

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

Reliant Resources' income (loss) from equity investments of unconsolidated subsidiaries is as follow:

	Year Ended December 31,		
	1999	2000	2001
	(In millions)		
Nevada generation plant .....	\$ (1)	\$ 42	\$ 5
Texas cogeneration plant .....	—	1	1
NEA.....	—	—	51
Income from equity investments in unconsolidated subsidiaries .....	<u>\$ (1)</u>	<u>\$ 43</u>	<u>\$ 57</u>

During 1999, there were no distributions from these investments. During 2000 and 2001, \$18 million and \$27 million, respectively, were the net distributions from these investments.

**(8) Indexed Debt Securities (ACES and ZENS) and AOL Time Warner Securities**

***(a) Original Investment in Time Warner Securities***

On July 6, 1999, the Company converted its 11 million shares of Time Warner Inc. (TW) convertible preferred stock (TW Preferred) into 45.8 million shares of Time Warner common stock (TW Common). Prior to the conversion, the Company's investment in the TW Preferred was accounted for under the cost method at a value of \$990 million in the Company's Consolidated Balance Sheets. The TW Preferred which was redeemable after July 6, 2000, had an aggregate liquidation preference of \$100 per share (plus accrued and unpaid dividends), was entitled to annual dividends of \$3.75 per share until July 6, 1999 and was convertible by the Company. The Company recorded pre-tax dividend income with respect to the TW Preferred of \$21 million in 1999 prior to the conversion. Effective on the conversion date, the shares of TW Common were classified as trading securities under SFAS No. 115 and an unrealized gain was recorded in the amount of \$2.4 billion (\$1.5 billion after-tax) to reflect the cumulative appreciation in the fair value of the Company's investment in Time Warner securities. Unrealized gains and losses resulting from changes in the market value of the TW Common (now AOL TW Common) are recorded in the Company's Statements of Consolidated Income.

***(b) ACES***

In July 1997, in order to monetize a portion of the cash value of its investment in TW Preferred, the Company issued 22.9 million of its unsecured 7% Automatic Common Exchange Securities (ACES) having an original principal amount of \$1.052 billion and maturing July 1, 2000. The market value of ACES was indexed to the market value of TW Common. On the July 1, 2000 maturity date, the Company tendered 37.9 million shares of TW Common to fully settle its obligations in connection with its unsecured 7% ACES having a value of \$2.9 billion.

***(c) ZENS***

On September 21, 1999, the Company issued approximately 17.2 million of its 2.0% Zero-Premium Exchangeable Subordinated Notes due 2029 (ZENS) having an original principal amount of \$1.0 billion. The original principal amount per ZENS will increase each quarter to the extent that the sum of the quarterly cash dividends and the interest paid during a quarter on the reference shares attributable to one ZENS is less than \$.045, so that the annual yield to investors from the date the Company issued the ZENS to the date of computation of the contingent principal amount is not less than 2.309%. At December 31, 2001, the principal amount of the ZENS had increased \$3 million as the reference shares no longer pay dividends. At maturity the holders of the ZENS will receive in cash the higher of the original principal amount of the ZENS (subject to adjustment as discussed above) or an amount based on the then-current market value of AOL TW

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Common, or other securities distributed with respect to AOL TW Common (1.5 shares of AOL TW Common and such other securities, if any, are referred to as reference shares). Each ZENS has an original principal amount of \$58.25, and is exchangeable at any time at the option of the holder for cash equal to 95% (100% in some cases) of the market value of the reference shares attributable to one ZENS. The Company pays interest on each ZENS at an annual rate of 2% plus the amount of any quarterly cash dividends paid in respect of the quarterly interest period on the reference shares attributable to each ZENS. Subject to some conditions, the Company has the right to defer interest payments from time to time on the ZENS for up to 20 consecutive quarterly periods. As of December 31, 2001, no interest payments on the ZENS had been deferred.

The Company used \$537 million of the net proceeds from the offering of the ZENS to purchase 9.2 million shares of TW Common (now 13.8 million shares of AOL TW Common), which are classified as trading securities under SFAS No. 115. Prior to the purchase of additional shares of TW Common on September 21, 1999, the Company owned approximately 8 million shares of TW Common (now 12 million shares of AOL TW Common). The Company now holds 25.8 million shares of AOL TW Common that are expected to be held to facilitate the Company's ability to meet its obligation under the ZENS.

Prior to January 1, 2001, an increase above \$58.25 (subject to some adjustments) in the market value per share of TW Common resulted in an increase in the Company's liability for the ZENS. However, as the market value per share of TW Common declined below \$58.25 (subject to some adjustments), the liability for the ZENS did not decline below the original principal amount. The market value per share of TW Common was \$52.24 as of December 31, 2000 and the market value per share of AOL TW Common was \$32.10 as of December 31, 2001. Upon adoption of SFAS No. 133 effective January 1, 2001, the ZENS obligation was bifurcated into a debt component and a derivative component (the holder's option to receive the appreciated value of AOL TW Common at maturity). The derivative component was valued at fair value and determined the initial carrying value assigned to the debt component (\$121 million) as the difference between the original principal amount of the ZENS (\$1.0 billion) and the fair value of the derivative component at issuance (\$879 million). Effective January 1, 2001 the debt component was recorded at its accreted amount of \$122 million and the derivative component is recorded at its current fair value of \$788 million, as a current liability, resulting in a transition adjustment pre-tax gain of \$90 million (\$58 million net of tax). The transition adjustment gain was reported in the first quarter of 2001 as the effect of a change in accounting principle. Subsequently, the debt component will accrete through interest charges at 17.5% up to the minimum amount payable upon maturity of the ZENS in 2029, approximately \$1.1 billion, and changes in the fair value of the derivative component will be recorded in the Company's Statements of Consolidated Income. During 2001, the Company recorded a \$70 million loss on the Company's investment in AOL TW Common. During 2001, the Company recorded a \$58 million gain associated with the fair value of the derivative component of the ZENS obligation. Changes in the fair value of the AOL TW Common held by the Company are expected to substantially offset changes in the fair value of the derivative component of the ZENS.

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The following table sets forth summarized financial information regarding the Company's investment in AOL TW securities and the Company's ACES and ZENS obligations (in millions).

	AOL TW Investment	ACES	Debt Component of ZENS	Derivative Component of ZENS
Balance at December 31, 1998 .....	\$ 990	\$ 2,350	\$ —	\$ —
Issuance of indexed debt securities .....	—	—	1,000	—
Purchase of TW Common .....	537	—	—	—
Loss on indexed debt securities .....	—	388	241	—
Gain on TW Common .....	<u>2,452</u>	<u>—</u>	<u>—</u>	<u>—</u>
Balance at December 31, 1999 .....	3,979	2,738	1,241	—
Loss (gain) on indexed debt securities .....	—	139	(241)	—
Loss on TW Common .....	(205)	—	—	—
Settlement of ACES .....	<u>(2,877)</u>	<u>(2,877)</u>	<u>—</u>	<u>—</u>
Balance at December 31, 2000 .....	897	—	1,000	—
Transition adjustment from adoption of SFAS No. 133 .....	—	—	(90)	—
Bifurcation of ZENS obligation .....	—	—	(788)	788
Accretion of debt component of ZENS .....	—	—	1	—
Gain on indexed debt securities .....	—	—	—	(58)
Loss on AOL TW Common .....	<u>(70)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Balance at December 31, 2001 .....	<u>\$ 827</u>	<u>\$ —</u>	<u>\$ 123</u>	<u>\$730</u>

**(9) Preferred Stock and Preference Stock**

**(a) Preferred Stock**

At December 31, 2000, Reliant Energy had 10,000,000 authorized shares of cumulative preferred stock, of which 97,397 shares were outstanding. As of that date, Reliant Energy's only outstanding series of preferred stock was its \$4.00 Preferred Stock. The \$4.00 Preferred Stock paid an annual dividend of \$4.00 per share, was redeemable at \$105 per share and had a liquidation price of \$100 per share to third parties.

On December 14, 2001, Reliant Energy redeemed all outstanding shares of its \$4.00 Preferred Stock at \$105 per share plus accrued dividends of \$0.478 per share for a total redemption payment of \$10.3 million. At December 31, 2001, Reliant Energy had 10,000,000 authorized shares of cumulative preferred stock, none of which were outstanding.

**(b) Preference Stock**

At December 31, 2000 and 2001, Reliant Energy had 10,000,000 authorized shares of preference stock, none of which were outstanding for financial reporting purposes. At December 31, 2001, Reliant Energy had issued and outstanding shares of preference stock that were held by various financing subsidiaries of the Company to support debt obligations of the subsidiaries to third party lenders. The aggregate amount of debt outstanding at these subsidiaries at December 31, 2001 was \$2.9 billion.

Reliant Energy has a Shareholder Rights Plan, which states that each share of Reliant Energy's common stock includes one associated preference stock purchase right (Right) which entitles the registered holder to purchase from Reliant Energy a unit consisting of one-thousandth of a share of Series A Preference Stock.

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The Rights, which expire on July 11, 2010, are exercisable upon some events involving the acquisition of 20% or more of Reliant Energy's outstanding common stock. Upon the occurrence of such an event, each Right entitles the holder to receive common stock with a current market price equal to two times the exercise price of the Right. At anytime prior to becoming exercisable, Reliant Energy may repurchase the Rights at a price of \$0.005 per Right. There are 700,000 shares of Series A Preference Stock reserved for issuance upon exercise of the Rights.

**(10) Long-term Debt and Short-term Borrowings**

	December 31, 2000		December 31, 2001	
	Long-Term	Current(1)	Long-Term	Current(1)
	(In millions)			
Short-term borrowings:				
Commercial paper .....		\$3,675		\$2,502
Lines of credit .....		853		290
Receivables facility .....		350		346
Other(2) .....		126		297
Total short-term borrowings .....		<u>\$5,004</u>		<u>\$3,435</u>
Long-term debt:				
Reliant Energy				
ZENS(3) .....	\$ —	\$1,000	\$ —	\$ 123
Debentures 7.88% to 9.38% due 2002 .....	100	250	—	100
First mortgage bonds 4.90% to 9.15% due 2002 to 2027 .....	1,261	—	1,161	100
Pollution control bonds 4.70% to 5.95% due 2011 to 2030 .....	1,046	—	1,046	—
Series 2001-1 Transition Bonds 3.84% to 5.63% due 2002 to 2013 ..	—	—	736	13
Other .....	12	1	11	1
Financing Subsidiaries (directly or indirectly owned by Reliant Energy)				
Debentures 7.40% due 2002 .....	300	225	—	300
Reliant Energy Power Generation, Inc.				
Notes payable various market rates due 2002 to 2024 .....	260	—	295	2
REPG(2)				
Debentures 6.00% to 8.94% due 2002 to 2006 .....	66	1	38	22
Reliant Energy Capital Europe(2)				
Notes payable various market rates due 2003 .....	565	—	534	—
RERC Corp.(4)				
Convertible debentures 6.00% due 2012 .....	93	—	82	—
Debentures 6.38% to 8.90% due 2003 to 2011 .....	1,285	—	1,833	—
Notes payable 8.77% to 9.23% paid 2001 .....	—	146	—	—
Unamortized discount and premium .....	8	—	6	—
Total long-term debt .....	<u>4,996</u>	<u>1,623</u>	<u>5,742</u>	<u>661</u>
Total borrowings .....	<u>\$4,996</u>	<u>\$6,627</u>	<u>\$5,742</u>	<u>\$4,096</u>

(1) Includes amounts due or exchangeable within one year of the date noted.

(2) Includes borrowings at December 31, 2000 and 2001 which are denominated in Euros. As of December 31, 2000 and 2001, the assumed exchange rate was 1.06 Euros and 1.12 Euros per U.S. dollar, respectively.

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- (3) Upon adoption of SFAS No. 133 effective January 1, 2001, the Company's ZENS obligation was bifurcated into a debt component and an embedded derivative component. For additional information regarding ZENS, see Note 8(b). As ZENS are exchangeable for cash at any time at the option of the holders, these notes are classified as a current portion of long-term debt.
- (4) Debt acquired in business acquisitions is adjusted to fair market value as of the acquisition date. Included in long term debt is additional unamortized premium related to fair value adjustments of long-term debt of \$12 million and \$9 million at December 31, 2000 and 2001, respectively, which is being amortized over the respective remaining term of the related long-term debt.

***(a) Short-term Borrowings***

As of December 31, 2001, the Company had credit facilities, which included the facilities of various financing subsidiaries, Reliant Resources, REPGB and RERC Corp., with financial institutions which provide for an aggregate of \$11.0 billion in committed credit. The facilities expire as follows: \$6.6 billion in 2002, \$3.6 billion in 2003 and \$0.8 billion in 2004. As of December 31, 2001, borrowings of \$4.6 billion were outstanding or supported under these credit facilities of which \$0.8 billion were classified as long-term debt, based on availability of committed credit with expiration dates exceeding one year and management's intention to maintain these borrowings in excess of one year. The remaining unused credit facilities totaled \$6.4 billion. Various credit facilities aggregating \$2.4 billion may be used for letters of credit of which \$0.4 billion were outstanding as of December 31, 2001. Interest rates on borrowings are based on the London Interbank Offered Rate (LIBOR) plus a margin, Euro interbank deposits plus a margin, a base rate or a rate determined through a bidding process. Credit facilities aggregating \$5.4 billion are unsecured. The credit facilities contain covenants and requirements that must be met to borrow funds and obtain letters of credit, as applicable. Such covenants are not anticipated to materially restrict the borrowers from borrowing funds or obtaining letters of credit, as applicable, under such facilities. As of December 31, 2001, the borrowers are in compliance with the covenants under all of these credit agreements.

The Company sells commercial paper to provide financing for general corporate purposes. As of December 31, 2001, \$2.5 billion of commercial paper was outstanding. The commercial paper borrowings are supported by various credit facilities discussed above, including \$4.7 billion in credit facilities expiring in 2002 and a \$350 million revolving credit facility expiring in 2003.

RERC Corp. has a receivables facility under which it sells its customer accounts receivable. Advances under this facility are reflected in the Consolidated Balance Sheets as short-term debt. At December 31, 2000 and 2001, the amount of the receivables facility was \$350 million and RERC Corp. had received advances of \$350 million and \$346 million, respectively. Fees and interest expense related to this facility for 1999, 2000 and 2001 aggregated \$19 million, \$24 million and \$15 million, respectively. The size of the receivables facility was increased from \$300 million to \$350 million in August 1999. For information on the reduction in the size of the facility in 2002, see Note 22(b).

The weighted average interest rate on short-term borrowings as of December 31, 1999, 2000 and 2001 was 5.84%, 7.43% and 3.29%, respectively.

The Company's revolving credit agreements are broadly-syndicated committed facilities which contain "material adverse change" clauses that could impact its ability to borrow under these facilities. The "material adverse change" clauses generally relate to the Company's ability to perform its obligations under the agreements.

***(b) Long-term Debt***

**Maturities.** The Company's maturities of long-term debt and sinking fund requirements, excluding the ZENS obligation, are \$538 million in 2002, \$1.2 billion in 2003, \$90 million in 2004, \$390 million in 2005 and

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\$218 million in 2006. The 2002 and 2003 amounts are net of sinking fund payments that can be satisfied with bonds that had been acquired and retired as of December 31, 2001.

*Liens.* At December 31, 2001, substantially all physical assets used in the conduct of the business and operations of the Electric Operations business segment are subject to liens securing the First Mortgage Bonds. After the Restructuring, only the assets of the transmission and distribution utility are expected to be subject to liens securing the First Mortgage Bonds. Sinking fund requirements on the First Mortgage Bonds may be satisfied by certification of property additions at 100% of the requirements as defined by the Mortgage and Deed of Trust. Sinking or improvement/replacement fund requirements for 1999, 2000 and 2001 have been satisfied by certification of property additions. The replacement fund requirement to be satisfied in 2002 is \$334 million.

*RERC Corp. Debt Issuance.* In February 2001, RERC Corp. issued \$550 million of unsecured notes that bear interest at 7.75% per year and mature in February 2011. Net proceeds to RERC Corp. were \$545 million. RERC Corp. used the net proceeds from the sale of the notes to pay a \$400 million dividend to Reliant Energy, and for general corporate purposes. Reliant Energy used the \$400 million proceeds from the dividend for general corporate purposes, including the repayment of short-term borrowings.

*Securitization.* For a discussion of the securitization financing completed in October 2001, see Note 4(a).

