

### **Unbilled Energy Revenues**

Revenues related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. However, the determination of the energy sales to individual customers is based on the reading of their meters which are read on a systematic basis throughout the month. At the end of each month, amounts of energy delivered to customers since the date of the last meter reading are estimated and the corresponding unbilled revenue is estimated. This unbilled electric revenue is estimated each month based on daily generation volumes, line losses and applicable customer rates based on analyses reflecting significant historical trends and experience. Unbilled natural gas sales are estimated based on estimated purchased gas volumes, estimated lost and unaccounted for gas and tariffed rates in effect. Accrued unbilled revenues recorded in the Consolidated Balance Sheet as of December 31, 2000 were \$39 million related to our Electric Operations business segment, \$3 million related to our Retail Energy business segment and \$551 million related to our Natural Gas Distribution business segment. Accrued unbilled revenues recorded in the Consolidated Balance Sheet as of December 31, 2001 were \$33 million related to our Electric Operations business segment, \$5 million related to our Retail Energy business segment and \$188 million related to our Natural Gas Distribution business segment.

### **Accounting for Derivatives and Hedging Instruments**

SFAS No. 133 established accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires an entity to recognize the fair value of derivative instruments held as assets or liabilities on the balance sheet. In accordance with SFAS No. 133, the effective portion of the change in the fair value of a derivative instrument designated as a cash flow hedge is reported in other comprehensive income, net of tax. Amounts in accumulated other comprehensive income are ultimately recognized in earnings when the related hedged forecasted transaction occurs. The change in the fair value of the ineffective portion of the derivative instrument designated as a cash flow hedge is recorded in earnings. Derivative instruments that have not been designated as hedges are adjusted to fair value through earnings.

We utilize derivative instruments such as futures, physical forward contracts, swaps and options to mitigate the impact of changes in electricity, natural gas and fuel prices on our operating results and cash flows. We utilize cross-currency swaps, forward contracts and options to hedge our net investments in and cash flows of our foreign subsidiaries, interest rate swaps to mitigate the impact of changes in interest rates and other financial instruments to manage various other market risks.

The determination of fair values of trading and marketing assets and liabilities for our energy trading, marketing and price risk management operations and non-trading derivative assets and liabilities, including stranded cost obligations related to our European Energy operations, are based on estimates. For further discussion, please read "— Trading and Marketing Operations", "Quantitative and Qualitative Disclosure About Market Risk" in Item 7A of this Form 10-K and Note 5 to our consolidated financial statements.

### **NEW ACCOUNTING PRONOUNCEMENTS**

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 "Business Combinations" (SFAS No. 141) and SFAS No. 142. SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles will be evaluated against these new criteria and may result in certain intangibles being transferred to goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. SFAS No. 142 provides for a nonamortization approach, whereby goodwill and certain intangibles with indefinite lives will not be amortized into results of operations, but instead will be reviewed periodically for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles with indefinite lives is more than its fair value. We adopted the provisions of each statement which apply to goodwill and intangible assets acquired prior to June 30, 2001 on January 1, 2002. The adoption of SFAS No. 141 did not have a material impact on our historical results of operations or financial position.

On January 1, 2002, we discontinued amortizing goodwill into the results of operations pursuant to SFAS No. 142. We recognized \$81 million of goodwill amortization expense in our Statements of Consolidated Income during 2001, excluding a \$19 million write-off of a Communications business goodwill balance which was recorded as goodwill amortization expense (please read Note 20 to our consolidated financial statements). We are in the process of determining further effects of adoption of SFAS No. 142 on our consolidated financial statements, including the review of goodwill and certain intangible assets for impairment. We have not completed our review pursuant to SFAS No. 142. However, based on our preliminary review, we believe an impairment of our European Energy business segment goodwill is reasonably possible. As of December 31, 2001, net goodwill associated with our European Energy business segment is \$632 million. We have not completed our preliminary review of our other business segments with net goodwill totaling \$2.0 billion. We anticipate finalizing our review of goodwill and certain intangible assets during 2002.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). SFAS No. 143 requires the fair value of a liability for an asset retirement legal obligation to be recognized in the period in which it is incurred. When the liability is initially recorded, associated costs are capitalized by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002, with earlier application encouraged. SFAS No. 143 requires entities to record a cumulative effect of change in accounting principle in the income statement in the period of adoption. We plan to adopt SFAS No. 143 on January 1, 2003 and are in the process of determining the effect of adoption on our consolidated financial statements. For certain operations subject to cost of service rate regulation, we are permitted to include annual charges for cost of removal and nuclear decommissioning costs in the revenues we charge customers.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144). SFAS No. 144 provides new guidance on the recognition of impairment losses on long-lived assets to be held and used or to be disposed of and also broadens the definition of what constitutes a discontinued operation and how the results of a discontinued operation are to be measured and presented. SFAS No. 144 supercedes SFAS No. 121 and APB Opinion No. 30, while retaining many of the requirements of these two statements. Under SFAS No. 144, assets held for sale that are a component of an entity will be included in discontinued operations if the operations and cash flows will be or have been eliminated from the ongoing operations of the entity and the entity will not have any significant continuing involvement in the operations prospectively. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, with early adoption encouraged. SFAS No. 144 is not expected to materially change the methods we use to measure impairment losses on long-lived assets, but may result in additional future dispositions being reported as discontinued operations than was previously permitted. We adopted SFAS No. 144 on January 1, 2002.

#### **Item 7A. *Quantitative and Qualitative Disclosures About Market Risk***

##### **Market Risk**

We are exposed to various market risks. These risks arise from transactions entered into in the normal course of business and are inherent in our consolidated financial statements. Most of the revenues and income from our business activities are impacted by market risks. Categories of market risks include exposures to commodity prices through trading and marketing and non-trading activities, interest rates, foreign currency exchange rates and equity prices. A description of each market risk category is set forth below:

- Commodity price risk results from exposures to changes in spot prices, forward prices and price volatilities of commodities, such as electricity, natural gas and other energy commodities.
- Interest rate risk primarily results from exposures to changes in the level of borrowings and changes in interest rates.

- Currency rate risk results from exposures to changes in the value of foreign currencies relative to our reporting currency, the U.S. dollar, and exposures to changes in currency rates in transactions executed in currencies other than a business segment's reporting currency.
- Equity price risk results from exposures to changes in prices of individual equity securities.

Management has established comprehensive risk management policies to monitor and manage these market risks. We seek to manage our exposures through the use of derivative financial instruments and derivative commodity instruments. During the normal course of business, we review our hedging strategies and determine the hedging approach we deem appropriate based upon the circumstances of each situation.

Derivative instruments such as futures, forward contracts, swaps or options, derive their value from underlying assets, indices, reference rates or a combination of these factors. These derivative instruments include negotiated contracts, which are referred to as over-the-counter derivatives, and instruments that are listed and traded on an exchange.

Our trading operations enter into derivative instrument transactions as a means of risk management, optimization of our current power generation asset position, and to take a market position. Derivative instrument transactions are entered into in our non-trading operations to manage and hedge certain exposures, such as exposure to changes in electricity and fuel prices, exposure to purchase and sale commitments of natural gas, exposure to interest rate risk on our floating-rate borrowings and foreign currency exposures related to our foreign investments. We believe that the associated market risk of these instruments can best be understood relative to the underlying assets or risk being hedged and our trading strategy.

#### ***Trading Market Risk***

Trading and marketing operations often involve market risk associated with managing energy commodities and establishing open positions in the energy markets, primarily on a short-term basis, through derivative instruments (Trading Energy Derivatives). Our trading and marketing businesses depend on price movements and volatility levels to create business opportunities, but these businesses must control risk within authorized limits.

We assess the risk of Trading Energy Derivatives using a value-at-risk (VAR) method, in order to maintain our total exposure within authorized limits. VAR is the potential loss in value of trading positions due to adverse market movements over a defined time period within a specified confidence level. We utilize the variance/covariance model of VAR, which relies on statistical relationships to describe how changes in different markets can affect a portfolio of instruments with different characteristics and market exposures.

For the VAR numbers reported below, a one-day holding period and a 95% confidence level were used, except for our European trading operations which uses a two-day to five-day holding period. This means that if VAR is calculated at \$10 million, we may state that there is a one in 20 chance that if prices move against our consolidated diversified positions, our pre-tax loss in liquidating or offsetting with hedges our portfolio in a one-day period would exceed \$10 million.

The VAR methodology employs a seasonally adjusted volatility-based approach with the following critical parameters: forward prices and volatility estimates, appropriate market-oriented holding periods and seasonally adjusted correlation estimates. We use the delta approximation method for reporting option positions. The instruments being evaluated could have features that may trigger a potential loss in excess of calculated amounts if changes in commodity prices exceed the confidence level of the model used. An inherent limitation of VAR is that past changes in market risk may not produce accurate predictions of future market risk. Moreover, VAR calculated for a one-day holding period does not fully capture the market risk of positions that cannot be liquidated or offset with hedges within one day. We cannot assure you that market volatility, failure of counterparties to meet their contractual obligations, future transactions or a failure of risk controls will not lead to significant losses from our trading, marketing and risk management activities.

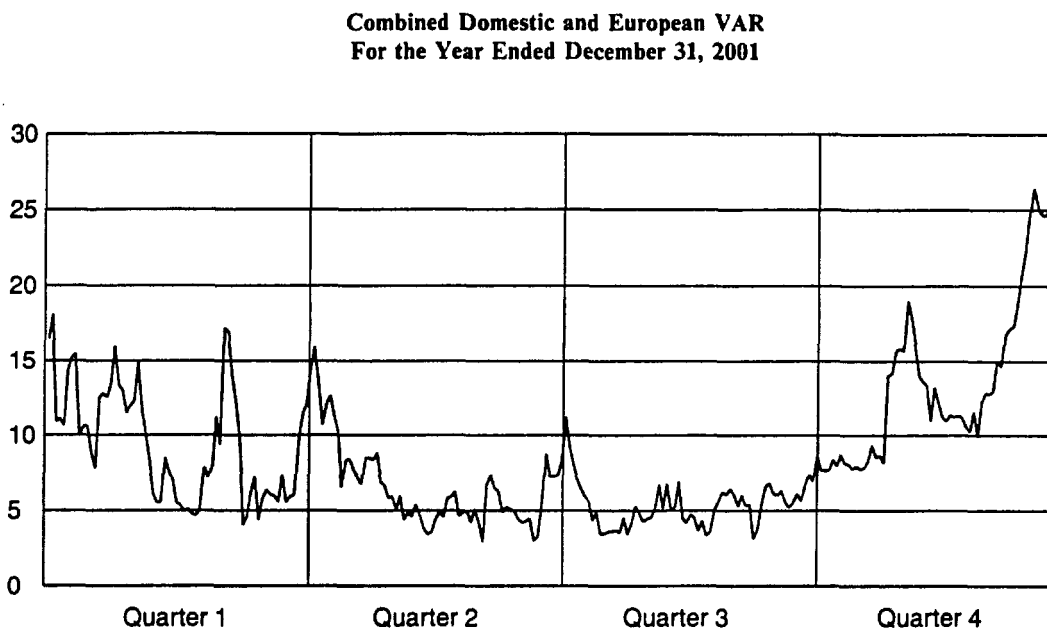
While we believe that our assumptions and approximations are reasonable for calculating VAR, there is no uniform industry methodology for estimating VAR, and different assumptions and/or approximations could produce materially different VAR estimates.

Our VAR limits are set by our board of directors, as further discussed below. Violations in overall VAR limits are required to be reported to the Audit Committee of our board of directors pursuant to our corporate-wide risk limit parameters. For further discussion on our risk management framework, please read “— Risk Management Structure” below.

The following presents the daily VAR for substantially all of our Trading Energy Derivative positions (in millions).

	2000	2001
As of December 31, .....	\$15	\$27
Year Ended December 31:		
Average .....	6	9
High .....	36	27
Low .....	1	3

The following chart presents the daily VAR for substantially all of our Trading Energy Derivatives during 2001 (in millions).



During the beginning of 2001, the high VAR levels were due to high natural gas and power prices and volatility levels, which continued from late 2000. VAR exposure was lower in the second and third quarters of 2001 due to the significant decline in natural gas and power prices and volatility levels. During the fourth quarter of 2001, VAR levels increased due to increased power marketing activities in ERCOT related to our Retail Energy business segment.

## ***Non-trading Market Risk***

### ***Commodity Price Risk***

Commodity price risk is an inherent component of our electric power generation businesses because the profitability of our generation assets depends significantly on commodity prices sufficient to create gross margin. During 2001, the majority of our non-trading commodity price risk was related to our electric power generation businesses. Prior to the energy delivery period, we attempt, in part to hedge the economics of our electric power facilities by selling power and purchasing equivalent fuel. Some power capacity is held in reserve and sold in the spot market. Non-trading derivative instruments (Non-trading Energy Derivatives) are used to mitigate exposure to variability in future cash flows from probable, anticipated future transactions attributable to a commodity risk. In this way, more certainty is provided as to the financial contribution associated with the operation of these assets. Beginning in 2002, our commodity price risk exposures related to our Retail Energy operations increased as we began to provide retail electric services to all customers of the T&D Utility who did not select another retail electric provider. For a discussion of risk factors affecting our Retail Energy operations, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Certain Factors Affecting Our Future Earnings — Factors Affecting the Results of Our Retail Energy Operations" in Item 7 of this Form 10-K.

To reduce our commodity price risk from market fluctuations in the revenues derived from the sale of natural gas and related transportation, we enter into futures transactions, forward contracts, swaps and options in order to hedge some expected purchases of natural gas and sales of natural gas (a portion of which are firm commitments at the inception of the hedge). Non-trading Energy Derivatives are also utilized to fix the price of compressor fuel or other future operational gas requirements and to protect natural gas distribution earnings against unseasonably warm weather during peak gas heating months, although usage to date for this purpose has not been material.

Derivative instruments, which we use as economic hedges, create exposure to commodity prices, which we use to offset the commodity exposure inherent in our businesses. The stand-alone commodity risk created by these instruments, without regard to the offsetting effect of the underlying exposure these instruments are intended to hedge, is described below. We measure the commodity risk of our Non-trading Energy Derivatives using a sensitivity analysis. The sensitivity analysis performed on our Non-trading Energy Derivatives measures the potential loss in earnings based on a hypothetical 10% movement in energy prices. An increase of 10% in the market prices of energy commodities from their December 31, 2001 levels would have decreased the fair value of our Non-trading Energy Derivatives by \$38 million, excluding non-trading derivatives liabilities associated with our European Energy business segment's stranded cost import contracts.

The above analysis of the Non-trading Energy Derivatives utilized for hedging purposes does not include the favorable impact that the same hypothetical price movement would have on our physical purchases and sales of natural gas and electric power to which the hedges relate. Furthermore, the Non-trading Energy Derivative portfolio, excluding the stranded cost import contracts, is managed to complement the physical transaction portfolio, thereby reducing overall risks within limits. Therefore, the adverse impact to the fair value of the portfolio of Non-trading Energy Derivatives held for hedging purposes associated with the hypothetical changes in commodity prices referenced above would be offset by a favorable impact on the underlying hedged physical transactions, assuming:

- the Non-trading Energy Derivatives are not closed out in advance of their expected term;
- the Non-trading Energy Derivatives continue to function effectively as hedges of the underlying risk; and
- as applicable, anticipated underlying transactions settle as expected.

If any of the above-mentioned assumptions cease to be true, a loss on the derivative instruments may occur, or the options might be worthless as determined by the prevailing market value on their termination or maturity date, whichever comes first. Non-trading Energy Derivatives intended as hedges, and which are effective as hedges, may still have some percentage which is not effective. The change in value of the Non-

trading Energy Derivatives which represents the ineffective component of the hedges, is recorded in our results of operations. During 2001, we recognized revenues of \$8 million in our Statements of Consolidated Income due to hedge ineffectiveness.

Our European Energy business segment's stranded cost import contracts have exposure to commodity prices. For information regarding these contracts, please read Notes 5(b) and 14(h) to our consolidated financial statements. A decrease of 10% in market prices of energy commodities from their December 31, 2001 levels would result in a loss of earnings of \$98 million.

#### *Interest Rate Risk*

We have issued long-term debt and have obligations under bank facilities that subject us to the risk of loss associated with movements in market interest rates. We utilize interest-rate swaps in order to hedge a portion of our floating-rate obligations.

We have outstanding long-term debt and commercial paper obligations under bank facilities, mandatory redeemable preferred securities of subsidiary trusts holding solely our junior subordinated debentures (Trust Preferred Securities), securities held in our nuclear decommissioning trust, some lease obligations and our obligations under the ZENS that subject us to the risk of loss associated with movements in market interest rates. We utilize interest-rate swaps in order to hedge portions of our floating-rate debt and to hedge a portion of the interest rate applicable to a future offering of long-term debt.

Our floating-rate obligations aggregated \$5.8 billion and \$4.2 billion at December 31, 2000 and 2001, respectively. If the floating interest rates were to increase by 10% from December 31, 2001 rates, our combined interest expense would increase by a total of \$1.2 million each month in which such increase continued.

At December 31, 2000 and 2001, we had outstanding fixed-rate debt (excluding indexed debt securities) and Trust Preferred Securities aggregating \$5.5 billion and \$6.2 billion, respectively, in principal amount and having a fair value of \$6.2 billion each year. These instruments are fixed-rate and, therefore, do not expose us to the risk of loss in earnings due to changes in market interest rates (please read Notes 10 and 11 to our consolidated financial statements). However, the fair value of these instruments would increase by approximately \$682 million if interest rates were to decline by 10% from their levels at December 31, 2001. In general, such an increase in fair value would impact earnings and cash flows only if we were to reacquire all or a portion of these instruments in the open market prior to their maturity.

As discussed in Note 14(k) to our consolidated financial statements, we contributed \$14.8 million in 1999, 2000 and 2001 to a trust established to fund our share of the decommissioning costs for the South Texas Project. In 2002, we will begin contributing \$2.9 million per year to this trust. The securities held by the trust for decommissioning costs had an estimated fair value of \$169 million as of December 31, 2001, of which approximately 46% were fixed-rate debt securities that subject us to risk of loss of fair value with movements in market interest rates. If interest rates were to increase by 10% from their levels at December 31, 2001, the decrease in fair value of the fixed-rate debt securities would not be material to us. In addition, the risk of an economic loss is mitigated. Any unrealized gains or losses are accounted for in accordance with SFAS No. 71 as a regulatory asset/liability because we believe that our future contributions, which are currently recovered through the ratemaking process, will be adjusted for these gains and losses. For further discussion regarding the recovery of decommissioning costs pursuant to the Texas Electric Restructuring Law, please read Note 4(a) to our consolidated financial statements.

