At December 31, 1998, Resources has approximately \$368 million of state net operating losses available to offset future state taxable income through the year 2013. In addition, Resources has approximately \$33 million of federal alternative minimum tax credits which are available to reduce future federal income taxes payable, if any, over an indefinite period (although not below the tentative minimum tax otherwise due

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in any year), and approximately \$2.6 million of state alternative minimum tax credits which are available to reduce future state income taxes payable, if any, through the year 2001. The valuation allowance reflects a net increase of \$2.3 million in 1998. This net increase results from a reassessment of Resources' usage of state tax attributes, including the future ability to use state net operating loss and alternative minimum tax credit carryforwards offset by changes in valuation allowances provided for expiring state net operating loss carryforwards.

**(12) Commitments and Contingencies**

*(a) Commitments.*

The Company has various commitments for capital expenditures, fuel, purchased power, cooling water and operating leases. Commitments in connection with Electric Operations' capital program are generally revocable by the Company, subject to reimbursement to manufacturers for expenditures incurred or other cancellation penalties. The Company's and its subsidiaries' other commitments have various quantity requirements and durations. However, if these requirements could not be met, various alternatives are available to mitigate the cost associated with the contracts' commitments.

*(b) Fuel and Purchased Power.*

The Company is a party to several long-term coal, lignite and natural gas contracts which have various quantity requirements and durations. Minimum payment obligations for coal and transportation agreements are approximately \$210 million in 1999, \$187 million in 2000 and \$188 million in 2001. Additionally, minimum payment obligations for lignite mining and lease agreements are approximately \$9 million for 1999, \$10 million for 2000 and \$10 million for 2001. Minimum payment obligations for both natural gas purchase and storage contracts associated with Electric Operations are approximately \$10 million in 1999, \$9 million in 2000 and \$9 million in 2001.

The Company also has commitments to purchase firm capacity from two cogenerators totaling approximately \$22 million in both 1999 and 2000. Texas Utility Commission rules currently allow recovery of these costs through Electric Operations' base rates for electric service and additionally authorize the Company to charge or credit customers through a purchased power cost recovery factor for any variation in actual purchased power costs from the cost utilized to determine its base rates. In the event that the Texas Utility Commission, at some future date, does not allow recovery through rates of any amount of purchased power payments, these two firm capacity contracts contain provisions allowing the Company to suspend or reduce payments and seek repayment for amounts disallowed. Both of these firm capacity contracts have initial terms ending March 31, 2005.

*(c) Operations Agreement with City of San Antonio.*

As part of the 1996 settlement of certain litigation claims asserted by the City of San Antonio with respect to the South Texas Project, the Company entered into a 10-year joint operations agreement under which the Company and the City of San Antonio, acting through the City Public Service Board of San Antonio (CPS), share savings resulting from the joint dispatching of their respective generating assets in order to take advantage of each system's lower cost resources. Under the terms of the joint operations agreement entered into between CPS and Electric Operations, the Company has guaranteed CPS minimum annual savings of \$10 million and a minimum cumulative savings of \$150 million over the 10-year term of the agreement. Based on current forecasts and other assumptions regarding the combined operation of the two generating systems, the Company anticipates that the savings resulting from joint operations will equal or exceed the minimum savings guaranteed under the joint operating agreement. In 1996, savings generated for CPS' account for a partial year of joint operations were approximately \$14 million. In 1997 and 1998, savings generated for CPS' account for a full year of operation were approximately \$22 million and \$14 million, respectively.

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*(d) Transportation Agreement.*

Resources had an agreement (ANR Agreement) with ANR Pipeline Company (ANR) which contemplated that Resources would transfer to ANR an interest in certain of Resources' pipeline and related assets. The interest represented capacity of 250 Mmcf/day. Under the ANR Agreement, an ANR affiliate advanced \$125 million to Resources. Subsequently, the parties restructured the ANR Agreement and Resources refunded in 1995 and 1993, respectively, \$50 million and \$34 million to ANR or an affiliate. Resources recorded \$41 million as a liability reflecting ANR's or its affiliates' use of 130 Mmcf/day of capacity in certain of Resources' transportation facilities. The level of transportation will decline to 100 Mmcf/day in the year 2003 with a refund of \$5 million to an ANR affiliate. The ANR Agreement will terminate in 2005 with a refund of the remaining balance.

*(e) Lease Commitments.*

The following table sets forth certain information concerning the Company's obligations under non-cancelable long-term operating leases:

Minimum Lease Commitments at December 31, 1998 (1)  
(Millions of Dollars)

1999 .....	\$ 20
2000 .....	16
2001 .....	15
2002 .....	11
2003 .....	10
2004 and beyond .....	66
Total .....	<u>\$ 138</u>

(1) Principally consisting of rental agreements for building space and data processing equipment and vehicles (including major work equipment).

Resources has a master leasing agreement which provides for the lease of vehicles, construction equipment, office furniture, data processing equipment and other property. For accounting purposes, the lease is treated as an operating lease. Resources does not expect to lease additional property under this lease agreement.

Total rental expense for all Resources' leases was approximately \$25 million in 1998. Total rental expense for all leases in 1997 since the Acquisition Date was approximately \$15 million.

*(f) Letters of Credit.*

At December 31, 1998, the Company and Resources had letters of credit incidental with their ordinary business operations totaling approximately \$34 million under which they are obligated to reimburse drawings, if any.

*(g) Indemnity Provisions.*

At December 31, 1998, Resources had a \$5.8 million accounting reserve on the Company's Consolidated Balance Sheet in Other Deferred Credits for possible indemnity claims asserted in connection with its disposition of Resources' former subsidiaries or divisions, including the sale of (i) Louisiana Intrastate Gas Corporation, a former Resources subsidiary engaged in the intrastate pipeline and liquids extraction business; (ii) Arkla Exploration Company, a former Resources subsidiary engaged in oil and gas exploration and production activities; and (iii) Dyco Petroleum Company, a former Resources subsidiary engaged in oil and gas exploration and production.

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*(h) Environmental Matters*

The Company is a defendant in litigation arising out of the environmental remediation of a site in Corpus Christi, Texas. The litigation was instituted in 1985 by adjacent landowners. The litigation is pending before the United States District Court for the Southern District of Texas, Corpus Christi Division. The site was operated by third parties as a metals reclaiming operation. Although the Company neither operated nor owned the site, certain transformers and other equipment originally sold by the Company may have been delivered to the site by third parties. The Company and others have remediated the site pursuant to a plan approved by appropriate state agencies and a federal court. To date, the Company has recovered or has commitments to recover from other responsible parties \$2.2 million of the more than \$3 million it has spent on remediation.

In 1992, the United States Environmental Protection Agency (EPA) (i) identified the Company, along with several other parties, as "potentially responsible parties" (PRP) under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) for the costs of cleaning up a site located adjacent to one of the Company's transmission lines in La Marque, Texas and (ii) issued an administrative order for the remediation of the site. The Company believes that the EPA took this action solely on the basis of information indicating that the Company in the 1950s acquired record title to a portion of the land on which the site is located. The Company does not believe that it now or previously has held any ownership interest in the property covered by the order and has obtained a judgement to that effect from a court in Galveston County, Texas. Based on this judgement and other defenses that the Company believes to be meritorious, the Company has elected not to adhere to the EPA's administrative order, even though the Company understands that other PRPs are proceeding with site remediation. To date, neither the EPA nor any other PRP has instituted an action against the Company for any share of the remediation costs for the site. However, if the Company was determined to be a responsible party, the Company could be jointly and severally liable along with the other PRPs for the aggregate remediation costs of the site (which the Company currently estimates to be approximately \$80 million in the aggregate) and could be assessed substantial fines and damage claims. Although the ultimate outcome of this matter cannot currently be predicted at this time, the Company does not believe that this case will have a material adverse effect on the Company's financial condition, liquidity or results of operations.

From time to time the Company and its subsidiaries have received notices from regulatory authorities or others regarding their status as potential PRPs in connection with sites found to require remediation due to the presence of environmental contaminants. In addition, the Company has been named as defendant in litigation related to such sites and in recent years has been named, along with numerous others, as a defendant in several lawsuits filed by a large number of individuals who claim injury due to exposure to asbestos while working at sites along the Texas Gulf Coast. Most of these claimants have been workers who participated in construction of various industrial facilities, including power plants, and some of the claimants have worked at locations owned by the Company. The Company anticipates that additional claims like those received may be asserted in the future and intends to continue its practice of vigorously contesting claims which it does not consider to have merit. Although their ultimate outcome cannot be predicted at this time, the Company does not believe, based on its experience to date, that these matters, either individually or in the aggregate, will have a material adverse effect on the Company's financial position, results of operation or cash flows.

*(i) Other.*

Electric Operations' service area is heavily dependent on oil, gas, refined products, petrochemicals and related businesses. Significant adverse events affecting these industries would negatively affect the revenues of the Company.

The Company and Resources are involved in legal, tax and regulatory proceedings before various courts, regulatory commissions and governmental agencies regarding matters arising in the ordinary course of business,

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some of which involve substantial amounts. The Company's management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. The Company's management believes that the effect on the Company's and Resources' respective financial statements, if any, from the disposition of these matters will not be material.

In February 1996, the cities of Wharton, Galveston and Pasadena filed suit, for themselves and a proposed class, against the Company and Houston Industries Finance Inc. (formerly a wholly owned subsidiary of the Company) citing underpayment of municipal franchise fees. The plaintiffs claim, among other things, that from 1957 to the present, franchise fees should have been paid on sales taxes collected by Electric Operations on receipts from sales to other utilities and on receipts from services as well as sales of electricity. Plaintiffs advance their claims notwithstanding their failure to notice such claims over the previous four decades. Because all of the franchise ordinances affecting Electric Operations expressly impose fees only on receipts from sales of electricity for consumption within a city, the Company regards plaintiffs' allegations as spurious and is vigorously contesting the matter. The plaintiffs' pleadings assert that their damages exceed \$250 million. The District Court for Harris County has granted a partial summary judgment in favor of the Company dismissing all claims for franchise fees based on sales tax collections. Other motions for partial summary judgement remain pending. Although the Company believes the claims to be without merit, the Company cannot at this time estimate a range of possible loss, if any, from the lawsuit, nor can any assurance be given as to its ultimate outcome.

**(13) Estimated Fair Value of Financial Instruments**

		December 31,			
		1998		1997	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
(Thousands of Dollars)					
<b>Financial Assets:</b>					
Company:					
Investment in Time Warner securities.....	\$	990,000	\$2,843,585	\$ 990,000	\$1,420,360
Resources:					
Energy Derivatives – non-trading .....		—	—	9,399	13,060
<b>Financial Liabilities:</b>					
Company:					
First mortgage bonds.....		2,036,284	2,177,434	2,495,459	2,651,260
Pollution control revenue bonds.....		581,385	582,069	123,000	123,000
Debentures.....		349,468	378,825	349,283	379,490
ACES.....		2,349,997	2,436,949	1,173,786	1,307,247
Trust preferred and capital securities.....		341,075	366,182	340,882	366,220
Interest rate swaps .....		109	3,160	65	1,679
Resources:					
Long-term debt.....		1,513,289	1,746,641	1,148,848	1,147,344
Trust preferred securities .....		1,157	1,467	21,290	24,569
Energy Derivatives – non-trading .....		—	8,166	—	—
Interest rate swaps .....		—	—	—	755

The fair values of cash and short-term investments, investment in the Company's nuclear decommissioning trust, short-term and other notes payable and floating rate debt of Reliant Energy International are estimated to be equivalent to carrying amounts. The remaining fair values have been determined using quoted market prices of the same or similar securities when available or other estimation techniques.

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The fair value of financial instruments included in the trading operations of Reliant Energy Services are marked-to-market at December 31, 1998 (see Note 2). Therefore, they are stated at fair value and are excluded from the table.

**(14) Unaudited Quarterly Information**

The following unaudited quarterly financial information includes, in the opinion of management, all adjustments (which comprise only normal recurring accruals) necessary for a fair presentation. Quarterly results are not necessarily indicative of a full year's operations because of seasonality and other factors, including rate increases and variations in operating expense patterns. Results of operations of the Resources businesses, purchased in 1997, are included beginning on the Acquisition Date.

	Year Ended December 31, 1998			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(thousands of dollars, except per share amounts)			
Revenues (1) .....	\$ 2,631,322	\$ 2,736,626	\$ 3,465,487	\$ 2,655,029
Operating Income (1) .....	282,892	455,809	512,955	225,732
Net Income (Loss) available for common stock (1) .....	(30,115)	41,484	251,709	(404,560)
Basic Earnings (Loss) per Common Share (2) .....	(.11)	.15	.89	(1.42)
Diluted Earnings (Loss) per Common Share (2) .....	(.11)	.15	.88	(1.42)

	Year Ended December 31, 1997			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(thousands of dollars, except per share amounts)			
Revenues .....	\$ 878,101	\$ 1,064,448	\$ 2,158,054	\$ 2,777,622
Operating Income .....	156,216	247,172	462,716	198,396
Net Income (Loss) available for common stock .....	59,620	121,463	243,898	(4,033)
Basic Earnings (Loss) per Common Share (2) .....	.26	.52	.93	(.01)
Diluted earnings (Loss) per Common Share (2) .....	.26	.52	.92	(.01)

- (1) Includes retroactive adjustment for change in accounting for energy price risk management and trading activities of Reliant Energy Services to mark-to-market accounting for the first, second and third quarters of 1998. (See Note 1(r))
- (2) Quarterly earnings per common share are based on the weighted average number of shares outstanding during the quarter, and the sum of the quarters may not equal annual earnings per common share.

**(15) Reportable Segments**

Effective January 1, 1998, the Company adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS No. 131). The Company's determination of reportable segments considers the strategic operating units under which the Company manages sales of various products and services to wholesale or retail customers in differing regulatory environments. The determination of reportable segments under SFAS No. 131 differs from that required in prior years, therefore business segment information for 1997 and 1996 has been restated to comply with SFAS No. 131. Consistent with the purchase accounting treatment for the Merger, financial information for Resources is included in the segment disclosures only for periods beginning on the Acquisition Date.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies except that certain executive benefit costs have not been allocated to segments. The Company evaluates performance based on operating income excluding certain corporate costs not allocated to the segments. The Company accounts for intersegment sales as if the sales were to third parties, that is, at current market prices.



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In accordance with SFAS No. 131, the Company has identified the following reportable segments: Electric Operations, Natural Gas Distribution, Interstate Pipelines, Wholesale Energy and Marketing (Wholesale Energy), International and Corporate. Electric Operations provides electric generation, transmission, distribution and sales to customers. Natural Gas Distribution operations consist of natural gas sales to, and natural gas transportation for, residential, commercial and industrial customers. Interstate Pipelines conducts interstate natural gas pipeline operations. Wholesale Energy is engaged in the acquisition, development and operation of non-rate regulated power generation facilities as well as the wholesale energy trading and marketing and natural gas gathering businesses. International participates in the development and acquisition of foreign independent power projects and the privatization of foreign generation and distribution facilities. Corporate includes the Company's unregulated retail electric services business, certain real estate holdings of the Company and corporate costs.