*Purchase of Convertible Debentures.* At December 31, 2000 and 2001, RERC Corp. had issued and outstanding \$98 million and \$86 million, respectively, aggregate principal amount (\$93 million and \$82 million, respectively, carrying amount) of its 6% Convertible Subordinated Debentures due 2012 (Subordinated Debentures). The holders of the Subordinated Debentures receive interest quarterly and have the right at any time on or before the maturity date thereof to convert each Subordinated Debenture into 0.65 shares of Reliant Energy common stock and \$14.24 in cash. After the Restructuring, each Subordinated Debenture will be convertible into 0.65 shares of CenterPoint Energy common stock and \$14.24 in cash. After the Distribution, each Subordinated Debenture will be convertible into an increased number of CenterPoint Energy shares based on a formula as provided in the relevant indenture and \$14.24 in cash. During 2001, RERC Corp. purchased \$11 million aggregate principal amount of its Subordinated Debentures.

*TERM Notes.* RERC Corp.'s \$500 million aggregate principal amount of 6¾% Term Enhanced ReMarketable Securities (TERM Notes) provide an investment bank with a call option, which gives it the right to have the TERM Notes redeemed from the investors on November 1, 2003 and then remarketed if it chooses to exercise the option. The TERM Notes are unsecured obligations of RERC Corp. which bear interest at an annual rate of 6¾% through November 1, 2003. On November 1, 2003, the holders of the TERM Notes are required to tender their notes at 100% of their principal amount. The portion of the proceeds attributable to the call option premium will be amortized over the stated term of the securities. If the option is not exercised by the investment bank, RERC Corp. will repurchase the TERM Notes at 100% of their principal amount on November 1, 2003. If the option is exercised, the TERM Notes will be remarketed on a date, selected by RERC Corp., within the 52-week period beginning November 1, 2003. During this period and prior to remarketing, the TERM Notes will bear interest at rates, adjusted weekly, based on an index selected by RERC Corp. If the TERM Notes are remarketed, the final maturity date of the TERM Notes will be November 1, 2013, subject to adjustment, and the effective interest rate on the remarketed TERM Notes will be 5.66% plus RERC Corp.'s applicable credit spread at the time of such remarketing.

*Extinguishments of Debt.* During the second quarter of 2000, REPGB negotiated the repurchase of \$272 million aggregate principal amount of its long-term debt for a total cost of \$286 million, including \$14 million in expenses. The book value of the debt repurchased was \$293 million, resulting in an extraordinary gain on the early extinguishment of long-term debt of \$7 million. Borrowings under a short-term

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banking facility and proceeds from the sale of trading securities by REPGb were used to finance the debt repurchase.

During 1999, the Company's regulated operations recorded losses from the extinguishment of debt of \$22 million. There were no losses recorded from the early extinguishment of debt in 2000 and 2001. As these costs will be recovered through regulated cash flows, these costs have been deferred and a regulatory asset has been recorded. For further discussion regarding the accounting, see Note 4(a).

***(c) Off-balance Sheet Financings***

For information regarding off-balance sheet financings and REMA sale-leaseback transactions related to Reliant Resources, see Notes 14(b) and 14(l).

**(11) Trust Preferred Securities**

In February 1997, two Delaware statutory business trusts created by Reliant Energy (HL&P Capital Trust I and HL&P Capital Trust II) issued to the public (a) \$250 million aggregate amount of preferred securities and (b) \$100 million aggregate amount of capital securities, respectively. In February 1999, a Delaware statutory business trust created by Reliant Energy (REI Trust I) issued \$375 million aggregate amount of preferred securities to the public. Reliant Energy accounts for REI Trust I, HL&P Capital Trust I and HL&P Capital Trust II as wholly owned consolidated subsidiaries. Each of the trusts used the proceeds of the offerings to purchase junior subordinated debentures issued by Reliant Energy having interest rates and maturity dates that correspond to the distribution rates and the mandatory redemption dates for each series of preferred securities or capital securities.

The junior subordinated debentures are the trusts' sole assets and their entire operations. Reliant Energy considers its obligations under the Amended and Restated Declaration of Trust, Indenture, Guaranty Agreement and, where applicable, Agreement as to Expenses and Liabilities, relating to each series of preferred securities or capital securities, taken together, to constitute a full and unconditional guarantee by Reliant Energy of each trust's obligations with respect to the respective series of preferred securities or capital securities.

The preferred securities and capital securities are mandatorily redeemable upon the repayment of the related series of junior subordinated debentures at their stated maturity or earlier redemption. Subject to some limitations, Reliant Energy has the option of deferring payments of interest on the junior subordinated debentures. During any deferral or event of default, Reliant Energy may not pay dividends on its capital stock. As of December 31, 2001, no interest payments on the junior subordinated debentures had been deferred.

In June 1996, a Delaware statutory business trust created by RERC Corp. (RERC Trust) issued \$173 million aggregate amount of convertible preferred securities to the public. RERC Corp. accounts for RERC Trust as a wholly owned consolidated subsidiary. RERC Trust used the proceeds of the offering to purchase convertible junior subordinated debentures issued by RERC Corp. having an interest rate and maturity date that correspond to the distribution rate and mandatory redemption date of the convertible preferred securities. The convertible junior subordinated debentures represent RERC Trust's sole assets and its entire operations. RERC Corp. considers its obligation under the Amended and Restated Declaration of Trust, Indenture and Guaranty Agreement relating to the convertible preferred securities, taken together, to constitute a full and unconditional guarantee by RERC Corp. of RERC Trust's obligations with respect to the convertible preferred securities.

The convertible preferred securities are mandatorily redeemable upon the repayment of the convertible junior subordinated debentures at their stated maturity or earlier redemption. Each convertible preferred security is convertible at the option of the holder into \$33.62 of cash and 1.55 shares of Reliant Energy common stock. During 2000 and 2001, convertible preferred securities of \$0.3 million and \$0.04 million,

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respectively, were converted. As of December 31, 2000 and 2001, \$0.4 million liquidation amount of convertible preferred securities were outstanding. Subject to some limitations, RERC Corp. has the option of deferring payments of interest on the convertible junior subordinated debentures. During any deferral or event of default, RERC Corp. may not pay dividends on its common stock to Reliant Energy. As of December 31, 2001, no interest payments on the convertible junior subordinated debentures had been deferred.

The outstanding aggregate liquidation amount, distribution rate and mandatory redemption date of each series of the preferred securities, convertible preferred securities or capital securities of the trusts and the identity and similar terms of each related series of junior subordinated debentures are as follows:

<u>Trust</u>	<u>Aggregate Liquidation Amounts as of December 31, 2000 and 2001 (In millions)</u>	<u>Distribution Rate/Interest Rate</u>	<u>Mandatory Redemption Date/Maturity Date</u>	<u>Junior Subordinated Debentures</u>
REI Trust I .....	\$375	7.20%	March 2048	7.20% Junior Subordinated Debentures due 2048
HL&P Capital Trust I ...	\$250	8.125%	March 2046	8.125% Junior Subordinated Deferrable Interest Debentures Series A
HL&P Capital Trust II ..	\$100	8.257%	February 2037	8.257% Junior Subordinated Deferrable Interest Debentures Series B
RERC Trust .....	\$ 1	6.25%	June 2026	6.25% Convertible Junior Subordinated Debentures due 2026

**(12) Stock-Based Incentive Compensation Plans and Retirement Plans**

**(a) Incentive Compensation Plans**

The Company has long-term incentive compensation plans (LICP) that provide for the issuance of stock-based incentives, including performance-based shares, performance-based units, restricted shares, stock options and stock appreciation rights, to key employees of the Company, including officers. As of December 31, 2001, 716 current and 54 former employees of the Company participate in the plans. A maximum of approximately 39 million shares of Reliant Energy common stock may be issued under these plans.

Awards in Reliant Resources common stock have been made from the Reliant Resources, Inc. Long-Term Incentive Plan (Resources LICP). Under the Resources LICP, participant awards may be in the form of stock options, performance-based shares or units, stock appreciation rights, restricted or unrestricted grants of common stock. As of December 31, 2001, 735 current employees and 4 former employees of Reliant Resources participate in the Resources LICP.

Performance-based shares, performance-based units and restricted shares are granted to employees without cost to the participants. The performance shares and units vest three years after the grant date based upon the performance of the Company over a three-year cycle, except as discussed below. The restricted shares vest to the participants at various times ranging from immediate vesting to vesting at the end of a six-year period. Upon vesting, the shares are issued to the plans' participants.

In 2001, awards of Reliant Resources performance-based shares and restricted shares have been made to Reliant Resources participants. For all other participants, awards have been made in performance-based units and restricted shares of Reliant Energy. During 1999, 2000 and 2001, the Company, including Reliant Resources, recorded compensation expense of \$8 million, \$22 million and \$9 million, respectively, related to performance-based shares, performance-based units and restricted share grants.



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The following table summarizes Reliant Energy's performance-based units, performance-based shares and restricted share grant activity for the years 1999 through 2001:

	Number of Performance-Based Units	Number of Performance-Based Shares	Number of Restricted Shares
Outstanding at December 31, 1998 .....	—	904,997	161,385
Granted .....	—	431,643	113,837
Canceled .....	—	(228,215)	(646)
Released to participants .....	—	(179,958)	(3,953)
Outstanding at December 31, 1999 .....	—	928,467	270,623
Granted .....	—	394,942	206,395
Canceled .....	—	(81,541)	(13,060)
Released to participants .....	—	(174,001)	(5,346)
Outstanding at December 31, 2000 .....	—	1,067,867	458,612
Granted .....	83,670	—	2,623
Canceled .....	—	(17,154)	(2,778)
Released to participants .....	—	(424,623)	(249,895)
Outstanding at December 31, 2001 .....	<u>83,670</u>	<u>626,090</u>	<u>208,562</u>
Weighted average fair value granted for 1999 ..	<u>\$ —</u>	<u>\$ 29.23</u>	<u>\$ 26.88</u>
Weighted average fair value granted for 2000 ..	<u>\$ —</u>	<u>\$ 25.19</u>	<u>\$ 28.03</u>
Weighted average fair value granted for 2001 ..	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 38.13</u>

The maximum value associated with the performance-based units granted in 2001 was \$150.

The following table summarizes Reliant Resources' performance-based shares and restricted share grant activity during 2001:

	Number of Performance-Based Shares	Number of Restricted Shares
Outstanding at December 31, 2000 .....	—	—
Granted .....	693,135	156,674
Canceled .....	—	—
Released to participants .....	—	—
Outstanding at December 31, 2001 .....	<u>693,135</u>	<u>156,674</u>
Weighted average fair value granted for 2001 .....	<u>\$ 22.50</u>	<u>\$ 33.11</u>

Assuming the Distribution occurs during calendar year 2002, the Company's compensation committee will authorize the conversion of outstanding Reliant Energy performance-based shares for the performance cycle ending December 31, 2002 to a number of time-based restricted shares of Reliant Energy's common stock equal to the number of performance-based shares that would have vested if the performance objectives for the performance cycle were achieved at the maximum level. These time-based restricted shares will vest if the participant holding the shares remains employed with the Company or with Reliant Resources and its subsidiaries through December 31, 2002. On the date of the Distribution, holders of these time-based restricted shares will receive shares of Reliant Resources common stock in the same manner as other holders

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of Reliant Energy common stock, but these shares of common stock will be subject to the same time-based vesting schedule, as well as to the terms and conditions of the plan under which the original performance shares were granted. Thus, following the Distribution, employees who held performance-based shares under the LICP for the performance cycle ending December 31, 2002 will hold time-based restricted shares of Reliant Energy common stock and time-based restricted shares of Reliant Resources common stock, which will vest following continuous employment through December 31, 2002.

Under both the Resources LICP and the Company's plans, stock options generally become exercisable in one-third increments on each of the first through third anniversaries of the grant date. The exercise price is the average of the high and low sales price of the common stock on the New York Stock Exchange on the grant date. The Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees" (APB Opinion No. 25), and related interpretations in accounting for its stock option plans. Accordingly, no compensation expense has been recognized for these fixed stock options. The following table summarizes stock option activity related to the Company and Reliant Resources for the years 1999 through 2001:

	Reliant Energy		Reliant Resources	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 1998 ...	2,945,654	\$24.87		
Options granted .....	3,806,051	26.74		
Options exercised .....	(83,610)	19.38		
Options canceled .....	(205,124)	25.96		
Outstanding at December 31, 1999 ...	<u>6,462,971</u>	25.99		
Options granted .....	5,936,510	22.14		
Options exercised .....	(1,061,169)	25.01		
Options canceled .....	(1,295,877)	23.96		
Outstanding at December 31, 2000 ...	<u>10,042,435</u>	24.13		
Options granted .....	1,887,668	46.23	8,826,432	\$29.82
Options exercised .....	(1,812,022)	24.11	—	—
Options canceled .....	(289,610)	27.38	(245,830)	28.28
Outstanding at December 31, 2001 ...	<u>9,828,471</u>	28.34	<u>8,580,602</u>	29.86
Options exercisable at December 31, 1999 .....	<u>1,350,374</u>	<u>\$23.87</u>		
Options exercisable at December 31, 2000 .....	<u>2,258,397</u>	<u>\$25.76</u>		
Options exercisable at December 31, 2001 .....	<u>3,646,228</u>	<u>\$25.38</u>	<u>6,500</u>	<u>\$30.00</u>

Exercise prices for Reliant Energy stock options outstanding held by Company employees ranged from \$7.00 to \$50.00. Exercise prices for Reliant Resources stock options outstanding held by Company employees

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ranged from \$15.65 to \$34.03. The following tables provide information with respect to outstanding Reliant Energy and Reliant Resources stock options held by the Company's employees on December 31, 2001:

<b>Reliant Energy</b>			
	<b>Options Outstanding</b>	<b>Average Exercise Price</b>	<b>Remaining Average Contractual Life (Years)</b>
<b>Ranges of Exercise Prices:</b>			
\$7.00-\$21.00 .....	3,974,064	\$20.46	8.1
\$21.01-\$26.00 .....	1,107,368	25.20	6.0
\$26.01-\$30.00 .....	2,450,119	27.16	7.3
\$30.01-\$50.00 .....	<u>2,296,920</u>	44.73	9.2
Total .....	<u>9,828,471</u>	28.34	7.9

  

<b>Reliant Resources</b>			
	<b>Options Outstanding</b>	<b>Average Exercise Price</b>	<b>Remaining Average Contractual Life (Years)</b>
<b>Ranges of Exercise Prices:</b>			
\$15.65-\$23.50 .....	95,436	\$20.62	9.7
\$23.51-\$34.03 .....	<u>8,485,166</u>	29.97	9.2
Total .....	<u>8,580,602</u>	29.86	9.2

The following table provides information with respect to Reliant Energy stock options exercisable at December 31, 2001:

	<b>Options Exercisable</b>	<b>Average Exercise Price</b>
<b>Ranges of Exercise Prices:</b>		
\$7.00-\$21.00 .....	991,464	\$20.36
\$21.01-\$26.00 .....	1,015,723	25.24
\$26.01-\$30.00 .....	1,439,165	27.23
\$30.01-\$47.22 .....	<u>199,876</u>	37.70
Total .....	<u>3,646,228</u>	25.38

As of December 31, 2001, Reliant Resources had 6,500 options exercisable at an exercise price of \$30.00.

In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), the Company applies the guidance contained in APB Opinion No. 25 and discloses the required pro forma effect on net income of the fair value based method of accounting for stock compensation. The weighted average fair values at date of grant for Reliant Energy options granted during 1999, 2000 and 2001 were \$3.13, \$5.07 and \$9.25, respectively. The weighted average fair value at date of grant for Reliant Resources options granted

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during 2001 was \$13.35. The fair values were estimated using the Black-Scholes option valuation model with the following weighted-average assumptions:

	Reliant Energy		
	1999	2000	2001
Expected life in years .....	5	5	5
Interest rate .....	5.10%	6.57%	4.87%
Volatility .....	21.23%	24.00%	31.91%
Expected common stock dividend .....	\$ 1.50	\$ 1.50	\$ 1.50

  

	Reliant Resources 2001
Expected life in years .....	5
Interest rate .....	4.94%
Volatility .....	42.65%

Pro forma information for 1999, 2000 and 2001 is provided to take into account the amortization of stock-based compensation to expense on a straight-line basis over the vesting period. Had compensation costs been determined as prescribed by SFAS No. 123, the Company's, including Reliant Resources', net income would have been reduced by \$5 million, \$10 million, and \$26 million in 1999, 2000 and 2001, respectively. Earnings per share would have been reduced by \$0.02 per share, \$0.03 per share and \$0.09 per share in 1999, 2000 and 2001, respectively.

