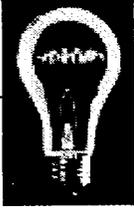
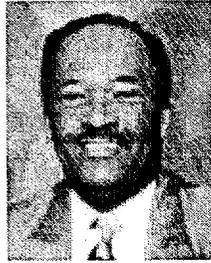


Committed to the People We Serve





BOARD OF TRUSTEES



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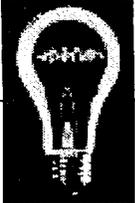


Howard W. Peak
Ex-officio Trustee
Mayor of San Antonio

CITIZENS ADVISORY COMMITTEE



(Left to Right) Reynaldo Nieto, Dominick Dina, Verna Eskridge, Gary G. Candy, Lee Jaye Rosenberg, Harold Tillman, Robert Eddie De La Garza, Susan Hughes, Jesse Frank Jenkins, Manuel R. Garcia III.
Not Pictured: Chairman Louis Edward Rowe, Raymond Aguillon, Jr., Royal Hammond, Jr.



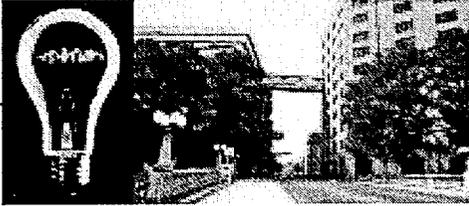
SENIOR MANAGEMENT TEAM



(Left to Right) General Manager and CEO Jamie A. Rochelle; Senior Vice President - Energy Supply William C. Gunst; Senior Vice President - Technical Services Joe O. Trevino; Senior Vice President - Customer and Energy Services Nadine L. Knaus; Senior Vice President - Electric Transmission and Distribution Systems Milton B. Lee II; Senior Vice President - Finance and Administration, and Secretary-Treasurer V. Gory Schaub.

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MESSAGE FROM THE CHAIRMAN AND CEO

Committed to ...

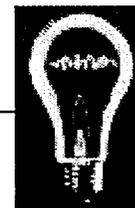
*The People We Serve —
Our Customers, Bondholders, The City, and Our Employees*



Clayton T. Gay Jr., CPS Board Chairman



Jamie A. Rochelle, General Manager and CEO



MESSAGE FROM THE CHAIRMAN AND CEO

City Public Service (CPS) enjoyed a year marked by numerous accomplishments and milestones. These were all realized in accordance with our mission “to produce and deliver high-value energy related products and services to meet the changing needs of our customers in the growing marketplace.” The marketplace is not only growing, it is changing rapidly, spurred on by the June 1999 passage of Senate Bill 7 (SB7), the Texas Electric Industry Restructuring Bill.

We realize that to maintain our successful status as one of the top municipally owned utilities, CPS must continuously exceed the expectations of our major stakeholders. This has been at the forefront of our initiatives this year to prepare for utility restructuring in Texas.

The most important stakeholders are our customers. Offering reliable service and excellent value continue to be the centerpiece of CPS’ customer-focused culture. We have embarked upon many new programs to address customer issues and needs, and to offer multiple products and services with convenient pricing and terms. Increased customer satisfaction levels were reflected in improved results from the J.D. Power & Associates Study and other customer surveys initiated this year. We utilized the results of such studies to stay focused on and in touch with our customers’ needs and perceptions.

As key stakeholders, our bondholders have recognized CPS’ financial strength and stability. We continuously review market opportunities to minimize costs and maximize our financial position and growth, while honoring our debt covenants. Fiscal year 2001 was no exception as we completed several strategic financial transactions that further strengthened our already healthy outlook. The historic lease/leaseback of the J.K. Spruce coal-fired plant netted over \$75 million for CPS. The \$216 million cash defeasance of debt coupled with the \$221 million new money bond issue were strategically implemented to reduce debt service. During the year, we maintained our excellent debt ratings, which are among the highest awarded by the nation’s principal bond rating agencies to municipal electric utilities.