Financial data for business segments, products and services and geographic areas are as follows:

	Electric Operations	Natural Gas Distribution	Interstate Pipelines	Wholesale Energy	Inter- national	Corporate and Other	Reconciling Eliminations	Consolidated
	(Thousands of Dollars)							
As of and for the Year Ended December 31, 1998:								
Revenues from external customers .....	\$ 4,350,275	\$ 1,811,509	\$ 126,988	\$ 4,289,006	\$ 258,945	\$ 651,741		\$11,488,464
Intersegment revenues.....		1,167	155,508	167,152		97,181	\$ (421,008)	
Depreciation and amortization.....	650,264	129,777	44,025	18,204	3,820	10,527		856,617
Operating income .....	1,013,979	137,955	128,328	59,170	181,707	(43,751)		1,477,388
Total assets.....	10,404,447	3,110,718	2,050,636	1,535,007	1,242,689	1,710,920	(915,895)	19,138,522
Equity investments in and advances to unconsolidated subsidiaries .....				42,252	1,009,348			1,051,600
Expenditures for additions to long- lived assets .....	433,474	161,735	59,358	365,512	435,077	28,077		1,483,233
As of and for the Year Ended December 31, 1997:								
Revenues from external customers .....	4,251,243	892,064	49,655	1,288,357	92,028	304,878		6,878,225
Intersegment revenues.....		505	58,678	76,301		34,853	(170,337)	
Depreciation and amortization.....	568,541	51,883	19,088	2,633	3,470	6,260		651,875
Operating income .....	994,938	54,502	31,978	912	19,510	(37,340)		1,064,500
Total assets.....	10,540,849	3,073,525	2,031,879	777,638	869,485	1,749,916	(597,686)	18,445,606
Equity investments in and advances to unconsolidated subsidiaries .....				3,325	700,777			704,102
Expenditures for additions to long- lived assets .....	236,977	61,078	16,304	14,038	231,528	23,899		583,824
For the Year Ended December 31, 1996:								
Revenues from external customers .....	4,025,027				62,059	8,191		4,095,277
Depreciation and amortization.....	545,685				1,648	2,705		550,038
Operating income .....	997,147				2,339	(9,020)		990,466
Expenditures for additions to long- lived assets .....	317,532				495,379	19,989		832,900

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**Reconciliation of Operating Income to Net Income (in thousands):**

	Year Ended December 31,		
	1998	1997	1996
Operating income.....	\$ 1,477,388	\$ 1,064,500	\$ 990,466
Interest income – IRS refund.....	981	56,269	
Dividend income.....	41,250	41,340	41,610
Interest expense.....	(513,905)	(397,957)	(309,980)
Unrealized loss on ACES.....	(1,176,211)	(121,402)	
Litigation settlements.....			(95,000)
Distribution on trust securities.....	(29,201)	(26,230)	
Preferred dividends of subsidiary.....		(2,255)	(22,563)
Income tax benefit (expense).....	30,432	(206,374)	(200,165)
Other income (expense).....	27,784	13,057	576
Net income (loss) available for Common Stock.....	<u>\$ (141,482)</u>	<u>\$ 420,948</u>	<u>\$ 404,944</u>

**Revenues by Products and Services (in thousands):**

	Year Ended December 31,		
	1998	1997	1996
Retail power sales.....	\$ 4,359,857	\$ 4,253,893	\$ 4,025,027
Retail gas sales.....	2,362,504	1,153,968	
Wholesale energy and energy related sales.....	4,248,181	1,271,400	
Gas transport.....	167,812	66,265	
Equity income from international investments.....	258,945	92,028	62,059
Energy products and services.....	91,165	40,671	8,191
Total.....	<u>\$ 11,488,464</u>	<u>\$ 6,878,225</u>	<u>\$ 4,095,277</u>

**Revenues and Long-Lived Assets by Geographic Areas (in thousands):**

	Year Ended December 31,		
	1998	1997	1996
<b>Revenues:</b>			
US.....	\$ 11,229,519	\$ 6,786,197	\$ 4,033,218
International.....	258,945	92,028	62,059
Total.....	<u>\$ 11,488,464</u>	<u>\$ 6,878,225</u>	<u>\$ 4,095,277</u>
<b>Long-lived assets:</b>			
US.....	\$ 14,865,161	\$ 14,691,820	
International.....	1,195,849	837,536	
Total.....	<u>\$ 16,061,010</u>	<u>\$ 15,529,356</u>	

**HOUSTON INDUSTRIES INCORPORATED**  
**d/b/a RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(16) Subsequent Events**

*(a) Foreign Currency Devaluation.*

In January 1999, the Brazilian real was devalued and allowed to float against other major currencies. The Company expects to take a charge against first quarter earnings as a result of the Brazilian devaluation. The charge will reflect the Company's proportionate share of the impact of the devaluation on foreign denominated debt of Brazilian corporations in which the Company holds an equity interest. The amount of the charge will not be known until the end of the first quarter.

At December 31, 1998, one U.S. dollar could be exchanged for 1.21 Brazilian reais. Using the exchange rate of 2.06 reais/dollar in effect at the end of February, and the average exchange rate in effect since the end of the year, the Company estimates that its share of the after-tax charge that would be recorded by the Brazilian companies in which it owns an interest would be approximately \$125 million.

*(b) Trust Preferred Securities.*

In February 1999, a Delaware statutory business trust (REI Trust I) established by the Company issued \$375 million of preferred securities to the public and \$11.6 million of common securities to the Company. The preferred securities have a distribution rate of 7.20% payable quarterly in arrears, a stated liquidation amount of \$25 per preferred security and must be redeemed by March 2048. REI Trust I used the proceeds from the sale of the preferred and common securities to purchase \$386.6 million aggregate principal amount of subordinated debentures (REI Debentures) from the Company having an interest rate corresponding to the distribution rate of the preferred securities and a maturity date corresponding to the mandatory redemption date of the preferred securities. Proceeds from the sale of the REI Debentures were used by the Company for general corporate purposes, including the repayment of short-term debt. REI Trust I is accounted for as a wholly owned consolidated subsidiary of the Company. The REI Debentures are the REI Trust I's sole asset and its entire operations. The Company has fully and unconditionally guaranteed, on a subordinated basis, REI Trust I's obligations, including the payment of distributions and all other payments due with respect to the preferred securities. The preferred securities are mandatorily redeemable upon the repayment of the REI Debentures at their stated maturity or earlier redemption. Subject to certain limitations, the Company has the option of deferring payments of interest on the REI Debentures held by REI Trust I. If and for as long as interest payments on the REI Debentures have been deferred, or an event of default under the indenture relating thereto has occurred and is continuing, the Company may not pay dividends on its capital stock.

*(c) Investment in Dutch Generating Company.*

On March 10, 1999, the Company and N.V. Energieproductiebedrijf UNA, a Dutch electric generating company (UNA), announced their intent to enter into a strategic partnership in the Netherlands. The transaction would involve the initial acquisition by a subsidiary of the Company of 40% of the capital stock of UNA for cash and a commitment to purchase the remaining 60% of the shares of UNA for cash by December 31, 2006.

UNA is based in Utrecht and owns 3,400 megawatts of electric generating capacity. The capacity is primarily fueled by natural gas.

The purchase price for the initial 40% interest will be approximately NLG 1.6 billion (approximately \$ U.S. 840 million at an exchange rate of NLG 1.88 per U.S. dollar). Of this amount, the shareholders of UNA will receive a cash payment of approximately NLG 675 million (approximately \$ U.S. 360 million) in exchange for shares representing 15% of the total capital stock of UNA. UNA will receive (i) a cash payment of approximately NLG 21 million (approximately \$ U.S. 11 million) and (ii) a five-year promissory note from a subsidiary of the Company in the principal amount of approximately NLG 875 million (approximately \$ U.S. 465 million) for 25% of the total

**HOUSTON INDUSTRIES INCORPORATED**  
**d/b/a RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

capital stock of the Company, representing newly issued shares. The promissory note will bear interest at the one-year EURIBOR rate, determined annually, and will be payable, subject to certain conditions, on demand.

Under the proposed terms of the acquisition, the shareholders of UNA would agree to sell (i) an additional 12% of the total capital stock to the Company no later than December 31, 2002 and (ii) the remaining 48% of the capital stock of UNA no later than December 31, 2006. The purchase price for the remaining 60% of the capital stock of UNA is approximately NLG 2.7 billion (approximately \$ U.S. 1.4 billion). The purchase obligations under the definitive agreements are in Dutch guilders.

The Company expects to record its initial investment in UNA under the equity method of accounting. The acquisition of the initial 40% of the capital stock of UNA is subject to various approvals. It is anticipated that the closing for this 40% interest will occur in June 1999.

## INDEPENDENT AUDITOR'S REPORT

Houston Industries Incorporated  
d/b/a Reliant Energy, Incorporated:

We have audited the accompanying consolidated balance sheets and the consolidated statements of capitalization of Houston Industries Incorporated d/b/a Reliant Energy, Incorporated and its subsidiaries (the "Company") as of December 31, 1998 and 1997, and the related statements of consolidated income, consolidated retained earnings and comprehensive income, and consolidated cash flows for each of the three years in the period ended December 31, 1998. Our audits also included the Company's financial statement schedule listed in Item 14(a)(3). These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Reliant Energy, Incorporated and its subsidiaries at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP

Houston, Texas  
February 25, 1999

**Item 7. *Management's Narrative Analysis of the Results of Operations of Reliant Energy Resources Corp. and Consolidated Subsidiaries.***

The following narrative and analysis should be read in combination with the consolidated financial statements and notes (Resources' Consolidated Financial Statements) of Reliant Energy Resources Corp. (formerly NorAm Energy Corp.) (Resources) contained in Item 8 of the Form 10-K of Resources.

**RELIANT ENERGY RESOURCES CORP.**

On August 6, 1997 (Acquisition Date), the former parent corporation (Former Parent) of Houston Industries Incorporated d/b/a Reliant Energy, Incorporated (Reliant Energy) merged with and into Reliant Energy, and NorAm Energy Corp. (Former Resources) merged with and into Resources. Effective upon the mergers (collectively, the Merger), each outstanding share of common stock of Former Parent was converted into one share of common stock (including associated preference stock purchase rights) of Reliant Energy, and each outstanding share of common stock of Former Resources was converted into the right to receive \$16.3051 cash or 0.74963 shares of common stock of Reliant Energy. The aggregate consideration paid to Former Resources stockholders in connection with the Merger consisted of \$1.4 billion in cash and 47.8 million shares of Reliant Energy's common stock valued at approximately \$1.0 billion. The overall transaction was valued at \$4.0 billion consisting of \$2.4 billion for Former Resources' common stock and common stock equivalents and \$1.6 billion of Former Resources debt (\$1.3 billion of which was long-term debt.)

The Merger was recorded under the purchase method of accounting with assets and liabilities of Resources reflected at their estimated fair values as of the Acquisition Date, resulting in a "new basis" of accounting. In Resources' Consolidated Financial Statements, periods which reflect the new basis of accounting are labeled as "Current Resources" and periods which do not reflect the new basis of accounting are labeled as "Former Resources." Former Resources' Statement of Consolidated Income for the seven months ended July 31, 1997 included certain adjustments from August 1, 1997 to the Acquisition Date for pre-merger transactions.

Effective January 1, 1998, Resources adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS No. 131). Because Resources is a wholly owned subsidiary of Reliant Energy, Resources' determination of reportable segments considers the strategic operating units under which Reliant Energy manages sales of various products and services to wholesale or retail customers in differing regulatory environments. In accordance with SFAS No. 131, Reliant Energy has identified the following reportable segments: Electric Operations, Natural Gas Distribution, Interstate Pipelines, Wholesale Energy Marketing and Generation (Wholesale Energy), International and Corporate. Of these segments, the following operations are conducted by Resources: Natural Gas Distribution, Interstate Pipelines, Wholesale Energy (which includes the energy trading and marketing operations and natural gas gathering operations of the Wholesale Energy segment but excludes the operations of Reliant Energy Power Generation, Inc.) and Corporate (excluding the impact of ACES).

Resources meets the conditions specified in General Instruction I to Form 10-K and is thereby permitted to use the reduced disclosure format for wholly owned subsidiaries of reporting companies specified therein. Accordingly, Resources has omitted from this Combined Annual Report the information called for by Item 4 (submission of matters to a vote of security holders), Item 10 (directors and executive officers), Item 11 (executive compensation), Item 12 (security ownership of certain beneficial owners and management) and Item 13 (certain relationships and related party transactions) of Form 10-K. In lieu of the information called for by Item 6 (selected financial data) and Item 7 (management's discussion and analysis of financial condition and results of operations) of Form 10-K, Resources has included the following Management's Narrative Analysis of the Results of Operations to explain material changes in the amount of revenue and expense items of Resources between 1998 and 1997. Reference is hereby made to Item 1 (business), Item 2 (properties), Item 3 (legal proceedings), Item 5 (market for common equity and related stockholder matters), Item 7A (quantitative and qualitative disclosures about market risk) and Item 9 (changes in and disagreements with accountants on accounting and financial disclosure) of this Combined Annual Report for additional information regarding Resources required by the reduced disclosure format of General Instruction I to Form 10-K.

## CONSOLIDATED RESULTS OF OPERATIONS

*Seasonality and Other Factors.* Resources' results of operations are affected by seasonal fluctuations in the demand for and, to a lesser extent, the price of natural gas. Resources' results of operations are also affected by, among other things, the actions of various federal and state governmental authorities having jurisdiction over rates charged by Resources and its subsidiaries, competition in Resources' various business operations, debt service costs and income tax expense. For a discussion of certain other factors that may affect Resources' future earnings see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company — Certain Factors Affecting Future Earnings of the Company and its Subsidiaries — Competition — Other Operations"; "— Impact of the Year 2000 Issue and Other System Implementation Issues" and "— Environmental Expenditures — Mercury Contamination" in Item 7 of Reliant Energy's Form 10-K.

*Accounting Impact of the Merger.* The Merger created a new basis of accounting for Resources, resulting in new carrying values for certain of Resources' assets, liabilities and equity commencing upon the Acquisition Date. Resources' financial statements for periods subsequent to the Acquisition Date are not comparable to prior periods because of the following purchase accounting adjustments:

1. The impact of the amortization of newly-recognized goodwill (\$39.4 million);
2. The amortization (to interest expense) of the revaluation of long-term debt (\$9.8 million);
3. The removal of the amortization (to operating expense) previously associated with the pension and postretirement obligations (\$2.1 million); and
4. The deferred income tax expense associated with these adjustments (\$4.9 million).

Interest expense and related debt incurred by Reliant Energy to fund the cash portion of the purchase consideration has not been pushed down to Resources and its subsidiaries.

Because results of operations and other financial information for periods before and after the Acquisition Date are not comparable, Resources is presenting certain financial data on: (i) an actual basis for Resources for 1998 and 1997 and (ii) a pro forma basis for 1997 as if the Merger had taken place at the beginning of the period. These results do not necessarily reflect the results which would have been obtained if the Merger had actually occurred on the dates indicated or the results that may be expected in the future.