As discussed in Note 10(b) to our consolidated financial statements, RERC Corp.'s \$500 million aggregate principal amount of 6<sup>3</sup>/<sub>4</sub>% Term Enhanced Remarketable Securities (TERM Notes) include an embedded option to remarket the securities. The option is expected to be exercised in the event that the ten-year Treasury rate in 2003 is below 5.66%. At December 31, 2001, we could terminate the option at a cost of \$21 million. A decrease of 10% in the December 31, 2001 level of interest rates would increase the cost of termination of the option by approximately \$16 million.

As discussed in Note 8 to our consolidated financial statements, upon adoption of SFAS No. 133 effective January 1, 2001, the ZENS obligation was bifurcated into a debt component of \$122 million and a derivative component of \$788 million. The debt component of \$122 million is a fixed-rate obligation and, therefore, does not expose us to the risk of loss in earnings due to changes in market interest rates. However, the fair value of the debt component would increase by approximately \$18 million if interest rates were to decline by 10% from levels at December 31, 2001. Changes in the fair value of the derivative component will be recorded in our Statements of Consolidated Income and, therefore, we are exposed to changes in the fair value of the derivative component as a result of changes in the underlying risk-free interest rate. If the risk-free interest rate were to increase by 10% from December 31, 2001 levels, the fair value of the derivative component would increase by approximately \$10 million, which would be recorded as a loss in our Statements of Consolidated Income.

During 2001, we entered into interest rate swaps having an aggregate notional amount of \$1.8 billion to fix the interest rate applicable to floating rate short-term debt and interest rate swaps of \$425 million to fix the interest rate applicable to floating rate long-term debt. At December 31, 2001, the swaps relating to short-term debt could be terminated at a cost of \$12 million and the swaps related to long-term debt, of which \$225 million had expired as of December 31, 2001, could be terminated at a cost of \$4 million. The swaps relating to short-term debt do not qualify as cash flow hedges under SFAS No. 133, and are marked to market in our Consolidated Balance Sheets with changes reflected in interest expense in the Statements of Consolidated Income. The swaps relating to long-term debt qualify for hedge accounting under SFAS No. 133 and the periodic settlements are recognized as an adjustment to interest expense in the Statements of Consolidated Income over the term of the swap agreement. A decrease of 10% in the December 31, 2001 level of interest rates would increase the cost of terminating the swaps related to short-term debt and long-term debt outstanding at December 31, 2001 by \$4 million each.

During 2001, we entered into forward-starting interest rate swaps having an aggregate notional amount of \$500 million to hedge the interest rate on a future offering of five-year notes. At December 31, 2001, these swaps could be terminated at a cost of \$2 million. These swaps qualify as cash flow hedges under SFAS No. 133. Should the expected issuance of the debt no longer be probable, any deferred amount will be recognized immediately into income. A decrease of 10% in the December 31, 2001 level of interest rates would increase the cost of terminating these swaps by \$12 million.

For information regarding the accounting for these interest rate swaps, please read Note 5 to our consolidated financial statements.

#### *Foreign Currency Exchange Rate Risk*

Our European operations expose us to risk of loss in the fair value of our foreign investments due to the fluctuation in foreign currencies relative to our reporting currency, the U.S. dollar. Additionally, our European Energy business segment transacts in several European currencies, although the majority of its business is conducted in the Euro and prior to January 2001, the Dutch Guilder. As of December 31, 2001, we had entered into foreign currency swaps and foreign currency forward contracts and had issued Euro-denominated borrowings to hedge our foreign currency exposure of our net European investment. Changes in the value of the foreign currency hedging instruments and Euro — denominated borrowings are recorded as foreign currency translation adjustments as a component of accumulated other comprehensive income (loss) in stockholders' equity. As of December 31, 2000 and 2001, we had recorded a loss of \$2 million and \$96 million, respectively, in cumulative net translation adjustments. The cumulative translation adjustments will be realized in earnings and cash flows only upon the disposition of the related investments. During the normal course of business, we review our currency hedging strategies and determine the hedging approach we deem appropriate based upon the circumstances of each situation.

As of December 31, 2001, our European Energy business segment had entered into transactions to purchase \$271 million at fixed exchange rates in order to hedge future fuel purchases payable in U.S. dollars. As of December 31, 2001, the fair value of these financial instruments was a \$3 million asset. An increase in

the value of the Euro of 10% compared to the U.S. dollar from its December 31, 2001 level would result in loss in the fair value of these foreign currency financial instruments of \$27 million.

Our European Energy business segment's stranded cost import contracts have foreign currency exposure. An increase of 10% in the U.S. dollar relative to the Euro from their December 31, 2001 levels would result in a loss of earnings of \$6 million.

Beginning in January 2002, our remaining Latin America operations will use the Argentine peso as their functional currency (please read Note 2(o) to our consolidated financial statements). These foreign operations will expose us to risk of loss in earnings and cash flows due to the fluctuation in foreign currencies relative to our consolidated reporting currency, the U.S. dollar. We account for adjustments resulting from translation of our investments with functional currencies other than the U.S. dollar as a charge or credit directly to a separate component of stockholders' equity.

#### *Equity Market Value Risk*

We are exposed to equity market value risk through our ownership of approximately 26 million shares of AOL TW Common, which are held by us to facilitate our ability to meet our obligations under the ZENS. Please read Note 8 to our consolidated financial statements for a discussion of the effect of adoption of SFAS No. 133 on our ZENS obligation and our historical accounting treatment of our ZENS obligation. Subsequent to adoption of SFAS No. 133, a decrease of 10% from their levels at December 31, 2001 market value of AOL TW Common would result in a net loss of approximately \$3 million, which would be recorded as a loss in our Statements of Consolidated Income.

As discussed above under "— Interest Rate Risk," we contribute to a trust established to fund our share of the decommissioning costs for the South Texas Project, which held debt and equity securities as of December 31, 2001. The equity securities expose us to losses in fair value. If the market prices of the individual equity securities were to decrease by 10% from their levels at December 31, 2001, the resulting loss in fair value of these securities would not be material to us. Currently, the risk of an economic loss is mitigated as discussed above under "— Interest Rate Risk."

We have equity investments, which are classified as "available-for-sale" under SFAS No. 115. As of December 31, 2001, the value of these securities was \$12 million. A 10% decline in the market value per share of these securities from December 31, 2001 would result in a loss in fair value of \$1 million.

#### **Risk Management Structure**

We have a risk control framework to limit, monitor, measure and manage the risk in our existing portfolio of assets and contracts and to risk-measure and authorize new transactions. These risks include market, credit, liquidity and operational exposures. We believe that we have effective procedures for evaluating and managing these risks to which we are exposed. Key risk control activities include limits on trading and marketing exposures and products, credit review and approval, credit and performance risk measurement and monitoring, validation of transactions, portfolio valuation and daily portfolio reporting including mark-to-market valuation, VAR and other risk measurement metrics.

We seek to monitor and control our risk exposures through a variety of separate but complementary processes and committees which involve business unit management, senior management and our board of directors, as detailed below.

**Board of Directors.** Our board of directors affirms the overall strategy and approves overall risk limits for commodity trading and marketing.



***Audit Committee.*** The Audit Committee of our board of directors assesses the adequacy of the risk control organization and policies. The Audit Committee of our board of directors meets at least four times a year to:

- approve the risk control organization structure;
- approve the corporate-wide risk control policy;
- monitor compliance with trading limits;
- review significant risk control issues; and
- recommend to our board of directors corporate-wide commodity risk limit parameters for trading and marketing activities.

***Executive Management.*** Our executive management appoints the Risk Oversight Committee members, reviews and approves recommendations of the Risk Oversight Committee prior to presentations to the Audit Committee of our board of directors, and approves and monitors broad risk limit allocations to the business segments and product types. Our executive management receives daily position reports of our trading and marketing activities.

***Risk Oversight Committee.*** The Risk Oversight Committee, which is comprised of corporate and business segment officers, oversees all of our trading, marketing and hedging activities and other activities involving market risks. These activities expose us to commodity price, credit, foreign currency and interest rate risks. The Risk Oversight Committee meets at least monthly. For trading, marketing and hedging activities, the Risk Oversight Committee:

- monitors compliance of our trading units;
- reviews daily position reports for trading and marketing activities;
- recommends adjustments to trading limits, products and policies to the Audit Committee of our board of directors;
- approves business segment's detailed policies and procedures;
- allocates board of director-approved trading and marketing risk capital limits, including VAR limits;
- approves new trading, marketing and hedging products and commodities;
- approves entrance into new trading markets;
- monitors processes and information systems related to the management of our risk to market exposures; and
- places guidelines and limits around hedging activities.

***Commitment Review Committee.*** The Commitment Review Committee, which is comprised of corporate officers, establishes corporate-wide standards for the evaluation of capital projects and other significant commitments, evaluates proposed capital projects and other significant commitments, and makes recommendations to the chief executive officer. The Commitment Review Committee is scheduled to meet on an as needed basis.

***Corporate Risk Control Organization.*** Our Corporate Risk Control Organization is headed by a chief risk control officer who has corporate-wide oversight for maintaining consistent application of corporate risk policies within individual business segments. The Corporate Risk Control Organization:

- recommends the corporate-wide risk management policies and procedures which are approved by the Audit Committee of our board of directors;
- provides updates of trading and marketing activities to the Audit Committee of our board of directors on a regular basis;

- provides oversight of our ongoing development and implementation of operational risk policies, framework and methodologies;
- monitors effectiveness of the corporate-wide risk management policies, procedures and risk limits;
- evaluates the business segment risk control organizations, including information systems and reporting;
- evaluates all significant valuation methodologies, assumptions and models;
- evaluates allocation of risk limits within our business segments;
- reviews daily position reports of trading and marketing activities; and
- reviews inherent risks in proposed transactions.

*Business Segment Risk Control Organizations.* The Corporate Risk Control Organization also serves as the risk control organization for the business segments that will comprise CenterPoint Energy. Each of Reliant Resources' business segments has a Business Segment Risk Control Organization, which is headed by a risk control officer who reports to the Corporate Risk Control Organization and the business segment's executive management outside of the commercial trading organization. The Business Segment Risk Control Organization:

- develops and maintains the risk control infrastructure, including policies, processes, personnel and information and valuation systems, to analyze and report the daily risk positions to Executive Management, the Risk Oversight Committee, the Corporate Risk Control Organization, the Internal Audit Department and the Controllers Organization;
- reviews credit exposures for customers and counterparties;
- reviews all significant valuation methodologies, assumptions and models used for risk measurement, mark-to-market valuations and structured transaction evaluations;
- ensures that risk systems can adequately measure positions and related risk exposures for new products and transactions;
- evaluates new transactions for compliance with risk policies and limits; and
- evaluates effectiveness of hedges.

The management of each of the business segments is responsible for the management of its risks and for maintaining an environment conducive to effective risk control activities as part of its overall responsibility for the business unit. Commercial management has in-depth knowledge of the primary sources of risk in their individual markets and the instruments available to hedge our exposures. Commercial management assigns risk limits that have been allocated to specific markets and to individual traders, within the limits imposed by the Risk Oversight Committee. Risk limits are monitored on a daily basis. Risk limit violations, including VAR, are reported to the appropriate level of management in the business segment, the Corporate Risk Control Organization, the Risk Oversight Committee, the board of directors and the Audit Committee of the board of directors.

Segregation of duties and management oversight are fundamental elements of our risk management process. There are segregation of duties among the trading and marketing functions; transaction validation and documentation; risk measurement and reporting; settlements function; accounting and financial reporting functions; and treasury function. These risk management processes and related controls are reviewed by our corporate Internal Audit Department on a regular basis. When appropriate, external advisors or consultants with relevant experience will assist the Internal Audit Department with their reviews.

The effectiveness of our policies and procedures for managing risk exposure can never be completely measured or fully assured. For example, we could experience losses which could have a material adverse effect on our financial condition, results of operations or cash flows, from unexpectedly large or rapid movements or disruptions in the energy markets, from regulatory-driven market rules changes, and bankruptcy of customers or counterparties.

## Credit Risk

Credit risk is inherent in our commercial activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. Broad credit policies and parameters are set by the Risk Oversight Committee. The Business Segment Risk Control Organizations prepare daily analyses of credit exposures. We enter into derivative instruments primarily with counterparties having a minimum investment grade credit rating (*i.e.*, a minimum credit rating for such entity's senior unsecured debt of BBB- for Standard & Poor's and Fitch or Baa3 for Moody's). In addition, we seek to enter into netting agreements that permit us to offset receivables and payables with a given counterparty. We also attempt to enter into agreements that enable us to either obtain collateral from a counterparty or to terminate upon the occurrence of adverse credit-related events. We are re-evaluating our current credit risk practices in light of changes in the marketplace, recent corporate failures and changing credit practices by the rating agencies.

It is our policy that all transactions must be within approved counterparty or customer credit limits. For each business segment, counterparty credit limits are established by the applicable business segment's credit risk control group. We employ tiered levels of approval authority for counterparty credit limits, with authority increasing from the operating business segment's credit analysts through the business segment's risk control officer, the Risk Oversight Committee and our executive management. The Business Segment Risk Control Organization monitors credit exposure daily. The mark-to-market values and cash settlement values for all transactions are compared to the authorized credit threshold for each counterparty. For long-term arrangements, we periodically review the financial condition of these counterparties in addition to monitoring the effectiveness of these contracts in achieving our objectives.

For information regarding our provision related to our energy sales in the California market, please read Note 14(g) to our consolidated financial statements. For information regarding our net provision related to energy sales to Enron which filed a voluntary petition for bankruptcy, please read Note 21 to our consolidated financial statements.

The following table presents the distribution by credit ratings of our total trading and marketing assets and total non-trading derivative assets as of December 31, 2001, after taking into consideration netting and set-off agreements with counterparties within each balance sheet caption (in millions).

<u>Credit Rating Equivalent</u>	<u>Exposure</u>	<u>Collateral Held(3)</u>	<u>Exposure Net of Collateral</u>	<u>Percentage of Exposure Net of Collateral</u>
AAA/Aaa .....	\$ 136	\$ —	\$ 136	5%
AA/Aa2 .....	191	—	191	7%
A/A2 .....	1,049	(4)	1,045	39%
BBB/Baa2 .....	1,152	(137)	1,015	38%
BB/Ba2 or lower .....	251	(26)	225	9%
Unrated(1) (2) .....	49	—	49	2%
	2,828	(167)	2,661	<u>100%</u>
Less: Credit and other reserves .....	114	—	114	
	<u>\$2,714</u>	<u>\$(167)</u>	<u>\$2,547</u>	

The following table presents credit exposure by maturity for total trading and marketing assets and non-trading derivative assets, net of collateral, as of December 31, 2001 (in millions).

<u>Credit Rating Equivalent</u>	<u>0-12 Months</u>	<u>1 Year or Greater</u>	<u>Exposure Net of Collateral</u>
AAA/Aaa .....	\$ 95	\$ 41	\$ 136
AA/Aa2 .....	142	49	191
A/A2 .....	860	185	1,045
BBB/Baa2 .....	660	355	1,015
BB/Ba2 or lower .....	125	100	225
Unrated(1)(2) .....	<u>31</u>	<u>18</u>	<u>49</u>
	1,913	748	2,661
Less: Credit and other reserves .....	<u>69</u>	<u>45</u>	<u>114</u>
	<u>\$1,844</u>	<u>\$703</u>	<u>\$2,547</u>

- (1) For unrated counterparties, we perform financial statement analysis, considering contractual rights and restrictions, and collateral, to create a synthetic credit rating.
- (2) In lieu of making an individual assessment of the credit of unrated counterparties, we may make a determination that the collateral held in respect of such obligations is sufficient to cover a substantial portion of our exposure. In making this determination, we take into account various factors, including market volatility.
- (3) Collateral consists of cash and standby letters of credit.