The major benefactor of our ongoing success in financial and operating results is our owner, the City of San Antonio and its citizens. Since 1942, when CPS was purchased by the City, the utility has provided over \$2.7 billion in benefits to the City. In fiscal year 2001, City payments totaled approximately \$185 million, representing a growing source of revenue for the City. In addition, the City was advanced \$12 million as part of the lease/leaseback transaction. As a result, San Antonio’s equity in CPS rose to over \$2.1 billion at fiscal year-end.

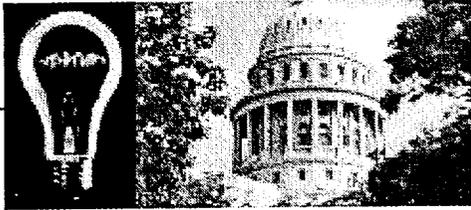
CPS also returns value to the local economy through our workforce and numerous supplier diversity programs. This year CPS received the Dwight D. Eisenhower Award for Excellence. CPS was recognized by the federal government for its utilization of small businesses in its purchasing and contracting activities. CPS’ annual payroll totaled \$164 million, representing a significant contribution to the local economy. We intend to remain fully responsive to our City’s concerns in every way possible, developing a mutually beneficial relationship.

All of this year’s major achievements would not have been possible without our most important resource — CPS’ spirited employees! Almost 4,000 highly skilled, dedicated and talented individuals drive CPS. Our employees contributed to a record-breaking United Way campaign and donated numerous hours of volunteer community service. Efforts to prepare for a fast-paced, restructured environment continued this year as new empowerment training and leadership programs were made available to our employees. In addition, we initiated market-based compensation programs with performance-based incentive pay and benefits packages to attract and retain the most capable workforce.

By acting upon the ongoing pledge to our major stakeholders, CPS will flourish in the changing environment, remaining the energy provider of choice. We are committed to maintaining our strong financial position; our respected status as a value-driven, low-cost utility; and our leadership position as the second largest municipally owned utility in the nation. Our commitment is to ultimately provide the best for our customers. At CPS, we are COMMITTED TO THE PEOPLE WE SERVE!

Clayton T. Gay Jr.
Chairman of the CPS Board of Trustees 2000–2001

Jamie A. Rochelle
General Manager and CEO



UTILITY RESTRUCTURING

Committed to ...

Preparing and Planning for Industry, Legal, and Regulatory Changes



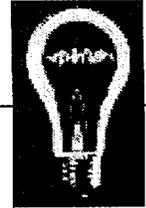
The CPS Regulatory Team includes (Left to Right) Les Barrow, Milton B. Lee, Maryann Randall, Steve Bartley, Dan Jones, Kathleen Garcia, and Lori Johnson.



CPS' bilingual deregulation brochure informs the community about electric restructuring.



CPS General Manager and CEO Jamie A. Rochelle and CPS employees are showcased in the deregulation campaign.



UTILITY RESTRUCTURING

The electric utility industry is rapidly changing across the nation due to the onset of deregulation. In Texas, electric industry restructuring attained a milestone in 1999 with the passage of SB7. On January 1, 2002, Investor Owned Utilities (IOUs) are required to open up their retail markets to competition, while remaining under price rate controls for a period. By that date, they are also required to unbundle generation, transmission, distribution, and retail energy sales functions into separate organizations. Initial pilot programs for retail competition are expected to begin in the summer of 2001.

The legislative process recognized the unique relationship that municipally owned electric utilities (MOUs) and rural electric cooperatives have with the public. As a result, MOUs have been given the choice under SB7, of whether or not to participate in the competitive electric retail market. As a municipality, CPS will coordinate the decision with its governing body, the City of San Antonio, regarding the irrevocable election strategy. This year CPS has been actively preparing for the utility's future under either option.

A CPS Market Readiness Team was formed in July 2000 to actively participate in and respond to state electric utility restructuring activities. This cross-functional management team has been interacting with the Electric Reliability Council of Texas (ERCOT) and other Independent System Operator (ISO) participants to assure CPS is involved in and prepared for upcoming requirements as a wholesale participant in the competitive market. During the year, CPS senior management served on the ERCOT Board and actively participated in policy development for the new ISO.

An executive reorganization occurred at midyear that better enables the utility to meet customer needs in a changing energy environment. The reorganization enlisted new skills and experience, and divided responsibilities to be more in line with operations in a more customer-focused structure.