The following table sets forth selected financial and operating data on an actual and pro forma basis for the years ended December 31, 1998 and 1997, followed by a discussion of significant variances in period-to-period results:

# SELECTED FINANCIAL RESULTS:

	Actual			Unaudited Pro Forma (1)	
	Year Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997	Year Ended December 31, 1997	Actual to Pro Forma Percentage Change
	(Thousands of Dollars)				
Operating Revenues .....	\$ 6,758,412	\$2,526,182	\$3,313,591	\$5,839,773	16%
Operating Expenses .....	6,448,107	2,434,282	3,141,295	5,597,716	15%
Operating Income .....	310,305	91,900	172,296	242,057	28%
Merger Transaction Costs (2) .....		1,144	17,256		
Consolidated .....	310,305	90,756	155,040	242,057	28%
Interest Expense, Net .....	111,337	47,490	78,660	112,996	(1%)
Distributions on Subsidiary Trust					
Securities .....	632	279	6,317	1,479	(57%)
Other (Income) and Deductions .....	(7,318)	(2,243)	(7,210)	(9,453)	(23%)
Income Tax Expense .....	111,830	24,383	31,398	71,093	57%
Extraordinary (Gain), Less Taxes .....			(237)		
Net Income .....	<u>\$ 93,824</u>	<u>\$ 20,847</u>	<u>\$ 46,112</u>	<u>\$ 65,942</u>	42%

(1) Pro forma results reflect purchase adjustments as if the Merger had occurred on January 1, 1997.

(2) For expenses associated with the completion of the business combination with Reliant Energy, see Note 1(o) to Resources' Consolidated Financial Statements.

1998 Compared to 1997 (Actual). Resources' consolidated net income for 1998 was \$94 million compared to consolidated net income of \$67 million in 1997. The increase in net income for 1998 as compared to 1997 was due to increased operating income from several business segments as discussed below, partially offset by a decrease in operating income from Resources' Natural Gas Distribution segment due to the effects of warm weather. Also contributing to the increase in net income was a reduction in interest expense due to the refinancing of debt and reduced interest expense due to debt fair value devaluation at the time of the Merger.

Resources operating revenues for 1998 were \$6.8 billion as compared to \$5.8 billion in 1997. The \$900 million, or 16% increase was primarily attributable to a \$1.4 billion increase in wholesale trading revenue. Wholesale trading revenue increased due to increased power and natural gas trading volumes. The increase in trading revenues was offset by reduced revenues at Resources' Natural Gas Distribution unit of approximately \$400 million, principally due to warmer weather.

Resources operating expenses for 1998 were \$6.4 billion compared to \$5.6 billion in 1997. The \$800 million, or 16% increase was primarily due to increased natural gas and purchased power expenses associated with increased wholesale trading activities. The increase in operating expenses was offset by decreased natural gas purchases at Resources' Natural Gas Distribution unit because of lower volumes resulting from the warmer weather.

Operating income increased in 1998 by \$65 million over 1997 due to improved operating results at Interstate Pipelines, Corporate retail operations and Wholesale Energy, partially offset by the unfavorable effects of warm weather on the operations of Natural Gas Distribution. Operating income for 1997 included approximately \$18 million of merger-related costs that did not recur in 1998. Improved results at Interstate Pipelines were due to continued cost control initiatives and reduced benefits expenses, as well as the effects of a rate case settlement and a dispute settlement which contributed to the increase in operating income. In addition, margins at Wholesale Energy improved over margins in 1997; however, this effect was partially offset by increased staffing expenses to support increased sales and marketing efforts and an increase in credit reserves. Improved results at Wholesale Energy were also due to the fact that operating income in 1997 for Wholesale Energy was negatively impacted by hedging losses associated with sales under peaking contracts and losses from the sale of natural gas held in storage and unhedged in the first quarter of 1997 totaling \$17 million.



*1998 (Actual) Compared to 1997 (Pro Forma).* Resources' consolidated net income for 1998 was \$94 million compared to pro forma net income of \$66 million in 1997. The increase in earnings for 1998 as compared to pro forma 1997 was due to increased operating income from several business segments, as discussed below, offset by the effects of unfavorable weather at Resources' Natural Gas Distribution unit. Also contributing to the increase in earnings is a reduction in interest expense due to the refinancing of debt.

Resources operating revenues for 1998 were \$6.8 billion compared to pro forma operating revenues of \$5.8 billion in 1997. The \$919 million, or 16% increase was primarily attributable to a \$1.4 billion increase in wholesale trading revenue. Wholesale trading revenue increased due to increased electric and natural gas trading volumes. The increase in trading revenues was offset by reduced revenues at Resources' Natural Gas Distribution unit of approximately \$400 million, principally due to warmer weather.

Resources operating expenses for 1998 were \$6.4 billion compared to pro forma operating expense of \$5.6 billion in 1997. The \$800 million, or 16% increase was primarily due to increased natural gas and purchased power expenses associated with increased wholesale trading activities. The increase in operating expense was offset by decreased natural gas purchases at Resources' Natural Gas Distribution unit because of lower volumes resulting from warmer weather.

Operating income increased in 1998 by \$68 million over pro forma 1997 due to improved operating results at Interstate Pipelines, Corporate retail operations and Wholesale Energy, partially offset by the unfavorable effects of warm weather on the operations of Natural Gas Distribution. Improved results at Interstate Pipelines are due to continued cost control initiatives and reduced benefits expenses as well as the effects of a rate case settlement and a dispute settlement. In addition, margins at Wholesale Energy improved over margins in 1997; however, this effect was partially offset by increased staffing expenses to support increased sales and marketing efforts and an increase in credit reserves at Wholesale Energy also contributed to the increase in operating income. Operating income in 1997 for Wholesale Energy was negatively impacted by hedging losses associated with sales under peaking contracts and losses from the sale of natural gas held in storage and unhedged in the first quarter of 1997 totaling \$17 million.

Resources estimates that its total direct cost of resolving the Year 2000 issues will be between \$5 and \$6 million. This estimate includes approximately \$3.4 million spent through year-end 1998. For additional information regarding Year 2000 issues, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company — Certain Factors Affecting Future Earnings of the Company and its Subsidiaries — Impact of the Year 2000 Issue and Other System Implementation Issues" in Item 7 of the Form 10-K of Reliant Energy, which has been jointly filed with the Resources Form 10-K.

#### NEW ACCOUNTING ISSUES

Reference is made to "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company — New Accounting Issues" in Item 7 of the Form 10-K of Reliant Energy, which has been jointly filed with the Resources Form 10-K, for discussion of certain new accounting issues.

Item 8. *Financial Statements and Supplementary Data of Resources.*

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
(A WHOLLY OWNED SUBSIDIARY OF RELIANT ENERGY, INCORPORATED)

**STATEMENTS OF CONSOLIDATED INCOME**  
(Thousands of Dollars)

	Current Resources		Former Resources	
	Twelve Months Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997	Twelve Months Ended December 31, 1996
Revenues .....	\$ 6,758,412	\$ 2,526,182	\$ 3,313,591	\$ 4,788,462
<b>Expenses</b>				
Natural gas and purchased power, net .....	5,552,972	2,050,660	2,603,852	3,571,411
Operation and maintenance .....	590,986	255,149	379,400	621,279
Depreciation and amortization .....	191,891	78,087	84,901	142,362
Taxes other than income taxes .....	112,258	50,386	73,142	116,600
Merger transaction costs .....		1,144	17,256	
Early retirement and severance .....				22,344
	<u>6,448,107</u>	<u>2,435,426</u>	<u>3,158,551</u>	<u>4,473,996</u>
Operating Income .....	<u>310,305</u>	<u>90,756</u>	<u>155,040</u>	<u>314,466</u>
<b>Other Income</b>				
Interest expense, net .....	(111,337)	(47,490)	(78,660)	(132,557)
Dividend requirement on preferred securities of subsidiary trust .....	(632)	(279)	(6,317)	(5,842)
Loss on sale of accounts receivable .....				(11,499)
Other, net .....	7,318	2,243	7,210	(3,078)
	<u>(104,651)</u>	<u>(45,526)</u>	<u>(77,767)</u>	<u>(152,976)</u>
Income Before Income Taxes .....	<u>205,654</u>	<u>45,230</u>	<u>77,273</u>	<u>161,490</u>
Income Tax Expense .....	<u>111,830</u>	<u>24,383</u>	<u>31,398</u>	<u>66,352</u>
Income Before Extraordinary Item .....	<u>93,824</u>	<u>20,847</u>	<u>45,875</u>	<u>95,138</u>
Extraordinary gain(loss) on early retirement of debt, less taxes .....			237	(4,280)
Net Income .....	<u>93,824</u>	<u>20,847</u>	<u>46,112</u>	<u>90,858</u>
Preferred dividend requirement .....				3,597
Earnings Available to Common Stock .....	<u>\$ 93,824</u>	<u>\$ 20,847</u>	<u>\$ 46,112</u>	<u>\$ 87,261</u>

See Notes to Resources' Consolidated Financial Statements

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
**(A WHOLLY OWNED SUBSIDIARY OF RELIANT ENERGY, INCORPORATED)**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME**  
**(Thousands of Dollars)**

	Common Stock (1)		Preferred Stock(2)			Accumulated Other Comprehensive Income	Total Stockholders' Equity	Total Comprehensive Income
	Shares	Amount	Amount	Paid in Capital	Retained Earnings (Deficit)			
<b>Former Resources:</b>								
Stockholders' Equity at December 31, 1995.....	124,803,693	\$ 78,002	\$ 130,000	\$ 880,885	\$ (336,940)	\$ 15,316	\$ 767,263	
Net Income.....					90,858		90,858	\$ 90,858
Cash Dividend:								
Preferred stock - \$1.50 per share.....					(3,900)		(3,900)	
Common stock - \$0.28 per share.....					(36,721)		(36,721)	
Change in Market Value of Marketable Equity Securities, net tax of \$8,730 .....						(15,311)	(15,311)	(15,311)
Conversion to Subordinated Debentures .....			(130,000)				(130,000)	
Issuance of Common Stock under Direct Stock Purchase Plan .....	937,193	586		9,668			10,254	
Public Issuance of Common Stock .....	11,500,000	7,188		101,775			108,963	
Other Issuances.....	667,287	417		8,725			9,142	
Comprehensive Income .....								75,547
Stockholders' Equity at December 31, 1996.....	137,908,173	86,193	—	1,001,053	(286,703)	5	800,548	
Net Income.....					46,112		46,112	46,112
Cash Dividends:								
Common stock - \$0.14 per share.....					(19,281)		(19,281)	
Change in Market Value of Marketable Equity Securities, net tax of (\$3,329).....						5,874	5,874	5,874
Conversion of Resources-Obligated Mandatorily Redeemable Convertible Preferred Securities of Subsidiary Trust Holding Solely Subordinated Debentures of Resources to Common Stock .....	11,428,262	7,143		131,425			138,568	
Other Issuances.....	347,527	216		5,796			6,012	
Comprehensive Income .....								51,986
Balance at July 31, 1997.....	149,683,962	93,552		1,138,274	(259,872)	5,879	977,833	
<b>Current Resources (Post Merger):</b>								
Adjustments due to Merger:								
Eliminate Former Resources Balances.....	(149,683,962)	(93,552)		(1,138,274)	259,872	(5,879)	(977,833)	
Capital contribution from Parent.....	1,000	1		2,463,831			2,463,832	
Net Income.....					20,847		20,847	20,847
Change in Market Value of Marketable Equity Securities, net tax of \$3,193 .....						(5,634)	(5,634)	(5,634)
Comprehensive Income .....								15,213
Balance at December 31, 1997.....	1,000	1		2,463,831	20,847	(5,634)	2,479,045	
Net Income.....					93,824		93,824	93,824
Change in Market Value of Marketable Equity Securities, net tax of \$5,877 .....						(10,370)	(10,370)	(10,370)
Comprehensive Income .....								\$ 83,454
Balance at December 31, 1998.....	1,000	\$ 1	\$ —	\$ 2,463,831	\$ 114,671	\$ (16,004)	\$ 2,562,499	

- (1) \$.625 par, authorized 250,000,000 shares. On the Acquisition Date, Resources' pre-merger common stock was canceled and replaced with 1,000 shares of common stock (all of which are owned by Reliant Energy); see Note 1(b).
- (2) \$3.00 Convertible exchangeable preferred stock, Series A (\$50 liquidation preference), cumulative, non-voting; authorized 10,000,000 shares, issued and outstanding 2,600,000 shares. On the Acquisition Date, Resources' pre-merger preferred stock was canceled.

See Notes to Resources' Consolidated Financial Statements

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
**(A WHOLLY OWNED SUBSIDIARY OF RELIANT ENERGY, INCORPORATED)**

**CONSOLIDATED BALANCE SHEETS**  
**(Thousands of Dollars)**

**ASSETS**

	December 31, 1998	December 31, 1997
<b>Current Assets:</b>		
Cash and cash equivalents.....	\$ 26,576	\$ 35,682
Accounts and notes receivable, principally customer .....	682,552	763,502
Unbilled revenue .....	145,131	205,746
Accounts and notes receivable – affiliated companies.....	193,177	10,161
Gas in underground storage.....	79,855	63,702
Materials and supplies.....	33,947	29,611
Gas purchased in advance of delivery.....	6,200	6,200
Fuel stock and petroleum products .....	81,230	345
Price risk management assets .....	265,203	
Other current assets.....	33,034	55,092
Total current assets.....	<u>1,546,905</u>	<u>1,170,041</u>
<b>Property, Plant and Equipment:</b>		
Natural gas .....	1,686,159	1,488,961
Interstate pipelines .....	1,302,829	1,258,087
Other .....	13,976	14,972
Total .....	<u>3,002,964</u>	<u>2,762,020</u>
Less accumulated depreciation and amortization .....	<u>187,936</u>	<u>59,531</u>
Property, plant and equipment — net .....	<u>2,815,028</u>	<u>2,702,489</u>
<b>Other Assets:</b>		
Goodwill, net.....	2,050,386	2,026,395
Prepaid pension asset .....	102,021	92,064
Investment in marketable equity securities.....	10,800	27,046
Regulatory asset for environmental costs.....	20,695	21,745
Gas purchased in advance of delivery.....	22,207	29,048
Deferred debits, net.....	87,479	93,010
Total other assets.....	<u>2,293,588</u>	<u>2,289,308</u>
<b>Total Assets .....</b>	<b><u>\$ 6,655,521</u></b>	<b><u>\$ 6,161,838</u></b>

See Notes to Resources' Consolidated Financial Statements

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
**(A WHOLLY OWNED SUBSIDIARY OF RELIANT ENERGY, INCORPORATED)**

**CONSOLIDATED BALANCE SHEETS**  
**(Thousands of Dollars) – (Continued)**

**LIABILITIES AND STOCKHOLDER'S EQUITY**

	December 31, 1998	December 31, 1997
<b>Current Liabilities:</b>		
Current maturities of long-term debt.....	\$ 203,438	\$ 232,145
Notes payable to banks.....		390,000
Notes payable to parent.....		22,100
Receivables facility.....	300,000	300,000
Accounts payable, principally trade.....	622,262	668,269
Income taxes payable.....	13,308	
Interest payable.....	36,197	27,273
Other taxes.....	42,107	41,315
Customer deposits.....	36,985	36,626
Price risk management liabilities.....	227,652	
Other current liabilities.....	172,616	164,329
Total current liabilities.....	<u>1,654,565</u>	<u>1,882,057</u>
<b>Deferred Credits and Other Liabilities:</b>		
Accumulated deferred income taxes.....	497,762	474,730
Estimated environmental remediation costs.....	20,695	21,745
Payable under capacity lease agreement.....	41,000	41,000
Benefit obligations.....	158,762	182,687
Estimated obligations under indemnification provisions of sale agreements.....	5,781	11,391
Refundable excess deferred income taxes.....	12,246	13,569
Other.....	187,765	117,621
Total deferred credits and other liabilities.....	<u>924,011</u>	<u>862,743</u>
<b>Resources-Obligated Mandatorily Redeemable Convertible Preferred Securities of Subsidiary Trust Holding Solely Junior Subordinated Debentures of Resources, net.....</b>	<u>1,157</u>	<u>21,290</u>
<b>Long-Term Debt, less Current Maturities.....</b>	<u>1,513,289</u>	<u>916,703</u>
<b>Stockholder's Equity:</b>		
Common stock.....	1	1
Paid-in capital.....	2,463,831	2,463,831
Retained earnings.....	114,671	20,847
Accumulated other comprehensive income.....	(16,004)	(5,634)
Total stockholder's equity.....	<u>2,562,499</u>	<u>2,479,045</u>
<b>Commitments and Contingencies (Note 8)</b>		
<b>Total Liabilities and Stockholder's Equity.....</b>	<u>\$ 6,655,521</u>	<u>\$ 6,161,838</u>