Item 8. *Financial Statements and Supplementary Data of the Company*

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED INCOME

(As Restated, See Note 1)

	Year Ended December 31,		
	1999	2000	2001
	(Thousands of dollars, except per share amounts)		
Revenues .....	\$13,794,548	\$28,269,159	\$40,809,455
Expenses:			
Fuel and cost of gas sold .....	6,330,893	15,049,322	19,505,052
Purchased power .....	3,095,110	7,580,108	15,126,826
Operation and maintenance .....	1,763,695	2,356,213	2,654,490
Taxes other than income taxes .....	441,242	498,061	542,847
Depreciation and amortization .....	905,305	906,318	911,450
Latin America operating results .....	(528)	1,113	—
Impairment of Latin America assets .....	—	40,711	75,342
Total .....	12,535,717	26,431,846	38,816,007
Operating Income .....	1,258,831	1,837,313	1,993,448
Other Income (Expense):			
Unrealized gain (loss) on AOL Time Warner investment .....	2,452,406	(204,969)	(70,215)
Unrealized (loss) gain on indexed debt securities .....	(629,523)	101,851	58,033
(Loss) income from equity investments in unconsolidated subsidiaries .....	(793)	42,860	57,440
Operating results from equity investments in unconsolidated Latin America assets .....	(26,176)	(40,583)	—
Impairment of Latin America unconsolidated equity investments .....	—	(130,842)	(4,330)
Loss on disposal of Latin America assets .....	—	(176,400)	—
Interest expense .....	(500,151)	(713,674)	(602,090)
Distribution on trust preferred securities .....	(51,220)	(54,358)	(55,598)
Minority interest .....	638	988	(81,399)
Other, net .....	60,836	96,366	123,496
Total .....	1,306,017	(1,078,761)	(574,663)
Income Before Income Taxes, Extraordinary Items, Cumulative Effect of Accounting Change and Preferred Dividends .....	2,564,848	758,552	1,418,785
Income Tax Expense .....	899,117	318,497	499,845
Income Before Extraordinary Items, Cumulative Effect of Accounting Change and Preferred Dividends .....	1,665,731	440,055	918,940
Extraordinary (Loss) Gain, net of tax of \$98,679 and \$0 in 1999 and 2000, respectively .....	(183,261)	7,445	—
Income Before Cumulative Effect of Accounting Change and Preferred Dividends .....	1,482,470	447,500	918,940
Cumulative Effect of Accounting Change, net of tax of \$33,205 in 2001 .....	—	—	61,619
Income Before Preferred Dividends .....	1,482,470	447,500	980,559
Preferred Dividends .....	389	389	858
Net Income Attributable to Common Stockholders .....	\$ 1,482,081	\$ 447,111	\$ 979,701
Basic Earnings Per Share:			
Income Before Extraordinary Items and Cumulative Effect of Accounting Change .....	\$ 5.84	\$ 1.54	\$ 3.17
Extraordinary Items, net of tax .....	(0.64)	0.03	—
Cumulative Effect of Accounting Change, net of tax .....	—	—	0.21
Net Income Attributable to Common Stockholders .....	\$ 5.20	\$ 1.57	\$ 3.38
Diluted Earnings Per Share:			
Income Before Extraordinary Items and Cumulative Effect of Accounting Change .....	\$ 5.82	\$ 1.53	\$ 3.14
Extraordinary Items, net of tax .....	(0.64)	0.03	—
Cumulative Effect of Accounting Change, net of tax .....	—	—	0.21
Net Income Attributable to Common Stockholders .....	\$ 5.18	\$ 1.56	\$ 3.35

See Notes to the Company's Consolidated Financial Statements

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME**  
(As Restated, See Note 1)

	Year Ended December 31,		
	1999	2000	2001
	(Thousands of dollars)		
Net income attributable to common stockholders .....	\$1,482,081	\$447,111	\$ 979,701
Other comprehensive (loss) income, net of tax:			
Foreign currency translation adjustments from continuing operations (net of tax of \$317, \$594 and \$98,088) .....	(587)	(1,104)	(94,066)
Foreign currency translation adjustments from assets held for sale (net of tax of \$22,826, \$40,862 and \$13) .....	(42,392)	75,887	(24)
Unrealized (loss) gain on available-for-sale securities (net of tax of \$373, \$1,492 and \$9,241) .....	(1,224)	(2,264)	16,984
Reclassification adjustments for gains on sales of available-for-sale securities realized in income (net of tax of \$4,668) .....	—	—	(8,670)
Reclassification adjustment for impairment loss on available-for-sale securities realized in net income (net of tax of \$9,276) ...	—	17,228	—
Additional minimum non-qualified pension liability adjustment (net of tax of \$11,127 and \$3,601) .....	—	(19,135)	5,965
Cumulative effect of adoption of SFAS No. 133 (net of tax of \$215,897) .....	—	—	(421,852)
Net deferred gain from cash flow hedges (net of tax of \$203,913)	—	—	412,445
Reclassification of deferred gain from cash flow hedges realized in net income (net of tax of \$96,876) .....	—	—	(91,599)
Other comprehensive (loss) income .....	(44,203)	70,612	(180,817)
Comprehensive Income .....	<u>\$1,437,878</u>	<u>\$517,723</u>	<u>\$ 798,884</u>

See Notes to the Company's Consolidated Financial Statements

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(As Restated, See Note 1)

	December 31,	
	2000	2001
	(Thousands of dollars)	
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 175,972	\$ 135,674
Restricted cash	50,000	167,421
Investment in AOL Time Warner common stock	896,824	826,609
Accounts receivable, net	2,623,492	1,922,708
Accrued unbilled revenues	592,618	226,428
Inventory	483,213	579,673
Trading and marketing assets	4,290,803	1,611,393
Non-trading derivative assets	—	399,896
Margin deposits on energy trading and hedging activities	521,004	213,727
Other	279,335	165,206
Total current assets	9,913,261	6,248,735
Property, Plant and Equipment, net	15,260,176	15,814,170
<b>Other Assets:</b>		
Goodwill and other intangibles, net	3,080,686	2,946,859
Regulatory assets	1,926,103	3,276,800
Trading and marketing assets	544,909	446,610
Non-trading derivative assets	—	256,402
Equity investments in unconsolidated subsidiaries	108,727	386,841
Stranded costs indemnification receivable	—	203,693
Net assets held for sale	194,858	8,000
Restricted cash	—	6,775
Other	931,709	1,085,659
Total other assets	6,786,992	8,617,639
<b>Total Assets</b>	<b>\$31,960,429</b>	<b>\$30,680,544</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities:</b>		
Short-term borrowings	\$ 5,004,494	\$ 3,435,347
Current portion of long-term debt	1,623,202	660,757
Indexed debt securities derivative	—	730,225
Accounts payable	3,057,948	1,439,840
Taxes accrued	172,449	307,827
Interest accrued	103,489	114,578
Dividends declared	110,893	9
Trading and marketing liabilities	4,272,771	1,478,335
Non-trading derivative liabilities	—	472,021
Margin deposits from customers on energy trading and hedging activities	284,603	144,700
Accumulated deferred income taxes, net	309,008	359,220
Other	706,357	563,323
Total current liabilities	15,645,214	9,706,182
<b>Other Liabilities:</b>		
Accumulated deferred income taxes, net	2,548,891	2,307,737
Unamortized investment tax credit	265,737	247,407
Trading and marketing liabilities	530,263	361,786
Non-trading derivative liabilities	—	649,036
Benefit obligations	491,964	547,369
Regulatory liabilities	237,487	1,359,883
Non-derivative stranded costs liability	—	203,693
Other	1,048,018	1,064,474
Total other liabilities	5,122,360	6,741,385
<b>Long-term Debt</b>	<b>4,996,095</b>	<b>5,741,944</b>
<b>Commitments and Contingencies (Note 14)</b>		
<b>Minority Interest in Consolidated Subsidiaries</b>	<b>9,345</b>	<b>1,047,366</b>
<b>Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trusts</b>		
<b>Holding Solely Junior Subordinated Debentures of the Company</b>	<b>705,355</b>	<b>705,744</b>
<b>Stockholders' Equity</b>	<b>5,482,060</b>	<b>6,737,923</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$31,960,429</b>	<b>\$30,680,544</b>

See Notes to the Company's Consolidated Financial Statements

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**STATEMENTS OF CONSOLIDATED CASH FLOWS**

	Year Ended December 31,		
	1999	2000	2001
	(Thousands of dollars)		
<b>Cash Flows from Operating Activities:</b>			
Net income attributable to common stockholders	\$ 1,482,081	\$ 447,111	\$ 979,701
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	905,305	906,318	911,450
Deferred income taxes	632,588	(41,892)	(110,279)
Investment tax credit	(58,706)	(18,330)	(18,330)
Cumulative effect of accounting change, net	—	—	(61,619)
Unrealized (gain) loss on AOL Time Warner investment	(2,452,406)	204,969	70,215
Unrealized loss (gain) on indexed debt securities	629,523	(101,851)	(58,033)
Undistributed losses (earnings) of unconsolidated subsidiaries	793	(24,931)	(30,280)
Curtailement and related enhancement of benefits	—	—	100,609
REPGB stranded cost indemnification settlement gain	—	—	(36,881)
Impairment of marketable equity securities	—	26,504	—
Extraordinary items	183,261	(7,445)	—
Net cash (used in) provided by assets held for sale	(24,547)	437,620	199,031
Minority interest	(638)	(988)	81,399
Changes in other assets and liabilities:			
Restricted cash	—	(50,000)	(117,421)
Accounts receivable, net	(325,777)	(1,933,033)	1,189,214
Inventory	51,480	(74,603)	(74,703)
Proceeds from sale of debt securities	—	123,428	—
Accounts payable	197,549	2,022,004	(1,635,274)
Federal tax refund	—	86,155	—
Fuel cost over (under) recovery/surcharge	73,567	(515,278)	422,672
Net trading and marketing assets and liabilities	(11,703)	(3,984)	(185,136)
Margin deposits on energy trading and hedging activities, net	(29,921)	(206,480)	167,374
Non-trading derivative	—	—	(51,415)
Prepaid lease obligations	—	—	(180,531)
Interest and taxes accrued	(29,858)	(48,841)	155,117
Other current assets	(21,337)	(93,731)	159,057
Other current liabilities	(4,143)	229,628	(70,841)
Other assets	(72,551)	(158,184)	(158,227)
Other liabilities	(55,939)	69,738	(1,441)
Other, net	34,931	70,100	67,639
Net cash provided by operating activities	1,103,552	1,344,004	1,713,067
<b>Cash Flows from Investing Activities:</b>			
Capital expenditures	(1,165,639)	(1,842,385)	(2,053,383)
Business acquisitions, net of cash acquired	(1,060,000)	(2,121,481)	—
Proceeds from sale-leaseback transactions	—	1,000,000	—
Payment of business purchase obligation	—	(981,789)	—
Investment in AOL Time Warner securities	(537,055)	—	—
Investments in unconsolidated subsidiaries	(36,582)	(5,755)	—
Net cash (used in) provided by assets held for sale	(55,100)	641,768	(13,397)
Other, net	(15,557)	23,444	(18,181)
Net cash used in investing activities	(2,869,933)	(3,286,198)	(2,084,961)
<b>Cash Flows from Financing Activities:</b>			
Proceeds from long-term debt, net	2,060,680	1,092,373	1,293,204
Increase (decrease) in short-term borrowings, net	822,468	2,170,314	(1,477,646)
Payments of long-term debt	(935,908)	(678,709)	(636,206)
Payment of common stock dividends	(427,255)	(426,859)	(433,918)
Proceeds from issuance of stock, net	30,452	53,809	100,430
Proceeds from subsidiary issuance of stock	—	—	1,696,074
Proceeds from sale of trust preferred securities, net	362,994	—	—
Purchase of treasury stock by subsidiary	—	—	(189,460)
Purchase of treasury stock	(90,708)	(27,306)	—
Redemption of preferred stock	—	—	(10,227)
Increase in restricted cash related to securitization financing	—	—	(6,775)
Net cash provided by (used in) assets held for sale	400	(120,173)	1,200
Other, net	(204)	(31,138)	672
Net cash provided by financing activities	1,822,919	2,032,311	337,348
Effect of Exchange Rate Changes on Cash	—	5,088	(5,752)
Net Increase (Decrease) in Cash and Cash Equivalents	56,538	95,205	(40,298)
Cash and Cash Equivalents at Beginning of Year	24,229	80,767	175,972
Cash and Cash Equivalents at End of Year	\$ 80,767	\$ 175,972	\$ 135,674
<b>Supplemental Disclosure of Cash Flow Information:</b>			
Cash Payments:			
Interest (net of amounts capitalized)	\$ 504,821	\$ 786,660	\$ 598,009
Income taxes	401,703	526,603	563,011

See Notes to the Company's Consolidated Financial Statements



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**STATEMENTS OF CONSOLIDATED STOCKHOLDERS' EQUITY**  
(As Restated, See Note 1)

	1999		2000		2001	
	Shares	Amount	Shares	Amount	Shares	Amount
	(Thousands of dollars and shares)					
<b>Preference Stock, none outstanding</b> .....	—	\$ —	—	\$ —	—	\$ —
<b>Cumulative Preferred Stock</b>						
Balance, beginning of year.....	97	9,740	97	9,740	97	9,740
Redemption of preferred stock .....	—	—	—	—	(97)	(9,740)
Balance, end of year.....	97	9,740	97	9,740	—	—
<b>Common Stock, no par; authorized 700,000,000 shares</b>						
Balance, beginning of year.....	296,271	3,136,826	297,612	3,182,751	299,914	3,257,190
Issuances related to benefit and investment plans .....	1,341	46,062	2,302	74,447	3,030	130,660
Unrealized gain on sale of subsidiaries' stock .....	—	—	—	—	—	509,499
Other .....	—	(137)	—	(8)	—	(48)
Balance, end of year.....	297,612	3,182,751	299,914	3,257,190	302,944	3,897,301
<b>Treasury Stock</b>						
Balance, beginning of year.....	(103)	(2,384)	(3,625)	(93,296)	(4,811)	(120,856)
Shares acquired .....	(3,524)	(90,708)	(1,184)	(27,306)	—	—
Contribution to pension plan.....	—	—	—	—	4,512	113,336
Other .....	2	(204)	(2)	(254)	299	7,520
Balance, end of year.....	(3,625)	(93,296)	(4,811)	(120,856)	—	—
<b>Unearned ESOP stock</b>						
Balance, beginning of year.....	(11,674)	(217,780)	(10,679)	(199,226)	(8,639)	(161,158)
Issuances related to benefit plan .....	995	18,554	2,040	38,068	1,569	29,270
Balance, end of year.....	(10,679)	(199,226)	(8,639)	(161,158)	(7,070)	(131,888)
<b>Retained Earnings</b>						
Balance, beginning of year.....		1,445,081		2,500,181		2,520,350
Net income .....		1,482,081		447,111		979,701
Common stock dividends — \$1.50 per share in 1999 and 2000 and \$1.125 in 2001.....		(426,981)		(426,942)		(323,518)
Balance, end of year.....		2,500,181		2,520,350		3,176,533
<b>Accumulated Other Comprehensive Loss</b>						
Balance, beginning of year.....		(49,615)		(93,818)		(23,206)
Other comprehensive (loss) income, net of tax:						
Foreign currency translation adjustments from continuing operations .....		(587)		(1,104)		(94,066)
Foreign currency translation adjustments from assets held for sale .....		(42,392)		75,887		(24)
Unrealized (loss) gain on available-for-sale securities .....		(1,224)		(2,264)		16,984
Reclassification adjustment for gains on sales of available-for-sale securities realized in income .....		—		—		(8,670)
Reclassification adjustment for impairment loss on available-for-sale securities realized in net income .....		—		17,228		—
Additional minimum non-qualified pension liability adjustment .....		—		(19,135)		5,965
Cumulative effect of adoption of SFAS No. 133 .....		—		—		(421,852)
Net deferred gain from cash flow hedges .....		—		—		412,445
Reclassification of deferred gain from cash flow hedges realized in net income.....		—		—		(91,599)
Other comprehensive (loss) income.....		(44,203)		70,612		(180,817)
Balance, end of year.....		(93,818)		(23,206)		(204,023)
Total Stockholders' Equity .....		\$5,306,332		\$5,482,060		\$6,737,923

See Notes to the Company's Consolidated Financial Statements

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Background and Basis of Presentation**

Reliant Energy, Incorporated (Reliant Energy), together with its subsidiaries (collectively, the Company), is a diversified international energy services company that provides energy and energy services primarily in North America and Western Europe. Reliant Energy is both an electric utility company and a utility holding company through its wholly owned subsidiary Reliant Energy Resources Corp. (RERC).

The Company's financial reporting business segments include the following: Electric Operations, Natural Gas Distribution, Pipelines and Gathering, Wholesale Energy, European Energy, Retail Energy, Latin America and Other Operations. Electric Operations includes the operations of Reliant Energy HL&P, an electric utility. Natural Gas Distribution consists of intrastate natural gas sales to, and natural gas transportation and distribution for, residential, commercial, industrial and institutional customers and some non-rate regulated retail gas marketing operations to commercial and industrial customers. Pipelines and Gathering includes the interstate natural gas pipeline operations and the natural gas gathering and pipelines services businesses. Wholesale Energy is engaged in the acquisition, development and operation of non-rate regulated power generation facilities as well as the wholesale energy trading, marketing, power origination and risk management services in North America. European Energy is engaged in the operation of power generation facilities in the Netherlands as well as wholesale energy trading and power origination activities in Europe. Retail Energy consists of the Company's unregulated retail electric operations, and has historically been reported in the Other Operations business segment. Other Operations includes unallocated general corporate expenses, a communications business and non-operating investments. Latin America primarily consists of an electric utility and an electric cogeneration plant located in Argentina. Wholesale Energy, European Energy, Retail Energy and certain operations included within Other Operations are currently owned by Reliant Resources.

Reliant Energy is in the process of separating its regulated and unregulated businesses into two publicly traded companies. In December 2000, Reliant Energy transferred a significant portion of its unregulated businesses to Reliant Resources, Inc. (Reliant Resources) which, at the time, was a wholly owned subsidiary. In May 2001, Reliant Resources conducted an initial public offering (Offering) of approximately 20% of its common stock (59.8 million shares of its common stock) at a price of \$30 per share, and received net proceeds from the Offering of \$1.7 billion. After the Offering, Reliant Energy owned approximately 80% of Reliant Resources. As of December 31, 2001, Reliant Energy owns approximately 83% of Reliant Resources due to treasury stock repurchases of \$189 million during 2001 by Reliant Resources. As a result of the Offering, the Company recorded directly into stockholders' equity as a component of common stock a \$509 million unrealized gain on the sale of subsidiaries' stock. Pursuant to a master separation agreement between Reliant Energy and Reliant Resources, Reliant Resources used \$147 million of the net proceeds to repay certain indebtedness owed to Reliant Energy. In connection with the Offering, Reliant Energy converted \$1.7 billion of intercompany indebtedness owed by Reliant Resources and its subsidiaries prior to the closing of the Offering to equity as a capital contribution to Reliant Resources. In December 2001, Reliant Energy's shareholders approved an agreement and plan of merger by which the following will occur (which we refer to as the Restructuring):

- CenterPoint Energy will become the holding company for Reliant Energy and its subsidiaries;
- Reliant Energy and its subsidiaries will become subsidiaries of CenterPoint Energy; and
- each share of Reliant Energy common stock will be converted into one share of CenterPoint Energy common stock.

After the Restructuring, Reliant Energy plans, subject to further corporate approvals, market and other conditions, to complete the separation of its regulated and unregulated businesses by distributing the shares of common stock of Reliant Resources that the Company owns to its shareholders (Distribution). The Company's goal is to complete the Restructuring and subsequent Distribution as quickly as possible after all

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

the necessary conditions are fulfilled, including receipt of an order from the Securities and Exchange Commission (SEC) granting the required approvals under the Public Utility Holding Company Act of 1935 (1935 Act) and an extension from the IRS of its private letter ruling that the Company has obtained regarding the tax-free treatment of the Distribution. Although receipt or timing of regulatory approvals cannot be assured, the Company believes it meets the standards for such approvals. Reliant Energy currently expects to complete the Restructuring and Distribution in the summer of 2002.