Subject to the Distribution, the Company expects to convert all outstanding Reliant Energy stock options granted prior to the Offering to a combination of adjusted Reliant Energy stock options and Reliant Resources stock options. For the converted stock options, the sum of the intrinsic value of the Reliant Energy stock options immediately prior to the record date of the Distribution will equal the sum of the intrinsic values of the adjusted Reliant Energy stock options and the Reliant Resources stock options granted immediately after the record date of the Distribution. As such, Reliant Resources employees who do not work for the Company will hold stock options of the Company. Both the number and the exercise price of all outstanding Reliant Energy stock options that were granted on or after the Offering will be adjusted to maintain the total intrinsic value of the grants.

**(b) Pension**

The Company sponsors multiple pension plans. The principal retiree benefit plans are discussed below. Other such plans are not significant individually or in the aggregate.

The Company maintains a pension plan which is a noncontributory defined benefit plan covering substantially all employees in the United States and certain employees in foreign countries. The benefit accrual is in the form of a cash balance of 4% of annual pay. Prior to 1999, the pension plan accrued benefits based on years of service, final average pay and covered compensation. As a result, certain employees participating in the plan as of December 31, 1998 are eligible for transition benefits through 2008.

The Company's funding policy is to review amounts annually in accordance with applicable regulations in order to achieve adequate funding of projected benefit obligations. The assets of the pension plans consist principally of common stocks and interest bearing obligations. Included in such assets are approximately 4.5 million shares of Reliant Energy common stock contributed from treasury stock during 2001. As of December 31, 2001, the fair value of Reliant Energy common stock was \$120 million or 8.7% of the pension plan assets.

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

REPGB is a foreign subsidiary of the Company and participates along with other companies in the Netherlands in making payments to pension funds which are not administered by the Company. The Company treats these payments as a defined contribution pension plan which provides retirement benefits for most of its employees. The contributions are principally based on a percentage of the employee's base compensation and charged against income as incurred. This expense was \$2 million, \$6 million and \$6 million for the three months ended December 31, 1999 and during 2000 and 2001, respectively.

Net pension cost for the Company (excluding REPGB) includes the following components:

	Year Ended December 31,		
	1999	2000	2001
	(In millions)		
Service cost — benefits earned during the period.....	\$ 34	\$ 33	\$ 37
Interest cost on projected benefit obligation .....	88	88	99
Expected return on plan assets .....	(141)	(146)	(138)
Net amortization .....	(5)	(12)	(3)
Curtailment .....	—	—	(23)
Benefit enhancement .....	—	—	69
Net pension (benefit) cost .....	<u>\$ (24)</u>	<u>\$ (37)</u>	<u>\$ 41</u>

Following are reconciliations of the Company's beginning and ending balances of its retirement plan benefit obligation, plan assets and funded status for 2000 and 2001 (excluding REPGB):

	Year Ended December 31,	
	2000	2001
	(In millions)	
<b>Change in Benefit Obligation</b>		
Benefit obligation, beginning of year .....	\$ 1,232	\$ 1,319
Service cost .....	33	37
Interest cost .....	88	99
Benefits paid .....	(85)	(92)
Plan amendments .....	3	—
Acquisitions .....	1	—
Transfer of obligation to non-qualified pension plan .....	(11)	—
Curtailment and benefit enhancement .....	—	57
Actuarial loss .....	58	71
Benefit obligation, end of year .....	<u>\$ 1,319</u>	<u>\$ 1,491</u>
<b>Change in Plan Assets</b>		
Plan assets, beginning of year .....	\$ 1,513	\$ 1,418
Employer contributions .....	—	107
Benefits paid .....	(85)	(92)
Actual investment return .....	(11)	(56)
Acquisitions .....	1	—
Plan assets, end of year .....	<u>\$ 1,418</u>	<u>\$ 1,377</u>

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

	<div>Year Ended December 31,</div>	
	<div>2000</div>	<div>2001</div>
	<div>(In millions)</div>	
<b>Reconciliation of Funded Status</b>		
Funded status .....	\$ 99	\$ (114)
Unrecognized transition asset .....	(4)	(2)
Unrecognized prior service cost .....	(125)	(92)
Unrecognized actuarial loss .....	<u>227</u>	<u>471</u>
Net amount recognized at end of year .....	<u>\$ 197</u>	<u>\$ 263</u>
<b>Actuarial Assumptions</b>		
Discount rate .....	7.5%	7.25%
Rate of increase in compensation levels .....	3.5-5.5%	3.5-5.5%
Expected long-term rate of return on assets .....	10.0%	9.5%

The transitional asset at January 1, 1986, is being recognized over 17 years, and the prior service cost is being recognized over 15 years.

Effective March 1, 2001, the Company no longer accrues benefits under a noncontributory pension plan for its domestic non-union employees of Reliant Resources and its participating subsidiaries' employees (Resources Participants). Effective March 1, 2001, each Resources Participant's unvested accrued benefit was fully vested and a one-time benefit enhancement was provided to some qualifying participants. After the Distribution, each Resources Participant may elect to have his accrued benefit (a) left in the Company's pension plan, (b) rolled over to a new Reliant Resources savings plan or an individual IRA account, or (c) paid in a lump sum or annuity distribution. During the first quarter of 2001, the Company incurred a charge to earnings of \$84 million (pre-tax) for a one-time benefit enhancement and a gain of \$23 million (pre-tax) related to the curtailment of the Company's pension plan.

In addition to the noncontributory pension plans discussed above, the Company maintains non-qualified pension plans which allow participants to retain the benefits to which they would have been entitled under the Company's noncontributory pension plan except for the federally mandated limits on these benefits or on the level of salary on which these benefits may be calculated. The expense associated with these non-qualified plans was \$5 million, \$25 million and \$25 million in 1999, 2000 and 2001, respectively. Expense for 2001 includes a one-time benefit enhancement of \$15 million, which is included in the \$84 million discussed above. The accrued benefit liability for the nonqualified pension plan was \$92 million and \$99 million at December 31, 2000 and 2001, respectively. In addition, these accrued benefit liabilities include the recognition of minimum liability adjustments of \$30 million as of December 31, 2000 and \$20 million as of December 31, 2001, which are reported as a component of comprehensive income, net of income tax effects.

The Company's prepaid pension asset is presented in the Consolidated Balance Sheets under the caption "Other Assets — Other."

**(c) Savings Plan**

The Company has employee savings plans that qualify as cash or deferred arrangements under Section 401(k) of the Internal Revenue Code of 1986, as amended (the Code). Under the plans, participating employees may contribute a portion of their compensation, pre-tax or after-tax, generally up to a maximum of 16% of compensation. The Company matches 75% to 125% (based on certain performance goals achieved) of the first 6% of each employee's compensation contributed, with most matching contributions subject to a vesting schedule. A substantial portion of the Company's match is invested in Reliant Energy common stock.

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

Effective March 1, 2001, the Company amended its savings plan for Reliant Resources participants and REMA's non-union employee savings plan to generally provide for (a) employer matching contributions equal to 100% of the first 6% of each employee's contributions to the plan, (b) a 2% employer contribution on a payroll basis for 2002, limited to the first \$85,000 of compensation, and (c) discretionary employer contributions up to 3% at the end of the plan year based on each employee's eligible compensation. Effective March 1, 2001, all prior and future employer contributions on behalf of such employees are fully vested.

The Company's savings plan has a leveraged Employee Stock Ownership Plan (ESOP) component. The Company may use ESOP shares to satisfy its obligation to make matching contributions under the Company's savings plan. Debt service on the ESOP loan is paid using all dividends on shares in the ESOP, interest earnings on funds held in the ESOP and cash contributions by the Company. Shares of Reliant Energy common stock are released from the encumbrance of the ESOP loan based on the proportion of debt service paid during the period.

The Company recognizes benefit expense for the ESOP equal to the fair value of the ESOP shares committed to be released. The Company credits to unearned ESOP shares the original purchase price of ESOP shares committed to be released to plan participants with the difference between the fair value of the shares and the original purchase price recorded to common stock. Dividends on allocated ESOP shares are recorded as a reduction to retained earnings. Dividends on unallocated ESOP shares are recorded as a reduction of principal or accrued interest on the ESOP loan.

The ESOP share balances at December 31, 2000 and 2001 were as follows:

	<u>December 31,</u>	
	<u>2000</u>	<u>2001</u>
Allocated shares transferred/distributed from the savings plan . . .	2,397,523	2,740,328
Allocated shares . . . . .	7,725,772	8,951,967
Unearned shares . . . . .	8,638,889	7,069,889
Total original ESOP shares . . . . .	<u>18,762,184</u>	<u>18,762,184</u>
Fair value of unearned ESOP shares . . . . .	<u>\$374,171,880</u>	<u>\$187,493,456</u>

As a result of the ESOP and the Company stock fund, the savings plan has significant holdings of Reliant Energy common stock. As of December 31, 2000 and 2001, an aggregate of 33,437,216 shares and 33,505,474 shares of Reliant Energy's common stock were held by the savings plan, which represented 66.0% and 56.1% of its investments, respectively. Given the concentration of the investments in Reliant Energy's common stock, the savings plan and its participants have market risk related to this investment.

The Company's savings plan benefit expense was \$35 million, \$53 million and \$55 million in 1999, 2000 and 2001, respectively.

***(d) Postretirement Benefits***

The Company sponsors multiple postretirement plans. The principal retiree benefit plans are discussed below. Other such plans are not significant individually or in the aggregate.

The Company provides certain healthcare and life insurance benefits for retired employees on a contributory and non-contributory basis. Employees become eligible for these benefits if they have met certain age and service requirements at retirement, as defined in the plans. Under plan amendments effective in early 1999, health care benefits for future retirees were changed to limit employer contributions for medical coverage.

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

Such benefit costs are accrued over the active service period of employees. The net unrecognized transition obligation, resulting from the implementation of accrual accounting, is being amortized over approximately 20 years.

The Company is required to fund a portion of its obligations in accordance with rate orders. All other obligations are funded on a pay-as-you-go basis.

Net postretirement benefit cost for the Company includes the following components:

	Year Ended December 31,		
	1999	2000	2001
	(In millions)		
Service cost — benefits earned during the period .....	\$ 5	\$ 6	\$ 7
Interest cost on projected benefit obligation .....	26	29	32
Expected return on plan assets .....	(9)	(11)	(13)
Net amortization .....	15	12	14
Curtailment .....	—	—	40
Net postretirement benefit cost .....	<u>\$37</u>	<u>\$ 36</u>	<u>\$ 80</u>

Following are reconciliations of the Company's beginning and ending balances of its postretirement benefit plans benefit obligation, plan assets and funded status for 2000 and 2001:

	Year Ended December 31,	
	2000	2001
	(In millions)	
<b>Change in Benefit Obligation</b>		
Benefit obligation, beginning of year .....	\$ 395	\$ 455
Service cost .....	6	7
Interest cost .....	29	32
Benefits paid .....	(27)	(18)
Participant contributions .....	3	5
Acquisitions .....	12	—
Plan amendments .....	3	—
Foreign exchange impact .....	(1)	(2)
Actuarial loss .....	35	6
Benefit obligation, end of year .....	<u>\$ 455</u>	<u>\$ 485</u>
<b>Change in Plan Assets</b>		
Plan assets, beginning of year .....	\$ 105	\$ 122
Benefits paid .....	(27)	(18)
Employer contributions .....	37	41
Participant contributions .....	3	5
Actual investment return .....	4	(11)
Plan assets, end of year .....	<u>\$ 122</u>	<u>\$ 139</u>



**RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES**  
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	<u>Year Ended December 31,</u>	
	<u>2000</u>	<u>2001</u>
	<u>(In millions)</u>	
<b>Reconciliation of Funded Status</b>		
Funded status .....	\$ (333)	\$ (346)
Unrecognized transition obligation .....	126	94
Unrecognized prior service cost .....	88	66
Unrecognized actuarial gain .....	<u>(52)</u>	<u>(23)</u>
Net amount recognized at end of year .....	<u>\$ (171)</u>	<u>\$ (209)</u>
<b>Actuarial Assumptions</b>		
Discount rate .....	6.6-7.5%	6.6-7.25%
Expected long-term rate of return on assets .....	10.0%	9.5%
Health care cost trend rates — Under 65 .....	8.0%	7.5%
Health care cost trend rates — 65 and over .....	9.0%	8.5%

The assumed health care rates gradually decline to 5.5% for both medical categories by 2010. The actuarial gains and losses are due to changes in actuarial assumptions.

If the health care cost trend rate assumptions were increased by 1%, the accumulated postretirement benefit obligation as of December 31, 2001 would increase by approximately 3.6%. The annual effect of the 1% increase on the total of the service and interest costs would be an increase of approximately 3%. If the health care cost trend rate assumptions were decreased by 1%, the accumulated postretirement benefit obligation as of December 31, 2001 would decrease by approximately 3.5%. The annual effect of the 1% decrease on the total of the service and interest costs would be a decrease of 2.9%.

Effective March 1, 2001, the Company discontinued providing subsidized postretirement benefits to its Resources Participants. The Company incurred a pre-tax loss of \$40 million during the first quarter of 2001 related to the curtailment of the Company's postretirement obligation.

The Company's postretirement obligation is presented as a liability in the Consolidated Balance Sheets under the caption "Benefit Obligations."

***(e) Postemployment Benefits***

Net postemployment benefit costs for former or inactive employees, their beneficiaries and covered dependents, after employment but before retirement (primarily health care and life insurance benefits for participants in the long-term disability plan) were \$11 million, \$2 million and \$6 million in 1999, 2000 and 2001, respectively.

The Company's postemployment obligation is presented as a liability in the Consolidated Balance Sheets under the caption "Benefit Obligations."

***(f) Other Non-qualified Plans***

Since 1985, the Company has had in effect deferred compensation plans which permit eligible participants to elect each year to defer a percentage of that year's salary (prior to December 1993, up to 25% or 40%, depending on age, and beginning in December 1993, up to 100%) and up to 100% of that year's annual bonus. In general, employees who attain the age of 60 during employment and participate in the Company's deferred compensation plans may elect to have their deferred compensation amounts repaid in (a) fifteen equal annual installments commencing at the later of age 65 or termination of employment or (b) a lump-sum distribution following termination of employment. Interest generally accrues on deferrals made in 1989 and

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

subsequent years at a rate equal to the average Moody's Long-Term Corporate Bond Index plus 2%, determined annually until termination when the rate is fixed at the greater of the rate in effect at age 64 or at age 65. Fixed rates of 19% to 24% were established for deferrals made in 1985 through 1988. During 1999, 2000 and 2001, the Company, including Reliant Resources, recorded interest expense related to its deferred compensation obligation of \$22 million, \$14 million and \$17 million, respectively. The discounted deferred compensation obligation recorded by the Company, including Reliant Resources, was \$159 million and \$161 million as of December 31, 2000 and 2001, respectively.

Each Reliant Resources participant has elected to have his non-qualified deferred compensation plan account balance, after the Distribution: (a) placed in a new Reliant Resources deferred compensation plan, which generally mirrors the former Reliant Energy deferred compensation plans; or, (b) rolled over to the new non-qualified deferred compensation plan discussed below.

Effective January 1, 2002, select key and highly compensated employees were eligible to participate in a new non-qualified deferred compensation plan. The plan allows eligible employees to elect to defer up to 80% of their annual base salary and/or up to 100% of their eligible annual bonus. The Company funds these deferred compensation liabilities by making contributions to a rabbi trust. Plan participants direct the allocation of their deferrals between one or more of the Company's designated investment funds within the rabbi trust. Participants may withdraw their deferrals and accumulated earnings, if any, at any time before their normal distributions would have commenced with a ten percent penalty.

The Company's obligations under other non-qualified plans are presented as a liability in the Consolidated Balance Sheets under the caption "Benefit Obligations."

***(g) Other Employee Matters***

As of December 31, 2001, approximately 36% of the Company's employees are subject to collective bargaining arrangements, of which contracts covering 8% of the Company's employees will expire prior to December 31, 2002.