See Notes to Resources' Consolidated Financial Statements

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
**(A WHOLLY OWNED SUBSIDIARY OF RELIANT ENERGY, INCORPORATED)**

**STATEMENTS OF CONSOLIDATED CASH FLOWS**  
**Increase (Decrease) in Cash and Cash Equivalents**  
**(Thousands of Dollars)**

	<b>Current Resources</b>		<b>Former Resources</b>	
	<b>Twelve Months Ended December 31, 1998</b>	<b>Five Months Ended December 31, 1997</b>	<b>Seven Months Ended July 31, 1997</b>	<b>Twelve Months Ended December 31, 1996</b>
<b>Cash Flows from Operating Activities:</b>				
Net income.....	\$ 93,824	\$ 20,847	\$ 46,112	\$ 90,858
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization.....	191,891	78,087	84,901	142,362
Deferred income taxes .....	31,810	36,770	14,589	28,809
Early retirement and severance, less cash cost .....				12,941
Extraordinary (gain)loss, less taxes....			(237)	4,280
Utilization of tax loss carryforwards..				(2,405)
Changes in other assets and liabilities, net of the effects of the acquisition:				
Accounts and notes receivable-net ..	(41,451)	(361,285)	313,586	(353,703)
Inventories .....	(102,125)	(2,250)	9,980	(14,895)
Deferred gas costs .....	(9,297)	8,655	(7,715)	12,788
Other current assets .....	18,719	(1,298)	(1,128)	10,935
Accounts payable .....	(67,024)	148,071	(224,590)	266,446
Interest and taxes accrued .....	13,454	(13,402)	(19,996)	4,712
Other current liabilities .....	9,416	42,284	(22,633)	10,483
Net price risk management activities .....	(29,857)			
Recoveries under gas contract disputes.....	6,841	2,600	5,500	10,900
Other-net.....	(10,942)	10,677	903	3,642
Net cash provided by (used in) operating activities.....	105,259	(30,244)	199,272	228,153
<b>Cash Flows from Investing Activities:</b>				
Purchase of Former Resources, net of cash acquired.....		(1,422,672)		
Capital expenditures .....	(253,972)	(93,414)	(88,638)	(172,200)
Other, net.....	8,068	(1,079)	(6,424)	(4,957)
Net cash used in investing activities.....	\$ (245,904)	\$ (1,517,165)	\$ (95,062)	\$ (177,157)

*(continued on next page)*

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
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**STATEMENTS OF CONSOLIDATED CASH FLOWS**  
**Increase (Decrease) in Cash and Cash Equivalents**  
**(Thousands of Dollars)**  
**(Continued)**

	Current Resources		Former Resources	
	Twelve Months Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997	Twelve Months Ended December 31, 1996
Cash Flows from Financing Activities:				
Cash portion of capital contribution from Reliant Energy .....		\$1,426,067		
Retirements and reacquisitions of long-term debt .....	\$(226,604)	(165,808)	\$ (230,667)	\$ (396,733)
Proceeds from bank term loan .....			150,000	
Public issuance of common stock .....				108,963
Public issuance of convertible preferred securities by subsidiary trust .....				167,756
Other debt borrowings (repayments) ..	(424,299)	317,500	(42,500)	105,000
Proceeds from issuance of debentures	812,849			
Increase in receivables facility .....		24,000	41,000	
Issuance of common stock under direct stock purchase plan, net .....				10,254
Common and preferred stock dividends .....			(19,281)	(40,621)
Redemption of convertible securities ..	(10,450)	(9,504)		
Increase (decrease) in overdrafts .....	(19,957)	(9,164)	(27,348)	9,055
Net cash provided by (used in) financing activities .....	131,539	1,583,091	(128,796)	(36,326)
Net Increase (Decrease) in Cash and Cash Equivalents .....	(9,106)	35,682	(24,586)	14,670
Cash and Cash Equivalents at Beginning of the Period .....	35,682		27,981	13,311
Cash and Cash Equivalents at End of the Period .....	\$ 26,576	\$ 35,682	\$ 3,395	\$ 27,981
Supplemental Disclosure of Cash Flow Information:				
Cash Payments:				
Interest (net of amounts capitalized) ..	\$ 105,393	\$ 55,951	\$ 67,100	\$ 140,751
Income taxes, net .....	46,522	714	20,900	29,657

The aggregate consideration paid to stockholders of Former Resources in connection with the Merger consisted of \$1.4 billion in cash and 47.8 million shares of Reliant Energy common stock valued at approximately \$1.0 billion. The overall transaction was valued at \$4.0 billion consisting of \$2.4 billion for Former Resources' common stock and common stock equivalents and \$1.6 billion of Former Resources debt. A significant portion (\$139 million) of the securities of a subsidiary trust was converted to Common Stock of Resources in non-cash transactions prior to the Merger; see Note 5.

See Notes to Resources' Consolidated Financial Statements

**RELIANT ENERGY RESOURCES CORP. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**For the Three Years Ended December 31, 1998**

**(1) Summary of Significant Accounting Policies**

*(a) Nature of Operations.*

Reliant Energy Resources Corp. (formerly NorAm Energy Corp.) (Resources), a Delaware corporation, is a wholly owned subsidiary of Houston Industries Incorporated d/b/a Reliant Energy, Incorporated (Reliant Energy). Resources is principally engaged in the natural gas industry, including gathering, transmission, marketing, storage and distribution. Collectively, these operations accounted for greater than 95% of Resources' total revenues, income or loss and identifiable assets during 1998.

Resources' natural gas distribution operations (Natural Gas Distribution) are conducted by three of its unincorporated divisions: Reliant Energy Entex, Reliant Energy Minnegasco and Reliant Energy Arkla. Resources' interstate pipeline operations (Interstate Pipelines) are conducted by its wholly owned subsidiaries, Reliant Energy Gas Transmission Company (REGT) and Mississippi River Transmission Corporation (MRT). Resources' wholesale energy marketing activities are conducted primarily by Reliant Energy Services, Inc. (Reliant Energy Services) and its gathering activities are conducted by Reliant Energy Field Services, Inc. (Reliant Energy Field Services). Resources' retail marketing activities are conducted by Reliant Energy Retail, Inc. (Reliant Energy Retail). Resources' principal operations are located in Arkansas, Louisiana, Minnesota, Mississippi, Missouri, Oklahoma and Texas.

In February 1999, NorAm Energy Corp. changed its name to Reliant Energy Resources Corp. and Houston Industries Incorporated began doing business as Reliant Energy, Incorporated.

For information regarding Resources' reportable segments, see Note 9.

*(b) Merger with Reliant Energy, Incorporated.*

On August 6, 1997 (Acquisition Date), the former parent corporation (Former HII) of Reliant Energy merged with and into Reliant Energy, and NorAm Energy Corp. (Former Resources) merged with and into Resources. Effective upon the mergers (collectively, the Merger), each outstanding share of common stock of Former HII was converted into one share of common stock (including associated preference stock purchase rights) of Reliant Energy, and each outstanding share of common stock of Former Resources was converted into the right to receive \$16.3051 cash or 0.74963 shares of common stock of Reliant Energy. The aggregate consideration paid to Former Resources stockholders in connection with the Merger consisted of \$1.4 billion in cash and 47.8 million shares of Reliant Energy's common stock valued at approximately \$1.0 billion. The overall transaction was valued at \$4.0 billion consisting of \$2.4 billion for Former Resources' common stock and common stock equivalents and \$1.6 billion of Former Resources' debt (\$1.3 billion of which was long-term debt).

The Merger was recorded under the purchase method of accounting with assets and liabilities of Resources reflected at their estimated fair values as of the Acquisition Date, resulting in a "new basis" of accounting. In Resources' consolidated financial statements (Resources' Consolidated Financial Statements), periods which reflect the new basis of accounting are labeled as "Current Resources" and periods which do not reflect the new basis of accounting are labeled "Former Resources". Former Resources' Statement of Consolidated Income for the seven months ended July 31, 1997 included certain adjustments from August 1, 1997 to the Acquisition Date for pre-merger transactions.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)**

Resources' Consolidated Balance Sheets for periods after the Acquisition Date reflect adjustments associated with Reliant Energy's allocation of the purchase price, principally consisting of (i) the revaluation of certain property, plant and equipment and long-term debt to their estimated fair market value, (ii) the recognition of certain pension and postretirement benefit obligations previously being recognized through amortization, (iii) the recognition of goodwill as described above, (iv) the elimination of Resources' historical goodwill, (v) the elimination of Resources' historical stockholders' equity balances and accumulated depreciation and amortization as of the Acquisition Date and (vi) the recognition of the associated deferred income tax effects. In addition, Resources' pre-merger common stock was canceled and replaced with 1,000 shares of common stock (all of which are owned by Reliant Energy), rendering presentation of per share data no longer meaningful. Reliant Energy's debt to fund the cash portion of the purchase consideration has not been allocated or "pushed down" to Resources and is not reflected on Resources' Consolidated Financial Statements.

Resources' Statements of Consolidated Income for periods after the Acquisition Date are principally affected by (i) the amortization (over 40 years) of the newly-recognized goodwill, partially offset by the elimination of the amortization of Resources' historical goodwill, (ii) the amortization (to interest expense) of the revaluation of long-term debt, (iii) the removal of the amortization (to operating expense) previously associated with the pension and postretirement obligations as described above and (iv) the deferred income tax expense associated with these adjustments. Interest expense on Reliant Energy's debt which was used to fund the cash portion of the acquisition has not been allocated or "pushed down" to Resources and is not reflected on Resources' Consolidated Financial Statements. For these reasons, among others, certain financial information for periods before and after the Acquisition Date is not comparable.

If the Merger had occurred on January 1, 1997 and 1996, Resources' unaudited pro forma net income for 1997 and 1996 would have been \$66 million and \$83 million, respectively. Pro forma results, which are based on assumptions deemed appropriate by Resources' management, have been prepared for informational purposes only and are not necessarily indicative of the results which would have resulted had the Merger actually taken place on the date indicated.

*(c) Regulatory Assets and Regulation.*

In general, Resources' Interstate Pipelines operations are subject to regulation by the Federal Energy Regulatory Commission, while its Natural Gas Distribution operations are subject to regulation at the state or municipal level. Historically, all of Resources' rate-regulated businesses have followed the accounting guidance contained in Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS No. 71). Resources discontinued application of SFAS No. 71 to REGT in 1992. As a result of the continued application of SFAS No. 71 to MRT and the Natural Gas Distribution operations, Resources' financial statements contain assets and liabilities which would not be recognized by unregulated entities.

At December 31, 1998 Resources' Consolidated Balance Sheet included approximately \$12 million in regulatory assets recorded as deferred debits. These assets represent probable future revenue to Resources associated with certain incurred costs as these costs are recovered through the rate making process. These costs are being recovered through rates over varying periods up to 40 years.

*(d) Principles of Consolidation.*

Resources' Consolidated Financial Statements include the accounts of Resources and its wholly owned subsidiaries. All significant intercompany transactions and balances are eliminated in consolidation.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)**

*(e) Property, Plant and Equipment.*

Property, plant and equipment has been revalued to estimated fair market value as of the Acquisition Date in accordance with the purchase method of accounting, and depreciated or amortized on a straight-line basis over their estimated useful lives (for additional information regarding the accounting of the Merger see Note 1(b) above). Prior to the Acquisition Date, such assets were carried at cost. Additions to and betterments of utility property are charged to property accounts at cost, while the costs of maintenance, repairs and minor replacements are charged to expense as incurred. Upon normal retirement of units of utility property, plant and equipment, the cost of such property, together with cost of removal less salvage, is charged to accumulated depreciation.

*(f) Depreciation and Amortization Expense.*

Goodwill, none of which is being recovered in regulated service rates, is amortized on a straight-line basis over 40 years. Approximately \$53.6 million of goodwill was amortized during 1998. Approximately \$29.9 million of goodwill was amortized during 1997 of which \$21.6 million represents amortization related to the Merger and was incurred during the period from the Acquisition Date through December 31, 1997. Goodwill amortization for 1996 was approximately \$14.2 million. Resources regularly compares the carrying value of its goodwill to the anticipated undiscounted future operating income from the businesses whose acquisition gave rise to the goodwill and no impairment is indicated or expected. For additional information regarding the amortization of goodwill in connection with the Merger, see Note 1(b) above.

*(g) Gas in Underground Storage.*

Inventories principally follow the average cost method. Gas inventory (at average cost) was \$79.9 million and \$63.7 million at December 31, 1998 and 1997, respectively. All non-utility inventories held for resale are valued at the lower of cost or market.

*(h) Fuel Stock and Petroleum Products.*

Fuel stock and petroleum products, principally heating oil, are used in trading operations and are marked-to-market in connection with the price risk management activities discussed in Note 2.

*(i) Revenues.*

Resources' rate-regulated divisions/subsidiaries bill customers on a monthly cycle billing basis. Revenues are recorded on an accrual basis, including an estimate for gas delivered but unbilled at the end of each accounting period.

*(j) Statements of Consolidated Cash Flows.*

For purposes of reporting cash flows, cash equivalents are considered to be short-term, highly liquid investments readily convertible into cash.

*(k) Derivative Financial Instruments (Risk Management).*

For information regarding Resources' accounting for derivative financial instruments associated with natural gas, electric power and transportation risk management activities, see Note 2.

For information regarding a change in accounting principle for trading activities see Note 1(r).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

*(l) Income Taxes.*

Reliant Energy files a consolidated federal income tax return in which Resources and its subsidiaries are included (as of the Acquisition Date). Reliant Energy follows a policy of comprehensive interperiod income tax allocation. For additional information regarding income taxes, see Note 7.

*(m) Investments in Marketable Equity Securities.*

A subsidiary of Resources holds certain equity securities classified as "available-for-sale" and reports such investments at estimated fair value with any unrealized gain or loss, net of tax, as a component of accumulated other comprehensive income. At December 31, 1998 and 1997, Resources' unrealized loss relating to these marketable equity securities was approximately \$16 million and \$5.6 million, respectively, net of tax.

*(n) Early Retirement and Severance.*

Prior to the Merger, during the first quarter of 1996, Resources instituted several early retirement and reorganization plans, pursuant to which a total of approximately 400 positions were eliminated resulting in expense for severance payments and enhanced retirement benefits reported as a non-recurring pre-tax charge of approximately \$22.3 million (approximately \$13.4 million after tax).

*(o) Merger Transaction Costs.*

"Merger transaction costs" include expenses associated with completion of the business combination with Reliant Energy (see Note 1(b)), principally consisting of investment banking and legal fees.