Effective December 1, 2000, Reliant Energy's board of directors approved a plan to dispose of the Company's Latin America business segment through sales of its assets. Accordingly, in its 2000 consolidated financial statements, the Company reported the results of its Latin America business segment as discontinued operations in accordance with Accounting Principles Board (APB) Opinion No. 30 "Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," (APB Opinion No. 30) for each of the three years in the period ended December 31, 2000. On December 20, 2001, negotiations for the sale of the remaining Latin America investments were terminated as a result of the recent economic developments in Argentina. The Company will continue to evaluate options related to the future disposition of these assets.

Accordingly, the Latin America business segment is no longer reported as discontinued operations. The related operating results and loss on disposal have been reclassified within the Consolidated Statements of Income for all periods into operating income with respect to consolidated subsidiaries and other income with respect to equity investments in unconsolidated subsidiaries as required for assets held for sale by Emerging Issues Task Force (EITF) Issue No. 90-6 (EITF 90-6). For additional information regarding the disposal of the Latin America business segment, see Note 19.

**Restatement**

On May 9, 2002, Reliant Resources determined that it had engaged in same-day commodity trading transactions involving purchases and sales with the same counterparty for the same volume at substantially the same price, which the personnel who effected these transactions apparently did so with the sole objective of increasing volumes. Reliant Resources commenced a review to quantify the amount and assess the impact of these trades (round trip trades). The Audit Committees of each of the Board of Directors of Reliant Energy and Reliant Resources (Audit Committees) also directed an internal investigation by outside legal counsel, with assistance by outside accountants, of the facts and circumstances relating to the round trip trades and related matters.

The Company currently reports all trading, marketing and risk management services transactions on a gross basis with such transactions being reported in revenues and expenses except primarily for financial gas transactions such as swaps. Therefore, the round trip trades were reflected in both the Company's revenues and expenses. The round trip trades should not have been recognized in revenues or expenses (i.e. they should have been reflected on a net basis). However, since the round trip trades were done at the same volume and substantially the same price, they had no impact on the Company's reported cash flows, operating income or net income.

Based on Reliant Resources' review, Reliant Resources determined that it engaged in such round trip trades in 1999, 2000 and 2001. The results of the Audit Committees' investigation were consistent with the results of Reliant Resources' review. The round trip trades were for 30 million megawatt hours (MWh) of power and 182 billion cubic feet (Bcf) in 1999, 30 million MWh of power in 2000, and 74 million MWh of power and 46 Bcf of natural gas in 2001. On May 13, 2002, Reliant Resources previously announced its preliminary findings of round trip trades which had identified 30 million MWh of power in 1999, 30 million MWh of power in 2000, and 78 million MWh of power and 45 Bcf of natural gas in 2001. In addition to the round trip trades reported on May 13, 2002, Reliant Resources' review also identified an additional transaction in 1999 involving 182 Bcf of natural gas totaling \$364 million, which based on available information, Reliant

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Resources believes was also recorded with the sole objective of increasing volumes but also resulted in increased revenues and fuel and cost of gas sold expense.

In the course of Reliant Resources' review, Reliant Resources also identified and determined to record on a net basis several transactions for energy related services (not involving round trip trades) that totaled \$85 million over the three year period ended December 31, 2001. These transactions were originally recorded on a gross basis.

During 1999, 2000 and 2001, these transactions, referred to above, collectively, had the effect of increasing revenues, fuel and cost of gas sold expense and purchased power expense as follows:

	<u>Year Ended December 31,</u>		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
	(In millions)		
Revenues .....	\$1,417	\$1,070	\$3,902
Fuel and cost of gas sold expense .....	376	27	208
Purchase power expense .....	1,041	1,043	3,694

In addition, during the May 2001 through September 2001 time frame, Reliant Resources entered into four structured transactions involving a series of forward or swap contracts to buy and sell an energy commodity in 2001 and to buy and sell an energy commodity in 2002 or 2003 (four structured transactions). The four structured transactions were intended to increase future cash flow and earnings and to increase certainty associated with future cash flow and earnings, albeit at the expense of 2001 cash flow and earnings. Each series of contracts in a structure were executed contemporaneously with the same counterparty and were for the same commodities, quantities and locations. The contracts in each structure were offsetting in terms of physical attributes. The transactions that settled in 2001 were previously recorded on a gross basis with such transactions being reported in revenues and expenses which resulted in \$1.5 billion of revenues, \$364 million in fuel and cost of gas sold and \$1.2 billion of purchased power expense being recognized during the period from May 2001 through December 31, 2001. Having further reviewed the transactions, Reliant Resources now believes these transactions should have been accounted for on a net basis.

During the fourth quarter of 2000, two power generation swap contracts with a fair value of \$261 million were terminated and replaced with a substantially similar contract providing for physical delivery and designated to hedge electric generation. The termination of the original contracts and execution of the replacement contract represented a substantive modification to the original contract. As a result, upon termination of the original contracts, a contractual liability representing the fair value of the original contracts and a deferred asset of equal amount should have been recorded. As of January 1, 2001, in connection with the adoption of Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended (SFAS No. 133), the deferred asset should have been recorded as a transition adjustment to other comprehensive loss. The liability and transition adjustment should have been amortized on a straight-line basis over the term of the power generation contract replacing the terminated power generation contracts (through May 2004). The Company previously did not give accounting recognition to these transactions. As a result, the Company has restated its Consolidated Balance Sheets as of December 31, 2000 and 2001 and the Statements of Consolidated Stockholders' Equity and Comprehensive Income for the year ended December 31, 2001, to appropriately account for these transactions as described above. The restatement had no impact on the Company's reported consolidated cash flows, operating income or net income.

The consolidated financial statements for 1999, 2000 and 2001 have been restated from amounts previously reported to reflect all of the transactions described herein. In addition, the unaudited quarterly financial data for the interim periods ended March 31, 2001, June 30, 2000 and 2001, and September 30, 2000 and 2001 have been restated from amounts previously reported to reflect all of the transactions described

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

herein. The unaudited restated condensed quarterly financial statement information for the quarters ended March 31, 2001, June 30, 2000 and 2001, September 30, 2000 and 2001, and December 31, 2000 and 2001 have been included in Note 17. The restatement had no impact on previously reported consolidated cash flows, operating income or net income. A summary of the principal effects of the restatement are as follows for 1999, 2000 and 2001: (Note — Those line items for which no change in amounts is shown were not affected by the restatement.)

	Year Ended December 31, 1999	
	As Restated	As Previously Reported
	(In millions)	
Revenues .....	\$13,794	\$15,211
Expenses:		
Fuel and Cost of Gas Sold .....	6,331	6,707
Purchased Power .....	3,095	4,136
Other Expenses .....	3,109	3,109
Total .....	<u>12,535</u>	<u>13,952</u>
Operating Income .....	1,259	1,259
Other Income, net .....	1,305	1,305
Income Tax Expense .....	(899)	(899)
Income Before Extraordinary Loss .....	1,665	1,665
Extraordinary Loss .....	(183)	(183)
Net Income Attributable to Common Stockholders .....	<u>\$ 1,482</u>	<u>\$ 1,482</u>

	Year Ended December 31, 2000	
	As Restated	As Previously Reported
	(In millions)	
Revenues .....	\$28,269	\$29,339
Expenses:		
Fuel and Cost of Gas Sold .....	15,050	15,077
Purchased Power .....	7,580	8,623
Other Expenses .....	3,802	3,802
Total .....	<u>26,432</u>	<u>27,502</u>
Operating Income .....	1,837	1,837
Other Expense, net .....	(1,079)	(1,079)
Income Tax Expense .....	(318)	(318)
Income Before Extraordinary Gain .....	440	440
Extraordinary Gain .....	7	7
Net Income Attributable to Common Stockholders .....	<u>\$ 447</u>	<u>\$ 447</u>

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	Year Ended December 31, 2001	
	<u>As Restated</u>	<u>As Previously Reported</u>
	(In millions)	
Revenues .....	\$40,810	\$46,226
Expenses:		
Fuel and Cost of Gas Sold .....	19,504	20,075
Purchased Power .....	15,127	19,972
Other Expenses .....	4,186	4,186
Total .....	<u>38,817</u>	<u>44,233</u>
Operating Income .....	1,993	1,993
Other Expense, net .....	(574)	(574)
Income Tax Expense .....	<u>(500)</u>	<u>(500)</u>
Income Before Cumulative Effect of Accounting Change .....	919	919
Cumulative Effect of Accounting Change, net of tax .....	<u>61</u>	<u>61</u>
Net Income Attributable to Common Stockholders .....	<u>\$ 980</u>	<u>\$ 980</u>

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	December 31, 2000	
	As Restated	As Previously Reported
	(in millions)	
ASSETS		
Current Assets:		
Other current assets .....	\$ 279	\$ 203
Other .....	<u>9,634</u>	<u>9,634</u>
Total current assets .....	<u>9,913</u>	<u>9,837</u>
Other Assets:		
Other noncurrent assets .....	932	747
Property, plant and equipment and other assets .....	<u>21,115</u>	<u>21,115</u>
Total other assets .....	<u>22,047</u>	<u>21,862</u>
Total Assets .....	<u><u>\$31,960</u></u>	<u><u>\$31,699</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Other current liabilities .....	\$ 706	\$ 630
Other .....	<u>14,939</u>	<u>14,939</u>
Total current liabilities .....	15,645	15,569
Other Liabilities:		
Other liabilities .....	1,048	863
Other .....	<u>4,074</u>	<u>4,074</u>
Total other liabilities .....	<u>5,122</u>	<u>4,937</u>
Long-term Debt .....	<u>4,996</u>	<u>4,996</u>
Minority Interest in Consolidated Subsidiaries .....	<u>9</u>	<u>9</u>
Company Obligated Mandatorily Redeemable Preferred		
Securities of Subsidiary Trusts .....	<u>706</u>	<u>706</u>
Stockholders' Equity:		
Cumulative Preferred Stock .....	10	10
Common Stock .....	3,257	3,257
Treasury Stock .....	(121)	(121)
Unearned ESOP .....	(161)	(161)
Retained earnings .....	2,520	2,520
Accumulated other comprehensive loss .....	<u>(23)</u>	<u>(23)</u>
Stockholders' equity .....	<u>5,482</u>	<u>5,482</u>
Total Liabilities and Stockholders' Equity .....	<u><u>\$31,960</u></u>	<u><u>\$31,699</u></u>

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	<u>December 31, 2001</u> <u>As Restated</u>	<u>As Previously</u> <u>Reported</u>
	(in millions)	
<b>ASSETS</b>		
Current Assets .....	\$ 6,249	\$ 6,249
Property, plant and equipment and other assets .....	<u>24,432</u>	<u>24,432</u>
<b>Total Assets</b> .....	<u><b>\$30,681</b></u>	<u><b>\$30,681</b></u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities:</b>		
Non-trading derivative liabilities .....	\$ 472	\$ 396
Accumulated deferred income taxes, net .....	359	386
Other .....	<u>8,875</u>	<u>8,875</u>
<b>Total current liabilities</b> .....	<u><b>9,706</b></u>	<u><b>9,657</b></u>
<b>Other Liabilities:</b>		
Accumulated deferred income taxes, net .....	2,308	2,346
Non-trading derivative liabilities .....	649	540
Other .....	<u>3,785</u>	<u>3,785</u>
<b>Total other liabilities</b> .....	<u><b>6,742</b></u>	<u><b>6,671</b></u>
<b>Long-term Debt</b> .....	<u><b>5,742</b></u>	<u><b>5,742</b></u>
<b>Minority Interest in Consolidated Subsidiaries</b> .....	<u><b>1,047</b></u>	<u><b>1,047</b></u>
<b>Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trusts</b> .....		
	<u><b>706</b></u>	<u><b>706</b></u>
<b>Stockholders' Equity:</b>		
Common Stock .....	3,897	3,897
Unearned ESOP .....	(132)	(132)
Retained earnings .....	3,177	3,177
Accumulated other comprehensive loss .....	<u>(204)</u>	<u>(84)</u>
<b>Stockholders' equity</b> .....	<u><b>6,738</b></u>	<u><b>6,858</b></u>
<b>Total Liabilities and Stockholders' Equity</b> .....	<u><b>\$30,681</b></u>	<u><b>\$30,681</b></u>

The restatement did not impact earnings per share for 1999, 2000 and 2001, the Statements of Consolidated Cash Flows for 1999, 2000 and 2001, the Statements of Consolidated Comprehensive Income for 1999 and 2000 or the Statements of Consolidated Stockholders' Equity as of December 31, 1999 and 2000.

In addition to the round trip trades described above, Reliant Resources' review and the Audit Committees' investigation also considered other transactions executed on the same day at the same volume, price and delivery terms and with the same counterparty. These transactions were executed in the normal course of Reliant Resources' trading and marketing activities, and were historically reported on a gross basis, and were not material.

Beginning with the quarter ended September 30, 2002, the Company will report all energy trading and marketing activities on a net basis in the Statements of Consolidated Income pursuant to Emerging Issues



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Task Force Issue No. 02-3, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities".

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

***(a) Reclassifications and Use of Estimates***

Some amounts from the previous years have been reclassified to conform to the 2001 presentation of financial statements. These 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, 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.

***(b) Market Risk and Uncertainties***

The Company is subject to the risk associated with price movements of energy commodities and the credit risk associated with the Company's risk management activities. For additional information regarding these risks, see Notes 5, 14(g) and 21. The Company is also subject to risks relating to the supply and prices of fuel and electricity, seasonal weather patterns, technological obsolescence and the regulatory environment in the United States, and Western Europe and Latin America.

***(c) Principles of Consolidation***

The accounts of Reliant Energy and its wholly owned and majority owned subsidiaries are included in the consolidated financial statements. All significant intercompany transactions and balances are eliminated in consolidation. The Company uses the equity method of accounting for investments in entities in which the Company has an ownership interest between 20% and 50% and exercises significant influence. For additional information regarding these investments, see Note 7. Other investments, excluding marketable securities, are generally carried at cost. The results of the Company's European Energy business segment are consolidated on a one-month lag basis due to the availability of financial information. The Company has made adjustments to the European Energy business segment's accounts to include the effect of the settlement of our indemnity for certain energy obligations in December 2001 (see Note 14(h)). The Company owns approximately 83% of Reliant Resources and has reflected the third-party interest in Reliant Resources as minority interest in the Consolidated Balance Sheets and Statements of Consolidated Income.

***(d) Revenues***

The Company records revenue for electricity and natural gas sales and services to retail customers, except for certain contracted sales to large commercial, industrial and institutional customers, under the accrual method and these revenues are generally recognized upon delivery. Pipelines and Gathering record revenues as transportation services are provided. Energy sales and services not billed by month-end are accrued based upon estimated energy and services delivered. Domestic non-rate regulated electric power and other non-rate regulated energy services are sold at market-based prices through existing power exchanges or through third-party contracts. Prior to January 1, 2001, energy revenues related to the Company's power generation facilities in Europe were generated under a regulated pricing structure, which included compensation for the cost of fuel, capital and operation and maintenance expenses. The wholesale electric market in the Netherlands opened to competition on January 1, 2001. Accordingly, beginning in 2001, electric power and other energy services in Europe are sold at market-based prices or through third-party contracts.

The Company's energy trading, marketing, power origination and risk management services activities and contracted sales of electricity to large commercial, industrial and institutional customers are accounted for under mark-to-market accounting. Under the mark-to-market method of accounting, financial instruments and contractual commitments are recorded at fair value in revenues upon contract execution. The net changes

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

in their fair values are recognized in the Statements of Consolidated Income as revenues in the period of change. Trading and marketing revenues related to the physical sale of natural gas, electric power and other energy related commodities are recorded on a gross basis in the delivery period. For additional discussion regarding trading and marketing revenue recognition and the related estimates and assumptions that can affect reported amounts of such revenues, see Note 5.

The gains and losses related to financial instruments and contractual commitments qualifying and designated as hedges related to the sale of electric power and sales and purchases of natural gas are recognized in the same period as the settlement of the underlying physical transaction. These realized gains and losses are included in operating revenues and operating expenses in the Statements of Consolidated Income. For additional discussion, see Note 5.

***(e) Long-lived Assets and Intangibles***

The Company records property, plant and equipment at historical cost. The Company recognizes repair and maintenance costs incurred in connection with planned major maintenance, such as turbine and generator overhauls, control system upgrades and air conditioner replacements, under the "accrual in advance" method for its non-rate regulated power generation operations acquired or developed prior to December 31, 1999. Planned major maintenance cycles primarily range from two to ten years. Under the accrual in advance method, the Company estimates the costs of planned major maintenance and accrues the related expense over the maintenance cycle. As of December 31, 2000 and 2001, the Company's maintenance reserve was \$27 million and \$19 million, respectively, of which \$20 million and \$17 million, respectively, were included in other long-term liabilities and the remainder in other current liabilities. The Company expenses all other repair and maintenance costs as incurred. Property, plant and equipment includes the following:

	Estimated Useful Lives (Years)	December 31,	
		2000	2001
		(In millions)	
Electric .....	5-75	\$18,754	\$20,092
Natural gas distribution .....	5-50	1,809	2,002
Pipelines and gathering .....	5-75	1,582	1,627
Other property .....	3-40	247	450
Total .....		22,392	24,171
Accumulated depreciation and amortization .....		(7,132)	(8,357)
Property, plant and equipment, net .....		\$15,260	\$15,814

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Company records goodwill for the excess of the purchase price over the fair value assigned to the net assets of an acquisition. Goodwill has been amortized on a straight-line basis over 5 to 40 years. See Note 3 and the following table for additional information regarding goodwill and the related amortization periods.

	Estimated Useful Lives (Years)	December 31,	
		2000	2001
		(In millions)	
Reliant Energy Resources Corp. (RERC Corp.) . . . . .	40	\$1,955	\$1,955
Reliant Energy Mid-Atlantic Power Holdings, LLC . . . . .	35	7	5
Reliant Energy Power Generation Benelux N.V. . . . .	30	897	877
Florida Generation Plant . . . . .	35	2	2
California Generation Plants . . . . .	30	70	70
Reliant Energy Services, Inc. . . . .	40	131	131
Other . . . . .	5-35	64	45
Total . . . . .		3,126	3,085
Accumulated amortization . . . . .		(222)	(303)
Foreign currency exchange impact . . . . .		(107)	(150)
Total goodwill, net . . . . .		\$2,797	\$2,632

The Company recognizes specifically identifiable intangibles, including air emissions regulatory allowances and water rights and permits, when specific rights and contracts are acquired. As of December 31, 2000 and 2001, specific intangibles were \$284 million and \$315 million, respectively. The Company amortizes air emissions regulatory allowances primarily on a units-of-production basis as utilized. The Company amortizes other acquired intangibles on a straight-line basis over the lesser of their contractual or estimated useful lives that range between 5 and 35 years.