**(13) Income Taxes**

The components of income before taxes are as follows:

	Year Ended December 31,		
	1999	2000	2001
	(In millions)		
United States .....	\$2,535	\$578	\$1,302
Foreign .....	29	180	117
Income before income taxes .....	<u>\$2,564</u>	<u>\$758</u>	<u>\$1,419</u>

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

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

	<u>Year Ended December 31,</u>		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
	(In millions)		
Current:			
Federal .....	\$300	\$297	\$ 625
State .....	4	25	2
Foreign .....	7	48	1
Total current .....	<u>311</u>	<u>370</u>	<u>628</u>
Deferred:			
Federal .....	554	(53)	(140)
State .....	34	1	16
Foreign .....	—	—	(4)
Total deferred .....	<u>588</u>	<u>(52)</u>	<u>(128)</u>
Income tax expense .....	<u>\$899</u>	<u>\$318</u>	<u>\$ 500</u>

A reconciliation of the federal statutory income tax rate to the effective income tax rate is as follows:

	<u>Year Ended December 31,</u>		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
	(In millions)		
Income before income taxes .....	\$2,564	\$758	\$1,419
Federal statutory rate .....	35%	35%	35%
Income taxes at statutory rate .....	<u>898</u>	<u>265</u>	<u>497</u>
Net addition (reduction) in taxes resulting from:			
State income taxes, net of valuation allowances and federal income tax benefit .....	25	17	12
Amortization of investment tax credit .....	(21)	(18)	(18)
Excess deferred taxes .....	(5)	(4)	(5)
REPG tax holiday .....	(5)	(44)	(50)
Federal and foreign valuation allowance .....	1	13	3
Goodwill amortization .....	18	19	25
Latin America operations .....	—	69	(5)
Minority interest .....	—	—	29
Other, net .....	(12)	1	12
Total .....	<u>1</u>	<u>53</u>	<u>3</u>
Income tax expense .....	<u>\$ 899</u>	<u>\$318</u>	<u>\$ 500</u>
Effective rate .....	35.1%	42.0%	35.2%

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

Following were the Company's tax effects of temporary differences between the carrying amounts of assets and liabilities in the financial statements and their respective tax bases:

	<u>December 31,</u>	
	<u>2000</u>	<u>2001</u>
	(In millions)	
Deferred tax assets:		
Current:		
Unrealized loss on indexed debt securities .....	\$ 555	\$ 472
Allowance for doubtful accounts .....	—	74
Non-trading derivative assets, net .....	—	19
Other .....	—	5
Total current deferred tax assets .....	<u>555</u>	<u>570</u>
Non-current:		
Alternative minimum tax and other credit carryforwards .....	25	—
Employee benefits .....	143	172
Disallowed plant cost, net .....	56	53
Operating loss carryforwards .....	84	47
Contingent liabilities associated with discontinuance of SFAS No. 71 ....	74	74
Environmental reserves .....	25	16
Allowance for doubtful accounts .....	34	—
Foreign exchange gains .....	26	27
Non-trading derivative liabilities, net .....	—	136
Non-derivative stranded costs liability .....	—	73
Impairment of foreign asset .....	—	52
Other .....	88	94
Valuation allowance .....	<u>(68)</u>	<u>(31)</u>
Total non-current deferred tax assets .....	<u>487</u>	<u>713</u>
Total deferred tax assets .....	<u>\$1,042</u>	<u>\$1,283</u>
Deferred tax liabilities:		
Current:		
Unrealized gain on AOL Time Warner investment .....	\$ 864	\$ 829
Trading and marketing assets, net .....	—	48
Hedges of net investment in foreign subsidiaries .....	—	52
Total current deferred tax liabilities .....	<u>864</u>	<u>929</u>

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

	December 31,	
	2000	2001
	(In millions)	
Non-current:		
Depreciation .....	2,290	2,252
Regulatory assets, net .....	380	438
Deferred state income taxes .....	69	69
Deferred gas costs .....	201	43
Trading and marketing assets, net .....	—	27
Stranded costs indemnification receivable .....	—	73
Other .....	96	119
Total non-current deferred tax liabilities .....	<u>3,036</u>	<u>3,021</u>
Total deferred tax liabilities .....	<u>3,900</u>	<u>3,950</u>
Accumulated deferred income taxes, net .....	<u>\$2,858</u>	<u>\$2,667</u>

*Tax Attribute Carryforwards.* At December 31, 2001, the Company had \$13 million, \$530 million and \$45 million of federal, state and foreign net operating loss carryforwards, respectively. The losses are available to offset future respective federal and state taxable income through the year 2021. The foreign losses available to offset future foreign taxable income will not expire under current foreign jurisdiction tax law.

The valuation allowance reflects a net increase of \$49 million in 2000 and a net decrease of \$37 million in 2001. These net changes resulted from a reassessment of the Company's future ability to use federal, state and foreign tax net operating loss carryforwards.

*REPGB Tax Holiday.* Under 1998 Dutch tax law relating to the Dutch electricity industry, REPGB qualifies for a zero percent tax rate through December 31, 2001. The tax holiday applies only to the Dutch income earned by REPGB. Beginning January 1, 2002, REPGB is subject to Dutch corporate income tax at standard statutory rates, which is currently 34.5%, and was enacted in 2001. Prior to 2001, the enacted rate was 35%. The effect of the change in the enacted tax rate was not material to the Company's results of operations.

As discussed in Note 14(h), the Dutch parliament has adopted legislation allocating to the Dutch generation sector, including REPGB, financial responsibility for certain stranded costs and other liabilities incurred by NEA prior to the deregulation of the Dutch wholesale market. These obligations include NEA's obligations under an out-of-market gas supply contract and three out-of-market electricity contracts. As a result of the above, the Company recorded a net stranded cost liability of \$369 million and a related deferred tax asset of \$127 million at December 31, 2001 for the Company's statutorily allocated share of these gas supply and electricity contracts. The Company believes that the costs incurred by REPGB subsequent to the tax holiday ending in 2001 related to these contracts will be deductible for Dutch tax purposes. However, due to uncertainties related to the deductibility of these costs, the Company has recorded an offsetting liability in other liabilities of \$127 million as of December 31, 2001.

*Undistributed Earnings of Foreign Subsidiaries.* The undistributed earnings of foreign subsidiaries aggregated \$298 million as of December 31, 2001, which, under existing tax law, will not be subject to U.S. income tax until distributed. Provisions for U.S. taxes have not been accrued on these undistributed earnings, as these earnings have been, or are intended to be, permanently reinvested. In the event of a distribution of these earnings in the form of dividends, the Company will be subject to U.S. income taxes net of allowable foreign tax credits.

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*Tax Refunds.* In 2000, the Company received refunds from the IRS totaling \$126 million in taxes and interest following audits of tax returns and refund claims for Reliant Energy's 1985, 1986 and 1990 through 1995 tax years, and RERC Corp.'s 1979 through 1993 tax years. The pre-tax income statement effect of \$40 million (\$26 million after-tax) was recorded in 2000 in other income in the Company's Statements of Consolidated Income. Of the refunds, \$26 million was recorded as a reduction in goodwill. Reliant Energy's consolidated federal income tax returns have been audited and settled through the 1996 tax year. All of RERC Corp.'s consolidated federal income tax returns for tax years ending on or prior to Reliant Energy's acquisition of RERC Corp. have been audited and settled.

**(14) Commitments and Contingencies**

**(a) Commitments and Guarantees**

The following information is presented separately for the Company's regulated and unregulated businesses:

**Reliant Energy (to become CenterPoint Energy subsequent to the Restructuring)**

*Capital and Environmental Commitments.* Reliant Energy anticipates investing up to \$397 million in capital and other special project expenditures between 2002 and 2006 for environmental compliance. Reliant Energy anticipates expenditures to be as follows (in millions):

2002 .....	\$234
2003 .....	132
2004 .....	28
2005 .....	3
2006 .....	<u>—</u>
Total .....	<u>\$397</u>

*Fuel and Purchased Power.* Fuel commitments include several long-term coal, lignite and natural gas contracts related to Texas power generation operations, which have various quantity requirements and durations that are not classified as non-trading derivatives assets and liabilities or trading and marketing assets and liabilities in the Company's Consolidated Balance Sheets as of December 31, 2001 as these contracts meet the SFAS No. 133 exception to be classified as "normal purchases contracts" (see Note 5) or do not meet the definition of a derivative. Minimum payment obligations for coal and transportation agreements that extend through 2009 are approximately \$199 million in 2002, \$129 million in 2003, \$133 million in 2004, \$137 million in 2005 and \$141 million in 2006. Purchase commitments related to lignite mining and lease agreements, natural gas purchases and storage contracts, and purchased power are not material to Reliant Energy's operations. Prior to January 1, 2002, the Electric Operations business segment was allowed recovery of these costs through rates for electric service. As of December 31, 2001, some of these contracts are above market. Reliant Energy anticipates that stranded costs associated with these obligations will be recoverable through the stranded cost recovery mechanisms contained in the Texas Electric Restructuring Law. For information regarding the Texas Electric Restructuring Law, see Note 4(a).

Reliant Energy's other long-term fuel supply commitments which have various quantity requirements and durations are not considered material either individually or in the aggregate to its results of operations or cash flows.

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**Reliant Resources — unregulated businesses**

As of December 31, 2001, the Wholesale Energy business segment had entered into commitments associated with various non-rate regulated electric generating projects, including commitments for the purchase of combustion turbines, aggregating \$440 million. In addition, the Wholesale Energy business segment has options to purchase additional generating equipment for a total estimated cost of \$42 million for future generation projects. Reliant Resources is actively attempting to remarket this equipment.

Reliant Resources is a party to several fuel supply contracts, commodity transportation contracts, and purchase power and electric capacity contracts, that have various quantity requirements and durations that are not classified as non-trading derivatives assets and liabilities or trading and marketing assets and liabilities in the Consolidated Balance Sheets as of December 31, 2001 as these contracts meet the SFAS No. 133 exception to be classified as "normal purchases contracts" (see Note 5) or do not meet the definition of a derivative. The maximum duration of any of these commitments is 21 years. Minimum purchase commitment obligations under these agreements are as follows for the next five years, as of December 31, 2001 (in millions):

	<u>Fuel Commitments</u>	<u>Transportation Commitments</u>	<u>Purchased Power and Electric and Gas Capacity Commitments</u>
2002.....	\$105	\$ 45	\$315
2003.....	39	84	119
2004.....	45	101	61
2005.....	45	101	61
2006.....	<u>45</u>	<u>101</u>	<u>61</u>
Total .....	<u>\$279</u>	<u>\$432</u>	<u>\$617</u>

The maximum duration under any individual fuel supply contract and transportation contract is 18 years and 21 years, respectively.

Reliant Resources' aggregate electric capacity commitments, including capacity auction products, are for 7,496 MW, 1,800 MW, 1,000 MW, 1,000 MW and 1,000 MW for 2002, 2003, 2004, 2005 and 2006, respectively. The maximum duration under any individual commitment is five years. Included in the above purchase power and electric capacity commitments are amounts to be acquired from Texas Genco in 2002 and 2003 of \$213 million and \$57 million, respectively.

As of December 31, 2001, Reliant Resources has commitments, including electric energy and capacity sale contracts and district heating contracts (see Note 14(h)) which are not classified as non-trading derivative assets and liabilities or trading and marketing assets and liabilities in the Consolidated Balance Sheets as these contracts meet the SFAS No. 133 exception to be classified as "normal sales contracts" or do not meet the definition of a derivative. The estimated minimum sale commitments under these contracts are \$450 million, \$211 million, \$194 million, \$174 million and \$159 million in 2002, 2003, 2004, 2005 and 2006, respectively.

In addition, in January 2002, Reliant Resources began providing retail electric services to approximately 1.5 million residential and small commercial customers previously served by Reliant Energy's electric utility division. Within Reliant Energy's electric utility division's territory, prices that may be charged to residential and small commercial customers by this retail electric service provider are subject to a fixed, specified price (price to beat) at the outset of retail competition. The Texas Utility Commission's regulations allow this retail electric provider to adjust its price to beat fuel factor based on a percentage change in the price of natural gas. In addition, the retail electric provider may also request an adjustment as a result of changes in its price of purchased energy. The retail electric provider may request that its price to beat be adjusted twice a year.

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Reliant Resources will not be permitted to sell electricity to residential and small commercial customers in the incumbent's traditional service territory at a price other than the price to beat until January 1, 2005, unless before that date the Texas Utility Commission determines that 40% or more of the amount of electric power that was consumed in 2000 by the relevant class of customers is committed to be served by other retail electric providers.

Reliant Resources guarantees the performance of certain of its subsidiaries' trading and hedging obligations. As of December 31, 2001, the fixed maximum amount of such guarantees was \$4.7 billion. In addition, Reliant Resources has issued letters of credit totaling \$51 million in connection with its trading activities. Reliant Resources does not consider it likely that it would be required to perform or otherwise incur any losses associated with these guarantees.

In addition to the above discussions, Reliant Resources' other commitments have various quantity requirements and durations and are not considered material either individually or in the aggregate to its results of operations or cash flows.

***(b) Lease Commitments***

In August 2000, the Company, 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 in the REMA acquisition. As lessee, the Company leases an interest in each facility from each owner-lessor under a facility lease agreement. The equity interests in all the subsidiaries of REMA are pledged as collateral for REMA's lease obligations. In addition, the subsidiaries have guaranteed the lease obligations. The lease documents contain restrictive covenants that restrict REMA's ability to, among other things, make dividend distributions unless REMA satisfies various conditions. The covenant restricting dividends would be suspended if the direct or indirect parent of REMA, meeting specified criteria, including having a rating on REMA's long-term unsecured senior debt of at least BBB from Standard and Poor's and Baa2 from Moody's, guarantees the lease obligations. The Company will make lease payments through 2029. The lease term expires in 2034. As of December 31, 2001, REMA had \$167 million of restricted funds that are available for REMA's working capital needs and to make future lease payments, including a lease payment of \$55 million which was made in January 2002.

In the first quarter of 2001, Reliant Resources entered into tolling arrangements with a third party to purchase the rights to utilize and dispatch electric generating capacity of approximately 1,100 MW extending through 2012. This electricity will be generated by two gas-fired, simple-cycle peaking plants, with fuel oil backup which are being constructed by a tolling partner. Reliant Resources anticipates construction to be completed by the summer of 2002, at which time Reliant Resources will commence tolling payments. The tolling arrangements qualify as operating leases.

In February 2001, the Company entered into a lease for office space for Reliant Resources in a building under construction. The lease agreement was assigned by the Company to Reliant Resources by an assignment and assumption agreement in June 2001. The lease term, which commences in the second quarter 2003, is 15 years with two five-year renewal options. Reliant Resources has the right to name the building.

The following table sets forth information concerning the Company's obligations under non-cancelable long-term operating leases at December 31, 2001, which primarily relate to the REMA leases mentioned above. Other non-cancelable, long-term operating leases for Reliant Energy and Reliant Resources principally



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consist of tolling arrangements, as discussed above, rental agreements for building space, data processing equipment and vehicles, including major work equipment.

	<u>REMA Sale-Lease Obligation</u>	<u>Reliant Resources Other</u>	<u>Reliant Energy Other</u>	<u>Total</u>
		(In millions)		
2002.....	\$ 136	\$ 52	\$ 14	\$ 202
2003.....	77	72	12	161
2004.....	84	87	7	178
2005.....	75	89	6	170
2006.....	64	90	5	159
2007 and beyond .....	<u>1,124</u>	<u>469</u>	<u>66</u>	<u>1,659</u>
Total .....	<u>\$1,560</u>	<u>\$859</u>	<u>\$110</u>	<u>\$2,529</u>

Total lease expense for all operating leases was \$39 million, \$62 million and \$112 million during 1999, 2000 and 2001, respectively. During 2001, the Company made lease payments related to the REMA lease of \$259 million. As of December 31, 2001, the Company had recorded a prepaid lease obligation related to the REMA sale-leaseback of \$59 million and \$122 million in other current assets and other long-term assets, respectively.

***(c) Cross Border Leases***

During the period from 1994 through 1997, under cross border lease transactions, REPGB leased several of its power plants and related equipment and turbines to non-Netherlands based investors (the head leases) and concurrently leased the facilities back under sublease arrangements with remaining terms as of December 31, 2001 of 1 to 23 years. REPGB utilized proceeds from the head lease transactions to prepay its sublease obligations and to provide a source for payment of end of term purchase options and other financial undertakings. The initial sublease obligations totaled \$2.4 billion of which \$1.6 billion remained outstanding as of December 31, 2001. These transactions involve REPGB providing to a foreign investor an ownership right in (but not necessarily title to) an asset, with a leaseback of that asset. The net proceeds to REPGB of the transactions were recorded as a deferred gain and are currently being amortized to income over the lease terms. At December 31, 2000 and 2001, the unamortized deferred gain on these transactions totaled \$77 million and \$68 million, respectively. The power plants, related equipment and turbines remain on the financial statements of REPGB and continue to be depreciated.

REPGB is required to maintain minimum insurance coverages, perform minimum annual maintenance and, in specified situations, post letters of credit. REPGB's shareholder is subject to some restrictions with respect to the liquidation of REPGB's shares. In the case of early termination of these contracts, REPGB would be contingently liable for some payments to the sublessors, which at December 31, 2001, are estimated to be \$272 million. Starting in March 2000, REPGB was required by some of the lease agreements to obtain standby letters of credit in favor of the sublessors in the event of early termination. The amount of the required letters of credit was \$272 million as of December 31, 2001. Commitments for these letters of credit have been obtained as of December 31, 2001.