*(p) Allowance for Doubtful Accounts.*

Accounts and notes receivable, principally customer, as presented on Resources' Consolidated Balance Sheets are net of an allowance for doubtful accounts of \$14.4 million and \$15.3 million at December 31, 1998 and 1997, respectively.

*(q) Related Party Transactions.*

Reliant Energy has established a "money fund" through which Resources can borrow or invest on a short-term basis. Investments of Resources, reflected within accounts and notes receivable-affiliated companies, totaled \$181 million at December 31, 1998. Borrowings of Resources, reflected within notes payable to parent, totaled \$22 million at December 31, 1997. Interest expense on such borrowings was \$0.2 million for the year ended December 31, 1998. Interest income on such investments was \$5.1 million for the year ended December 31, 1998.

Certain subsidiaries of Resources have entered into office rental agreements with Reliant Energy. In 1998, subsidiaries of Resources paid \$0.9 million of rent expense to Reliant Energy.

*(r) Change in Accounting Principle*

In the fourth quarter of 1998, Resources adopted mark-to-market accounting for all of the energy price risk management and trading activities of Reliant Energy Services. Under mark-to-market accounting, Resources records the fair value of energy-related derivative financial instruments, including physical forward contracts, swaps, options and exchange-traded futures contracts, at each balance sheet date. Such amounts are recorded in Resources' Consolidated Balance Sheet as price risk management assets, price risk management liabilities, deferred debits and deferred liabilities. The realized and unrealized gains (losses) are recorded as a component of operating revenues in Resources' Consolidated Statements of Income. Resources has applied mark-to-market accounting

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

retroactively to January 1, 1998. This change was made in order to adopt a generally accepted accounting methodology that provided consistency between financial reporting and the methodology used in all reported periods by Resources in managing its trading activities. There was no material cumulative effect resulting from the accounting change.

Resources will adopt Emerging Issues Task Force Issue 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" in the first quarter of 1999 for Reliant Energy Services' trading activities. Resources does not expect the implementation of EITF Issue 98-10 to be material to its consolidated financial statements.

*(s) Reclassifications and Use of Estimates.*

Certain amounts from the previous years have been reclassified to conform to the 1998 presentation of financial statements. Such reclassifications do not affect earnings.

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

*(t) New Accounting Pronouncement.*

In 2000, Resources expects to adopt Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133), which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Resources is in the process of determining the effect of adoption of SFAS No. 133.

**(2) Derivative Financial Instruments**

*(a) Price Risk Management and Trading Activities.*

Resources, through its subsidiary, Reliant Energy Services, offers energy price risk management services primarily in the natural gas, electric and crude oil and refined product industries. Reliant Energy Services provides these services by utilizing a variety of derivative financial instruments, including fixed and variable-priced physical forward contracts, fixed-price swap agreements, variable-price swap agreements, exchange-traded energy futures and option contracts, and swaps and options traded in the over-the-counter financial markets (Trading Derivatives). Fixed-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between a fixed and variable price for the commodity. Variable-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between industry pricing publications or exchange quotations.

Prior to 1998 Reliant Energy Services applied hedge accounting to certain physical commodity activities that qualified for hedge accounting. In 1998, Reliant Energy Services adopted mark-to-market accounting for all of its price risk management and trading activities. Accordingly, as of such date, such Trading Derivatives are recorded at fair value with realized and unrealized gains (losses) recorded as a component of operating revenues in Resources' Consolidated Statements of Income. The recognized, unrealized balance is recorded as price risk management assets/liabilities and deferred debits/credits on Resources' Consolidated Balance Sheets (See Note 1(r)).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

The notional quantities, maximum terms and the estimated fair value of Trading Derivatives at December 31, 1998 are presented below (volumes in billions of British thermal units equivalent (BBtue) and dollars in millions):

	Volume-Fixed Price Payor	Volume-Fixed Price Receiver	Maximum Term (years)
<b>1998</b>			
Natural gas.....	937,264	977,293	9
Electricity .....	122,950	124,878	3
Crude oil and products.....	205,499	204,223	3

	Fair Value		Average Fair Value (a)	
	Assets	Liabilities	Assets	Liabilities
<b>1998</b>				
Natural gas.....	\$ 224	\$ 213	\$ 124	\$ 108
Electricity .....	34	33	186	186
Crude oil and products.....	29	23	21	17
	<u>\$ 287</u>	<u>\$ 269</u>	<u>\$ 331</u>	<u>\$ 311</u>

The notional quantities, maximum terms and the estimated fair value of derivative financial instruments at December 31, 1997 are presented below (volumes in BBtue and dollars in millions):

	Volume-Fixed Price Payor	Volume-Fixed Price Receiver	Maximum Term (years)
<b>1997</b>			
Natural gas.....	85,701	64,890	4
Electricity .....	40,511	42,976	1

	Fair Value		Average Fair Value (a)	
	Assets	Liabilities	Assets	Liabilities
<b>1997</b>				
Natural gas.....	\$ 46	\$ 39	\$ 56	\$ 48
Electricity .....	6	6	3	2
	<u>\$ 52</u>	<u>\$ 45</u>	<u>\$ 59</u>	<u>\$ 50</u>

(a) Computed using the ending balance of each month.

In addition to the fixed-price notional volumes above, Reliant Energy Services also has variable-priced agreements, as discussed above, totaling 1,702,977 and 101,465 BBtue as of December 31, 1998 and 1997, respectively. Notional amounts reflect the volume of transactions but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure Resources' exposure to market or credit risks.

All of the fair values shown in the table above at December 31, 1998 and substantially all at December 31, 1997 have been recognized in income. The fair value as of December 31, 1998 and 1997 was estimated using quoted prices where available and considering the liquidity of the market for the Trading Derivatives. The prices are subject to significant changes based on changing market conditions.

At December 31, 1998, \$22 million of the fair value of the assets and \$41 million of the fair value of the liabilities are recorded as long-term in deferred debits and deferred credits, respectively, on Resources' Consolidated Balance Sheets.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

The weighted-average term of the trading portfolio, based on volumes, is less than one year. The maximum and average terms disclosed herein are not indicative of likely future cash flows, as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and Resources' risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

In addition to the risk associated with price movements, credit risk is also inherent in Resources', and its subsidiaries' risk management activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. The following table shows the composition of the total price risk management assets of Reliant Energy Services as of December 31, 1998.

	Investment Grade (1)	Total
	(Thousands of Dollars)	
Energy marketers .....	\$ 102,458	\$ 123,779
Financial institutions .....	61,572	61,572
Gas and electric utilities .....	46,880	48,015
Oil and gas producers .....	7,197	8,323
Industrials .....	1,807	3,233
Independent power producers .....	1,452	1,463
Others .....	45,421	46,696
Total .....	<u>\$ 266,787</u>	<u>293,081</u>
Credit and other reserves .....		<u>(6,464)</u>
Energy price risk management assets (2) .....		<u>\$ 286,617</u>

- (1) "Investment Grade" is primarily determined using publicly available credit ratings along with the consideration of credit support (e.g., parent company guarantees) and collateral, which encompass cash and standby letters of credit.
- (2) Resources has credit risk exposure with respect to two investment grade customers, each of which represents an amount greater than 5% but less than 10% of Price Risk Management Assets.

*(b) Non-Trading Activities.*

To reduce the risk from market fluctuations in the price of electric power, natural gas and related transportation, Resources and certain of its subsidiaries enter into futures transactions, swaps and options (Energy Derivatives) in order to hedge certain natural gas in storage, as well as certain expected purchases, sales and transportation of natural gas and electric power (a portion of which are firm commitments at the inception of the hedge). Energy Derivatives are also utilized to fix the price of compressor fuel or other future operational gas requirements, although usage to date for this purpose has not been material. Resources applies hedge accounting with respect to its derivative financial instruments.

Certain subsidiaries of Resources also utilize interest rate derivatives (principally interest rate swaps) in order to adjust the portion of its overall borrowings which are subject to interest rate risk and also utilize such derivatives to effectively fix the interest rate on debt expected to be issued for refunding purposes.

For transactions involving either Energy Derivatives or interest rate derivatives, hedge accounting is applied only if the derivative (i) reduces the price risk of the underlying hedged item and (ii) is designated as a hedge at its inception. Additionally, the derivatives must be expected to result in financial impacts which are inversely correlated to those of the item(s) to be hedged. This correlation (a measure of hedge effectiveness) is measured both at the

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)**

inception of the hedge and on an ongoing basis, with an acceptable level of correlation of at least 80% for hedge designation. If and when correlation ceases to exist at an acceptable level, hedge accounting ceases and mark-to-market accounting is applied.

In the case of interest rate swaps associated with existing obligations, cash flows and expenses associated with the interest rate derivative transactions are matched with the cash flows and interest expense of the obligation being hedged, resulting in an adjustment to the effective interest rate. When interest rate swaps are utilized to effectively fix the interest rate for an anticipated debt issuance, changes in the market value of the interest rate derivatives are deferred and recognized as an adjustment to the effective interest rate on the newly issued debt.

Unrealized changes in the market value of Energy Derivatives utilized as hedges are not generally recognized in Resources' Consolidated Statements of Income until the underlying hedged transaction occurs. Once it becomes probable that an anticipated transaction will not occur, deferred gains and losses are recognized. In general, the financial impact of transactions involving these Energy Derivatives is included in Resources' Statements of Consolidated Income under the captions (i) fuel expenses, in the case of natural gas transactions and (ii) purchased power, in the case of electric power transactions. Cash flows resulting from these transactions in Energy Derivatives are included in Resources' Statements of Consolidated Cash Flows in the same category as the item being hedged.

At December 31, 1998, subsidiaries of Resources were fixed-price payors and fixed-price receivers in Energy Derivatives covering 42,498 billion British thermal units (BBtu) and 3,930 BBtu of natural gas, respectively. At December 31, 1997, subsidiaries of Resources were fixed-price payors and fixed-price receivers in Energy Derivatives covering 38,754 BBtu and 7,647 BBtu of natural gas, respectively. Also, at December 31, 1998 and 1997, subsidiaries of Resources were parties to variable-priced Energy Derivatives totaling 21,437 BBtu and 3,630 BBtu of natural gas, respectively. The weighted average maturity of these instruments is less than one year.

The notional amount is intended to be indicative of Resources' and its subsidiaries' level of activity in such derivatives, although the amounts at risk are significantly smaller because, in view of the price movement correlation required for hedge accounting, changes in the market value of these derivatives generally are offset by changes in the value associated with the underlying physical transactions or in other derivatives. When Energy Derivatives are closed out in advance of the underlying commitment or anticipated transaction, however, the market value changes may not offset due to the fact that price movement correlation ceases to exist when the positions are closed, as further discussed below. Under such circumstances, gains (losses) are deferred and recognized as a component of income when the underlying hedged item is recognized in income.

The average maturity discussed above and the fair value discussed in Note 10 are not necessarily indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and Resources' risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

*(c) Trading and Non-trading — General Policy.*

In addition to the risk associated with price movements, credit risk is also inherent in Resources' and its subsidiaries' risk management activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. While as yet Resources and its subsidiaries have experienced only minor losses due to the credit risk associated with these arrangements, Resources has off-balance sheet risk to the extent that the counterparties to these transactions may fail to perform as required by the terms of each such contract. In order to minimize this risk, Resources and/or its subsidiaries, as the case may be, enter into such contracts primarily with those counterparties with a minimum Standard & Poor's or Moody's rating of BBB- or Baa3, respectively. For long-term arrangements, Resources and its subsidiaries periodically review the financial condition of such firms in addition to monitoring the effectiveness of these financial contracts in achieving Resources' objectives. Should the

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counterparties to these arrangements fail to perform, Resources would seek to compel performance at law or otherwise or obtain compensatory damages in lieu thereof. Resources might be forced to acquire alternative hedging arrangements or be required to honor the underlying commitment at then-current market prices. In such event, Resources might incur additional loss to the extent of amounts, if any, already paid to the counterparties. In view of its criteria for selecting counterparties, its process for monitoring the financial strength of these counterparties and its experience to date in successfully completing these transactions, Resources believes that the risk of incurring a significant financial statement loss due to the non-performance of counterparties to these transactions is minimal.

Resources' policies prohibit the use of leveraged financial instruments.

**(3) Capital Stock**

*(a) Earnings Per Share.*

As a result of the Merger, Resources is no longer required to present earnings per share (EPS) data as its common shares (all of which are owned by Reliant Energy) are not publicly held. EPS data for 1998, 1997 and 1996 has not been included because Resources believes it is no longer meaningful.

*(b) Direct Stock Purchase Plan and Dividend Reinvestment Plan.*

Resources' Direct Stock Purchase Plan and Dividend Reinvestment Plan were suspended and canceled in connection with the Merger.

**(4) Long-term and Short-term Financing**

*(a) Short-term Financing.*

In 1998, Resources met its short-term financing needs primarily through a bank facility, bank lines of credit, a receivables facility and the issuance of commercial paper. In March 1998, Resources replaced its \$400 million revolving credit facility with a five-year \$350 million revolving credit facility (Resources Credit Facility). Borrowings under the Resources Credit Facility are unsecured and bear interest at a rate based upon either the London interbank offered rate (LIBOR) plus a margin, a base rate or a rate determined through a bidding process. The Resources Credit Facility is used to support Resources' issuance of up to \$350 million of commercial paper. There were no commercial paper borrowings and no loans outstanding under the Resources Credit Facility at December 31, 1998. Borrowings under Resources' prior credit facility at December 31, 1997 were \$340 million. In addition, Resources had \$50 million of outstanding loans under uncommitted lines of credit at December 31, 1997 having a weighted average interest rate of 6.82%.

A \$65 million committed bank facility under which Resources obtained letters of credit and all of Resources' uncommitted lines of credit were terminated in 1998. Subsequent to the December 1998 termination, Resources obtained letters of credit under an uncommitted line. Resources expects to amend the Resources Credit Facility in March 1999 to add a \$65 million letter of credit subfacility.

Under a trade receivables facility (Receivables Facility) which expires in August 1999, Resources sells, with limited recourse, an undivided interest (limited to a maximum of \$300 million) in a designated pool of accounts receivable. The amount of receivables sold and uncollected was \$300 million at December 31, 1998 and at December 31, 1997. The weighted average interest rate was approximately 5.54% at December 31, 1998 and 5.65% at December 31, 1997. Certain of Resources' remaining receivables serve as collateral for receivables sold and represent the maximum exposure to Resources should all receivables sold prove ultimately uncollectible. Resources has retained servicing responsibility under the Receivables Facility for which it is paid a servicing fee. Pursuant to SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities",



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Resources accounts for amounts transferred pursuant to the Receivables Facility as collateralized borrowings. As a result, these receivables are recorded as assets on Resources' Consolidated Balance Sheet and amounts received by Resources pursuant to this facility are recorded as a current liability under the caption "Receivables Facility."

*(b) Long-term Debt.*

Resources' consolidated long-term debt outstanding, which is summarized in the following table, is noncallable and without sinking fund requirements except as noted. Carrying amounts and amounts due in one year reflect \$33.2 million and \$3.4 million, respectively, for fair value adjustments recorded in connection with the Merger.