The Company periodically evaluates long-lived assets, including property, plant and equipment, goodwill and specifically identifiable intangibles, when events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. The determination of whether an impairment has occurred is based on an estimate of undiscounted cash flows attributable to the assets, as compared to the carrying value of the assets. An impairment analysis of generating facilities requires estimates of possible future market prices, load growth, competition and many other factors over the lives of the facilities. A resulting impairment loss is highly dependent on these underlying assumptions. During 2001, the Company determined equipment and goodwill associated with its Communications business was impaired and accordingly recognized \$22 million of fixed asset impairments and \$19 million of goodwill impairments (see Note 20). For discussion of goodwill impairment analysis in 2002, see Note 2(q).

During December 2001, the Company evaluated its European Energy business segment's long-lived assets and goodwill for impairment. As of December 31, 2001, pursuant to Statement of Financial Accounting Standards (SFAS) No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (SFAS No. 121), no impairment had been indicated. For discussion of goodwill impairment analysis in 2002, see Note 2(q).

During the fourth quarter of 2001, the Distribution of Reliant Resources was deemed to be a probable event. As Reliant Resources has an option, subject to the completion of the Distribution, to purchase the Company's Texas generation assets in 2004 (see Note 4(b)), the Company was required to evaluate these assets for potential impairment in accordance with SFAS No. 121, due to an expected decrease in the number of years the Company expects to hold and operate these assets. As of December 31, 2001, no impairment had been indicated. The Company anticipates that future events, such as the expected public offering of the Company's Texas generation operations (see Note 4(b)), or change in the estimated holding period of the Texas generation assets, will require the Company to re-evaluate these assets for impairment between now and 2004. If an impairment is indicated, it could be material and will not be fully recoverable through the 2004 true-up proceeding calculations (see Note 4(a)).

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Texas Electric Restructuring Law provides the Company recovery of the regulatory book value of its Texas generating assets for the amount the regulatory book value exceeds the estimated market value. If the Texas generating assets are sold to Reliant Resources, or to a third party in the future, a loss on sale of these assets, or an impairment of the recorded recoverable electric generation plant mitigation regulatory asset (see Note 2(f)), will occur to the extent the recorded book value of the Texas generating assets exceeds the regulatory book value. As of December 31, 2001, the recorded book value was \$638 million in excess of the regulatory book value. This amount declines each year as the recorded book value is depreciated and increases by the amount of non-environmental capital expenditures. For further discussion of the difference between the regulatory book value and the recorded book value, see Note 4.

**(f) Regulatory Assets and Liabilities**

The Company applies the accounting policies established in SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS No. 71) to the accounts of transmission and distribution operations of Reliant Energy HL&P and the utility operations of Natural Gas Distribution and to some of the accounts of Pipelines and Gathering. For information regarding Reliant Energy HL&P's electric generation operations' discontinuance of the application of SFAS No. 71 in 1999 and the effect on its regulatory assets and the Texas Electric Choice Plan (Texas Electric Restructuring Law), see Note 4(a).

The following is a list of regulatory assets/liabilities reflected on the Company's Consolidated Balance Sheets as of December 31, 2000 and 2001:

	December 31,	
	2000	2001
	(In millions)	
Recoverable impaired plant costs, net .....	\$ 281	\$ —
Recoverable electric generation related regulatory assets, net .....	1,150	160
Securitized regulatory asset .....	—	740
Regulatory tax asset, net .....	186	111
Unamortized loss on reacquired debt .....	66	62
Recoverable electric generation plant mitigation .....	—	1,967
Excess mitigation liability .....	—	(1,126)
Other long-term assets/liabilities .....	6	3
Total .....	<u>\$1,689</u>	<u>\$ 1,917</u>

If, as a result of changes in regulation or competition, the Company's ability to recover these assets and liabilities would not be assured, then pursuant to SFAS No. 101, "Regulated Enterprises Accounting for the Discontinuation of Application of SFAS No. 71" (SFAS No. 101) and SFAS No. 121, the Company would be required to write off or write down these regulatory assets and liabilities. In addition, the Company would be required to determine any impairment to the carrying costs of plant and inventory assets. See Note 4(a) for a discussion of the discontinuation of SFAS No. 71 related to Reliant Energy HL&P's electric generation operations.

Through December 31, 2001, the Texas Utility Commission provided for the recovery of most of Reliant Energy HL&P's fuel and purchased power costs from customers through a fixed fuel factor included in electric rates. Included in the above table in recoverable electric generation related regulatory assets, net are \$558 million and \$200 million of regulatory assets related to the recovery of fuel costs as of December 31, 2000 and 2001.

In December 2001, the Company recorded a regulatory asset for recoverable electric generation plant mitigation for \$2.0 billion and recorded a regulatory liability of \$1.1 billion for excess mitigation, resulting in net regulatory assets of \$841 million on which the Company will not earn a return and which are not included in the Company's rate base. Recoverable electric plant generation regulatory assets are anticipated to be recovered in the 2004 true-up proceedings as further discussed in Note 4(a). The Company is entitled to

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

recover its full amount of stranded costs in the 2004 true-up proceeding. That recovery would include any amounts whose earlier mitigation was prevented by excess mitigation credits and the reversal of redirected depreciation ordered by the Texas Utility Commission.

In 2001, the Company monetized \$738 million of regulatory assets in a securitization financing authorized by the Texas Utility Commission pursuant to the Texas Electric Restructuring Law. For additional information regarding the securitization financing, see Note 4(a).

For additional information regarding recoverable impaired plant costs and recoverable electric generation related assets and the related amortization during 1999, 2000 and 2001, see Notes 2(g) and 4(a).

***(g) Depreciation and Amortization Expense***

Depreciation is computed using the straight-line method based on economic lives or a regulatory mandated method. Other amortization expense includes amortization of regulatory assets and air emissions regulatory allowances and other intangibles. See Notes 2(f) and 4(a) for additional discussion of these items.

The following table presents depreciation, goodwill amortization and other amortization expense for 1999, 2000 and 2001.

	<b>Year Ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
	<b>(In millions)</b>		
Depreciation expense .....	\$547	\$391	\$436
Goodwill amortization expense .....	62	86	81
Write off of Communications goodwill .....	—	—	19
Other amortization expense .....	296	429	375
Total depreciation and amortization expense .....	<u>\$905</u>	<u>\$906</u>	<u>\$911</u>

In June 1998, the Texas Utility Commission issued an order approving a transition to competition plan (Transition Plan) filed by Reliant Energy HL&P in December 1997. In order to reduce Reliant Energy HL&P's exposure to potential stranded costs related to generation assets, the Transition Plan permitted the redirection of depreciation expense to generation assets that Reliant Energy HL&P otherwise would apply to transmission, distribution and general plant assets (Redirected Depreciation). In addition, the Transition Plan provided that all earnings above a stated overall annual rate of return on invested capital be used to recover Reliant Energy HL&P's investment in generation assets (Accelerated Depreciation). Reliant Energy HL&P implemented the Transition Plan effective January 1, 1998 and pursuant to its terms, recorded \$194 million in Accelerated Depreciation and \$195 million in Redirected Depreciation in 1998 and \$104 million in Accelerated Depreciation and \$99 million in Redirected Depreciation in the first six months in 1999. Due to the discontinuance of SFAS No. 71 to Reliant Energy HL&P's generation operations, the provisions for Accelerated and Redirected Depreciation of the Transition Plan were no longer applied effective July 1, 1999. For additional information regarding the discontinuance of SFAS No. 71 to the Electric Operations business segments' generation operations and the related Texas Electric Restructuring Law, as well as an October 3, 2001 order finding that the Company had overmitigated its stranded costs, see Note 4(a).

***(h) Capitalization of Interest and Allowance for Funds Used During Construction***

Allowance for funds used during construction (AFUDC) represents the approximate net composite interest cost of borrowed funds and a reasonable return on the equity funds used for construction. Although AFUDC increases both utility plant and earnings, it is realized in cash through depreciation provisions included in rates for subsidiaries that apply SFAS No. 71. Interest and AFUDC for subsidiaries that apply SFAS No. 71 are capitalized as a component of projects under construction and will be amortized over the assets' estimated useful lives. During 1999, 2000 and 2001, the Company capitalized interest and AFUDC related to debt of \$19 million, \$45 million and \$68 million, respectively.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(i) Income Taxes**

The Company files a consolidated federal income tax return. The Company follows a policy of comprehensive interperiod income tax allocation. The Company uses the liability method of accounting for deferred income taxes and measures deferred income taxes for all significant income tax temporary differences. Investment tax credits were deferred and are being amortized over the estimated lives of the related property. Unremitted earnings from the Company's foreign operations are deemed to be permanently reinvested in foreign operations. For additional information regarding income taxes, see Note 13.

**(j) Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable, principally from customers, are net of an allowance for doubtful accounts of \$89 million and \$136 million at December 31, 2000 and 2001, respectively. The provision for doubtful accounts in the Company's Statements of Consolidated Income for 1999, 2000 and 2001 was \$16 million, \$80 million and \$90 million, respectively. In addition, during the year ended December 31, 2001, the Company wrote off \$15 million of receivables for refunds related to energy sales in California and \$88 million related to energy sales to Enron Corp. and its affiliates (Enron) which filed a voluntary petition for bankruptcy during the fourth quarter of 2001. For information regarding the provision against receivable balances related to energy sales in the California market and to Enron, see Notes 14(g) and 21, respectively.

During 1999, 2000 and 2001, the Company had an agreement under which it sold substantially all of the customer accounts receivable of Reliant Energy HL&P. Receivables aggregating \$4.4 billion, \$4.9 billion and \$5.8 billion were sold in 1999, 2000 and 2001, respectively. In December 2001, Reliant Energy HL&P terminated the agreement under which it sold its customer accounts receivable and recorded an early termination charge of \$20 million in the Statements of Consolidated Income. Proceeds for the repurchase of receivables, which occurred in January 2002, were obtained from a combination of bank loans and the sale of commercial paper. Net proceeds from the sale of customer accounts receivable were \$523 million at December 31, 2001. Such proceeds were not reflected as debt in the Consolidated Balance Sheets.

**(k) Inventory**

Inventory consists principally of materials and supplies, coal and lignite, natural gas and heating oil. Inventories used in the production of electricity and in the retail natural gas distribution operations are valued at the lower of average cost or market except for coal and lignite, which are valued under the last-in, first-out method. Heating oil and natural gas used in the trading and marketing operations are accounted for under mark-to-market accounting as discussed in Note 5.

	<u>December 31,</u>	
	<u>2000</u>	<u>2001</u>
	(In millions)	
Materials and supplies .....	\$270	\$273
Coal and lignite .....	59	92
Natural gas .....	107	173
Heating oil .....	47	42
Total inventory .....	<u>\$483</u>	<u>\$580</u>

**(l) Investment in Other Debt and Equity Securities**

In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (SFAS No. 115), the Company reports "available-for-sale" securities at estimated fair value within other long-term assets in the Company's Consolidated Balance Sheets and any unrealized gain or loss, net of tax, as a separate component of stockholders' equity and accumulated other comprehensive (loss) income. In accordance with SFAS No. 115, the Company reports "trading" securities at estimated fair value in the Company's Consolidated Balance Sheets, and any unrealized holding gains and losses are recorded as other income (expense) in the Company's Statements of Consolidated Income.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

As of December 31, 2000 and 2001, the Company held "available-for-sale" debt and equity securities in its nuclear decommissioning trust, which is reported at its fair value of \$159 million and \$169 million, respectively, in the Company's Consolidated Balance Sheets in other long-term assets. Any unrealized losses or gains are accounted for in accordance with SFAS No. 71 as a regulatory asset/liability.

In addition, as of December 31, 2000 and 2001, the Company held marketable equity securities of \$5 million and \$12 million, respectively, classified as "available-for-sale." At December 31, 2000, the accumulated unrealized loss, net of tax, relating to these equity securities was \$2 million. At December 31, 2001, the accumulated unrealized gain, net of tax, relating to these equity securities was \$6 million.

During 2000, pursuant to SFAS No. 115, the Company incurred a pre-tax impairment loss equal to the \$27 million of cumulative unrealized losses that had been charged to accumulated other comprehensive loss through December 31, 1999. Management's determination to recognize this impairment resulted from a combination of events occurring in 2000 related to this investment. These events affecting the investment included changes occurring in the investment's senior management, announcement of significant restructuring charges and related downsizing for the entity, reduced earnings estimates for this entity by brokerage analysts and the bankruptcy of a competitor of the investment in the first quarter of 2000. These events, coupled with the stock market value of the Company's investment in these securities continuing to be below the Company's cost basis, caused management to believe the decline in fair value of these "available-for-sale" securities to be other than temporary.

As of December 31, 2000 and 2001, the Company held an investment in AOL Time Warner common stock, which was classified as a "trading" security. For information regarding the Company's investment in AOL Time Warner, Inc. common stock, see Note 8.

As of December 31, 2000, the Company did not hold debt or equity securities that are classified as "trading", other than its investment in AOL Time Warner. As of December 31, 2001, the Company held equity securities classified as "trading" totaling \$1 million, other than its investment in AOL Time Warner. The Company recorded unrealized holding gains on "trading" securities, excluding unrealized gains and losses related to the Company's investment in AOL Time Warner, included in gains from investments in the Statements of Consolidated Income of \$16 million, \$4 million and \$5 million during 1999, 2000 and 2001, respectively.

***(m) Project Development Costs***

Project development costs include costs for professional services, permits and other items that are incurred incidental to a particular project. The Company expenses these costs as incurred until the project is considered probable. After a project is considered probable, capitalizable costs incurred are capitalized to the project. When project operations begin, the Company begins to amortize these costs on a straight-line basis over the life of the facility. As of December 31, 2000 and 2001, the Company had recorded in the Consolidated Balance Sheets project development costs of \$7 million and \$9 million, respectively.

***(n) Environmental Costs***

The Company expenses or capitalizes environmental expenditures, as appropriate, depending on their future economic benefit. The Company expenses amounts that relate to an existing condition caused by past operations, and that do not have future economic benefit. The Company records undiscounted liabilities related to these future costs when environmental assessments and/or remediation activities are probable and the costs can be reasonably estimated. Subject to SFAS No. 71, a corresponding regulatory asset is recorded in anticipation of recovery through the rate making process by subsidiaries that apply SFAS No. 71 in some circumstances.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

***(o) Foreign Currency Adjustments***

Local currencies are the functional currency of the Company's foreign operations. Foreign subsidiaries' assets and liabilities have been translated into U.S. dollars using the exchange rate at the balance sheet date. Revenues, expenses, gains and losses have been translated using the weighted average exchange rate for each month prevailing during the periods reported. Cumulative adjustments resulting from translation have been recorded as a component of accumulated other comprehensive loss in stockholders' equity. Through December 31, 2001, the U.S. dollar had been the functional currency for the Company's operations in Argentina since the revenues and costs of these operations were based primarily on U.S. dollar-indexed contracts. Since the inception of the Company's operations in Argentina, the Argentine peso has been pegged to the U.S. dollar at a rate of one Argentine peso to one U.S. dollar. As a result, no foreign currency adjustments have resulted from these operations through 2001. The Company has determined that the functional currency for its Argentina operations in 2002 will be the Argentine peso as a result of Argentine legislation enacted in January 2002 requiring that all U.S. dollar-indexed contracts be restructured to Argentine pesos.

***(p) Statements of Consolidated Cash Flows***

For purposes of reporting cash flows, the Company considers cash equivalents to be short-term, highly liquid investments with maturities of three months or less from the date of purchase. As of December 31, 2001, the Company has recorded \$167 million of restricted cash that is available for Reliant Energy Mid-Atlantic Power Holdings LLC and its subsidiaries' (collectively, REMA) working capital needs and future lease payments. For additional discussion regarding REMA's lease transactions, see Note 14(b). In connection with a financing completed in October 2001, the Company was required to establish restricted cash accounts to collateralize the bonds that were issued in this financing transaction. These restricted cash accounts are reflected as Restricted Cash in the Consolidated Balance Sheets and are classified as long-term as they are not available for withdrawal until the maturity of the bonds. Cash and Cash Equivalents does not include Restricted Cash. For additional information regarding the securitization financing, see Note 4(a).

***(q) New Accounting Pronouncements***

Staff Accounting Bulletin No. 101, "Revenue Recognition" (SAB No. 101), was issued by the SEC on December 3, 1999. SAB No. 101 summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. The consolidated financial statements reflect the accounting guidance provided in SAB No. 101.

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 "Business Combinations" (SFAS No. 141) and SFAS No. 142 "Goodwill and Other Intangible Assets" (SFAS No. 142). SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles will be evaluated against these new criteria and may result in certain intangibles being transferred to goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. SFAS No. 142 provides for a nonamortization approach, whereby goodwill and certain intangibles with indefinite lives will not be amortized into results of operations, but instead will be reviewed periodically for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles with indefinite lives is more than its fair value. The Company adopted the provisions of each statement which apply to goodwill and intangible assets acquired prior to June 30, 2001 on January 1, 2002. The adoption of SFAS No. 141 did not have a material impact on the Company's historical results of operations or financial position. On January 1, 2002, the Company discontinued amortizing goodwill into the results of operations pursuant to SFAS No. 142. The Company recognized \$81 million of goodwill amortization expense in the Statements of Consolidated Income during 2001, excluding a \$19 million write-off of its Communications business goodwill.



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

balance which was recorded as goodwill amortization expense (see Note 20). The Company is in the process of determining further effects of adoption of SFAS No. 142 on its consolidated financial statements, including the review of goodwill and certain intangible assets for impairment. The Company has not completed its review pursuant to SFAS No. 142. However, based on the Company's preliminary review, the Company believes an impairment of its European Energy business segment goodwill is reasonably possible. As of December 31, 2001, net goodwill associated with the European Energy business segment is \$632 million. The Company has not completed its preliminary review of its other business segments with net goodwill totaling \$2.0 billion. The Company anticipates finalizing its review of goodwill and certain intangible assets during 2002.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). SFAS No. 143 requires the fair value of a liability for an asset retirement legal obligation to be recognized in the period in which it is incurred. When the liability is initially recorded, associated costs are capitalized by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002, with earlier application encouraged. SFAS No. 143 requires entities to record a cumulative effect of change in accounting principle in the income statement in the period of adoption. The Company plans to adopt SFAS No. 143 on January 1, 2003 and is in the process of determining the effect of adoption on its consolidated financial statements. For certain operations subject to cost of service rate regulation, the Company is permitted to include annual charges for cost of removal and nuclear decommissioning costs in the revenues charged to customers.