CPS continued its efforts to unbundle revenue and costs into separately identifiable functions, comparable to the process required by SB7 for IOUs.

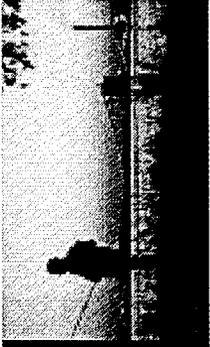
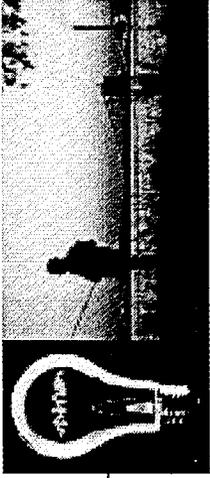
An interdisciplinary team of CPS management and staff worked extensively with the Texas Public Power Association (TPPA) and its members to provide guidance and ideas for the Public Utility Commission of Texas (PUCT) staff on the code of conduct project for municipal utilities participating in retail competition. As a result, the PUCT adopted final regulations that favorably recognize the unique issues and operating requirements of MOUs.

Besides its strong leadership role in the TPPA, the utility continued its very active participation in the American Public Power Association (APPA). Management and staff company-wide have been involved in various ongoing programs and committees within the APPA. At the national level, this industry group has continued and heightened its efforts to reach legislators, regulators, and consumers with more facts about the value of public power.

Arthur von Rosenberg, CPS' former General Manager and CEO who currently sits on the APPA Board, was selected as the 2000 recipient of the APPA's James D. Donovan Individual Achievements Award. The Donovan award is given to nominees whose personal achievements have impacted the electric utility industry generally and have contributed substantially to public power.

CPS legal and governmental affairs teams in San Antonio and Austin have actively represented our interests before legislators and regulatory bodies. They continuously monitor the activities of powerful interests within the industry, such as independent power marketers, for actions that might impact CPS.

In the late fall, CPS unveiled its deregulation information campaign to the public. This major media event was designed to better educate our customers about the facts of deregulation within Texas and the nation. CPS reaffirmed its promise to be "Committed to the People We Serve" and assured customers that we will be ready to face the challenges of statewide electric utility restructuring. This bilingual educational campaign included mailings to all customers in November and encompassed all forms of print and broadcast media.



ENVIRONMENT

Committed to ...

Preserving and Protecting Our Environment



Energy Education Section Supervisor Pete Bernal awards an electric lawnmower to a CPS customer on the CPS produced "Home & Lifestyle" television show.



CPS' environmental programs include an award-winning recycling program.



ENVIRONMENT

CPS' commitment to environmental excellence is one of our highest priorities. The utility has an Environmental Division of experienced and highly qualified individuals who are committed to following the legal and regulatory standards established for the utility by federal, state, and local authorities. They provide professional oversight and guidance to CPS staff to ensure compliance with corporate policies and strategies on environmental matters.

CPS power plants are already among the cleanest in the nation and will become cleaner in the near future. We have embarked upon an ambitious program to reduce emissions from our power plants. In 1998, a three-year program was introduced to reduce Nitrogen Oxide (NOx) emissions from CPS power plants. As the program nears completion, we have lowered NOx emissions by 30 percent, exceeding our original goal of 15 percent.

CPS demonstrated its commitment to reduce emissions when we began commercial operation of the combined-cycle plant in June 2000. The von Rosenberg Generating Station uses cleaner burning natural gas for fuel, employing both combustion controls and Selective Catalytic Reduction System to further reduce NOx emissions. It is now the lowest NOx emitting plant in Texas. In support of our ongoing commitment to environmental protection, we are striving to reduce NOx emissions by 50 percent system-wide before 2005.

Since its inception, CPS' "Mow Down Smog" lawn mower rebate program has removed over 2,000 pieces of gasoline-powered lawn equipment and replaced them with virtually pollution-free electric lawn equipment. The program includes mowers and tools such as edgers, string trimmers, and chainsaws. Other ozone programs include the purchase of alternative-fueled vehicles, use of cleaner-burning gasoline in CPS' fleet, and ambient monitoring downwind of CPS power plants.