***(d) Naming Rights to Houston Sports Complex***

In October 2000, Reliant Resources acquired the naming rights for the new football stadium for the Houston Texans, the National Football League's newest franchise. In addition, the naming rights cover the entertainment and convention facilities included in the stadium complex. The agreement extends for 32 years. In addition to naming rights, the agreement provides Reliant Resources with significant sponsorship rights.

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The aggregate cost of the naming rights will be approximately \$300 million. During the fourth quarter of 2000, Reliant Resources incurred an obligation to pay \$12 million in order to secure the long-term commitment and for the initial advertising of which \$10 million was expensed in the Statement of Consolidated Income in 2000. Starting in 2002, when the new stadium is operational, Reliant Resources will pay \$10 million each year through 2032 for annual advertising under this agreement.

***(e) Transportation Agreement***

A subsidiary of RERC Corp. had an agreement (ANR Agreement) with ANR Pipeline Company (ANR) that contemplated that this subsidiary would transfer to ANR an interest in some of RERC Corp.'s pipeline and related assets. As of December 31, 2000 and 2001, the Company had recorded \$41 million in other long-term liabilities in the Company's Consolidated Balance Sheets to reflect the Company's obligation to ANR for the use of 130 million cubic feet (Mmcf)/day of capacity in some of the Company's transportation facilities. The level of transportation will decline to 100 Mmcf/day in the year 2003 with a refund of \$5 million to ANR. The ANR Agreement will terminate in 2005 with a refund of \$36 million.

***(f) Legal, Environmental and Other Regulatory Matters***

***Legal Matters***

***Reliant Energy HL&P Municipal Franchise Fee Lawsuits.*** In February 1996, the cities of Wharton, Galveston and Pasadena filed suit, for themselves and a proposed class of all similarly situated cities in Reliant Energy HL&P's service area, against Reliant Energy and Houston Industries Finance, Inc. (formerly a wholly owned subsidiary of Reliant Energy) alleging underpayment of municipal franchise fees. Plaintiffs claim that they are entitled to 4% of all receipts of any kind for business conducted within these cities over the previous four decades. Because the franchise ordinances at issue affecting Reliant Energy HL&P expressly impose fees only on its own receipts and only from sales of electricity for consumption within a city, the Company regards all of plaintiffs' allegations as spurious and is vigorously contesting the case. The plaintiffs' pleadings asserted that their damages exceeded \$250 million. The 269th Judicial District Court for Harris County granted partial summary judgment in favor of Reliant Energy dismissing all claims for franchise fees based on sales tax collections. Other motions for partial summary judgment were denied. A six-week jury trial of the original claimant cities (but not the class of cities) ended on April 4, 2000 (Three Cities case). Although the jury found for Reliant Energy on many issues, they found in favor of the original claimant cities on three issues, and assessed a total of \$4 million in actual and \$30 million in punitive damages. However, the jury also found in favor of Reliant Energy on the affirmative defense of laches, a defense similar to a statute of limitations defense, due to the original claimant cities having unreasonably delayed bringing their claims during the 43 years since the alleged wrongs began.

The trial court in the Three Cities case granted most of Reliant Energy's motions to disregard the jury's findings. The trial court's rulings reduced the judgment to \$1.7 million, including interest, plus an award of \$13.7 million in legal fees. In addition, the trial court granted Reliant Energy's motion to decertify the class and vacated its prior orders certifying a class. Following this ruling, 45 cities filed individual suits against Reliant Energy in the District Court of Harris County.

The Three Cities case has been appealed. The Company believes that the \$1.7 million damage award resulted from serious errors of law and that it will be set aside by the Texas appellate courts. In addition, the Company believes that because of an agreement between the parties limiting fees to a percentage of the damages, reversal of the award of \$13.7 million in attorneys' fees in the Three Cities case is probable.

The extent to which issues in the Three Cities case may affect the claims of the other cities served by Reliant Energy HL&P cannot be assessed until judgments are final and no longer subject to appeal. However, the trial court's rulings disregarding most of the jury's findings are consistent with Texas Supreme Court

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opinions over the past decade. The Company estimates the range of possible outcomes for the plaintiffs to be between zero and \$18 million inclusive of interest and attorneys' fees.

*California Wholesale Market.* Reliant Energy, Reliant Energy Services, REPG and several other subsidiaries of Reliant Resources, as well as three officers of some of these companies, have been named as defendants in class action lawsuits and other lawsuits filed against a number of companies that own generation plants in California and other sellers of electricity in California markets. Pursuant to the terms of the master separation agreement between Reliant Energy and Reliant Resources (see Note 4(c)), Reliant Resources has agreed to indemnify Reliant Energy for any damages arising under these lawsuits and may elect to defend these lawsuits at its own expense. Three of these lawsuits were filed in the Superior Court of the State of California, San Diego County; two were filed in the Superior Court in San Francisco County; and one was filed in the Superior Court of Los Angeles County. While the plaintiffs allege various violations by the defendants of state antitrust laws and state laws against unfair and unlawful business practices, each of the lawsuits is grounded on the central allegation that defendants conspired to drive up the wholesale price of electricity. In addition to injunctive relief, the plaintiffs in these lawsuits seek treble the amount of damages alleged, restitution of alleged overpayments, disgorgement of alleged unlawful profits for sales of electricity, costs of suit and attorneys' fees. The cases were initially removed to federal court and were then assigned to Judge Robert H. Whaley, United States District Judge, pursuant to the federal procedures for multi-district litigation. On July 30, 2000, Judge Whaley remanded the cases to state court. Upon remand to state court, the cases were assigned to Superior Court Judge Janis L. Sammartino pursuant to the California state coordination procedures. On March 4, 2002, Judge Sammartino adopted a schedule proposed by the parties that would result in a trial beginning on March 1, 2004. On March 8, 2002, the plaintiffs filed a single, consolidated complaint naming numerous defendants, including Reliant Energy Services and other Reliant Resources' subsidiaries, that restated the allegations described above and alleged that damages against all defendants could be as much as \$1 billion.

Plaintiffs have voluntarily dismissed Reliant Energy from two of the three class actions in which it was named as a defendant. The ultimate outcome of the lawsuits cannot be predicted with any degree of certainty at this time. However, the Company believes, based on its analysis to date of the claims asserted in these lawsuits and the underlying facts, that resolution of these lawsuits will not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

On March 11, 2002, the California Attorney General filed a civil lawsuit in San Francisco Superior Court naming Reliant Energy, Reliant Resources, Reliant Energy Services, REPG, and several other subsidiaries of Reliant Resources as defendants. Pursuant to the terms of the master separation agreement between Reliant Energy and Reliant Resources (see Note 4(c)), Reliant Resources has agreed to indemnify Reliant Energy for any damages arising under these lawsuits and may elect to defend these lawsuits at its own expense. The Attorney General alleges various violations by the defendants of state laws against unfair and unlawful business practices arising out of transactions in the markets for ancillary services run by the California Independent System Operator (Cal ISO). In addition to injunctive relief, the Attorney General seeks restitution and disgorgement of alleged unlawful profits for sales of electricity, and civil penalties. The ultimate outcome of this lawsuit cannot be predicted with any degree of certainty at this time.

On March 19, 2002, the California Attorney General filed a complaint with the FERC naming Reliant Energy Services and "all other public utility sellers" in California as defendants. The complaint alleges that sellers with market-based rates have violated their tariffs by not filing with the FERC transaction-specific information about all of their sales and purchases at market-based rates. The California Attorney General argues that, as a result, all past sales should be subject to refund if found to be above just and reasonable levels. The ultimate outcome of this complaint proceeding cannot be predicted with any degree of certainty at this time. However, the Company believes, based on its analysis to date of the claims asserted in the complaint, the underlying facts, and the relevant statutory and regulatory provisions, that resolution of this

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lawsuit will not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

*Natural Gas Measurement Lawsuits.* In 1997, a suit was filed under the Federal False Claim Act against RERC and certain of its subsidiaries alleging mismeasurement of natural gas produced from federal and Indian lands. The suit seeks undisclosed damages, along with statutory penalties, interest, costs, and fees. The complaint is part of a larger series of complaints filed against 77 natural gas pipelines and their subsidiaries and affiliates. An earlier single action making substantially similar allegations against the pipelines was dismissed by the U.S. District Court for the District of Columbia on grounds of improper joinder and lack of jurisdiction. As a result, the various individual complaints were filed in numerous courts throughout the country. This case was consolidated, together with the other similar False Claim Act cases filed and transferred to the District of Wyoming. Motions to dismiss were denied. The defendants intend to vigorously contest this case.

In addition, RERC, REGT, REFS and MRT have been named as defendants in a class action filed in May 1999 against approximately 245 pipeline companies and their affiliates. The plaintiffs in the case purport to represent a class of natural gas producers and fee royalty owners who allege that they have been subject to systematic gas mismeasurement by the defendants, including certain Reliant Energy entities, for more than 25 years. The plaintiffs seek compensatory damages, along with statutory penalties, treble damages, interest, costs and fees. The action is currently pending in state court in Stevens County, Kansas. Plaintiffs initially sued Reliant Energy Services, but that company was dismissed without prejudice on June 8, 2001. Other Reliant Energy entities that were misnamed or duplicative have also been dismissed. MRT and REFS have filed motions to dismiss for lack of personal jurisdiction and are currently responding to discovery on personal jurisdiction. All four Reliant Energy defendants have joined in a motion to dismiss.

The defendants plan to raise significant affirmative defenses based on the terms of the applicable contracts, as well as on the broad waivers and releases in take or pay settlements that were granted by the producer-sellers of natural gas who are putative class members.

*Environmental Matters*

*Clean Air Standards.* The Company has participated in a lawsuit against the Texas Natural Resource Conservation Commission (TNRCC) regarding the limitation of the emission of oxides of nitrogen (NOx) in the Houston area. A settlement of the lawsuit was reached with the TNRCC in the second quarter of 2001 and revised emissions limitations were adopted by the TNRCC in the third quarter of 2001. The revised limitations provide for an increase in allowable NOx emissions, compared to the original TNRCC requirements, through 2004. Further emission reduction requirements may or may not be required through 2007, depending upon the outcome of further investigations of regional air quality issues. To achieve the TNRCC NOx reduction requirements, the Company anticipates investing up to \$721 million in capital and other special project expenditures by 2004, including costs incurred through December 31, 2001, and potentially up to an additional \$88 million between 2004 and 2007. The Texas Electric Restructuring Law provides for stranded cost recovery for expenditures incurred before May 1, 2003 to achieve the NOx reduction requirements.

*Hydrocarbon Contamination.* On August 24, 2001, 37 plaintiffs filed suit against Reliant Energy Gas Transmission Company, Inc., Reliant Energy Pipeline Services, Inc., RERC, Reliant Energy Services, Inc., other Reliant Energy entities and third parties (Docket No. 460, 916-Div. "B"), in the 1st Judicial District Court, Caddo Parish, Louisiana. The petition has now been supplemented five times. As of March 11, 2002, there were 628 plaintiffs, a majority of whom are Louisiana residents who live near the Wilcox Aquifer. In addition to the Reliant Energy entities, the plaintiffs have sued the State of Louisiana through its Department of Environmental Quality, several individuals, some of whom are present employees of the State of Louisiana, the Bayou South Gas Gathering Company, L.L.C., Martin Timber Company, Inc., and several trusts.

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The suit alleges that, at some unspecified date prior to 1985, the defendants allowed or caused hydrocarbon or chemical contamination of the Wilcox Aquifer which lies beneath property owned or leased by the defendants and which is the sole or primary drinking water aquifer in the area. The primary source of the contamination is alleged by the plaintiffs to be a gas processing facility in Haughton, Bossier Parish, Louisiana known as the "Sligo Facility." This facility was purportedly used for gathering natural gas from surrounding wells, separating gasoline and hydrocarbons from the natural gas for marketing, and transmission of natural gas for distribution. This site was originally leased and operated by predecessors of Reliant Energy Gas Transmission Company in the late 1940s and was operated until Arkansas Louisiana Gas Company ceased operations of the plant in the late 1970s.

Beginning about 1985, the predecessors of certain Reliant Energy defendants engaged in a voluntary remediation of any subsurface contamination of the groundwater below the property they own or lease. This work has been done in conjunction with and under the direction of the Louisiana Department of Environmental Quality. The plaintiffs seek monetary damages for alleged damage to the aquifer underlying their property, unspecified alleged personal injuries, alleged fear of cancer, alleged property damage or diminution of value of their property, and in addition seek damages for trespass, punitive, and exemplary damages. The quantity of monetary damages sought is unspecified. As of December 31, 2001, the Company is unable to estimate the monetary damages, if any, that the plaintiffs may be awarded in this matter.

*Manufactured Gas Plant Sites.* RERC and its predecessors operated a manufactured gas plant (MGP) until 1960 adjacent to the Mississippi River in Minnesota, formerly known as Minneapolis Gas Works (MGW). RERC has substantially completed remediation of the main site other than ongoing water monitoring and treatment. The manufactured gas was stored in separate holders. RERC is negotiating clean-up of one such holder. There are six other former MGP sites in the Minnesota service territory. Remediation has been completed on one site. Of the remaining five sites, RERC believes that two were neither owned nor operated by RERC. RERC believes it has no liability with respect to the sites it neither owned nor operated.

At December 31, 2000 and 2001, RERC had accrued \$18 million and \$23 million, respectively, for remediation of the Minnesota sites. At December 31, 2001, the estimated range of possible remediation costs was \$11 million to \$49 million. The cost estimates of the MGW site are based on studies of that site. The remediation costs for the other sites are based on industry average costs for remediation of sites of similar size. The actual remediation costs will be dependent upon the number of sites remediated, the participation of other potentially responsible parties (PRP), if any, and the remediation methods used.

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

*Other Minnesota Matters.* At December 31, 2000 and 2001, RERC had recorded accruals of \$4 million and \$5 million, respectively for other environmental matters in Minnesota for which remediation may be required. At December 31, 2001 the estimated range of possible remediation costs was \$4 million to \$8 million.

*Mercury Contamination.* The Company's pipeline and distribution operations have in the past employed elemental mercury in measuring and regulating equipment. It is possible that small amounts of mercury may have been spilled in the course of normal maintenance and replacement operations and that these spills may have contaminated the immediate area with elemental mercury. This type of contamination has been found by the Company at some sites in the past, and the Company has conducted remediation at sites found to be contaminated. Although the Company is not aware of additional specific sites, it is possible that other contaminated sites may exist and that remediation costs may be incurred for these sites. Although the total

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amount of these costs cannot be known at this time, based on experience by the Company and that of others in the natural gas industry to date and on the current regulations regarding remediation of these sites, the Company believes that the costs of any remediation of these sites will not be material to the Company's financial position, results of operations or cash flows.

*REMA Ash Disposal Site Closures and Site Contaminations.* Under the agreement to acquire REMA (see Note 3(a)), the Company became responsible for liabilities associated with ash disposal site closures and site contamination at the acquired facilities in Pennsylvania and New Jersey prior to a plant closing, except for the first \$6 million of remediation costs at the Seward Generating Station. A prior owner retained liabilities associated with the disposal of hazardous substances to off-site locations prior to November 24, 1999. As of December 31, 2000 and 2001, REMA has liabilities associated with six future ash disposal site closures and six current site investigations and environmental remediations. The Company has recorded its estimate of these environmental liabilities in the amount of \$36 million as of December 31, 2000 and 2001. The Company expects approximately \$16 million will be paid over the next five years.

*REPGB Asbestos Abatement and Soil Remediation.* Prior to the Company's acquisition of REPGB (see Note 3(b)), REPGB had a \$25 million obligation primarily related to asbestos abatement, as required by Dutch law, and soil remediation at six sites. During 2000, the Company initiated a review of potential environmental matters associated with REPGB's properties. REPGB began remediation in 2000 of the properties identified to have exposed asbestos and soil contamination, as required by Dutch law and the terms of some leasehold agreements with municipalities in which the contaminated properties are located. All remediation efforts are to be fully completed by 2005. As of December 31, 2000 and 2001, the recorded estimated undiscounted liability for this asbestos abatement and soil remediation was \$24 million and \$18 million, respectively.