In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144). SFAS No. 144 provides new guidance on the recognition of impairment losses on long-lived assets to be held and used or to be disposed of and also broadens the definition of what constitutes a discontinued operation and how the results of a discontinued operation are to be measured and presented. SFAS No. 144 supercedes SFAS No. 121 and APB Opinion No. 30, while retaining many of the requirements of these two statements. Under SFAS No. 144, assets held for sale that are a component of an entity will be included in discontinued operations if the operations and cash flows will be or have been eliminated from the ongoing operations of the entity and the entity will not have any significant continuing involvement in the operations prospectively. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, with early adoption encouraged. SFAS No. 144 is not expected to materially change the methods used by the Company to measure impairment losses on long-lived assets, but may result in additional future dispositions being reported as discontinued operations than was previously permitted. The Company adopted SFAS No. 144 on January 1, 2002.

See Note 5 for the Company's adoption of SFAS No. 133 on January 1, 2001 and adoption of subsequent cleared guidance.

**(3) Business Acquisitions**

***(a) Reliant Energy Mid-Atlantic Power Holdings, LLC***

On May 12, 2000, a subsidiary of the Company purchased entities owning electric power generating assets and development sites located in Pennsylvania, New Jersey and Maryland having an aggregate net generating capacity of approximately 4,262 MW. With the exception of development entities that were sold to another subsidiary of Reliant Resources in July 2000, the assets of the entities acquired are held by REMA. The purchase price for the May 2000 transaction was \$2.1 billion. In 2002, the Company made an \$8 million payment to the prior owner for post-closing adjustments which resulted in an adjustment to purchase price. The Company accounted for the acquisition as a purchase with assets and liabilities of REMA reflected at their estimated fair values. The Company's fair value adjustments related to the acquisition primarily included adjustments in property, plant and equipment, air emissions regulatory allowances, specific intangibles,

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

materials and supplies inventory, environmental reserves and related deferred taxes. The air emissions regulatory allowances of \$153 million are being amortized on a units-of-production basis as utilized. The specific intangibles which relate to water rights and permits of \$43 million will be amortized over the estimated life of the related facility of 35 years. The excess of the purchase price over the fair value of the net assets acquired of \$5 million was recorded as goodwill and historically was amortized over 35 years. The Company finalized these fair value adjustments in May 2001. There were no additional material modifications to the preliminary adjustments from December 31, 2000. Funds for the acquisition of REMA were made available through commercial paper borrowings by a finance subsidiary, which borrowings were supported by credit facilities.

The net purchase price of REMA was allocated and the fair value adjustments to the seller's book value are as follows:

	<u>Purchase Price Allocation</u>	<u>Fair Value Adjustments</u>
	(In millions)	
Current assets .....	\$ 85	\$ (27)
Property, plant and equipment .....	1,898	627
Goodwill .....	5	(146)
Other intangibles .....	196	33
Other assets .....	3	(5)
Current liabilities .....	(50)	(13)
Other liabilities .....	(39)	(15)
Total .....	<u>\$2,098</u>	<u>\$ 454</u>

Adjustments to property, plant and equipment, other intangibles which includes air emissions regulatory allowances and other specific intangibles, and environmental reserves included in other liabilities are based primarily on valuation reports prepared by independent appraisers and consultants.

In August 2000, the Company, through subsidiaries, entered into separate sale-leaseback transactions with each of three owner-lessors covering the subsidiaries' respective 16.45%, 16.67% and 100% interests in the Conemaugh, Keystone and Shawville generating stations, respectively, acquired as part of the REMA acquisition. As lessee, Reliant Resources leases an interest in each facility from each owner-lessor under a facility lease agreement. As consideration for the sale of the Company's interest in the facilities, the Company received \$1.0 billion in cash. The Company used the \$1.0 billion of sale proceeds to repay certain commercial paper borrowings as described above.

The Company's results of operations include the results of REMA only for the period beginning May 12, 2000. The following table presents selected actual financial information and unaudited pro forma information for 1999 and 2000, as if the acquisition had occurred on November 24, 1999 and January 1, 2000, as applicable. Pro forma information for operations prior to November 24, 1999 would not be meaningful since historical financial results of the business and the revenue generating activities underlying that period are substantially different from the wholesale generation activities that REMA has been engaged in after November 24, 1999. Pro forma amounts also give effect to the sale and leaseback of interests in three of the REMA generating plants, which were consummated in August 2000.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	Year Ended December 31,			
	1999		2000	
	Actual	Unaudited Pro forma	Actual	Unaudited Pro forma
	(In millions)			
Revenues .....	\$13,794	\$13,824	\$28,269	\$28,436
Income after tax and before extraordinary items ....	1,666	1,656	440	431
Net income attributable to common stockholders ...	1,482	1,472	447	438

These unaudited pro forma results, based on assumptions deemed appropriate by the Company's management, have been prepared for informational purposes only and are not necessarily indicative of the amounts that would have resulted if the acquisition of the REMA entities had occurred on November 24, 1999 and January 1, 2000, as applicable. Purchase-related adjustments to the results of operations include the effects on depreciation and amortization, interest expense and income taxes.

**(b) Reliant Energy Power Generation Benelux N.V.**

Effective October 7, 1999, a subsidiary of the Company acquired REPGb, a Dutch electric generation company, for a total net purchase price, payable in Dutch Guilders (NLG), of \$1.9 billion based on an exchange rate on October 7, 1999 of 2.06 NLG per U.S. dollar. The aggregate purchase price paid in 1999 by the Company consisted of \$833 million in cash. On March 1, 2000, under the terms of the acquisition agreement, the Company funded the remaining purchase obligation for \$982 million. A portion (\$596 million) of this obligation was financed with a three-year term loan facility obtained in the first quarter of 2000.

The Company recorded the REPGb acquisition under the purchase method of accounting, with assets and liabilities of REPGb reflected at their estimated fair values. As outlined in the table below, the Company's fair value adjustments related to the acquisition of REPGb primarily included increases in property, plant and equipment, long-term debt, severance liabilities, post-employment benefit liabilities and deferred foreign taxes. Additionally, a \$19 million receivable was recorded in connection with the acquisition as the selling shareholders agreed to reimburse REPGb for some obligations incurred prior to the purchase of REPGb. Adjustments to property, plant and equipment are based on valuation reports prepared by independent appraisers and consultants. The excess of the purchase price over the fair value of net assets acquired of \$877 million was recorded as goodwill and was historically amortized on a straight-line basis over 30 years. The Company finalized these fair value adjustments in September 2000. The Company finalized a severance plan (REPGb Plan) in connection with the REPGb acquisition in September 2000 (commitment date) and in accordance with EITF Issue No. 95-3 "Recognition of Liabilities in Connection with a Purchase Business Combination," recorded this liability of \$19 million in the third quarter of 2000. During 2001, the Company utilized \$8 million of the reserve for the REPGb Plan. As of December 31, 2001, the remaining severance liability is \$11 million. The majority of the \$11 million of remaining severance liability will be disbursed in accordance with the terms and conditions outlined by a collective labor bargaining agreement regarding employees near retirement age (Social Plan) in accordance with applicable Dutch labor law. The Social Plan, which by formula defines termination benefits, prescribes a payout period for up to five years for an employee subsequent to termination date. In the fourth quarter of 2001, the Dutch taxing authority finalized REPGb's tax basis of property, plant and equipment as of October 1999. As a result, the Company recorded an adjustment to decrease goodwill and accumulated deferred tax liability by \$5 million in the fourth quarter of 2001. As of December 31, 2001, the tax basis of other certain assets and liabilities has not been finalized.

In connection with the acquisition of REPGb, the Company developed a comprehensive business process reengineering and employee severance plan intended to make REPGb competitive in the deregulated Dutch electricity market that began January 1, 2001. The REPGb Plan's initial conceptual formulation was initiated prior to the acquisition of REPGb in October 1999. The finalization of the REPGb Plan was approved and

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

completed in September 2000. The Company identified 195 employees who were involuntarily terminated in REPGB's following functional areas: plant operations and maintenance, procurement, inventory, general and administrative, legal, finance and support. The Company has notified all employees identified under the severance component of the REPGB Plan that they are subject to involuntary termination and the majority of terminations occurred during 2001. The termination benefits under the REPGB Plan are governed by REPGB's Social Plan, a collective bargaining agreement between REPGB and its various representative labor unions signed in 1998. The Social Plan provides defined benefits for involuntarily severed employees depending upon age, tenure and other factors, and was agreed to by the management of REPGB as a result of the anticipated deregulation of the Dutch electricity market. The Social Plan is still in force and binding on the current management of the Company and REPGB. The Company is still executing the REPGB Plan as of the date of these consolidated financial statements.

The net purchase price of REPGB was allocated and the fair value adjustments to the seller's book value are as follows:

	<u>Purchase Price Allocation</u>	<u>Fair Value Adjustments</u>
	(In millions)	
Current assets .....	\$ 244	\$ 34
Property, plant and equipment .....	1,899	719
Goodwill .....	877	877
Current liabilities .....	(336)	—
Deferred taxes .....	(76)	(76)
Long-term debt .....	(422)	(87)
Other long-term liabilities .....	(244)	(35)
Total .....	<u>\$1,942</u>	<u>\$1,432</u>

The following table presents selected actual financial information for 1999 and unaudited pro forma information for 1999, as if the acquisition of REPGB had occurred on January 1, 1999. The pro forma results are based on assumptions deemed appropriate by the Company's management, have been prepared for informational purposes only and are not necessarily indicative of the consolidated results that would have resulted if the acquisition of REPGB had occurred on January 1, 1999. Purchase related adjustments to results of operations include amortization of goodwill, interest expense and the effects on depreciation and amortization of the assessed fair value of some of REPGB's net assets and liabilities.

	<u>1999</u>	
	<u>Actual</u>	<u>Pro forma</u>
	(In millions)	
Revenues .....	\$13,794	\$14,371
Net income attributable to common stockholders .....	1,482	1,455

**(c) Florida Generation Plant Purchase**

On October 6, 1999, the Company purchased a steam turbine generation plant (Indian River) with a net generating capacity of 619 MW from a Florida municipality (Municipality) for a net purchase price of \$188 million. Indian River, located near Titusville, Florida, consists of three conventional steam generation units fueled by both oil and natural gas. Under the Company's ownership, the units will sell up to 578 MW of power generation from Indian River to the Municipality through a power purchase agreement that was originally scheduled to expire in September 2003, but has been extended through September 2007. During the option period, the Municipality has the right to purchase up to 500 MW for the first two years of the option period and 300 MW for the final two years. Any excess power generated by the plant may be sold to other utilities and rural electric cooperatives within the state and other entities within the Florida wholesale market.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Company recorded the acquisition under the purchase method of accounting. The purchase price has been allocated to assets acquired and liabilities assumed based on their estimated fair market values at the date of acquisition. The Company's fair value adjustments related to the acquisition of Indian River primarily included increases in property, plant and equipment, specific intangibles related to water rights and permits, major maintenance reserves and related deferred taxes. The specific intangibles of \$112 million are being amortized over their contractual lives of 35 years. The Company finalized these fair value adjustments during September 2000. There were no material adjustments made to the purchase allocation subsequent to December 31, 1999.

Net purchase price of Indian River was allocated as follows (in millions):

Current assets .....	\$ 15
Property, plant and equipment .....	93
Goodwill .....	2
Other intangibles .....	112
Major maintenance reserve .....	(3)
Other long-term liabilities .....	<u>(31)</u>
Total .....	<u>\$188</u>

The Company's results of operations include Indian River's results of operations only for the period beginning with the October 6, 1999 acquisition date. Pro forma information has not been presented for Indian River for 1999. Pro forma information would not be meaningful since historical financial results of the business and the revenue generating activities underlying that period as described below are substantially different from the wholesale generation activities that Indian River has been engaged in after October 6, 1999. Prior to the Company's acquisition, the acquired Indian River generation operations were fully integrated with, and its results of operations were consolidated into, the Municipality's vertically-integrated utility operations. In addition, prior to the Company's acquisition, the electric output of these facilities was sold based on rates set by regulatory authorities and are not indicative of these assets' future operating results as a wholesale electricity provider.

**(4) Regulatory Matters**

***(a) Texas Electric Choice Plan and Discontinuance of SFAS No. 71 for Electric Generation Operations***

In June 1999, the Texas legislature adopted the Texas Electric Restructuring Law, which substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail electric competition. Retail pilot projects allowing competition for up to 5% of each utility's load in all customer classes began in the third quarter of 2001, and retail electric competition for all other customers began in January 2002. In preparation for competition, the Company made significant changes in the electric utility operations it conducts through its electric utility division, Reliant Energy HL&P. In addition, the Texas Utility Commission issued a number of new rules and determinations in implementing the Texas Electric Restructuring Law.

The Texas Electric Restructuring Law defined the process for competition and created a transition period during which most utility rates were frozen at rates not in excess of their then-current levels. The Texas Electric Restructuring Law provided for utilities to recover their generation related stranded costs and regulatory assets (as defined in the Texas Electric Restructuring Law).

***Retail Choice.*** Under the Texas Electric Restructuring Law, beginning January 1, 2002, retail customers of most investor owned electric utilities in Texas became eligible to purchase their electricity from any of a number of "retail electric providers," which are certified by the Texas Utility Commission. Retail electric providers may not own or operate generation assets and their sales prices are not subject to traditional

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

cost-of-service rate regulation. Retail electric providers that are affiliates of electric utilities may compete substantially statewide for these sales, but prices they charge within the affiliated electric utility's traditional service territory are subject to some limitations at the outset of retail choice, as described below. The Texas Utility Commission has prescribed regulations governing quality, reliability and other aspects of service from retail electric providers. Reliant Resources intends to compete in the Texas retail market and, as a result, has certified three of its subsidiaries as retail electric providers.

*Unbundling.* As of January 1, 2002, electric utilities in Texas such as Reliant Energy HL&P unbundled their businesses in order to separate power generation, transmission and distribution, and retail activities into different units. Pursuant to the Texas Electric Restructuring Law, the Company submitted a plan in January 2000 that was later amended and updated to accomplish the required separation (the Business Separation Plan). For additional information regarding the Business Separation Plan, see Note 4(b). The transmission and distribution business will continue to be subject to cost-of-service rate regulation and will be responsible for the delivery of electricity to retail customers. The Company plans to transfer the Texas generation facilities that were formerly part of the Reliant Energy HL&P integrated utility (Texas generation business) to an indirect wholly owned partnership (Texas Genco) in connection with the Restructuring. As a result of these changes, the Company's Texas generation operations will no longer be conducted as part of an integrated utility and will comprise a new business segment in 2002, Electric Generation. Additionally, these operations will not be part of the Company's business if they are acquired in 2004 by Reliant Resources pursuant to an option agreement as described below. At that time, Reliant Resources will be an unaffiliated company as a result of the planned Distribution.

*Generation.* Power generators began selling electric energy to wholesale purchasers, including retail electric providers, at unregulated prices on January 1, 2002. To facilitate a competitive market, each power generation company affiliated with a transmission and distribution utility is required to sell at auction 15% of the output of its installed generating capacity. The first auction was held in September 2001 for power delivered beginning January 1, 2002. This obligation continues until January 1, 2007 unless before that date the Texas Utility Commission determines that at least 40% of the quantity of electric power consumed in 2000 by residential and small commercial load in the electric utility's service area is being served by retail electric providers other than the affiliated retail electric provider. See Note 4(b) for information regarding the capacity auctions and the effect of the Business Separation Plan on the Company. Texas Genco plans to auction all of its remaining capacity (less approximately 10% withheld to provide for unforeseen outages) during the time period prior to Reliant Resources' exercise of the Texas Genco option discussed below. Pursuant to the Business Separation Plan, Reliant Resources is entitled to purchase, at prices established in these auctions, 50% (but no less than 50%) of the remaining capacity, energy and ancillary services auctioned by Texas Genco.

*Rates.* Base rates charged by Reliant Energy HL&P on September 1, 1999 were frozen until January 1, 2002. Pursuant to Texas Utility Commission regulations, effective January 1, 2002, after the cycle meter read in January 2002, retail rates charged to residential and small commercial customers by an affiliated retail electric provider were reduced by 6% from the average rates (on a bundled basis) in effect on January 1, 1999. Following adjustments for changes in fuel prices, this actually resulted in a 17% rate reduction for Reliant Resources, through its subsidiaries, as an affiliated retail provider. That reduced rate, known as the "price to beat", is being charged by the affiliated retail electric provider to residential and small commercial customers in the utility's service area who have not elected service from another retail electric provider. The affiliated retail electric provider may not offer different rates to residential or small commercial customer classes in the utility's service area until the earlier of the date the Texas Utility Commission determines that 40% of power consumed by that class in the affiliated transmission and distribution utility's service area is being served by non-affiliated retail electric providers or January 1, 2005. In addition, the affiliated retail electric provider must make the price to beat rate available to eligible consumers until January 1, 2007.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Stranded Costs.* Reliant Energy HL&P will be entitled to recover its stranded costs (*i.e.*, the excess of net book value of generation assets (as defined by the Texas Electric Restructuring Law) over the market value of those assets) and its regulatory assets related to generation. The Texas Electric Restructuring Law prescribes specific methods for determining the amount of stranded costs and the details for their recovery. During the transition period to deregulation (the Transition Period) which included 1998 and the first six months of 1999, and extending through the base rate freeze period from July 1999 through 2001, the Texas Electric Restructuring Law provided that earnings above a stated overall annual rate of return on invested capital be used to recover the Electric Operations business segments' investment in generation assets (Accelerated Depreciation). In addition, during the Transition Period, the redirection of depreciation expense to generation assets that the Electric Operation business segment would otherwise apply to transmission, distribution and general plant assets was permitted for regulatory purposes (Redirected Depreciation). See discussion of the accounting treatment of Accelerated Depreciation and Redirected Depreciation for financial reporting purposes below under "Accounting." We cannot predict the amount, if any, of these costs that may not be recovered.