CPS' support of environmental protection also includes water resource management. Braunig and Calaveras Lakes were built as cooling sources for the power plants at those locations. By using these lakes to cool power plants, CPS saves the Edwards Aquifer up to 40,000 acre-feet of water each year. We continue to monitor the quality of our plant water discharges as required in our permits.

Braunig and Calaveras Lakes are also two of the largest municipally owned reservoirs to operate a successful fishery. CPS awarded a \$100,000 grant to the Texas Parks and Wildlife Department's Inland Fisheries Division to maintain and promote the fisheries. In addition to fishing, the lakes also provide easy access to public recreation such as boating and camping.

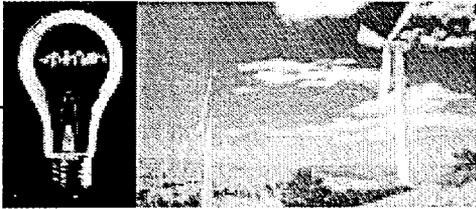
In conjunction with San Antonio Water System and Bexar Metro Water District, CPS continued its joint appliance rebate program. The utilities gave cash rebates to customers who purchased laundry appliances with efficient energy and water ratings. Since 1998, over 5,000 customers have participated.

CPS, the City, and other local organizations sponsored the Energy 2000 Symposium in February. During that time, local and national experts presented information about renewable energy options, such as solar power.

Conservation efforts also include our award-winning recycling program. For many years, CPS has been maintaining its efforts to recycle and manage materials. These include the recovery of usable products, the reduction of waste through more efficient processes, and the use of environmentally preferable products. Through these comprehensive efforts, we have reduced costs for our customers while conserving natural resources.

When completed in the spring of 2002, CPS' new Northside Customer Service Center will be another hallmark of our environmental initiatives. In addition to providing all of the usual customer service functions, the center will test and demonstrate new forms of renewable and alternative energy sources. Called "Solar Serve," the project represents a \$7.3 million renovation, \$3.2 million of which will be applied to the development of "green energy" systems. This model facility will showcase the utility's recent product offerings, like Windtricity™, and other green technologies such as solar power, gas-powered AC, and photovoltaic systems.

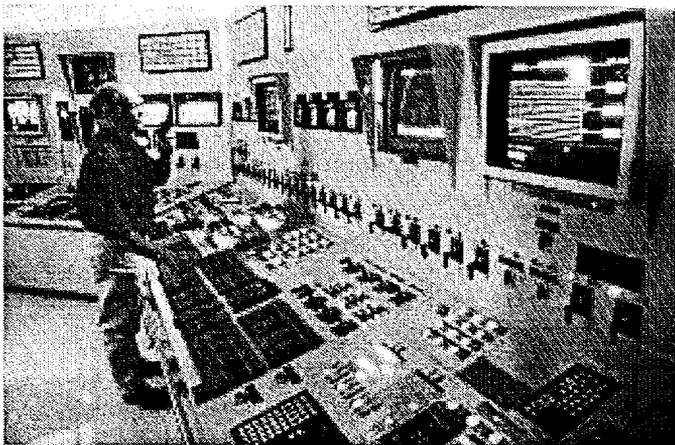
CPS believes that protecting our environment is a primary corporate responsibility. Over the years, our proactive environmental programs have been recognized with numerous state and federal awards. In the future, we will be fully committed to improving environmental performance by safeguarding the air we breathe, the water we drink, and the people we serve.



ENERGY SUPPLY

Committed to ...

Responsible, Diverse, Low-Cost Generation



CPS Control Room Operators work around-the-clock to monitor power plant operations.



A benchmark for performance and safety; the South Texas Project Nuclear Power Plant provides almost a third of CPS' electric power.



ENERGY SUPPLY

Challenged with the most severe summer and winter temperatures in many years, CPS responded by generating electricity at historic levels. The all-time record high temperature for San Antonio of 111 degrees on September 5 spurred new records. The hourly peak demand set that day of 4,091 megawatts (MW) was almost ten percent above the prior year mark. On the same day, 24-hour energy consumption was 74,090 megawatt hours, exceeding the prior year usage by six percent. As a result, 2001 marked the establishment of record electric sales.