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

*Other Matters*

The Company is involved in other legal, environmental, tax and regulatory proceedings before various courts, regulatory commissions and governmental agencies regarding matters arising in the ordinary course of business. Some of these proceedings involve substantial amounts. The Company's management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. The Company's management believes that the disposition of these matters will not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

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*(g) California Wholesale Market Uncertainty.*

*Receivables.* During portions of 2000 and 2001, prices for wholesale electricity in California increased dramatically as a result of a combination of factors, including higher natural gas prices and emission allowance costs, reduction in available hydroelectric generation resources, increased demand, decreased net electric imports and limitations on supply as a result of maintenance and other outages. The resulting supply and demand imbalance disproportionately impacted California utilities that relied too heavily on short-term power markets to meet their load requirements. Although wholesale prices increased, California's deregulation legislation kept retail rates frozen at 10% below 1996 levels for two of California's public utilities, Pacific Gas and Electric (PG&E) and Southern California Edison Company (SCE), until rates were raised by the California Public Utilities Commission (CPUC) early in 2001.

Due to the disparity between wholesale and retail rates, the credit ratings of PG&E and SCE fell below investment grade. Additionally, PG&E filed for protection under the bankruptcy laws on April 6, 2001. As a result, PG&E and SCE are no longer considered creditworthy and since January 17, 2001 have not directly purchased power from third-party suppliers through the Cal ISO to serve their net short load. Pursuant to emergency legislation enacted by the California Legislature, the California Department of Water Resources (CDWR) has negotiated and purchased power through short and long-term contracts on behalf of PG&E and SCE to meet their net short loads. In December 2001, the CDWR began making payments to the Cal ISO for real-time transactions. The CDWR has now made payment through the Cal ISO for most real-time energy deliveries subsequent to January 17, 2001.

In addition, certain contracts intended to serve as collateral for sales to the California Power Exchange (Cal PX) were seized by California Governor Gray Davis in February 2001. The Ninth Circuit Court of Appeals subsequently ruled that Governor Davis' seizure of these contracts was wrongful. The Company has filed a lawsuit, currently pending in California, to require the state of California to compensate it for the seizure of these contracts. Although SCE made a payment on March 1, 2002 to the Cal PX that included amounts it owed to the Company under these contracts, the Company is still seeking to recover the market value of the contracts at the time they were seized by Governor Davis, which was significantly higher than the contract value, and to collect amounts owed as a result of payment defaults by PG&E under the contracts. The timing and ultimate resolution of these claims is uncertain at this time.

On September 20, 2001, PG&E filed a Plan of Reorganization and an accompanying disclosure statement with the bankruptcy court. Under this plan, PG&E would pay all allowed creditor claims in full, through a combination of cash and long-term notes. Components of the plan will require the approval of the FERC, the SEC and the Nuclear Energy Regulatory Commission, in addition to the bankruptcy court. PG&E has stated it seeks to have this plan confirmed by December 31, 2002. A number of parties are contesting PG&E's reorganization plan, including a number of California parties and agencies. The bankruptcy judge in the PG&E case has ordered that the CPUC may file a competing plan. The details of the CPUC's proposal are unknown at this time. The ability of PG&E to have its reorganization plan confirmed, including the provision providing for the payment in full of unsecured creditors, is uncertain at this time.

On October 5, 2001, a federal district court in California entered a stipulated judgment approving a settlement between SCE and the CPUC in an action brought by SCE regarding the recovery of its wholesale power costs under the filed rate doctrine. Under the stipulated judgment, a rate increase approved earlier in 2001 will remain in place until the earlier of SCE recovering \$3.3 billion or December 31, 2002. After that date, the CPUC will review the sufficiency of retail rates through December 31, 2005. A consumer organization has appealed the judgment to the Ninth Circuit Court of Appeals, and no hearing has been held to date. Under the stipulated judgment, any settlement with SCE's creditors that is entered into after March 1, 2002 must be approved by the CPUC. The Company has appealed this provision of the judgment. On March 1, 2002, SCE made a payment to the Cal PX that included amounts it owed the Company. The Company has made a filing with FERC seeking an order providing for the disbursement of the funds owed to

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the suppliers. The FERC and the bankruptcy court governing the Cal PX bankruptcy proceedings are considering how to dispense this money and it remains uncertain when those funds will be paid over to the Company.

As of December 31, 2000, the Company was owed a total of \$282 million by the Cal PX and the Cal ISO. As of December 31, 2001, the Company was owed a total of \$302 million by the Cal ISO, the Cal PX, the CDWR, and California Energy Resources Scheduling for energy sales in the California wholesale market during the fourth quarter of 2000 through December 31, 2001. From January 1, 2002 through March 26, 2002, the Company has collected \$45 million of these receivable balances. As of December 31, 2001, the Company had a pre-tax provision of \$68 million against receivable balances related to energy sales in the California market, including \$39 million recorded in 2000 and \$29 million recorded in 2001. Management will continue to assess the collectability of these receivables based on further developments affecting the California electricity market and the market participants described herein.

*FERC Market Mitigation.* In response to the filing of a number of complaints challenging the level of wholesale prices, the FERC initiated a staff investigation and issued a number of orders implementing a series of wholesale market reforms. Under these orders, and subject to review and adjustment based on the pending refund proceeding described below, the Company may face an as yet undetermined amount of refund liability. See “— FERC Refunds” below. Under these orders, for the period January 1, 2001 through June 19, 2001, approximately \$20 million of the \$149 million charged by the Company for sales in California to the Cal ISO and the Cal PX were identified as being subject to possible refunds. During the second quarter of 2001, the Company accrued refunds of \$15 million, \$3 million of which had been previously expensed during the first quarter of 2001.

On April 26, 2001, the FERC issued an order replacing the previous price review procedures and establishing a market monitoring and mitigation plan, effective May 29, 2001, for the California markets. The plan establishes a cap on prices during periods when power reserves fall below 7% in the Cal ISO (reserve deficiency periods). The Cal ISO is instructed to use data submitted confidentially by gas-fired generators in California and daily indices of natural gas and emissions allowance costs to establish the market-clearing price in real-time based on the marginal cost of the highest-cost generator called to run. The plan also requires generators in California to offer all their available capacity for sale in the real-time market, and conditions sellers' market-based rate authority such that sellers engaging in certain bidding practices will be subject to increased scrutiny by the FERC, potential refunds and even revocation of their market-based rate authority.

On June 19, 2001, the FERC issued an order modifying the market monitoring and mitigation plan adopted in its April 26 order, to apply price controls to all hours, instead of just hours of low operating reserve, and to extend the mitigation measures to other Western states in addition to California, including Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington and Wyoming. The FERC set July 2, 2001 as the refund effective date for sales subject to the price mitigation plan throughout the West region. This means that transactions after that date may be subject to refund if found to be unjust or unreasonable. The proxy market clearing price calculated by the Cal ISO will apply during periods of reserve deficiency to all sales in the Cal ISO and Western spot markets. In non-reserve deficiency hours in California, the maximum price in California and the other Western states will be capped at 85% of the highest Cal ISO hourly market clearing price established during the most recent reserve deficiency period. Sellers other than marketers will be allowed to bid higher than the maximum prices, but such bids are subject to justification and potential refund. Justification of higher prices is limited to establishing higher actual gas costs than the proxy calculation averages and making a showing that conditions in natural gas markets changed significantly. The modified monitoring and mitigation plan went into effect June 20, 2001, and will terminate on September 30, 2002, covering two summer peak seasons, or approximately 16 months.

On December 19, 2001, the FERC issued a series of orders on price mitigation in California and the West region. These orders largely maintained existing mitigation mechanisms, but did make a temporary modifica-



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tion to the way that mitigated market clearing prices will be set during the winter months, allowing the maximum prices to rise if gas prices rise. The FERC removed the requirement that non-reserve deficiency prices be limited to 85% of the most recent reserve deficiency prices, allowing prices to rise to a mitigated clearing price of \$108/MWh (above which price transactions must be justified as described above). In addition, the FERC determined that if gas prices in California rise by 10%, the mitigated price may be revised to take that change into account. The formula will then track subsequent cumulative changes of at least 10%, but may not fall below a maximum price of \$108/MWh. This modification is effective December 20, 2001 through April 30, 2002, at which point the previous mitigation formula is reinstated.

Also, the December 19 orders affirm the June 19 order's requirement that generators must offer all available capacity for sale in the real-time market. As a result of this requirement, the Company's opportunity to sell ancillary services in the West region in the future may be reduced. During 2001, the Company recorded \$42 million in revenues related to ancillary services in the West region.

In addition to the impact on ancillary services sales, certain aspects of the December 19, 2001 orders may have retroactive application that may affect prices charged in the West region since June 21, 2001. Because the precise application of the December 19, 2001 order is not known at this time, the Company cannot anticipate the resulting impact on earnings.

The Company believes that while the mitigation plan will reduce volatility in the market, the Company will nevertheless be able to profitably operate its facilities in the West. Additionally, as noted above, the mitigation plan allows sellers, such as the Company, to justify prices above the proxy price. However, previous efforts by the Company to justify prices above the proxy price have been rejected by the FERC and there is no certainty that the FERC will allow for the recovery of costs above the proxy price. Finally, any adverse impacts of the mitigation plan on the Company's operations would be mitigated, in part, by the Company's forward hedging activities.

*FERC Refunds.* The FERC issued an order on July 25, 2001 adopting a refund methodology and initiating a hearing schedule to determine (1) revised mitigated prices for each hour from October 2, 2000 through June 20, 2001; (2) the amount owed in refunds by each supplier according to the methodology (these amounts may be in addition to or in place of the refund amounts previously determined by the FERC); and (3) the amount currently owed to each supplier. The amounts of any refunds will be determined by the FERC after the conclusion of the hearing process. On December 19, 2001, the FERC issued an order modifying the methodology to be used to determine refund amounts. The schedule currently anticipates that the Administrative Law Judge will make his refund amount recommendations to the FERC in October 2002. However, the Company does not know when the FERC will issue its final decision. The Company has not reserved any amounts for potential future refund liability resulting from the FERC refund hearing, nor can it currently predict the amount of these potential refunds, if any, because the methodology used to calculate these refunds is not final and will depend on information that is still subject to review and challenge in the hearing process. Any refunds that are determined in the FERC proceeding will likely be offset against unpaid amounts owed, if any, to the Company for its prior sales.

On November 20, 2001, the FERC instituted an investigation under Section 206 of the Federal Power Act regarding the tariffs of all sellers with market-based rates authority, including the Company. In this proceeding, the FERC conditions the market-based rate authority of all sellers on their not engaging in anti-competitive behavior. Such condition will apply upon a further order from FERC establishing a refund effective date. This condition allows the FERC, if it determines that a seller has engaged in anti-competitive behavior subsequent to the start of the refund effective period, to order refunds back to the date of such behavior. The FERC invited comments regarding this proposal, and the Company has filed comments in opposition to the proposal. On March 11, 2002, the FERC's Staff held a conference with market participants to discuss the comments FERC has received, and possible modification of the proposed conditions to address concerns raised in the comments while protecting consumers against anticompetitive behavior. The timing of

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further action by FERC is uncertain. If the FERC does not modify or reject its proposed approach for dealing with anti-competitive behavior, the Company's future earnings may be affected by the open-ended refund obligation.

On February 13, 2002, the FERC issued an order initiating a staff investigation into potential manipulation of electric and natural gas prices in the Western region for the period January 1, 2000 forward. While this order does not propose any action against the Company, if the investigation results in findings that markets were dysfunctional during this period, those findings may be used in support of existing or future claims by the FERC or others that prices in the Company's long-term contracts entered into after January 1, 2000 for sales in the West region should be altered.

*Other Investigations.* In addition to the FERC investigation discussed above, several state and other federal regulatory investigations and complaints have commenced in connection with the wholesale electricity prices in California and other neighboring Western states to determine the causes of the high prices and potentially to recommend remedial action. In California, the California State Senate and the California Office of the Attorney General have separate ongoing investigations into the high prices and their causes. Although these investigations have not been completed and no findings have been made in connection with either of them, the California Attorney General has filed a civil lawsuit in San Francisco Superior Court alleging that the Company has violated state laws against unfair and unlawful business practices and a complaint with the FERC alleging the Company violated the terms of its tariff with the FERC (see Note 14(f)). Adverse findings or rulings could result in punitive legislation, sanctions, fines or even criminal charges against the Company or its employees. The Company is cooperating with both investigations and has produced a substantial amount of information requested in subpoenas issued by each body. The Washington and Oregon attorneys general have also begun similar investigations.

*Legislative Efforts.* Since the inception of the California energy crisis, various pieces of legislation, including tax proposals, have been introduced in the U.S. Congress and the California Legislature addressing several issues related to the increase in wholesale power prices in 2000 and 2001. For example, a bill was introduced in the California legislature that would have created a "windfall profits" tax on wholesale electricity sales and would subject exempt wholesale generators, such as the Company's subsidiaries that own generation facilities in California, to regulation by the CPUC as "public utilities." To date, only a few energy-related bills have passed and the Company does not believe that the legislation that has been enacted to date on these issues will have a material adverse effect on the Company. However, it is possible that legislation could be enacted on either the state or federal level that could have a material adverse effect on the Company's financial condition, results of operations and cash flows.

**(h) Indemnification of Stranded Costs**

*Background.* In January 2001, the Dutch Electricity Production Sector Transitional Arrangements Act (Transition Act) became effective and, among other things, allocated to REPGB and the three other large-scale Dutch generation companies, a share of the assets, liabilities and stranded cost commitments of NEA. Prior to the enactment of the Transition Act, NEA acted as the national electricity pooling and coordinating body for the generation output of REPGB and the three other large-scale national Dutch generation companies. REPGB and the three other large-scale Dutch generation companies are shareholders of NEA.

The Transition Act and related agreements specify that REPGB has a 22.5% share of NEA's assets, liabilities and stranded cost commitments. NEA's stranded cost commitments consisted primarily of various uneconomical or stranded cost investments and commitments, including a gas supply and three power contracts entered into prior to the liberalization of the Dutch wholesale electricity market. REPGB's stranded cost obligations also include uneconomical district heating contracts which were previously administered by NEA prior to deregulation of the Dutch power market.

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The gas supply contract expires in 2016 and provides for gas imports aggregating 2.283 billion cubic meters per year. Prior to December 31, 2001, one of the stranded cost power contracts was settled. The two remaining stranded cost power contracts have the following capacities and terms: (a) 300 MW through 2005, and (b) 600 MW through March 2002 and 750 MW through 2009. Under the Transition Act, REPGB can either assume its 22.5% allocated interest in the contracts or, subject to the terms of the contracts, sell its interests to third parties. The district heating obligations relate to three heating water supply contracts entered into with various municipalities and expire from 2013 through 2015. Under the district heating contracts, the municipal districts are required to take annually a combined minimum of 5,549 terajoules (TJ) increasing annually to 7,955 TJ over the life of the contracts.

The Transition Act also authorized the government to purchase from NEA at least a majority of the shares in the Dutch national transmission grid company which was sold to the Dutch government on October 25, 2001 for approximately NLG 2.6 billion (approximately \$1.05 billion based on an exchange rate of 2.48 NLG per U.S. dollar as of December 31, 2001).

Prior to December 31, 2001, the former shareholders agreed pursuant to a share purchase agreement to indemnify REPGB for up to NLG 1.9 billion in stranded cost liabilities (approximately \$766 million). The indemnity obligation of the former shareholders and various provincial and municipal entities (including the city of Amsterdam), was secured by a NLG 900 million escrow account (approximately \$363 million).

The Transition Act provided that, subject to the approval of the European Commission, the Dutch government will provide financial compensation to the Dutch generation companies, including REPGB, for liabilities associated with (a) long-term district heating contracts and (b) an experimental coal facility. In July 2001, the European Commission ruled that under certain conditions the Dutch government can provide financial compensation to the generation companies for the district heating contracts. To the extent that this compensation is not ultimately provided to the generation companies by the Dutch government, REPGB was to collect its compensation directly from the former shareholders as further discussed below.

In January 2001, the Company recognized an out-of-market, net stranded cost liability for its gas and electric contracts and district heating commitments. At such time, the Company recorded a corresponding asset of equal amount for the indemnification of this obligation from REPGB's former shareholders and the Dutch government, as applicable. Pursuant to SFAS No. 133, the gas and electric contracts are marked-to-market (see Note 5). As of December 31, 2001, the Company has recorded a liability of \$369 million for its stranded cost gas and electric commitments in non-trading derivative liabilities and a liability of \$206 million for its district heating commitments in current and non-current other liabilities. As of December 31, 2001, the Company has recorded an indemnification receivable from the Dutch government for the district heating stranded cost liability of \$206 million. The settlement of the indemnification related to gas and electric contract commitments in December 2001 is discussed below.