In accordance with the Texas Electric Restructuring Law, beginning on January 1, 2002, and ending when the true-up proceeding is completed in January 2004, any difference between market power prices received in the generation capacity auction and the Texas Utility Commission's earlier estimates of those market prices will be included in the 2004 stranded cost true-up, as further discussed below. This component of the true-up is intended to ensure that neither the customers nor the Company are disadvantaged economically as a result of the two-year transition period by providing this pricing structure.

On October 24, 2001, Reliant Energy Transition Bond Company LLC (Bond Company), a Delaware limited liability company and direct wholly owned subsidiary of Reliant Energy, issued \$749 million aggregate principal amount of its Series 2001-1 Transition Bonds pursuant to a financing order of the Texas Utility Commission. Classes of the bonds have final maturity dates of September 15, 2007, September 15, 2009, September 15, 2011 and September 15, 2015, and bear interest at rates of 3.84%, 4.76%, 5.16% and 5.63%, respectively. Scheduled payments on the bonds are from 2002 through 2013. Net proceeds to the Bond Company from the issuance were \$738 million. The Bond Company paid Reliant Energy \$738 million for the transition property. Reliant Energy used the net proceeds for general corporate purposes, including the repayment of indebtedness.

The Transition Bonds are secured primarily by the "transition property," which includes the irrevocable right to recover, through non-bypassable transition charges payable by certain retail electric customers, the qualified costs of Reliant Energy HL&P authorized by the financing order. The holders of the Bond Company's bonds have no recourse to any assets or revenues of Reliant Energy, and the creditors of Reliant Energy have no recourse to any assets or revenues (including, without limitation, the transition charges) of the Bond Company. Reliant Energy has no payment obligations with respect to the Transition Bonds except to remit collections of transition charges as set forth in a servicing agreement between Reliant Energy and the Bond Company and in an intercreditor agreement among Reliant Energy, the Bond Company and other parties.

Costs associated with nuclear decommissioning will continue to be subject to cost-of-service rate regulation and are included in a charge to transmission and distribution customers. For further discussion of the effect of the Business Separation Plan on funding of the nuclear decommissioning trust fund, see Note 4(b).

*True-Up Proceeding.* The Texas Electric Restructuring Law and current Texas Utility Commission implementation guidance provide for a True-up Proceeding to be initiated in January 2004. The purpose of the True-up Proceeding is to quantify and reconcile the amount of stranded costs, the capacity auction true-up, unreconciled fuel costs (see Note 2(f)), and other regulatory assets associated with Reliant Energy HL&P's

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

electric generating operations that were not previously securitized through the Transition Bonds. The True-up Proceeding will result in either additional charges or credits being assessed on certain retail electric customers.

*Accounting.* Historically, Reliant Energy HL&P has applied the accounting policies established in SFAS No. 71. Effective June 30, 1999, the Company applied SFAS No. 101 to Reliant Energy HL&P's electric generation operations. Reliant Energy HL&P's transmission and distribution operations continue to meet the criteria of SFAS No. 71.

In 1999, the Company evaluated the effects that the Texas Electric Restructuring Law would have on the recovery of its generation related regulatory assets and liabilities. The Company determined that a pre-tax accounting loss of \$282 million existed because it believes only the economic value of its generation related regulatory assets (as defined by the Texas Electric Restructuring Law) will be recovered. Therefore, the Company recorded a \$183 million after-tax extraordinary loss in the fourth quarter of 1999. Pursuant to EITF Issue No. 97-4, the remaining recoverable regulatory assets will not be written off and will become associated with the transmission and distribution portion of the Company's electric utility business. For details regarding Reliant Energy HL&P's regulatory assets, see Note 2(f).

At June 30, 1999, the Company performed an impairment test of its previously regulated electric generation assets pursuant to SFAS No. 121 on a plant specific basis. Under SFAS No. 121, an asset is considered impaired, and should be written down to fair value, if the future undiscounted net cash flows expected to be generated by the use of the asset are insufficient to recover the carrying amount of the asset. For assets that are impaired pursuant to SFAS No. 121, the Company determined the fair value for each generating plant by estimating the net present value of future cash inflows and outflows over the estimated life of each plant. The difference between fair value and net book value was recorded as a reduction in the current book value. The Company determined that \$808 million of electric generation assets were impaired in 1999. Of this amount, \$756 million related to the South Texas Project Electric Generating Station (South Texas Project) and \$52 million related to two gas-fired generation plants. The Texas Electric Restructuring Law provides for recovery of this impairment through regulated cash flows during the transition period and through charges to transmission and distribution customers. As such, a regulatory asset was recorded for an amount equal to the impairment loss and was included on the Company's Consolidated Balance Sheets as a regulatory asset. The Company recorded amortization expense related to the recoverable impaired plant costs and other assets created from discontinuing SFAS No. 71 of \$221 million in the third and fourth quarters of 1999, \$329 million in 2000 and \$258 million in 2001.

The impairment analysis requires estimates of possible future market prices, load growth, competition and many other factors over the lives of the plants. The resulting impairment loss is highly dependent on these underlying assumptions. In addition, after January 10, 2004, Reliant Energy HL&P must finalize and reconcile stranded costs (as defined by the Texas Electric Restructuring Law) in a filing with the Texas Utility Commission. Any positive difference between the regulatory net book value and the fair market value of the generation assets (as defined by the Texas Electric Restructuring Law) will be collected through future charges. Any overmitigation of stranded costs may be refunded by a reduction in future charges. This final reconciliation allows alternative methods of third party valuation of the fair market value of these assets, including outright sale, stock valuations and asset exchanges.

In order to reduce potential exposure to stranded costs related to generation assets, Reliant Energy HL&P redirected \$195 million and \$99 million of depreciation in 1998 and for the six months ended June 30, 1999, respectively, from transmission and distribution related plant assets to generation assets for regulatory and financial reporting purposes (Redirected Depreciation). This redirection was in accordance with the Company's Transition Plan. Subsequent to June 30, 1999, Redirected Depreciation expense could no longer be recorded by the electric generation operations portion of Reliant Energy HL&P for financial reporting purposes as this portion of electric operations is no longer accounted for under SFAS No. 71. During the six months ended December 31, 1999 and during 2000 and 2001, \$99 million, \$218 million and \$230 million in



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

depreciation expense, respectively, was redirected from transmission and distribution for regulatory and financial reporting purposes and was established as an embedded regulatory asset included in transmission and distribution related plant and equipment balances. As of December 31, 2000 and 2001, the cumulative amount of Redirected Depreciation for regulatory purposes was \$611 million and \$841 million, respectively, prior to the effects of the October 3, 2001 order discussed below.

Additionally, as allowed by the Texas Utility Commission, in an effort to further reduce potential exposure to stranded costs related to generation assets, Reliant Energy recorded Accelerated Depreciation of \$194 million and \$104 million in 1998 and for the six months ended June 30, 1999, respectively, for regulatory and financial reporting purposes. Accelerated Depreciation expense was recorded in accordance with the Company's Transition Plan during this period. Subsequent to June 30, 1999, Accelerated Depreciation expense could no longer be recorded by the electric generation operations portion of Reliant Energy HL&P for financial reporting purposes, as this portion of electric operations is no longer accounted for under SFAS No. 71. During the six months ended December 31, 1999 and during 2000 and 2001, \$179 million, \$385 million and \$264 million of Accelerated Depreciation was recorded for regulatory reporting purposes, reducing the regulatory book value of Reliant Energy HL&P's electric generation assets.

The Texas Utility Commission issued a final order on October 3, 2001 (October 3, 2001 Order) that established the transmission and distribution utility rates that became effective January 2002. In this Order, the Texas Utility Commission found that Reliant Energy HL&P had overmitigated its stranded costs by redirecting transmission and distribution depreciation and by accelerating depreciation of generation assets as provided under the Transition Plan and Texas Electric Restructuring Law. As a result of the October 3, 2001 Order, Reliant Energy HL&P was required to reverse the \$841 million embedded regulatory asset related to Redirected Depreciation, thereby reducing the net book value of transmission and distribution assets. Reliant Energy HL&P was required to record a regulatory liability of \$1.1 billion related to Accelerated Depreciation. The October 3, 2001 Order requires this amount to be refunded through excess mitigation credits to certain retail electric customers during a seven year period beginning in January 2002. On appeal, a Texas District court upheld the Texas Utility Commission's order. An appeal may be taken to a Texas Court of Appeal, but no further appeal has yet been filed.

As of December 31, 2001, in contemplation of the True-up Proceeding, Reliant Energy HL&P has recorded a regulatory asset of \$2.0 billion representing the estimated recovery of previously incurred stranded costs, which includes a regulatory liability of \$1.1 billion plus the reversal of previously recorded Redirected Depreciation. This estimated recovery is based upon current projections of the market value of the Reliant Energy HL&P electric generation assets to be covered by the True-up Proceeding calculations. Because generally accepted accounting principles require the Company to estimate fair market values in advance of the final reconciliation, the financial impacts of the Texas Electric Restructuring Law with respect to the final determination of stranded costs in 2004 are subject to material changes. Factors affecting such changes may include estimation risk, uncertainty of future energy and commodity prices and the economic lives of the plants. If events were to occur that made the recovery of some of the remaining generation related regulatory assets no longer probable, the Company would write off the remaining balance of such assets as a charge against earnings. For additional discussion of potential future impairment of the assets of the Company's Texas generation business, see Note 2(e).

*Other Accounting Policy Changes.* As a result of discontinuing SFAS No. 71, effective July 1, 1999, allowance for funds used during construction is no longer accrued on generation related construction projects. Instead, interest is being capitalized on these projects in accordance with SFAS No. 34, "Capitalization of Interest Cost."

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Previously, in accordance with SFAS No. 71, Reliant Energy HL&P deferred the premiums and expenses that arose when long-term debt was redeemed and amortized these costs over the life of the new debt. If no new debt was issued, these costs would be amortized over the remaining original life of the retired debt. Effective July 1, 1999, costs resulting from the retirement of debt attributable to the generation operations of Reliant Energy HL&P will be recorded in accordance with SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," unless these costs will be recovered through regulated cash flows. In that case, these costs will be deferred and recorded as a regulatory asset by the entity through which the source of the regulated cash flows will be derived.

***(b) Business Separation Plan***

*Restructuring of Regulated Entities and Distribution of Reliant Resources Stock.* Pursuant to the Business Separation Plan, subject to receipt of an order from the Securities and Exchange Commission (SEC) described below, Reliant Energy will become a subsidiary of a new holding company, CenterPoint Energy, which initially will own the Company's (a) electric transmission and distribution operations, (b) natural gas distribution businesses, (c) electric generating assets in Texas that were formerly operated by Reliant Energy HL&P, (d) interstate pipelines, gas gathering and pipeline services operations, (e) interests in energy companies in Latin America (see Note 19) and (f) interests in Reliant Resources. In these Notes, references to Reliant Energy in connection with events occurring or the performance of agreements after the Restructuring generally refer to CenterPoint Energy.

Upon becoming a subsidiary of CenterPoint Energy, Reliant Energy will transfer the stock of its principal operating subsidiaries to a subsidiary of CenterPoint Energy and will transfer its electric generating assets in Texas that were formerly operated by Reliant Energy HL&P to Texas Genco. In January 2004, Reliant Resources will have the right to exercise an option to acquire Texas Genco, as further discussed below. As a result of the stock and asset transfers described above, Reliant Energy will become solely a transmission and distribution utility, with its other businesses becoming indirect subsidiaries of CenterPoint Energy, which will assume all of Reliant Energy's debt other than its first mortgage bonds. The indebtedness of certain wholly owned financing subsidiaries of Reliant Energy is expected to be refinanced by the regulated holding company by the end of 2002.

The Company anticipates that, upon completion of the Restructuring and subject to approval by the Company's board of directors, market and other conditions, CenterPoint Energy will distribute all of the stock it owns in Reliant Resources to CenterPoint Energy's shareholders, affecting the separation of its operations into two publicly traded corporations. The Company has obtained a private letter ruling from the IRS providing for the tax-free treatment of the Distribution that is predicated on the completion of the Distribution by April 30, 2002. The Company has requested an extension of this deadline. While there can be no assurance that the Company will receive the extension, the Company anticipates that it will receive an extension that allows it to proceed with the Distribution after April 30, 2002.

Reliant Energy has made and will continue to make internal asset and stock transfers intended to allocate the assets and liabilities of Reliant Energy in accordance with regulatory requirements and as contemplated by the Business Separation Plan. Forms of each of the intercompany agreements described below were prepared and entered into by Reliant Energy and Reliant Resources prior to the Offering.

The Restructuring as currently planned cannot be completed unless and until the SEC issues an order granting the required approvals under the Public Utility Holding Company Act of 1935 (1935 Act). While the Company believes such an order will be received, and that both the Restructuring and Distribution will be completed during the summer of 2002, there can be no assurances that such will be the case. The Restructuring has been designed to enable the Company to meet all of the requirements of the Texas Electric Restructuring Law. The Company has not formulated an alternative restructuring plan that could be implemented were the SEC to refuse to grant the requested approvals for CenterPoint Energy.

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Agreements Related to Texas Generating Assets.* Pursuant to the Business Separation Plan, Reliant Energy expects to cause Texas Genco to conduct an initial public offering of approximately 20% of its capital stock by the end of 2002. If the initial public offering is not conducted, Reliant Energy may distribute approximately 20% of Texas Genco's capital stock to its stockholders in a transaction taxable both to it and its stockholders as part of the valuation of stranded costs. In connection with the separation of its unregulated businesses from its regulated businesses, Reliant Energy granted Reliant Resources an option, subject to the completion of the Distribution, to purchase all of the shares of capital stock of Texas Genco that will be owned by Reliant Energy after the initial public offering or distribution (*Texas Genco Option*). The *Texas Genco Option* may be exercised between January 10, 2004 and January 24, 2004. The per share exercise price under the option will be the average daily closing price on the national exchange for publicly held shares of common stock of Texas Genco for the 30 consecutive trading days with the highest average closing price during the 120 trading days immediately preceding January 10, 2004, plus a control premium, up to a maximum of 10%, to the extent a control premium is included in the valuation determination made by the Texas Utility Commission relating to the market value of Texas Genco's common stock equity. The exercise price is also subject to adjustment based on the difference between the cash dividends paid during the period there is a public ownership interest in Texas Genco and Texas Genco's earnings during that period. Reliant Resources has agreed that if it exercises the *Texas Genco Option* and purchases the shares of Texas Genco common stock, Reliant Resources will also purchase all notes and other receivables from Texas Genco then held by Reliant Energy, at their principal amount plus accrued interest. Similarly, if Texas Genco holds notes or receivables from the Company, Reliant Resources will assume those obligations in exchange for a payment to Reliant Resources by the Company of an amount equal to the principal plus accrued interest.

Exercise of the *Texas Genco Option* by Reliant Resources will be subject to various regulatory approvals, including Hart-Scott-Rodino antitrust clearance and United States Nuclear Regulatory Commission (NRC) license transfer approval. The option will be exercisable only if Reliant Energy or CenterPoint Energy distributes all of the shares of Reliant Resources common stock it owns to its shareholders.

At the time of the Restructuring, Texas Genco will become the beneficiary of the decommissioning trust that has been established to provide funding for decontamination and decommissioning of a nuclear electric generation station in which Reliant Energy owns a 30.8% interest (see Note 6). The master separation agreement provides that Reliant Energy will collect through rates or other authorized charges to its electric utility customers amounts designated for funding the decommissioning trust, and will pay the amounts to Texas Genco. Texas Genco will in turn be required to deposit these amounts received from Reliant Energy into the decommissioning trust. Upon decommissioning of the facility, in the event funds from the trust are inadequate, Reliant Energy or its successor will be required to collect through rates or other authorized charges to customers as contemplated by the Texas Utilities Code all additional amounts required to fund Texas Genco's obligations relating to the decommissioning of the facility. Following the completion of the decommissioning, if surplus funds remain in the decommissioning trust, the excess will be refunded to Reliant Energy's or its successor's ratepayers.

***(c) Reliant Energy HL&P Regulatory Filings***

As of December 31, 2000 and 2001, Reliant Energy HL&P was under-collected on fuel recovery by \$558 million and \$200 million, respectively. In two separate filings with the Texas Utility Commission in 2000, Reliant Energy HL&P received approval to implement fuel surcharges to collect the under-recovery of fuel expenses, as well as to adjust the fuel factor to compensate for significant increases in the price of natural gas. For additional information regarding this matter, see Note 2(f).

On March 15, 2001, Reliant Energy HL&P filed an application with the Texas Utility Commission to revise its fuel factor and address its undercollected fuel costs of \$389 million, which was the accumulated amount from September 2000 through February 2001, plus estimates for March and April 2001. Reliant

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Energy HL&P requested to revise its fixed fuel factor to be implemented with the May 2001 billing cycle and proposed to defer the collection of the \$389 million until the 2004 stranded costs True-up Proceeding. On April 16, 2001, the Texas Utility Commission issued an order approving interim rates effective with the May 2001 billing cycle.

On June 21, 2001, Reliant Energy HL&P filed an application with the Texas Utility Commission to terminate the interim factor and return to the prior fuel factor due to the forecasted decline in natural gas prices. On July 20, 2001, the Texas Utility Commission issued an order of dismissal approving Reliant Energy HL&P's request that the interim rates approved on April 16, 2001, effective with Reliant Energy HL&P's May 2001 billing month, be terminated and Reliant Energy HL&P prospectively bill its customers using the prior fuel factor established in a previous order beginning with Reliant Energy HL&P's August billing month. The Texas Utility Commission also granted Reliant Energy HL&P a good cause exception in that Reliant Energy HL&P will not be required to refund amounts collected through the interim rates. Reliant Energy HL&P did not waive its right to collect any final fuel balance. The final fuel balance is subject to review, and the amount to be included in the 2004 stranded cost true-up will be determined during the final fuel reconciliation. The Texas Utility Commission currently has scheduled Reliant Energy HL&P to file its final fuel reconciliation in July 2002.

***(d) Arkla Rate Case***

On November 21, 2001, Arkla filed a rate case (Docket 01-243-U) with the Arkansas Public Service Commission seeking an increase in rates for its Arkansas customers of approximately \$47 million on an annual basis. Arkla's last rate increase was authorized in 1995. In the rate filing, Arkla maintains that its rate base has grown by \$183 million, and its operating expenses have increased from \$93 million to \$106 million on an annual basis and, therefore, Arkla's current rates for service to Arkansas customers do not provide a reasonable opportunity for Arkla to cover its operating costs and earn a fair return on its investment. A decision in the case is expected by the fourth quarter of 2002.