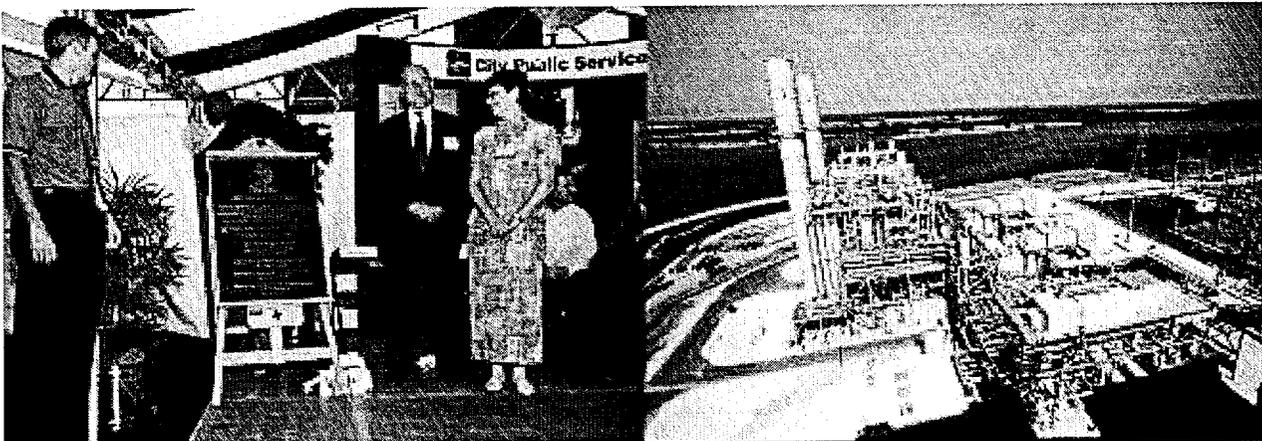
CPS has prepared for such challenges by diversifying its generating facilities. This includes the Arthur von Rosenberg (AvR) Plant which began commercial operation in June 2000, in time for the summer energy demands. This 512-MW combined-cycle, gas-fueled plant increased CPS' total capacity by 11.3 percent to 5,027 MW. Its technologically-advanced fuel-efficient process uses about 30 percent less fuel than traditional gas units. The plant is also environmentally sound, with NOx emissions significantly lower than the national average.

The project was completed two years ahead of our anticipated system load growth. CPS' strategy was to finance this plant with existing internal funds and litigation proceeds. Therefore, excess capacity from the unit has been sold on the wholesale market since there are no restrictions due to treasury rules for the private use of tax-exempt debt financing.

As was strategically planned, the addition of the AvR Plant allowed CPS to increase its short-term off-system sales to other utilities by 79.5 percent this year. A total of 844.4 million kilowatt hours (kWh) of off-system sales provided \$54.7 million in revenue, an increase of 106 percent from fiscal 2000. CPS pursued long-term wholesale customers, including a contract with the City of Brady to provide energy beginning in December 2002.

Electric generation fuel diversity has been a key CPS strategy in keeping generation costs down. The fuels diversity program was strengthened this year by the completion of the South Gate Gas Supply Pipeline. The new pipeline is comprised of almost 59 miles of 30-inch steel pipe, which is coated and cathodically protected to mitigate corrosion.

While initially constructed to meet fuel requirements for the combined-cycle gas plant, the pipeline will also be used to obtain competitive pricing for the entire systems in the future. With the addition of the South Gate Metering Station at the southern leg of the line, gas supplies from other competitive sources can be obtained, ensuring the lowest gas costs to our customers.



Mayor Howard W. Peak and former CPS General Manager Arthur von Rosenberg and his wife, Frances, help dedicate the combined-cycle power plant named in his honor in July 2000. The von Rosenberg Plant began commercial operation in June 2000.



ENERGY SUPPLY

When natural gas unit costs climbed to historic levels in late fiscal 2001, CPS was able to generate most of its requirements using nuclear power, coal, and oil to reduce the costs passed on to our customers. Less expensive low-sulfur coal has been a major stabilizing factor in CPS' fuels and resource planning processes. Coal unit costs were similar to the prior year; generation with coal was about 47 percent this year, a slight decrease from 2000.