*Settlement of Stranded Cost Indemnification.* In December 2001, REPGB and its former shareholders entered into a settlement agreement immediately resolving the former shareholders of their stranded cost indemnity obligations related to the gas supply and power contracts under the original share purchase agreement, and provides conditional terms for the possible settlement of their stranded cost indemnity obligation related to district heating obligations under certain conditions. The settlement agreement was approved in December 2001 by the Ministry of Economic Affairs of the Netherlands.

Under the settlement agreement, the former shareholders paid to REPGB NLG 500 million (\$202 million) in January and February 2002. The payment represents a settlement of the obligations of the former shareholders to indemnify REPGB for all stranded cost liabilities other than those relating to the district heating contracts. The full amount of this payment was placed into an escrow account in the name of REPGB to fund its stranded cost obligations related to the gas and electric import contracts. Any remaining escrow funds as of January 1, 2004 will be distributed to REPGB.

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Under the settlement agreement, the former shareholders will continue to indemnify REPGb for the stranded cost liabilities relating to district heating contracts. The terms of the indemnity are as follows:

- The settlement agreement acknowledges that the Netherlands is finalizing regulations for compensation of stranded cost associated with district heating projects. Within 21 days after the date these compensation rules take effect, REPGb can elect to receive one of two forms of indemnification under the settlement agreement.
- If the compensation to be paid by the Netherlands under these rules is at least as much as the compensation to be paid under the original indemnification agreement, REPGb can elect to receive a one-time payment of NLG 60 million (\$24 million). In addition, unless the decree implementing the new compensation rules provides for compensation for the lifetime of the district heating projects, REPGb can receive an additional cash payment of NLG 15 million (\$6 million).
- If the compensation rules do not provide for compensation at least equal to that provided under the original indemnification agreement, REPGb can claim indemnification for stranded cost losses up to a maximum of NLG 700 million (\$282 million) less the amount of compensation provided by the new compensation rules and certain proceeds received from arbitrations.
- If no new compensation rules have taken effect on or prior to December 31, 2003, REPGb is entitled, but not obligated, to elect to receive indemnification under the formula described above.

Under the terms of the original indemnification agreement, the former shareholders were entitled to receive any and all distributions and dividends above NLG 125 million (\$51 million) paid by NEA. Under the settlement agreement, the former shareholders waived all rights under the original indemnification agreement to claim distributions of NEA.

Reliant Resources recognized a net gain of \$37 million for the difference between the sum of (a) the cash settlement payment of \$202 million and the additional rights to claim distributions of Reliant Resources' NEA investment recognized of \$248 million and (b) the amount recorded as stranded cost indemnity receivable related to the stranded cost gas and electric commitments of \$369 million and claims receivable related to stranded cost incurred in 2001 of \$44 million both previously recorded in the Consolidated Balance Sheets.

*Investment in NEA.* During the second quarter of 2001, Reliant Resources recorded a \$51 million pre-tax gain (NLG 125 million) recorded as equity income for the preacquisition gain contingency related to the acquisition of REPGb for the value of its equity investment in NEA. This gain was based on Reliant Resources' evaluation of NEA's financial position and fair value. The fair value of Reliant Resources' investment in NEA is dependent upon the ultimate resolution of its existing contingencies and proceeds received from liquidating its remaining net assets. Prior to the settlement agreement discussed above, pursuant to the purchase agreement of REPGb, as amended, REPGb was entitled to a NLG 125 million dividend from NEA with any remainder owing to the former shareholders. As mentioned above, REPGb entered into an agreement with its former shareholders to settle the original indemnification agreement and the former shareholders waived all rights to distributions of NEA. Accordingly, as a component of the net gain recognized from the settlement of the stranded cost indemnity, Reliant Resources recorded a \$248 million increase in its investment in NEA. As of December 31, 2001, Reliant Resources has recorded \$299 million in equity investments of unconsolidated subsidiaries for its investment in NEA.

*(i) Operations Agreement with City of San Antonio*

As part of the 1996 settlement of certain litigation claims asserted by the City of San Antonio with respect to the South Texas Project, the Company entered into a 10-year joint operations agreement under which the Company and the City of San Antonio, acting through the City Public Service Board of San Antonio (CPS), share savings resulting from the joint dispatching of their respective generating assets in

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order to take advantage of each system's lower cost resources. In January 2000, the contract term was extended for three years and is expected to terminate in 2009. Under the terms of the joint operations agreement entered into between CPS and Electric Operations, the Company has guaranteed CPS minimum annual savings of \$10 million up to a total cumulative savings of \$150 million over the term of the agreement. The cumulative obligation was met in the first quarter of 2001. In 1999, 2000 and 2001, savings generated for CPS' account were \$14 million, \$60 million and \$65 million, respectively. Through December 31, 2001, cumulative savings generated for CPS' account were \$189 million.

*(j) Nuclear Insurance*

The Company and the other owners of the South Texas Project maintain nuclear property and nuclear liability insurance coverage as required by law and periodically review available limits and coverage for additional protection. The owners of the South Texas Project currently maintain \$2.75 billion in property damage insurance coverage, which is above the legally required minimum, but is less than the total amount of insurance currently available for such losses.

Pursuant to the Price Anderson Act, the maximum liability to the public of owners of nuclear power plants was \$9.3 billion as of December 31, 2001. Owners are required under the Price Anderson Act to insure their liability for nuclear incidents and protective evacuations. The Company and the other owners of the South Texas Project currently maintain the required nuclear liability insurance and participate in the industry retrospective rating plan.

There can be no assurance that all potential losses or liabilities will be insurable, or that the amount of insurance will be sufficient to cover them. Any substantial losses not covered by insurance would have a material effect on the Company's financial condition, results of operations and cash flows.

*(k) Nuclear Decommissioning*

The Company contributed \$14.8 million per year in 1999, 2000 and 2001 to a trust established to fund its share of the decommissioning costs for the South Texas Project. Pursuant to the October 3, 2001 Order, beginning in 2002, the Company will contribute \$2.9 million per year to this trust. There are various investment restrictions imposed upon the Company by the Texas Utility Commission and the NRC relating to the Company's nuclear decommissioning trust. Additionally, the Company's board of directors has appointed the Nuclear Decommissioning Trust Investment Committee to establish the investment policy of the trust and oversee the investment of the trusts' assets. 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 and the remaining 54% were equity securities. For a discussion of the accounting treatment for the securities held in the Company's nuclear decommissioning trust, see Note 2(1). In July 1999, an outside consultant estimated the Company's portion of decommissioning costs to be approximately \$363 million. While the current funding levels currently exceed minimum NRC requirements, no assurance can be given that the amounts held in trust will be adequate to cover the actual decommissioning costs of the South Texas Project. Such costs may vary because of changes in the assumed date of decommissioning and changes in regulatory requirements, technology and costs of labor, materials and equipment. Pursuant to the Texas Electric Restructuring Law, costs associated with nuclear decommissioning that have not been recovered as of January 1, 2002, will continue to be subject to cost-of-service rate regulation and will be included in a charge to transmission and distribution customers. For information regarding the effect of the Business Separation Plan on funding of the nuclear decommissioning trust fund, see Note 4(b).

*(l) Construction Agency Agreement and Equipment Financing Structure*

In 2001, Reliant Resources, through several of its subsidiaries, entered into operative documents with special purpose entities to facilitate the development, construction, financing and leasing of several power

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generation projects. The special purpose entities are not consolidated by the Company. The special purpose entities have an aggregate financing commitment from equity and debt participants (Investors) of \$2.5 billion of which the last \$1.1 billion is currently available only if the cash is collateralized. The availability of the commitment is subject to satisfaction of various conditions, including the obligation to provide cash collateral for the loans and letters of credit outstanding on November 27, 2004. Reliant Resources, through several of its subsidiaries, acts as construction agent for the special purpose entities and is responsible for completing construction of these projects by December 31, 2004, but Reliant Resources has generally limited its risk during construction to an amount not in excess of 89.9% of costs incurred to date, except in certain events. Upon completion of an individual project and exercise of the lease option, Reliant Resources' subsidiaries will be required to make lease payments in an amount sufficient to provide a return to the Investors. If Reliant Resources does not exercise its option to lease any project upon its completion, Reliant Resources must purchase the project or remarket the project on behalf of the special purpose entities. Reliant Resources' ability to exercise the lease option is subject to certain conditions. Reliant Resources must guarantee that the Investors will receive an amount at least equal to 89.9% of their investment in the case of a remarketing sale at the end of construction. At the end of an individual project's initial operating lease term (approximately five years from construction completion), Reliant Resources' subsidiary lessees have the option to extend the lease with the approval of Investors, purchase the project at a fixed amount equal to the original construction cost, or act as a remarketing agent and sell the project to an independent third party. If the lessees elect the remarketing option, they may be required to make a payment of an amount not to exceed 85% of the project cost, if the proceeds from remarketing are not sufficient to repay the Investors. Reliant Resources has guaranteed the performance and payment of its subsidiaries' obligations during the construction periods and, if the lease option is exercised, each lessee's obligations during the lease period. At any time during the construction period or during the lease, Reliant Resources may purchase a facility by paying an amount approximately equal to the outstanding balance plus costs.

Reliant Resources, through its subsidiary, REPG, has entered into an agreement with a bank whereby the bank, as owner, entered or will enter into contracts for the purchase and construction of power generation equipment and REPG, or its subagent, acts as the bank's agent in connection with administering the contracts for such equipment. Under the agreement, the bank has agreed to provide up to a maximum aggregate amount of \$650 million. REPG and its subagents must cash collateralize their obligation to administer the contracts. This cash collateral is approximately equivalent to the total payments by the bank for the equipment, interest and other fees. As of December 31, 2001, the bank had assumed contracts for the purchase of eleven turbines, two heat recovery steam generators and one air-cooled condenser with an aggregate cost of \$398 million. REPG, or its designee, has the option at any time to purchase, or, at equipment completion, subject to certain conditions, including the agreement of the bank to extend financing, to lease the equipment, or to assist in the remarketing of the equipment under terms specified in the agreement. All costs, including the purchase commitment on the turbines, are the responsibility of the bank. The cash collateral is deposited by REPG or an affiliate into a collateral account with the bank and earns interest at LIBOR less 0.15%. Under certain circumstances, the collateral deposit or a portion of it, will be returned to REPG or its designee. Otherwise, it will be retained by the bank. At December 31, 2001, REPG and its subsidiary had deposited \$230 million into the collateral account. The bank's payments for equipment under the contracts totaled \$227 million as of December 31, 2001. In January 2002, the bank sold to the parties to the construction agency agreements discussed above, equipment contracts with a total contractual obligation of \$258 million, under which payments and interest during construction totaled \$142 million. Accordingly, \$142 million of Reliant Resources' collateral deposits were returned to Reliant Resources. As of December 31, 2001, there were equipment contracts with a total contractual obligation of \$140 million under which payments during construction totaled \$83 million. Currently this equipment is not designated for current planned power generation construction projects. Therefore, the Company anticipates that it will either purchase the equipment, assist in the remarketing of the equipment or negotiate to cancel the related contracts.

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

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

The fair values of cash and cash equivalents, investments in debt and equity securities classified as "available-for-sale" and "trading" in accordance with SFAS No. 115, and short-term borrowings are estimated to be approximately equivalent to carrying amounts and have been excluded from the table below. The fair value of financial instruments included in the trading operations are marked-to-market at December 31, 2000 and 2001 (see Note 5). The fair values of non-trading derivative assets and liabilities are recognized in the Consolidated Balance Sheets at December 31, 2001 (see Note 5). Therefore, these financial instruments are stated at fair value and are excluded from the table below. The fair values of non-trading derivative assets and liabilities as of December 31, 2000 have been determined using quoted market prices for the same or similar instruments when available or other estimation techniques.

	<u>December 31, 2000</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>
	(In millions)	
Financial assets:		
Energy derivatives — non-trading .....	\$ —	\$ 520
Financial liabilities:		
Long-term debt (excluding capital leases) .....	6,607	6,512
Trust preferred securities .....	705	665
Energy derivatives — non-trading .....	—	69
Foreign currency swaps .....	62	68
	<u>December 31, 2001</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>
	(In millions)	
Financial liabilities:		
Long-term debt (excluding capital leases) .....	\$6,391	\$6,406
Trust preferred securities .....	706	664

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

**(16) Earnings Per Share**

The following table reconciles numerators and denominators of the Company's basic and diluted earnings per share (EPS) calculations:

	For the Year Ended December 31,		
	1999	2000	2001
	(In millions, except per share and share amounts)		
Basic EPS calculation:			
Income before extraordinary items and cumulative effect of accounting change .....	\$ 1,665	\$ 440	\$ 919
Extraordinary items .....	(183)	7	—
Cumulative effect of accounting change, net of tax .....	—	—	61
Net income attributable to common stockholders .....	<u>\$ 1,482</u>	<u>\$ 447</u>	<u>\$ 980</u>
Weighted average shares outstanding .....	285,040,000	284,652,000	289,776,000
Basic EPS:			
Income before extraordinary items and cumulative effect of accounting change .....	\$ 5.84	\$ 1.54	\$ 3.17
Extraordinary items .....	(0.64)	0.03	—
Cumulative effect of accounting change, net of tax .....	—	—	0.21
Net income attributable to common stockholders .....	<u>\$ 5.20</u>	<u>\$ 1.57</u>	<u>\$ 3.38</u>
Diluted EPS calculation:			
Net income attributable to common stockholders .....	\$ 1,482	\$ 447	\$ 980
Plus: Income impact of assumed conversions:			
Interest on 6¼% convertible trust preferred securities .....	—	—	—
Total earnings effect assuming dilution .....	<u>\$ 1,482</u>	<u>\$ 447</u>	<u>\$ 980</u>
Weighted average shares outstanding .....	285,040,000	284,652,000	289,776,000
Plus: Incremental shares from assumed conversions(1)			
Stock options .....	260,000	1,652,000	1,650,000
Restricted stock .....	698,000	955,000	754,000
6¼% convertible trust preferred securities .....	23,000	14,000	13,000
Weighted average shares assuming dilution .....	<u>286,021,000</u>	<u>287,273,000</u>	<u>292,193,000</u>
Diluted EPS:			
Income before extraordinary items and cumulative effect of accounting change .....	\$ 5.82	\$ 1.53	\$ 3.14
Extraordinary items .....	(0.64)	0.03	—
Cumulative effect of accounting change, net of tax .....	—	—	0.21
Net income attributable to common stockholders .....	<u>\$ 5.18</u>	<u>\$ 1.56</u>	<u>\$ 3.35</u>

- (1) Options to purchase 433,915, 442,385 and 2,074,437 shares were outstanding for the years ended December 31, 1999, 2000 and 2001, respectively, but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares for the respective years.



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

**(17) Restated Unaudited Quarterly Information**

As discussed in Note 1, the unaudited quarterly financial data for the interim periods ended March 31, 2001, June 30, 2000 and 2001, September 30, 2000 and 2001 and December 31, 2000 and 2001 have been restated from amounts previously reported to reflect certain transactions on a net basis. 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 unaudited quarterly information for the quarters ended March 31, 2000 and 2001, June 30, 2000 and 2001, September 30, 2000 and 2001, and December 31, 2000 and 2001: (Note — Those line items for which no change in amounts are shown were not affected by the restatement.)