**(5) Derivative Financial Instruments**

Effective January 1, 2001, the Company adopted SFAS No. 133, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. This statement requires that derivatives be recognized at fair value in the balance sheet and that changes in fair value be recognized either currently in earnings or deferred as a component of other comprehensive income (loss), depending on the intended use of the derivative, its resulting designation and its effectiveness. If certain conditions are met, an entity may designate a derivative instrument as hedging (a) the exposure to changes in the fair value of an asset or liability (Fair Value Hedge), (b) the exposure to variability in expected future cash flows (Cash Flow Hedge) or (c) the foreign currency exposure of a net investment in a foreign operation. For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period it occurs.

Adoption of SFAS No. 133 on January 1, 2001 resulted in an after-tax increase in net income of \$61 million and a cumulative after-tax increase in accumulated other comprehensive loss of \$422 million. The adoption also increased current assets, long-term assets, current liabilities and long-term liabilities by approximately \$627 million, \$67 million, \$778 million, and \$277 million, respectively, in the Company's Consolidated Balance Sheets. During the year ended December 31, 2001, \$165 million of the initial after-tax transition adjustment recognized in other comprehensive income was recognized in net income.

The application of SFAS No. 133 is still evolving as the FASB clears issues previously submitted to the Derivatives Implementation Group for consideration. During the second quarter of 2001, an issue that applies exclusively to the electric industry and allows the normal purchases and normal sales exception for option-type contracts if certain criteria are met was approved by the FASB with an effective date of July 1, 2001. The

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

adoption of this cleared guidance had no impact on the Company's results of operations. Certain criteria of this previously approved guidance were revised in October and December 2001 and became effective on April 1, 2002. The Company is currently in the process of determining the effect of adoption of the revised guidance.

During the third quarter of 2001, the FASB cleared an issue related to application of the normal purchases and normal sales exception to contracts that combine forward and purchased option contracts. The effective date of this guidance is April 1, 2002, and the Company is currently assessing the impact of this cleared issue and does not believe it will have a material impact on the Company's consolidated financial statements.

The Company is exposed to various market risks. These risks arise from transactions entered into in the normal course of business and are inherent in the Company's consolidated financial statements. The Company utilizes derivative instruments such as futures, physical forward contracts, swaps and options (Energy Derivatives) to mitigate the impact of changes in electricity, natural gas and fuel prices on its operating results and cash flows. The Company utilizes cross-currency swaps, forward contracts and options to hedge its net investments in and cash flows of its foreign subsidiaries, interest rate swaps to mitigate the impact of changes in interest rates and other financial instruments to manage various other market risks.

Trading and marketing operations often involve risk associated with managing energy commodities and establishing open positions in the energy markets, primarily on a short-term basis. These risks fall into three different categories: price and volume volatility, credit risk of trading counterparties and adequacy of the control environment for trading. The Company routinely enters into Energy Derivatives to hedge purchase and sale commitments, fuel requirements and inventories of natural gas, coal, electricity, crude oil and products, emission allowances and other commodities and to minimize the risk of market fluctuations in its trading, marketing, power origination and risk management services operations.

Energy Derivatives primarily used by the Company are described below:

- Future contracts are exchange-traded standardized commitments to purchase or sell an energy commodity or financial instrument, or to make a cash settlement, at a specific price and future date.
- Physical forward contracts are commitments to purchase or sell energy commodities in the future.
- Swap agreements require payments to or from counterparties based upon the differential between a fixed price and variable index price (fixed price swap) or two variable index prices (variable price swap) for a predetermined contractual notional amount. The respective index may be an exchange quotation or an industry pricing publication.
- Option contracts convey the right to buy or sell an energy commodity, financial instrument at a predetermined price or settlement of the differential between a fixed price and a variable index price or two variable index prices.

***(a) Energy Trading, Marketing, Power Origination and Price Risk Management Activities***

The Company offers energy price risk management services primarily related to natural gas, electric power and other energy related commodities. These activities also include the establishing of open positions in the energy markets, primarily on a short-term basis, and transactions intended to optimize the Company's power generation portfolio, but which do not qualify for hedge accounting. The Company provides these services by utilizing a variety of derivative instruments (Trading Energy Derivatives).

The Company applies mark-to-market accounting for all of its energy trading, marketing, power origination and price risk management services operations in North America and Europe, as well as to retail contracted sales to large commercial, industrial and institutional customers. Accordingly, these Trading Energy Derivatives are recorded at fair value with net realized and unrealized gains (losses) recorded as a

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

component of revenues. The recognized, unrealized balances are recorded as trading and marketing assets/liabilities.

	Fair Value	
	Assets	Liabilities
	(In millions)	
December 31, 2000		
Natural gas .....	\$3,823	\$3,818
Electricity .....	974	946
Oil and other .....	39	39
	<u>\$4,836</u>	<u>\$4,803</u>
December 31, 2001		
Natural gas .....	\$1,389	\$1,303
Electricity .....	648	517
Oil and other .....	21	20
	<u>\$2,058</u>	<u>\$1,840</u>

All of the fair values shown in the table above at December 31, 2000 and 2001 have been recognized in income. The fair values as of December 31, 2000 and 2001, are estimated using quoted prices where available, other valuation techniques when market data is not available, for example in illiquid markets, and other factors such as time value and volatility factor for the underlying commitment. The Company's alternative pricing methodologies include, but are not limited to, extrapolation of forward pricing curves using historically reported data from illiquid pricing points. These same pricing techniques are used to evaluate a contract prior to taking the position.

The fair values in the above table are subject to significant changes based on fluctuating market prices and conditions. Changes in the assets and liabilities from trading, power origination, marketing and price risk management services result primarily from changes in the valuation of the portfolio of contracts, newly originated transactions and the timing of settlements. The most significant estimates include natural gas and power forward market prices, volatility and credit risk. For the contracted retail electric sales to large commercial, industrial and institutional customers, significant variables affecting contract values also include the variability in electricity consumption patterns due to weather and operational uncertainties (within contract parameters). Market prices assume a normal functioning market with an adequate number of buyers and sellers providing market liquidity. Insufficient market liquidity could significantly affect the values that could be obtained for these contracts, as well as the costs at which these contracts could be hedged.

The weighted-average term of the trading portfolio, based on volumes, is less than one year. The maximum term of the trading portfolio is 17 years. These maximum and average terms 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 the Company's 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.

**(b) Non-Trading Activities**

**Cash Flow Hedges.** To reduce the risk from market fluctuations in revenues and the resulting cash flows derived from the sale of electric power, natural gas and other commodities, the Company may enter into Energy Derivatives in order to hedge exposure to variability in cash flows (Non-trading Energy Derivatives).

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Non-trading Energy Derivative portfolios are managed to complement the physical transaction portfolio, reducing overall risks within authorized limits.

The Company applies hedge accounting for its Non-trading Energy Derivatives utilized in non-trading activities only if there is a high correlation between price movements in the derivative and the item designated as being hedged. This correlation, a measure of hedge effectiveness, is measured both at the inception of the hedge and on an ongoing basis, with an acceptable level of correlation of at least 80% to 120% for hedge designation. If and when correlation ceases to exist at an acceptable level, hedge accounting ceases and mark-to-market accounting is applied. During 2001, the amount of hedge ineffectiveness recognized in earnings from derivatives that are designated and qualify as Cash Flow Hedges was a gain of \$8 million. No component of the derivative instruments' gain or loss was excluded from the assessment of effectiveness. If it becomes probable that an anticipated transaction will not occur, the Company realizes in net income the deferred gains and losses recognized in accumulated other comprehensive income (loss). During the year ended December 31, 2001, there was a \$3.6 million deferred loss recognized in earnings as a result of the discontinuance of cash flow hedges because it was no longer probable that the forecasted transaction would occur due to credit problems of a customer. Once the anticipated transaction occurs, the accumulated deferred gain or loss recognized in accumulated other comprehensive income (loss) is reclassified and included in the Company's Statements of Consolidated Income under the captions (a) fuel expenses, in the case of natural gas purchase transactions, (b) purchased power, in the case of electric power purchase transactions and (c) revenues, in the case of electric power and natural gas sales transactions and financial electric power or natural gas derivatives. Cash flows resulting from these transactions in Non-trading Energy Derivatives are included in the Statements of Consolidated Cash Flows in the same category as the item being hedged. As of December 31, 2001, the Company's current non-trading derivative assets and liabilities and corresponding amounts in accumulated other comprehensive loss were expected to be reclassified into net income during the next twelve months.

The maximum length of time the Company is hedging its exposure to the variability in future cash flows for forecasted transactions excluding the payment of variable interest on existing financial instruments is eleven years.

In addition, as of December 31, 2001, the European Energy business segment had entered into transactions to purchase \$271 million at fixed exchange rates in order to hedge future fuel purchases payable in U.S. dollars.

*Interest Rate Swaps.* During 2001, the Company entered into interest rate swaps with an aggregate notional amount of \$1.8 billion to fix the interest rate applicable to floating rate short-term debt and interest rate swaps with a notional amount of \$425 million to fix the interest rate applicable to floating rate long-term debt. At December 31, 2001, \$225 million of the swaps relating to long-term debt had expired. The swaps relating to short-term debt do not qualify as cash flow hedges under SFAS No. 133, and are marked to market on the Consolidated Balance Sheets with changes reflected in interest expense in the Statements of Consolidated Income. The swaps relating to long-term debt qualify for hedge accounting under SFAS No. 133 and the periodic settlements are recognized as an adjustment to interest expense in the Statements of Consolidated Income over the term of the swap agreement. During 2001, the Company entered into forward-starting interest rate swaps having an aggregate notional amount of \$500 million to hedge the interest rate on a portion of a future offering of five-year notes. These swaps qualify as cash flow hedges under SFAS No. 133. Should the expected issuance of the debt no longer be probable, any deferred amount will be recognized immediately into income. The maximum length of time the Company is hedging its exposure to the payment of variable interest rates is four years.

*Hedge of the Foreign Currency Exposure of Net Investment in Foreign Subsidiaries.* The Company has substantially hedged the foreign currency exposure of its net investment in its European subsidiaries through a combination of Euro-denominated borrowings, foreign currency swaps and foreign currency forward contracts

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

to reduce the Company's exposure to changes in foreign currency rates. During the normal course of business, the Company reviews its currency hedging strategies and determines the hedging approach deemed appropriate based upon the circumstances of each situation.

The Company records the changes in the value of the foreign currency hedging instruments and Euro-denominated borrowings as foreign currency translation adjustments included as a component of accumulated other comprehensive loss. The effectiveness of the hedging instruments can be measured by the net change in foreign currency translation adjustments attributed to the Company's net investment in its European subsidiaries. These amounts generally offset amounts recorded in stockholders' equity as adjustments resulting from translation of the hedged investment into U.S. dollars. During 2001, the derivative and non-derivative instruments designated as hedging the net investment in the Company's European subsidiaries resulted in a gain of \$31 million, which is included in the balance of the cumulative translation adjustment.

*Other Derivatives.* In December 2000, the Dutch parliament adopted legislation allocating to the Dutch generation sector, including REPGB, financial responsibility for various stranded costs contracts and other liabilities. The legislation became effective in all material respects on January 1, 2001. In particular, the legislation allocated to the Dutch generation sectors, including REPGB, financial responsibility to purchase electricity and gas under gas supply and electricity contracts. These contracts are derivatives pursuant to SFAS No. 133. As of December 31, 2001, the Company had recognized \$369 million in short-term and long-term non-trading derivative liabilities for REPGB's portion of these stranded costs contracts. Future changes in the valuation of these stranded cost import contracts which remain an obligation of REPGB will be recorded as adjustments to the Company's Statements of Consolidated Income. The valuation of the contracts could be affected by, among other things, changes in the price of electric power, coal, low sulfur fuel oil and the value of the United States dollar and British pound relative to the Euro. For additional information regarding REPGB's stranded costs and the related indemnification by former shareholders of these stranded costs during 2001, see Note 14(h).

During 2001, Reliant Resources entered into two structured transactions which were recorded on the Consolidated Balance Sheets in non-trading derivative assets and liabilities involving a series of forward contracts to buy and sell an energy commodity in 2001 and to buy and sell an energy commodity in 2002 or 2003. The change in fair value of these derivative assets and liabilities must be recorded in the Statements of Consolidated Income for each reporting period. During 2001, \$117 million of net non-trading derivative liabilities were settled related to these transactions, and a \$1 million pre-tax unrealized gain was recognized. As of December 31, 2001, Reliant Resources has recognized \$221 million of non-trading derivative assets and \$103 million of non-trading derivative liabilities related to these transactions.

*(c) Credit Risks*

In addition to the risk associated with price movements, credit risk is inherent in the Company's risk management activities and hedging activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. The Company 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 contract. The Company enters into derivative instruments primarily with counterparties having at least a minimum investment grade credit rating (i.e. a minimum credit rating for such entity's senior unsecured debt of BBB- for Standard & Poor's and Fitch or Baa3 for Moody's). In addition, the Company seeks to enter into netting agreements that permit it to offset receivables and payables with a given counterparty. The Company also attempts to enter into agreements that enable the Company to obtain collateral from a counterparty or to terminate upon the occurrence of credit-related events. For long-term arrangements, the Company periodically reviews the financial condition of these counterparties in addition to monitoring the effectiveness of these financial contracts in achieving the Company's objectives. If the counterparties to these arrangements fail to perform, the Company would seek to compel performance at law or otherwise obtain compensatory damages.



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Company might be forced to acquire alternative hedging arrangements or be required to replace the underlying commitment at then-current market prices. In this event, the Company might incur additional losses to the extent of amounts, if any, already paid to the counterparties. For information regarding the provision related to energy sales in California, see Note 14(g). For information regarding the net provision recorded in 2001 related to energy sales to Enron, see Note 21.

The following tables show the composition of the trading and marketing assets of the Company as of December 31, 2000 and 2001 and the non-trading derivative assets as of December 31, 2001.

	December 31, 2000		December 31, 2001	
	Investment Grade(2)	Total	Investment Grade(2)	Total
(In millions)				
<b>Trading and Marketing Assets</b>				
Energy marketers .....	\$2,291	\$2,481	\$ 683	\$ 757
Financial institutions .....	1,099	1,228	495	495
Gas and electric utilities .....	472	542	538	544
Oil and gas producers .....	474	566	135	176
Commercial, industrial and institutional customers ...	73	85	119	184
Total .....	<u>\$4,409</u>	4,902	<u>\$1,970</u>	2,156
Credit and other reserves .....		(66)		(98)
Trading and marketing assets .....		<u>\$4,836</u>		<u>\$2,058</u>

	December 31, 2001	
	Investment Grade(1)(2)	Total
(In millions)		
<b>Non-trading Derivative Assets</b>		
Energy marketers .....	\$371	\$408
Financial institutions .....	76	76
Gas and electric utilities .....	89	90
Oil and gas producers .....	8	76
Commercial, industrial and institutional customers .....	7	8
Others .....	5	14
Total .....	<u>\$556</u>	672
Credit and other reserves .....		(16)
Non-trading derivative assets .....		<u>\$656</u>

- (1) "Investment Grade" is primarily determined using publicly available credit ratings along with the consideration of credit support (such as parent company guarantees) and collateral, which encompass cash and standby letters of credit.
- (2) For unrated counterparties, the Company performs financial statement analysis, considering contractual rights and restrictions, and collateral, to create a synthetic credit rating.

**(d) Trading and Non-trading — General Policy**

The Company has established a Risk Oversight Committee comprised of corporate and business segment officers that oversees all commodity price, foreign currency and credit risk activities, including the Company's trading, marketing, power origination, risk management services and hedging activities. The committee's

**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

duties are to approve the Company's commodity risk policies, allocate risk capital within limits established by the Company's board of directors, approve trading of new products and commodities, monitor risk positions and monitor compliance with the Company's risk management policies and procedures and trading limits established by the Company's board of directors.

The Company's policies prohibit the use of leveraged financial instruments. A leveraged financial instrument, for this purpose, is a transaction involving a derivative whose financial impact will be based on an amount other than the notional amount or volume of the instrument.

**(6) Jointly Owned Electric Utility Plant**

The Company has a 30.8% interest in the South Texas Project, which consists of two 1,250 MW nuclear generating units and bears a corresponding 30.8% share of capital and operating costs associated with the project. The South Texas Project is owned as a tenancy in common among its four co-owners, with each owner retaining its undivided ownership interest in the two nuclear-fueled generating units and the electrical output from those units. The four co-owners have delegated management and operating responsibility for the South Texas Project to the South Texas Project Nuclear Operating Company (STPNOC). STPNOC is managed by a board of directors comprised of one director from each of the four owners, along with the chief executive officer of STPNOC. As of December 31, 2001, the total utility plant in service and construction work in progress for the total South Texas Project was \$5.8 billion and \$120 million, respectively. The Company's investment in the South Texas Project was \$316 million (net of \$2.2 billion accumulated depreciation which includes an impairment loss recorded in 1999 of \$756 million). For additional information regarding the impairment loss, see Note 4(a). The Company's investment in nuclear fuel was \$35 million (net of \$286 million amortization) as of December 31, 2001.

**(7) Equity Investments in Unconsolidated Subsidiaries**

The Company has a 50% interest in a 490 MW electric generation plant in Boulder City, Nevada. The plant became operational in May 2000. Reliant Resources has a 50% partnership interest in a 100 MW cogeneration plant in Orange, Texas which began commercial operations in December 1999. In addition, Reliant Resources, through REPGb, acquired a 22.5% interest in BV Nederlands Elektriciteit Administratiekantoor (NEA), which was formerly the coordinating body for the Dutch electricity generating sector. For information regarding Reliant Resources' investment in NEA and financial impacts, see Note 14(h). See Note 3(b) for a description of 1999 equity accounting related to REPGb during 1999.

Reliant Resources' equity investments in unconsolidated subsidiaries are as follows:

	As of December 31,	
	2000	2001
	(In millions)	
Nevada generation plant .....	\$ 77	\$ 57
Texas cogeneration plant .....	32	31
NEA .....	—	299
Equity investments in unconsolidated subsidiaries .....	<u>\$109</u>	<u>\$387</u>