	December 31, 1998			
	Effective Rate	Principal Amount	Carrying Amounts	
			Non-Current Portion	Current Portion
		(millions of dollars)		
Medium-term notes, Series A and B due through 2001, weighted average rate of 8.96% at December 31, 1998 .....	6.4%	\$ 165.6	\$ 177.6	
8.875% Series due 1999 .....	6.3%	200.0		\$ 202.7
7.5% Series due 2000 .....	6.4%	200.0	203.1	
8.9% Series due 2006 .....	6.8%	145.1	163.4	
6% Convertible Subordinated Debentures due 2012 .....	6.5%	109.6	104.6	
10% Series due 2019(1).....	8.8%	42.8	47.6	
6 ½% Series due 2008 .....	6.5%	300.0	300.0	
6 ¾% Series due 2003.....	6.4%	517.0	517.0	
Other.....				0.7
		<u>\$ 1,680.1</u>	<u>\$ 1,513.3</u>	<u>\$ 203.4</u>

		December 31, 1997		
	Effective Rate	Principal Amount	Carrying Amounts	
			Non-Current Portion	Current Portion
		(millions of dollars)		
Medium-term notes, Series A and B due through 2001, weighted average rate of 8.90% at December 31, 1997 .....	6.4%	\$ 241.6	\$ 183.8	\$ 78.8
Bank Term Loan due 1998 .....	6.2%	150.0		153.3
8.875% Series due 1999 .....	6.3%	200.0	207.2	
7.5% Series due 2000 .....	6.4%	200.0	205.0	
8.9% Series due 2006 .....	6.8%	145.1	165.1	
6% Convertible Subordinated Debentures due 2012 .....	6.5%	116.3	107.2	
10% Series due 2019(1) .....	8.8%	42.8	47.8	
Other .....	4.1%	0.6	0.6	
		\$ 1,096.4	\$ 916.7	\$ 232.1

(1) In the fourth quarter of 1997 Resources purchased \$101.4 million aggregate principal amount of its 10% Debentures due 2019 at an average price of 111.98% plus accrued interest. Because Resources' debt was stated at fair market value as of the Acquisition Date, the loss on the reacquisition of these debentures was not material.

Consolidated maturities of long-term debt and sinking fund requirements for Resources are approximately \$207 million for 1999, \$228 million in 2000, \$151 million in 2001, \$7 million in 2002 and \$7 million in 2003.

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Resources' retirements and reacquisitions of long-term debt are summarized in the following table. In cases where premiums were paid or discounts were realized in association with these reacquisitions and retirements, such amounts are reported in Resources' Statements of Consolidated Income as "Extraordinary gain (loss) on early retirement of debt, less taxes" and are net of taxes of \$0.1 million and (\$2.5) million in 1997 and 1996, respectively. For retirements and reacquisitions after the Acquisition Date, gains or losses on early retirement are immaterial since the carrying amounts reflect the fair value adjustments described above.

	Year Ended December 31,	
	1998(1)	1997(1)
Reacquisition of 10% Debentures due 2019.....		\$ 101.4
Reacquisition of 6% Convertible Subordinated Debentures due 2012(2).....	\$ 6.7	5.8
Retirement, at maturity, of Medium Term Notes(3).....	76.0	52.0
Retirement of Bank Term Loan due 2000.....	150.0	
Retirement of 9.875% Notes due 1997.....		225.0
Net (gain) loss on reacquisition of debt, less taxes.....		(0.2)
	\$ 232.7	\$ 384.0

- (1) Excludes the conversion of 6% Convertible Subordinated Debentures due 2012 in the amount of approximately \$0 and \$.7 million at December 31, 1998 and December 31, 1997, respectively.  
(2) These reacquired debentures may be credited against sinking fund requirements.  
(3) Weighted average interest rate of 8.75% and 9.25% in 1998 and 1997, respectively.

In June 1996, Resources exercised its right to exchange the \$130 million principal amount of its \$3.00 Convertible Exchangeable Preferred Stock, Series A for its 6% Convertible Subordinated Debentures due 2012 (Subordinated Debentures). The holders of the Subordinated Debentures receive interest quarterly and have the right at any time on or before the maturity date thereof to convert each Subordinated Debenture into 0.65 shares of common stock of Reliant Energy and \$14.24 in cash. The Subordinated Debentures are callable beginning in 1999 at redemption prices beginning at 105.0% and declining to par in November 2009. Resources is required to make annual sinking fund payments of \$6.5 million on the Subordinated Debentures which began on March 15, 1997 and will continue on each succeeding March 15 up to and including March 15, 2011. Resources (i) may credit against the sinking fund requirements any Subordinated Debentures redeemed by Resources and Subordinated Debentures which have been converted at the option of the holder and (ii) may deliver purchased Subordinated Debentures in satisfaction of the sinking fund requirements. Resources satisfied its 1998 sinking fund requirement of \$6.5 million by delivering Subordinated Debentures purchased in 1996 and 1997.

In February 1998, Resources issued \$300 million principal amount of 6.5% debentures due February 1, 2008. The proceeds from the sale of the debentures were used to repay short-term indebtedness of Resources, including the indebtedness incurred in connection with the 1997 purchase of \$101 million aggregate principal amount of its 10% debentures and the repayment of \$53 million aggregate principal amount of Resources debt that matured in December 1997 and January 1998. In connection with the issuance of the 6.5% debentures, Resources received approximately \$1 million upon unwinding a \$300 million treasury rate lock agreement, which was tied to the interest rate on 10-year treasury bonds. The rate lock agreement was executed in January 1998, and proceeds from the unwind will be amortized over the 10 year life of Resources' 6.5% debentures.

In November 1998, Resources sold \$500 million aggregate principal amount of its 6 3/8% Term Enhanced ReMarketable Securities (TERM Notes). Included within the TERM Notes is an embedded option sold to an investment bank which gives the investment bank the right to remarket the TERM Notes in 2003 if it chooses to exercise the option. The net proceeds of \$514 million from the offering of the TERM Notes were used for general corporate purposes, including the repayment of (i) \$178.5 million of Resources' outstanding commercial paper and

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(ii) a \$150 million term loan of Resources that matured on November 13, 1998. The TERM Notes are unsecured obligations of Resources which bear interest at an annual rate of 6 3/8% through November 1, 2003. On November 1, 2003, the holders of the TERM Notes are required to tender their notes at 100% of their principal amount. The portion of the proceeds attributable to the option premium will be amortized over the stated term of the securities. If the option is not exercised, Resources will repurchase the TERM Notes at 100% of their principal amount on November 1, 2003. If the option is exercised, the TERM Notes will be remarketed on a date, selected by Resources, within the 52-week period beginning November 1, 2003. During such period and prior to remarketing, the TERM Notes will bear interest at rates, adjusted weekly, based on an index selected by Resources. If the TERM Notes are remarketed, the final maturity date of the TERM Notes will be November 1, 2013, subject to adjustment, and the effective interest rate on the remarketed TERM Notes will be 5.66% plus Resources' applicable credit spread at the time of such remarketing.

*(b) Restrictions on Debt.*

Under the provisions of the Resources Credit Facility, Resources' total debt is limited to 55% of its total capitalization. This provision did not significantly restrict Resources' ability to issue debt or to pay dividends in 1998. At December 31, 1998, Resources' total debt to total capitalization equaled 40%.

**(5) Trust Securities**

In June 1996, a Delaware statutory business trust (Resources Trust) established by Resources issued in a public offering \$172.5 million of convertible preferred securities and sold approximately \$5.3 million of Resources Trust common stock (106,720 shares, representing 100% of the Resources Trust's common equity) to Resources. The convertible preferred securities have a distribution rate of 6.25% payable quarterly in arrears, a stated liquidation amount of \$50 per convertible preferred security and must be redeemed by 2026. The proceeds from the sale of the preferred and common securities were used by Resources Trust to purchase \$177.8 million of 6.25% Convertible Junior Subordinated Debentures from Resources having an interest rate corresponding to the distribution rate of the convertible preferred securities and a maturity date corresponding to the mandatory redemption date of the convertible preferred securities. Under existing law, interest payments made by Resources for the junior subordinated debentures are deductible for federal income tax purposes. Resources has the right at any time and from time to time to defer interest payments on the junior subordinated debentures for successive periods not to exceed 20 consecutive quarters for each such extension period. In such case, (1) quarterly distributions on the junior subordinated debentures would also be deferred and (2) Resources has agreed to not declare or pay any dividend on any common or preferred stock, except in certain instances.

The Resources Trust is accounted for as a wholly owned consolidated subsidiary of Resources. The junior subordinated debentures are the sole assets of the Resources Trust. Resources has fully and unconditionally guaranteed, on a subordinated basis, the Resources Trust's obligations, including the payment of distributions and all other payments, with respect to the convertible preferred securities. The convertible preferred securities are mandatorily redeemable upon the repayment of the related junior subordinated debentures at their stated maturity or earlier redemption. Each convertible preferred security is convertible at the option of the holder into \$33.62 of cash and 1.55 shares of Reliant Energy common stock. During 1998, convertible preferred securities aggregating \$15.5 million were converted, leaving \$0.9 million liquidation amount of convertible preferred securities outstanding at December 31, 1998.

**(6) Stock-Based Incentive Compensation Plans and Employee Benefit Plans**

*(a) Incentive Compensation Plans.*

Prior to the Merger, Resources had several incentive compensation plans which provided for the issuance of stock-based incentives (including restricted shares, stock options and stock appreciation rights) to directors and key

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employees of Resources, including officers. The charge to earnings in 1997 and 1996 related to the incentive compensation plans was \$1.4 million and \$4.4 million, respectively. All stock options granted under such plans were either converted into similar Reliant Energy options or "cashed out" prior to the Merger. All restricted stock and substantially all stock appreciation rights were "cashed out" with the Merger. Resources granted 463,856 shares of restricted stock in 1996 with a weighted average fair value at the grant date of \$11.86. At December 31, 1996, there were 77,371 stock appreciation rights outstanding. As of the Acquisition Date, less than 1,000 stock appreciation rights were outstanding. The following is certain information relating to options issued pursuant to Resources' incentive compensation plans.

	Number of Shares	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 1995 .....	1,033,019	\$ 8.82
Options Granted (2).....	579,749	\$ 8.69
Options Exercised .....	(28,019)	\$ 6.44
Options Forfeited/Expired .....	(76,821)	\$ 11.99
Outstanding at December 31, 1996 .....	1,507,928	\$ 8.65
Options Exercised .....	(147,092)	\$ 6.47
Options Forfeited/Expired .....	(10,682)	\$ 12.42
Options Cashed Out Upon Merger .....	(521,857)	
Options Converted at Acquisition (1).....	(828,297)	
Outstanding at December 31, 1997 .....		
Exercisable at:		
December 31, 1996.....	911,660	\$ 9.48

- (1) Effective upon the Merger, each holder of an unexpired Resources stock option, whether or not then exercisable, was entitled to elect to either (i) have all or any portion of their Resources stock options canceled and "cashed out" or (ii) have all or any portion of their Resources stock options converted to the Reliant Energy stock options. There were 828,297 Resources stock options converted into 622,504 Reliant Energy stock options at the Acquisition Date.
- (2) The weighted average grant date fair value of the options granted in 1996 was \$2.39.

In October 1995, the Financial Accounting Standards Board issued SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123). SFAS No. 123 provides for the disclosure of certain information concerning the "fair value" of securities issued pursuant to stock-based employee compensation plans, and gives Resources the option of calculating and recording compensation expense utilizing either (i) SFAS No. 123's "fair value" methodology which measures compensation expense as the "fair value" of all securities at the date on which they are granted to the employee or (ii) the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25) which, in general, do not require the recording of compensation expense for options and stock appreciation rights issued pursuant to plans structured similarly to those of Resources. Resources elected to continue to apply the provisions of APB No. 25 for the purpose of computing compensation expense associated with the relevant plan, although certain additional required disclosure has been made in accordance with the provisions of SFAS No. 123.

The "fair value" as applied to restricted stock represents the quoted NYSE closing market price of the shares on the grant date. The term "fair value" as applied to stock options granted in 1996 and 1995 is a statistical calculation made utilizing a methodology generally referred to as the Black-Scholes option pricing model. The model yields a value for each option which is dependent on a number of variables which are inputs to the relevant calculations. For the purposes of determining the "fair value" of stock options in the preceding table, Resources assumed (i) a risk free interest rate (based on U.S. Treasury strips with a remaining term of five years) of 5.24% to 7.84%, (ii) an expected option life (duration) of five years, (iii) an expected volatility of 31.6% to 36.4% and (iv) an expected dividend yield of 3.4%. To the extent that actual conditions during the post-grant, pre-exercise period differ from

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these assumptions, the actual value of the options to the employee will differ from the calculated "fair value" at grant date (see above regarding the effect of the Merger). Had compensation cost been determined in accordance with the provisions of SFAS No. 123, the impact on Resources' earnings for 1996 would have been immaterial.

*(b) Employee Benefit Plans.*

Resources has two qualified pension plans (the Qualified Plans) which cover substantially all employees: (1) the plan which covers Resources' employees other than Reliant Energy Minnegasco employees and (2) the plan which covers Reliant Energy Minnegasco employees. The Qualified Plans provide benefits based on the participants' years of service and highest average compensation. The funding policy for the Qualified Plans is to contribute at least the minimum amount required to be funded as determined by Resources' consulting actuaries. Plan assets are made up of marketable equity and high-grade fixed income securities.

In addition to the Qualified Plans, Resources maintains certain non-qualified plans which principally consist of (i) a retirement restoration plan which allows participants to retain the benefit to which they would have been entitled under the Qualified Plans except for the federally mandated limits on such benefits or on the level of salary on which such benefits may be calculated and (ii) certain supplemental benefit plans which, in the past, were entered into with individual employees or with small groups of employees. Participants in these non-qualified plans are general creditors of Resources with respect to these benefits, as these plans are not funded by Resources in advance of the cash payment of benefits. The benefit obligation for the non-qualified plans at December 31, 1998 and 1997 was \$37.7 million and \$36.3 million, respectively. Expense of approximately \$1.7 million, \$3.1 million and \$2.0 million associated with these non-qualified plans was recorded during 1998, 1997 and 1996, respectively.

In 1998, Resources adopted SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" (SFAS No. 132). SFAS No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of these plans.

Net Pension cost (qualified plans only) for Resources includes the following components:

	Current Resources		Former Resources	
	Twelve Months Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997	Twelve Months Ended December 31, 1996
	(Thousands of Dollars)			
Service cost — benefits earned during the period .....	\$ 13,466	\$ 5,095	\$ 7,220	\$ 11,817
Interest cost on projected benefit obligation .....	33,357	15,015	20,313	29,946
Expected return on plan assets .....	(53,043)	(23,856)	(26,716)	(41,800)
Amortization(1) .....			66	(641)
Net pension cost (credit) .....	<u>\$ (6,220)</u>	<u>\$ (3,746)</u>	<u>\$ 883</u>	<u>\$ (678)</u>

(1) Amortization after the Acquisition Date represents amortization of unrecognized loss incurred after the Acquisition Date. For further discussion of the accounting for the Merger see Note 1(b).