	Year Ended December 31, 2000		
	First Quarter	Second Quarter	
	As Previously Reported	As Restated (In millions)	As Previously Reported
Revenues .....	\$4,213	\$5,719	\$5,755
Fuel and cost of gas sold .....	2,333	2,915	2,922
Purchased power .....	785	1,377	1,406
Operating income .....	346	508	508
Income before extraordinary item .....	133	217	217
Extraordinary item, net of tax .....	—	7	7
Net income attributable to common stockholders .....	133	224	224
<b>Basic Earnings Per Share:(1)</b>			
Income before extraordinary item .....	\$ 0.47	\$ 0.76	\$ 0.76
Extraordinary item, net of tax .....	—	0.03	0.03
Net income attributable to common stockholders .....	<u>\$ 0.47</u>	<u>\$ 0.79</u>	<u>\$ 0.79</u>
<b>Diluted Earnings Per Share:(1)</b>			
Income before extraordinary item .....	\$ 0.47	\$ 0.75	\$ 0.75
Extraordinary item, net of tax .....	—	0.03	0.03
Net income attributable to common stockholders .....	<u>\$ 0.47</u>	<u>\$ 0.78</u>	<u>\$ 0.78</u>

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

Year Ended December 31, 2000				
	Third Quarter		Fourth Quarter	
	As Restated	As Previously Reported	As Restated	As Previously Reported
	(In millions)			
Revenues .....	\$9,109	\$9,502	\$9,228	\$9,869
Fuel and cost of gas sold .....	3,882	3,895	5,920	5,927
Purchased power .....	3,428	3,808	1,990	2,624
Operating income .....	778	778	205	205
Income before extraordinary item .....	389	389	(299)	(299)
Extraordinary item, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	389	389	(299)	(299)
<b>Basic Earnings Per Share:(1)</b>				
Income before extraordinary item .....	\$ 1.36	\$ 1.36	\$(1.04)	\$(1.04)
Extraordinary item, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	<u>\$ 1.36</u>	<u>\$ 1.36</u>	<u>\$(1.04)</u>	<u>\$(1.04)</u>
<b>Diluted Earnings Per Share:(1)</b>				
Income before extraordinary item .....	\$ 1.34	\$ 1.34	\$(1.04)	\$(1.04)
Extraordinary item, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	<u>\$ 1.34</u>	<u>\$ 1.34</u>	<u>\$(1.04)</u>	<u>\$(1.04)</u>
Year Ended December 31, 2001				
	First Quarter		Second Quarter	
	As Restated	As Previously Reported	As Restated	As Previously Reported
	(In millions)			
Revenues .....	\$12,052	\$13,284	\$10,269	\$11,991
Fuel and cost of gas sold .....	7,666	7,667	5,008	5,313
Purchased power .....	2,877	4,108	3,660	5,077
Operating income .....	454	454	614	614
Income before cumulative effect of accounting change .....	201	201	316	316
Cumulative effect of accounting change, net of tax .....	61	61	—	—
Net income attributable to common stockholders .....	262	262	316	316
<b>Basic Earnings Per Share:(1)</b>				
Income before cumulative effect of accounting change .....	\$ 0.69	\$ 0.69	\$ 1.09	\$ 1.09
Cumulative effect of accounting change, net of tax .....	<u>0.22</u>	<u>0.22</u>	<u>—</u>	<u>—</u>
Net income attributable to common stockholders .....	<u>\$ 0.91</u>	<u>\$ 0.91</u>	<u>\$ 1.09</u>	<u>\$ 1.09</u>
<b>Diluted Earnings Per Share:(1)</b>				
Income before cumulative effect of accounting change .....	\$ 0.69	\$ 0.69	\$ 1.08	\$ 1.08
Cumulative effect of accounting change, net of tax .....	<u>0.21</u>	<u>0.21</u>	<u>—</u>	<u>—</u>
Net income attributable to common stockholders .....	<u>\$ 0.90</u>	<u>\$ 0.90</u>	<u>\$ 1.08</u>	<u>\$ 1.08</u>

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

	Year Ended December 31, 2001			
	Third Quarter		Fourth Quarter	
	As Restated	As Previously Reported	As Restated	As Previously Reported
	(In millions)			
Revenues .....	\$10,903	\$12,511	\$7,586	\$8,440
Fuel and cost of gas sold .....	3,667	3,928	3,163	3,167
Purchased power .....	5,348	6,695	3,242	4,092
Operating income .....	779	779	146	146
Income before cumulative effect of accounting change .....	355	355	47	47
Cumulative effect of accounting change, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	355	355	47	47
<b>Basic Earnings Per Share:(1)</b>				
Income before cumulative effect of accounting change .....	\$ 1.22	\$ 1.22	\$ 0.16	\$ 0.16
Cumulative effect of accounting change, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	<u>\$ 1.22</u>	<u>\$ 1.22</u>	<u>\$ 0.16</u>	<u>\$ 0.16</u>
<b>Diluted Earnings Per Share:(1)</b>				
Income before cumulative effect of accounting change .....	\$ 1.21	\$ 1.21	\$ 0.16	\$ 0.16
Cumulative effect of accounting change, net of tax .....	—	—	—	—
Net income attributable to common stockholders .....	<u>\$ 1.21</u>	<u>\$ 1.21</u>	<u>\$ 0.16</u>	<u>\$ 0.16</u>

(1) Quarterly earnings per common share are based on the weighted average number of shares outstanding during the quarter, and the sum of the quarters may not equal annual earnings per common share.

The quarterly operating results incorporate the results of operations of REMA from its respective acquisition date as discussed in Note 3 (a). The variances in revenues, operating income and net income (loss) from quarter to quarter were primarily due to this acquisition, the seasonal fluctuations in demand for energy and energy services and changes in energy commodity prices and the timing of maintenance expenses on electric generation plants.

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 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 Company's remaining Latin America investments were terminated as a result of the recent adverse economic developments in Argentina.

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 Statements of Consolidated 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 EITF 90-6. For additional discussion of our Latin America business segment, see Note 19.

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

**(18) Reportable Business Segments**

The Company's determination of reportable business segments considers the strategic operating units under which the Company manages sales, allocates resources and assesses performance of various products and services to wholesale or retail customers in differing regulatory environments. Financial information for REMA and REPGb are included in the business segment disclosures only for periods beginning on their respective acquisition dates. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies except that some executive benefit costs have not been allocated to business segments. The Company evaluates performance based on operating income excluding some corporate costs not allocated to the business segments. Long-lived assets include net property, plant and equipment, net goodwill, net air emissions regulatory allowances and other intangibles and equity investments in unconsolidated subsidiaries. The Company accounts for intersegment sales as if the sales were to third parties, that is, at current market prices. In the fourth quarter of 2000, the Company transferred its non-rate regulated retail gas marketing operations from Retail Energy to Natural Gas Distribution and its natural gas gathering business from Wholesale Energy to Pipelines and Gathering. In the third quarter of 2001, the Company began reporting the results of its unregulated retail electric business as a separate business segment entitled "Retail Energy". Historically, Retail Energy's operations had been reported as part of the Other Operations business segment. Reportable business segments from previous years have been restated to conform to the 2001 presentation.

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 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 Company's remaining assets in Argentina were terminated as a result of the recent adverse 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.

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

The Company has identified the following reportable business segments: Electric Operations, Natural Gas Distribution, Pipelines and Gathering, Wholesale Energy, European Energy, Retail Energy, Latin America and Other Operations. For a description of the financial reporting business segments, see Note 1. Financial data for business segments, products and services and geographic areas are as follows:

	Electric Operations	Natural Gas Distribution	Pipelines and Gathering	Wholesale Energy	European Energy	Retail Energy	Latin America/ Assets Held for Sale	Other Operations	Reconciling Eliminations	Consolidated
	(In millions)									
As of and for the year ended December 31, 1999:										
Revenues from external customers .....	\$ 4,483	\$2,742	\$ 151	\$ 6,231	\$ 153	\$ 23	\$ —	\$ 11	\$ —	\$13,794
Intersegment revenues .....	—	46	180	264	—	—	—	1	(491)	—
Depreciation and amortization .....	667	137	53	21	21	—	—	6	—	905
Operating income (loss) .....	981	158	131	27	32	(14)	(4)	(52)	—	1,259
Total assets .....	9,941	3,683	2,486	2,821	3,247	51	1,078	4,257	(1,107)	26,457
Equity investments in unconsolidated subsidiaries .....	—	—	—	78	—	—	—	—	—	78
Expenditures for long-lived assets .....	573	206	79	481	834	45	—	44	—	2,262
As of and for the year ended December 31, 2000:										
Revenues from external customers .....	5,494	4,470	177	17,494	580	41	—	13	—	28,269
Intersegment revenues .....	—	34	207	578	—	23	—	1	(843)	—
Depreciation and amortization .....	507	145	56	108	76	4	—	10	—	906
Operating income (loss) .....	1,230	118	137	479	89	(70)	(44)	(102)	—	1,837
Total assets .....	10,691	4,518	2,358	11,148	2,521	151	195	1,486	(1,108)	31,960
Equity investments in unconsolidated subsidiaries .....	—	—	—	109	—	—	—	—	—	109
Expenditures for long-lived assets .....	643	195	61	1,966	995	28	—	63	—	3,951
As of and for the year ended December 31, 2001:										
Revenues from external customers .....	5,503	4,638	225	29,075	1,192	154	—	23	—	40,810
Intersegment revenues .....	2	104	190	667	—	57	—	2	(1,022)	—
Depreciation and amortization .....	453	147	58	118	76	11	—	48	—	911
Operating income (loss) .....	1,091	130	137	899	56	(13)	(75)	(232)	—	1,993
Total assets .....	12,012	3,732	2,361	8,290	3,380	391	8	1,438	(931)	30,681
Equity investments in unconsolidated subsidiaries .....	—	—	—	88	299	—	—	—	—	387
Expenditures for long-lived assets .....	936	209	54	658	21	117	—	58	—	2,053

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

	Year Ended December 31,		
	1999	2000	2001
	(In millions)		
<b>Reconciliation of Operating Income to Net Income Attributable to Common Stockholders:</b>			
Operating income .....	\$ 1,259	\$ 1,837	\$ 1,993
(Loss) income from equity investments in unconsolidated subsidiaries .....	(1)	43	57
Gain (loss) on AOL Time Warner investment .....	2,452	(205)	(70)
(Loss) gain on indexed debt securities .....	(630)	102	58
Operating results from equity investments in unconsolidated Latin America assets .....	(26)	(41)	—
Impairment of Latin America unconsolidated equity investments .....	—	(131)	(4)
Loss on disposal of Latin America assets .....	—	(176)	—
Interest expense and other charges .....	(551)	(768)	(658)
Minority interest .....	1	1	(81)
Other income, net .....	60	96	124
Income tax expense .....	(899)	(318)	(500)
Extraordinary (loss) gain, net of tax .....	(183)	7	—
Cumulative effect of accounting change, net of tax .....	—	—	61
Net income attributable to common stockholders .....	<u>\$ 1,482</u>	<u>\$ 447</u>	<u>\$ 980</u>
<b>Revenues by Products and Services:</b>			
Retail power sales .....	\$ 4,483	\$ 5,494	\$ 5,503
Retail gas sales .....	2,742	4,383	4,546
Wholesale energy and energy related sales .....	6,383	18,073	30,267
Gas transport .....	151	177	225
Energy products and services .....	35	142	269
Total .....	<u>\$13,794</u>	<u>\$28,269</u>	<u>\$40,810</u>
<b>Revenues and Long-Lived Assets by Geographic Areas:</b>			
<b>Revenues:</b>			
US .....	\$13,524	\$26,640	\$37,295
Netherlands .....	153	580	1,192
Other .....	117	1,049	2,323
Total .....	<u>\$13,794</u>	<u>\$28,269</u>	<u>\$40,810</u>
<b>Long-lived assets:</b>			
US .....	\$13,605	\$16,079	\$16,724
Netherlands .....	2,648	2,371	2,424
Total .....	<u>\$16,253</u>	<u>\$18,450</u>	<u>\$19,148</u>

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

After the Distribution, CenterPoint Energy's business will consist principally of regulated operations. As a result, CenterPoint Energy's business segments will consist of the following:

- Electric Transmission and Distribution;
- Electric Generation;
- Natural Gas Distribution;
- Pipelines and Gathering; and
- Other Operations.

The Wholesale Energy, European Energy, Retail Energy and unregulated portions of our Other Operations business segments will be conducted by Reliant Resources as a separate publicly traded company. The operations conducted by the Electric Generation business segment may also be acquired by Reliant Resources in January 2004 pursuant to the Texas Genco Option. For additional information, see Note 4(b).

**(19) Discontinued Operations and Assets Held for Sale**

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 APB Opinion No. 30 for each of the three years in the period ended December 31, 2000.

In the fourth quarter of 2000, the Latin America business segment sold its investments in El Salvador, Colombia and Brazil for an aggregate \$790 million in after-tax proceeds. The Company recorded a \$242 million after-tax (\$294 million pre-tax) loss in connection with the sale of these investments. The Company, through its subsidiaries, continues to operate investments in Argentina which include a 100% interest in a 160 MW cogeneration project, Argener, and a 90% interest in a utility, EDESE (collectively, the Argentine Investments).

In the fourth quarter of 2000 and in the first quarter of 2001, the Company recorded additional after-tax impairments related to the Argentine Investments of \$89 million and \$7 million (\$95 million and \$6 million pre-tax), respectively, based on the expected net realizable value of the businesses upon their disposition.

On December 20, 2001, negotiations for the sale of the Argentine Investments were terminated as a result of the recent adverse 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 Statements of Consolidated 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 EITF 90-6.

During December 2001, the Company concluded there were indicators of impairment related to the remaining assets in this business segment, and accordingly, an impairment evaluation was conducted at the end of the fourth quarter under the guidelines of SFAS No. 121. This evaluation resulted in an after-tax impairment charge of \$43 million (\$80 million pre-tax), representing the excess of book value over estimated net realizable value. As of December 31, 2001, the Company had \$8 million of Latin America net assets held for sale recorded in its Consolidated Balance Sheets. The fair value of the remaining net assets was determined using a net discounted cash flows approach. The charge was included as a component of operating income with respect to consolidated subsidiaries and other income with respect to equity investments in

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

unconsolidated subsidiaries. The impairment was primarily related to the recent economic deterioration in Argentina.

**(20) Reliant Energy Communications**

During the third quarter of 2001, management decided to exit the Company's Communications business which served as a facility-based competitive local exchange carrier and Internet services provider and owned network operations centers and managed data centers in Houston and Austin. Consequently, the Company determined the goodwill associated with the Communications business was impaired. The Company recorded a total of \$54 million of pre-tax disposal charges in the third and fourth quarters of 2001. These charges included the write-off of goodwill of \$19 million, fixed asset impairments of \$22 million, and severance accruals and other incremental costs associated with exiting the Communications business, totaling \$13 million.

**(21) Bankruptcy of Enron Corp. and its Affiliates**

During the fourth quarter of 2001, Enron filed a voluntary petition for bankruptcy. Accordingly, the Company recorded an \$85 million provision, comprised of provisions against 100% of receivables of \$88 million and net non-trading derivative balances of \$52 million, offset by the Company's net trading and marketing liabilities to Enron of \$55 million.

The non-trading derivatives with Enron were designated as Cash Flow Hedges (see Note 5). The net gain on these derivative instruments previously reported in other comprehensive income will remain in accumulated other comprehensive loss and will be reclassified into earnings during the period in which the originally designated hedged transactions occur.

**(22) Subsequent Events**

***(a) Orion Power Holdings, Inc.***

In February 2002, Reliant Resources acquired all of the outstanding shares of Orion Power for \$26.80 per share in cash for an aggregate purchase price of \$2.9 billion. Reliant Resources funded the Orion Power acquisition with a term loan supported by a \$2.9 billion credit facility and \$41 million of cash on hand. Interest rates on the term loan are based on LIBOR plus a margin or a base rate. The term loan must be repaid within one year from the date on which it was funded. As a result of the acquisition, Reliant Resources' consolidated net debt obligations also increased by the amount of Orion Power's net debt obligations. As of February 19, 2002, Orion Power's debt obligations were \$2.4 billion (\$2.1 billion net of cash acquired some of which is restricted pursuant to debt covenants). Orion Power is an independent electric power generating company formed in March 1998 to acquire, develop, own and operate power-generating facilities in certain deregulated wholesale markets throughout North America. As of February 28, 2002, Orion Power had 81 power plants in operation with a total generating capacity of 5,644 MW and an additional 804 MW in construction or in various stages of development.

***(b) Factoring Agreement***

In the first quarter of 2002, RERC reduced its trade receivables facility from \$350 million to \$150 million. Borrowings under the receivables facility aggregating \$196 million were repaid in January 2002 with proceeds from the issuance of commercial paper under RERC's \$350 million revolving credit facility and from the liquidation of short-term investments.



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

***(c) Interest Rate Swaps***

In the first quarter of 2002, the Company entered into interest rate swaps with an aggregate notional amount of \$1.25 billion. Swaps with a notional amount of \$250 million were entered into for the purpose of fixing rates on short-term debt subject to interest rate fluctuations and do not qualify as cash flow hedges under SFAS No. 133. The swaps with a notional amount of \$1 billion were entered into to hedge the interest rate on a future offering of five-year fixed rate notes. These swaps qualify as cash flow hedges under SFAS No. 133.

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Reliant Energy, Incorporated and Subsidiaries:  
Houston, Texas

We have audited the accompanying consolidated balance sheets of Reliant Energy, Incorporated and its subsidiaries (the Company) as of December 31, 2000 and 2001, and the related consolidated statements of income, stockholders' equity, comprehensive income and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14(a)(2). These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2000 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 5 to the consolidated financial statements, the Company changed its method of accounting for derivatives and hedging activities in 2001.

As discussed in Note 1 to the consolidated financial statements, the accompanying consolidated financial statements have been restated.

DELOITTE & TOUCHE LLP

March 28, 2002

(July 3, 2002 as to the effects of the restatement discussed in Note 1)