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Reconciliations of Resources' beginning and ending balances of its pension plan benefit obligation, plan assets and funded status for 1998 and 1997 are set forth below (in thousands of dollars):

	Current Resources		Former Resources
	Twelve Months Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997
<b>Change in Benefit Obligation</b>			
Benefit obligation, beginning of period.....	\$ 513,247	\$ 485,206	\$ 435,490
Service cost.....	13,466	5,095	7,220
Interest cost.....	33,357	15,015	20,313
Benefits paid.....	(23,870)	(9,408)	(13,340)
Plan amendments.....	(53,736)		
Actuarial (gain) loss.....	70,746	17,339	35,523
Benefit obligation, end of period .....	<u>553,210</u>	<u>513,247</u>	<u>485,206</u>
<b>Change in Plan Assets</b>			
Plan asset, beginning of period.....	569,718	577,275	500,451
Benefits paid.....	(23,870)	(9,408)	(13,340)
Actual investment return.....	78,514	1,851	90,164
Plan assets, end of period .....	<u>\$ 624,362</u>	<u>\$ 569,718</u>	<u>\$ 577,275</u>
	<b>Year ended December 31,</b>		
	<b>1998</b>	<b>1997</b>	
<b>Reconciliation of Funded Status</b>			
Funded status .....	\$ 71,152	\$ 56,471	
Unrecognized prior service cost.....	(53,736)		
Unrecognized actuarial (gain) loss .....	84,618	39,344	
Net amount recognized at end of year .....	<u>\$ 102,034</u>	<u>\$ 95,815</u>	

Resources' Consolidated Balance Sheets included \$102 million and \$92 million prepaid benefit cost at December 31, 1998 and 1997, respectively.

The assumed rate of increase in future compensation levels utilized in the above calculations was 3.5% - 5.5% in 1998, 4% - 6% in 1997 and 4% in 1996. The expected long-term rate of return on fund assets utilized in the above calculations was 10% for 1998 and 1997. The weighted average discount rate was 6.5% for 1998 and 7.25% for 1997.

In 1998, Reliant Energy's and Resources' board of directors approved an amendment, effective January 1, 1999, which converted the present value of the accrued benefits under the existing pension plans into a cash balance plan. Under the cash balance formula, each participant has an account, for recordkeeping purposes only, to which credits are allocated annually based on a percentage of the participant's pay. The applicable percentage is 4%.

The purpose of the plan change is to continue to provide uniform retirement income benefits across all employee groups, which are competitive both within the utility industry as well as with other companies within the United States.

Resources will continue to reflect the costs of the qualified pension plan according to the provisions of SFAS No. 87 as amended by SFAS No. 132. As a result of the January 1, 1999 amendment, which is reflected in the

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December 31, 1998 disclosure, Resources' benefit obligation declined \$54 million. The plan amendment had no impact on 1998 expense.

The actuarial loss is due to changes in certain actuarial assumptions.

Resources has an employee savings plan (the ESP) which covers substantially all employees other than Reliant Energy Minnegasco employees. Under the terms of the ESP, employees may contribute up to 12% of total compensation, of which contributions up to 6% are matched by Resources. Employer contributions to the ESP of \$9.2 million, \$9.3 million and \$8.9 million were expensed during 1998, 1997 and 1996, respectively. The Reliant Energy Minnegasco employees are covered by various thrift and profit sharing plans, the terms of which vary from plan to plan. Expenses of approximately \$1.6 million, \$1.5 million and \$1.4 million related to these plans were recorded during 1998, 1997 and 1996, respectively.

Resources records the liability for postretirement benefit plans other than pensions (primarily health care) under SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions". Resources provides these benefits under a defined benefit plan for all eligible former employees who retired prior to July 1, 1992, and under a defined contribution plan for all others. A substantial number of Resources' employees may become eligible for postretirement benefits if they are participating in such plans when they reach normal retirement age. As of December 31, 1998, Resources had contributed a total of \$6 million to an external fund (associated with Reliant Energy Minnegasco employees) to provide for these benefits. Resources currently expects that it will fund these benefits utilizing external funding techniques for additional employees in the future.

The net postretirement benefit cost includes the following components:

	Current Resources		Former Resources	
	Twelve Months Ended December 31, 1998	Five Months Ended December 31, 1997	Seven Months Ended July 31, 1997	Twelve Months Ended December 31, 1996
	(Thousands of Dollars)			
Service cost — benefits earned during the period .....	\$ 635	\$ 115	\$ 164	\$ 306
Interest cost on accumulated postretirement benefit obligation .....	6,660	3,561	4,948	9,234
Expected return on plan assets .....	(463)	(73)	(107)	(108)
Net amortization .....			3,875	7,983
Net postretirement benefit cost .....	<u>\$ 6,832</u>	<u>\$ 3,603</u>	<u>\$ 8,880</u>	<u>\$ 17,415</u>

Reconciliations of Resources' beginning and ending balances of its postretirement benefit plan's benefit obligation, plan assets and funded status for 1998 and 1997 are set forth below (in thousands of dollars):

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	<b>Current Resources</b>		<b>Former Resources</b>
	<b>Twelve Months</b>	<b>Five Months</b>	<b>Seven Months</b>
	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>
	<b>December 31, 1998</b>	<b>December 31, 1997</b>	<b>July 31, 1997</b>
<b>Change in Benefit Obligation</b>			
Benefit obligation, beginning of period.....	\$ 118,472	\$ 115,721	\$ 129,381
Service cost.....	635	115	164
Interest cost.....	6,660	3,561	4,948
Benefits paid.....	(11,569)	(3,543)	(7,093)
Participant contributions.....	1,856	568	1,138
Plan amendments.....	28,936		
Actuarial (gain) loss.....	(921)	2,050	(12,817)
Benefit obligation, end of period .....	<u>144,069</u>	<u>118,472</u>	<u>115,721</u>
<b>Change in Plan Assets</b>			
Plan asset, beginning of period.....	4,502	2,909	3,051
Benefits paid.....	(11,569)	(3,543)	(7,093)
Employer contributions.....	11,163	5,171	5,209
Participant contributions.....	1,856	568	1,138
Actual investment return.....	509	(603)	604
Plan assets, end of period .....	<u>\$ 6,461</u>	<u>\$ 4,502</u>	<u>\$ 2,909</u>

	<b>Year ended December 31,</b>	
	<b>1998</b>	<b>1997</b>
<b>Reconciliation of Funded Status</b>		
Funded status .....	\$ (137,608)	\$ (113,970)
Unrecognized prior service cost.....	28,936	
Unrecognized actuarial (gain) loss .....	1,759	2,726
Net amount recognized at end of year .....	<u>\$ (106,913)</u>	<u>\$ (111,244)</u>

Resources' Consolidated Balance Sheets included \$107 million and \$111 million of postretirement benefit liability at December 31, 1998 and 1997, respectively.

The weighted average discount rate used in determining the accumulated benefit obligation for postretirement benefits was 6.50% for 1998, 7.25% for 1997 and 7.5% for 1996. The cost of covered health care benefits (for those participants entitled to a defined benefit as a result of having retired prior to July 1, 1992) is assumed to increase by 6.0% and 6.7% for pre-65 and post-65, respectively, initially and then increase at a decreasing rate to an annual and continuing increase of 5.4% by 2001. Based on these assumptions, a one percentage point increase in the assumed health care cost trend rate would increase the annual net periodic postretirement benefit cost (before any deferral for regulatory reasons) and the accumulated benefit obligation at December 31, 1998 and 1997 by approximately 6.7% and 10.8%, respectively. A one percentage point decrease in the assumed health care cost trend rate would decrease the annual net periodic postretirement benefit cost (before any deferral for regulatory reasons) and the accumulated benefit obligation as December 31, 1998 by approximately 6.0% and 9.6%, respectively.

In 1998, Reliant Energy's and Resources' boards of directors approved an amendment, effective January 1, 1999, which created an account balance based on credited service at December 31, 1998. Under the new plan, each participant has an account, for recordkeeping purposes only, to which a \$750 credit is allocated annually. This account balance vests after 5 years of service after age 50. At retirement the account balance can be used to purchase medical benefits. It may not be taken as cash.



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The purpose of the plan change is to continue to provide uniform retiree medical benefits across all employee groups, which are competitive both within the utility industry as well as with other companies within the United States.

Resources will continue to reflect the costs of the retiree medical plan according to the provisions of SFAS No. 106 as amended by SFAS No. 132. As a result of the January 1, 1999 amendment, which is reflected in the December 31, 1998 disclosure, Resources' benefit obligation increased \$29 million. The plan amendment had no impact on 1998 expense.

The actuarial gain is due to changes to certain actuarial assumptions.

**(7) Income Taxes**

Reliant Energy files a consolidated federal income tax return, in which Resources and its subsidiaries are included. Prior to the Acquisition Date, Resources and its subsidiaries filed a consolidated federal income tax return. Resources' pre-acquisition consolidated federal income tax returns have been audited and settled through the year 1986. Investment tax credits are generally deferred and amortized over the lives of the related assets. The unamortized investment tax credit in deferred credits on Resources' Consolidated Balance Sheets was \$5.8 million and \$5.2 million for 1998 and 1997, respectively.

The components of Resources' income tax provision are set forth below:

	<b>Current Resources</b>		<b>Former Resources</b>	
	<b>Twelve Months Ended December 31, 1998</b>	<b>Five Months Ended December 31, 1997</b>	<b>Seven Months Ended July 31, 1997</b>	<b>Twelve Months Ended December 31, 1996</b>
	(Thousands of Dollars)			
Federal				
Current .....	\$ 30,539	\$ (12,005)	\$ 16,339	\$ 33,654
Deferred .....	61,020	36,673	12,795	25,760
Investment tax credit .....	(609)	(262)	(363)	(636)
State				
Current .....	7,235	536	833	4,525
Deferred .....	13,645	(559)	1,794	3,049
Income tax expense .....	<u>\$ 111,830</u>	<u>\$ 24,383</u>	<u>\$ 31,398</u>	<u>\$ 66,352</u>

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The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate of 35% to income from continuing operations. The reasons for this difference are as follows:

	<b>Current Resources</b>		<b>Former Resources</b>	
	<b>Twelve Months Ended December 31, 1998</b>	<b>Five Months Ended December 31, 1997</b>	<b>Seven Months Ended July 31, 1997</b>	<b>Twelve Months Ended December 31, 1996</b>
	(Thousands of Dollars)			
Income before income taxes .....	\$ 205,654	\$ 45,230	\$ 77,273	\$ 161,490
Statutory rate.....	35%	35%	35%	35%
Income taxes at statutory rate.....	71,979	15,831	27,046	56,522
Increase (decrease) in tax resulting from:				
State income taxes, net of federal income tax benefit(1) .....	14,737	(9)	1,708	4,923
Investment tax credit.....	(609)	(262)	(363)	(636)
Research and experimentation credit .....				(188)
Adjustment to prior-year accruals...	2,049	106	(34)	301
Goodwill amortization .....	17,971	7,242	2,430	4,163
Other, net .....	5,703	1,475	611	1,267
Total .....	39,851	8,552	4,352	9,830
Income taxes .....	\$ 111,830	\$ 24,383	\$ 31,398	\$ 66,352
Effective Rate.....	54.4%	53.9%	40.6%	41.1%

- (1) Calculation of the accrual for state income taxes at the end of each year requires that Resources estimate the manner in which its income for that year will be allocated and/or apportioned among the various states in which it conducts business, which states have widely differing tax rules and rates. These allocation/apportionment factors change from year to year and the amount of taxes ultimately payable may differ from that estimated as a part of the accrual process. For these reasons, the amount of state income tax expense may vary significantly from year-to-year, even in the absence of significant changes to state income tax valuation allowances or changes in individual state income tax rates.

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The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and liabilities as of December 31, 1998 and 1997, were as follows:

	December 31,	
	1998	1997
	(Thousands of Dollars)	
<b>Deferred Tax Assets:</b>		
Employee benefit accruals .....	\$ 42,572	\$ 53,277
Gas purchase contract accruals .....	8,377	8,267
Deferred state income taxes .....	14,236	14,460
State operating loss carryforwards .....	23,178	29,515
Alternative minimum tax credit carryforwards .....	39,595	60,669
Other.....	34,698	57,509
Valuation allowance .....	(8,591)	(6,353)
Total deferred tax assets – net .....	154,065	217,344
<b>Deferred Tax Liabilities:</b>		
Property, plant and equipment, principally due to depreciation methods and lives .....	539,773	558,758
Deferred gas costs .....	13,663	34,113
Deferred state income taxes .....	70,000	70,000
Regulatory obligations.....	811	6,690
Other.....	27,580	22,513
Total deferred tax liabilities .....	651,827	692,074
Accumulated deferred income taxes – net.....	\$ 497,762	\$ 474,730

At December 31, 1998, Resources has approximately \$368 million of state net operating losses available to offset future state taxable income through the year 2013. In addition, Resources has approximately \$33 million of federal alternative minimum tax credits which are available to reduce future federal income taxes payable, if any, over an indefinite period (although not below the tentative minimum tax otherwise due in any year), and approximately \$2.6 million of state alternative minimum tax credits which are available to reduce future state income taxes payable, if any, through the year 2001. The valuation allowance reflects a net increase of \$2.3 million in 1998. This net increase results from a reassessment of Resources' usage of state tax attributes, including the future ability to use state net operating loss and alternative minimum tax credit carryforwards, offset by changes in valuation allowances provided for expiring state net operating loss carryforwards.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

**(8) Commitments and Contingencies**

**(a) Lease Commitments.**

The following table sets forth certain information concerning Resources' obligations under operating leases:

Minimum Lease Commitments at December 31, 1998(1)  
(millions of dollars)

1999 .....	\$ 19
2000 .....	15
2001 .....	14
2002 .....	10
2003 .....	9
2004 and beyond .....	61
Total .....	<u>\$ 128</u>

- (1) Principally consisting of rental agreements for building space and data processing equipment and vehicles (including major work equipment); approximately \$16 million represents rental agreements with Reliant Energy.

Resources has a master leasing agreement which provides for the lease of vehicles, construction equipment, office furniture, data processing equipment and other property. For accounting purposes, the lease is treated as an operating lease. At December 31, 1998, the unamortized value of equipment covered by the master leasing agreement was \$26.9 million. Resources does not expect to lease additional property under this lease agreement.

Total rental expense for all leases was \$25.0 million, \$24.0 million and \$33.4 million in 1998, 1997 and 1996, respectively.

**(b) Letters of Credit.**

At December 31, 1998, Resources had letters of credit incidental to its ordinary business operations totaling approximately \$30 million under which Resources is obligated to reimburse drawings, if any.

**(c) Indemnity Provisions.**

At December 31, 1998, Resources had a \$5.8 million accounting reserve on its Consolidated Balance Sheets in "Estimated obligations under indemnification provisions of sale agreements" for possible indemnity claims asserted in connection with its disposition of former subsidiaries or divisions, including the sale of (i) Louisiana Intrastate Gas Corporation, a former subsidiary engaged in the intrastate pipeline and liquids extraction business (1992); (ii) Arkla Exploration Company, a former subsidiary engaged in oil and gas exploration and production activities (June 1991); and (iii) Dyco Petroleum Company, a former subsidiary engaged in oil and gas exploration and production (1991).

**(d) Sale of Receivables.**

Certain of Resources' receivables are collateral for receivables which have been sold pursuant to the terms of the Receivables Facility. For information regarding these receivables, see Note 4(a).

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*(e) Gas Purchase Claims.*

In conjunction with settlements of "take-or-pay" claims, Resources has prepaid for certain volumes of gas, which prepayments have been recorded at their net realizable value and, to the extent that Resources is unable to realize at least the carrying amount as the gas is delivered and sold, Resources' earnings will be reduced, although such reduction is not expected to be material. In addition to these prepayments, Resources is a party to a number of agreements which require it to either purchase or sell gas in the future at prices which may differ from then prevailing market prices or which require it to deliver gas at a point other than the expected receipt point for volumes to be purchased. To the extent that Resources expects that these commitments will result in losses over the contract term, Resources has established reserves equal to such expected losses. As of December 31, 1998, these reserves were not material.

*(f) Transportation Agreement.*

Resources had an agreement (ANR Agreement) with ANR Pipeline Company (ANR) which contemplated that Resources would transfer to ANR an interest in certain of Resources' pipeline and related assets. The interest represented capacity of 250 Mmcf/day. Under the ANR Agreement, an ANR affiliate advanced \$125 million to Resources. Subsequently, the parties restructured the ANR Agreement and Resources refunded in 1995 and 1993, respectively, \$50 million and \$34 million to ANR or an affiliate. Resources recorded \$41 million as a liability reflecting ANR's or its affiliates' use of 130 Mmcf/day of capacity in certain of Resources' transportation facilities. The level of transportation will decline to 100 Mmcf/day in the year 2003 with a refund of \$5 million to an ANR affiliate. The ANR Agreement will terminate in 2005 with a refund of the remaining balance.

*(g) Environmental Matters.*

To the extent that potential environmental remediation costs are quantified within a range, Resources establishes reserves equal to the most likely level of costs within the range and adjusts such accruals as better information becomes available. In determining the amount of the liability, future costs are not discounted to their present value and the liability is not offset by expected insurance recoveries. If justified by circumstances within Resources' business subject to SFAS No. 71, corresponding regulatory assets are recorded in anticipation of recovery through the rate making process.

*Manufactured Gas Plant Sites.* Resources and its predecessors operated a manufactured gas plant (MGP) adjacent to the Mississippi River in Minnesota formerly known as Minneapolis Gas Works (FMGW) until 1960. Resources has substantially completed remediation of the main site other than ongoing water monitoring and treatment. There are six other former MGP sites in the Minnesota service territory. Remediation has been completed on one site. Of the remaining five sites, Resources believes that two were neither owned nor operated by Resources; two were owned by Resources at one time but were operated by others and are currently owned by others; and one site was previously owned and operated by Resources but is currently owned by others. Resources believes it has no liability with respect to the sites it neither owned nor operated.

At December 31, 1998, Resources had estimated a range of \$12 million to \$70 million for possible remediation of the Minnesota sites. The low end of the range was determined based on only those sites presently owned or known to have been operated by Resources, assuming use of Resources' proposed remediation methods. The upper end of the range was determined based on the sites once owned by Resources, whether or not operated by Resources. The cost estimates of the FMGW site are based on studies of that site. The remediation costs for the other sites are based on industry average costs for remediation of sites of similar size. The actual remediation costs will be dependent upon the number of sites remediated, the participation of other potentially responsible parties, if any, and the remediation methods used.

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At December 31, 1998 and 1997, Resources had recorded accruals of \$5.4 million and \$3.3 million, respectively (with a maximum estimated exposure of approximately \$8 million and \$18 million at December 31, 1998 and 1997, respectively) and an offsetting regulatory asset for environmental matters in connection with a former fire training facility, a landfill and an underground gas storage facility for which future remediation may be required. This accrual is in addition to the accrual for MGP sites as previously discussed.

In its 1995 rate case, Reliant Energy Minnegasco was allowed to recover approximately \$7 million annually for remediation costs. In 1998, Reliant Energy Minnegasco received approval to reduce its annual recovery rate to zero. Remediation costs are subject to a true-up mechanism whereby any over or under recovered amounts, net of certain insurance recoveries, plus carrying charges, would be deferred for recovery or refund in the next rate case. At December 31, 1998 and 1997, Reliant Energy Minnegasco had over recovered \$13 million and \$1.8 million, respectively. At December 31, 1998 and 1997, Minnegasco had recorded a liability of \$20.7 million and \$21.7 million, respectively, to cover the cost of future remediation. In addition, at December 31, 1998, Minnegasco had receivables from insurance settlements of \$.6 million. These insurance settlements will be collected in 1999. Minnegasco expects that approximately 43% of its accrual as of December 31, 1998 will be expended within the next five years. The remainder will be expended on an ongoing basis for an estimated 40 years. In accordance with the provisions of SFAS No. 71, a regulatory asset has been recorded equal to the liability accrued. Minnegasco is continuing to pursue recovery of at least a portion of these costs from insurers. Minnegasco believes the difference between any cash expenditures for these costs and the amount recovered in rates during any year will not be material to Resources' overall cash requirements, results of operations or cash flows.

Issues relating to the identification and remediation of MGPs are common in the natural gas distribution industry. Resources has received notices from the United States Environmental Protection Agency (EPA) and others regarding its status as a potentially responsible party (PRP) for other sites. Based on current information, Resources has not been able to quantify a range of environmental expenditures for potential remediation expenditures with respect to other MGP sites.

*Mercury Contamination.* Like other natural gas pipelines, Resources' pipeline operations have in the past employed elemental mercury in meters used on its pipelines. Although the mercury has now been removed from the meters, it is possible that small amounts of mercury have been spilled at some of those sites in the course of normal maintenance and replacement operations and that such spills have contaminated the immediate area around the meters with elemental mercury. Such contamination has been found by Resources at some sites in the past, and Resources has conducted remediation at sites found to be contaminated. Although Resources is not aware of additional specific sites, it is possible that other contaminated sites exist and that remediation costs will be incurred for such sites. Although the total amount of such costs cannot be known at this time, based on experience by Resources and others in the natural gas industry to date and on the current regulations regarding remediation of such sites, Resources believes that the cost of any remediation of such sites will not be material to Resources' financial position, results of operation or cash flows.

*Potentially Responsible Party Notifications.* From time to time Resources and its subsidiaries have been notified that they are PRP's with respect to properties which environmental authorities have determined warrant remediation under state or federal environmental laws and regulations. In October 1994 the EPA issued such a notice with respect to the South 8<sup>th</sup> Street landfill site in West Memphis, Arkansas, and in December 1995, the Louisiana Department of Environmental Quality advised that one of Resources' subsidiaries had been identified as a PRP with respect to a hazardous waste site in Shreveport, Louisiana.

In 1998, MRT received a notice of potential liability from the EPA regarding MRT's PRP status with respect to the Gurley Pit Superfund Site. The notice stated that MRT is a PRP for the response costs at this site because MRT allegedly generated materials that were disposed of at the site. MRT subsequently notified the EPA that it does not believe that it has liability because it did not have operations in the state from which the material was allegedly

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hauled. In December 1998, MRT learned that the South 8<sup>th</sup> Street Superfund Site Group and the EPA reached a tentative settlement regarding the South 8<sup>th</sup> Street and Gurley Pit Superfund Sites.

Considering the information currently known about such sites and the involvement of Resources or its subsidiaries in activities at these sites, Resources does not believe that these matters will have a material adverse effect on Resources' financial position, results of operation or cash flows.

Resources is a party to litigation (other than that specifically noted) which arises in the normal course of business. Management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. Management believes that the effect on Resources' Consolidated Financial Statements, if any, from the disposition of these matters will not be material.

**(9) Reportable Segments**

Effective January 1, 1998, Resources adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS No. 131). Because Resources is a wholly owned subsidiary of Reliant Energy, Resources' determination of reportable segments considers the strategic operating units under which Reliant Energy manages sales of various products and services to wholesale or retail customers in differing regulatory environments. Subsequent to the Acquisition Date, segment financial data includes information for Reliant Energy and Resources on a combined basis, except for Electric Operations which has no Resources operations and International, which has minimal Resources operations. Reconciling items included under the caption "Elimination of Non-Resources Operations" reduce the consolidated Reliant Energy amounts by those operations not conducted within the Resources legal entity. Operations not owned or operated by Resources, but included in segment information before elimination include primarily the operations and assets of Reliant Energy's non-rate regulated power generation business, Reliant Energy's investment in Time Warner securities and non-Resources corporate expenses. The determination of reportable segments under SFAS No. 131 differs from that required in prior years; therefore business segment information for 1997 and 1996 has been restated to comply with SFAS No. 131.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies except that certain executive benefit costs have not been allocated to segments. Reliant Energy evaluates performance based on operating income excluding certain corporate costs not allocated to the segments. Reliant Energy and Resources account for intersegment sales as if the sales were to third parties, that is, at current market prices.

In accordance with SFAS No. 131, Reliant Energy has identified the following reportable segments: Electric Operations, Natural Gas Distribution, Interstate Pipelines, Wholesale Energy, International and Corporate. Natural Gas Distribution operations consist of natural gas sales to, and natural gas transportation for, residential, commercial and certain industrial customers. Interstate Pipelines conducts interstate natural gas pipeline operations. Wholesale Energy is engaged in the acquisition, development and operation of non-utility power generation facilities, as well as the wholesale energy marketing and natural gas gathering businesses. Corporate includes the Reliant Energy's and Resources' unregulated retail electric services business, certain real estate holdings of Reliant Energy and corporate costs.

Financial data for business segments and products and services are as follows:

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	Natural Gas Distribution	Interstate Pipelines	Wholesale Energy	Corporate and Other	Reconciling Eliminations	Elimination of non-Resources Operations	Consolidated
	(Thousands of Dollars)						
Current Resources							
As of and for the Year Ended							
December 31, 1998:							
Revenues from external customers .....	\$ 1,811,509	\$ 126,988	\$ 4,289,006	\$ 651,741		\$ (120,832)	\$ 6,758,412
Intersegment revenues.....	1,167	155,508	167,152	97,181	\$ (421,008)		
Depreciation and amortization.....	129,777	44,025	18,204	10,527		(10,642)	191,891
Operating income .....	137,955	128,328	59,170	(43,751)		28,603	310,305
Total assets.....	3,110,718	2,050,636	1,535,007	1,710,920	(915,895)	(835,865)	6,655,521
Equity investments in and advances to unconsolidated subsidiaries .....			42,252			(42,252)	
Expenditures for additions to long-lived assets....	161,735	59,358	365,512	28,077		(368,778)	245,904
Current Resources							
As of and for the Five Months Ended							
December 31, 1997:							
Revenues from external customers .....	892,064	49,655	1,288,357	304,878		(8,772)	2,526,182
Intersegment revenues.....	505	58,678	76,301	34,853	(170,337)		
Depreciation and amortization.....	51,883	19,088	2,633	6,260		(1,777)	78,087
Operating income .....	54,502	31,978	912	(37,340)		40,704	90,756
Total assets.....	3,073,525	2,031,879	777,638	1,749,916	(597,686)	(873,434)	6,161,838
Equity investments in and advances to unconsolidated subsidiaries .....			3,325			(3,325)	
Expenditures for additions to long-lived assets....	61,078	16,304	14,038	23,899		(20,826)	94,493
Former Resources							
For the Seven Months Ended							
July 31, 1997:							
Revenues from external customers .....	1,309,060	86,465	1,589,032	329,034			3,313,591
Intersegment revenues.....	672	100,246	88,188	35,285	(224,391)		
Depreciation and amortization.....	56,626	17,230	1,629	9,416			84,901
Operating income .....	111,934	76,730	(13,262)	(20,362)			155,040
Expenditures for additions to long-lived assets....	69,422	9,619	8,996	7,025			95,062
Former Resources							
As of and for the Year Ended							
December 31, 1996							
Revenue from external customers .....	2,112,303	144,752	2,017,599	513,808			4,788,462
Intersegment revenues.....	1,286	200,510	178,005	41,141	(420,942)		
Depreciation and amortization.....	94,853	29,172	2,113	16,224			142,362
Operating income .....	178,141	107,903	25,978	2,444			314,466
Expenditures for additions to long-lived assets....	116,400	39,900	10,200	10,657			177,157

(1) Includes data for operations conducted and assets owned at the parent corporation level. This data is eliminated for purposes of the consolidated data.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

Reconciliation of Operating Income to Net Income:

	<u>Current Resources</u> Year ended December 31, 1998	<u>Current Resources</u> Five months ended December 31, 1997	<u>Former Resources</u> Seven months ended July 31, 1997	<u>Former Resources</u> Year ended December 31, 1996
	(Thousands of Dollars)			
Operating income.....	\$ 310,305	\$ 90,756	\$ 155,040	\$ 314,466
Interest expense .....	(111,337)	(47,490)	(78,660)	(132,557)
Distribution on trust securities .....	(632)	(279)	(6,317)	
Preferred dividends of subsidiary .....				(5,842)
Income taxes .....	(111,830)	(24,383)	(31,398)	(66,352)
Other income (expense) .....	7,318	2,243	7,210	(18,857)
Net income .....	<u>\$ 93,824</u>	<u>\$ 20,847</u>	<u>\$ 45,875</u>	<u>\$ 90,858</u>

Revenues by Products and Services:

	<u>Current Resources</u> Year ended December 31, 1998	<u>Current Resources</u> Five months ended December 31, 1997	<u>Former Resources</u> Seven months ended July 31, 1997	<u>Former Resources</u> Year ended December 31, 1996
	(Thousands of Dollars)			
Retail power sales .....	\$ 9,582	\$ 2,650	\$ 1,805	\$ 407
Retail gas sales .....	2,362,504	1,153,968	1,595,480	2,570,708
Wholesale energy and energy related sales .....	4,248,181	1,271,746	1,562,842	1,975,400
Gas transport .....	167,812	66,265	112,655	186,952
Energy products and services .....	91,165	40,325	40,809	54,995
Elimination of non-Resources operations .....	(120,832)	( 8,772)		
Total .....	<u>\$ 6,758,412</u>	<u>\$ 2,526,182</u>	<u>\$ 3,313,591</u>	<u>\$ 4,788,462</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**

**(10) Estimated Fair Value of Financial Instruments**

	December 31,			
	1998		1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(Thousands of Dollars)			
Financial Assets of Resources:				
Energy Derivatives - non-trading .....			\$ 9,399	\$ 13,060
Financial Liabilities of Resources:				
Long-term debt .....	\$ 1,513,289	\$ 1,746,641	1,148,848	1,147,344
Trust preferred securities .....	1,157	1,467	21,290	24,569
Energy Derivatives - non-trading .....		8,166		
Interest rate swaps .....				755

The fair values of cash and short-term investments, marketable equity securities, short-term and other notes payable are estimated to be equivalent to carrying amounts. The remaining fair values have been determined using quoted market prices of the same or similar securities when available or other estimation techniques.

The fair value of financial instruments included in the trading operations of Reliant Energy Services are marked-to-market at December 31, 1998 (see Note 2). Therefore, they are stated at fair value and are excluded from the table above.

**(11) Unaudited Quarterly Information**

The following unaudited quarterly financial information includes, in the opinion of management, all adjustments (which comprise only normal recurring accruals) necessary for a fair presentation. Quarterly results are not necessarily indicative of a full year's operations because of seasonality and other factors, including rate increases and variations in operating expense patterns.

The Merger was recorded under the purchase method of accounting, resulting in new carrying values for certain of Resources' assets, liabilities and equity based on preliminary analysis. The new basis is reflected in Resources' Consolidated Financial Statements beginning with the Acquisition Date. (For additional information; see Note 1(b).)

	Year Ended December 31, 1998			
	First Quarter(1)	Second Quarter(1)	Third Quarter(1)	Fourth Quarter(1)
	(thousands of dollars)			
Operating Revenues .....	\$ 1,754,524	\$ 1,380,488	\$ 1,927,120	\$ 1,696,280
Operating Income (loss) .....	143,494	15,734	23,653	127,424
Net income (loss)(2) .....	\$ 61,827	\$ (4,872)	\$ (2,586)	\$ 39,455