Months of negotiations by CPS management resulted in successful term and spot coal supply contract extensions with coal suppliers. This was further complimented by a favorable long-term coal transportation agreement completed at year-end.

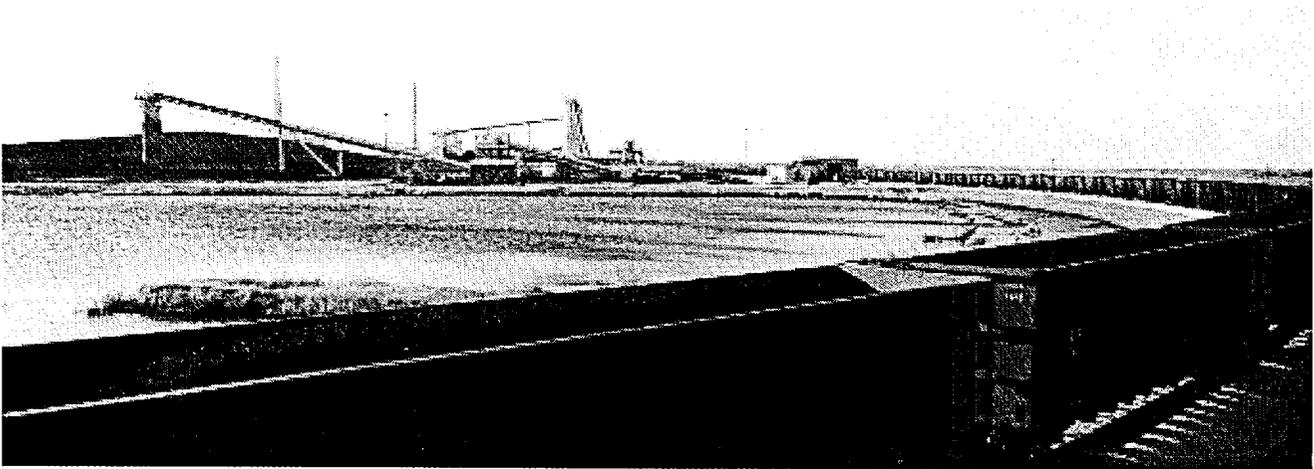
The South Texas Project (STP) nuclear plant contributed 28.6 percent of the electric generation load in 2001. This reliable fuel source has been the largest contributor to low electric costs for our customers. It has also been the cleanest fuel in emissions per unit of power. Units 1 and 2 produced at 78.3 percent and 96.8 percent of capacity, respectively, for the fiscal year. In the spring, the Project successfully installed four advanced-designed steam generators in Unit 1. These will enhance the safety and reliability, and are expected to increase the longevity of the unit.

The STP Operating Company continues to actively evaluate and implement cost reduction initiatives, including the voluntary early retirement and severance program in February 2000.

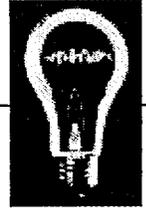
STP continued an excellent safety record, being recognized with high marks from nuclear organizations. The Institute of Nuclear Power Operations (INPO) assigned a Category 1 Rating in overall performance for the third time in a row, which is the highest rating the INPO can give. The Nuclear Regulatory Commission evaluating 18 areas for safety and performance gave green marks, the highest possible, to STP in all areas.

In resolution of CPS' claims against Houston Lighting & Power (now Reliant Energy), an agreement signed in July 1996 provides that the two utilities jointly dispatch their generating plants, other than STP, to take advantage of plant efficiencies and favorable fuel costs. The agreement stipulates that CPS must receive at least \$10 million in cumulative benefits per year, and \$150 million savings over the ten-year agreement, or Reliant Energy will compensate CPS for the difference. Pursuant to the agreement, CPS supplied 3.9 billion kWh of electricity to Reliant Energy during the fiscal year, for a cumulative total of 15.3 billion kWh to date. CPS received \$70 million in benefits this year and cumulative savings of \$135 million through the end of this fiscal year.

All of the above initiatives reflect CPS' commitment to provide responsible, diverse, low-cost generation. CPS will continue to employ other energy supply strategies to maintain its low production costs.



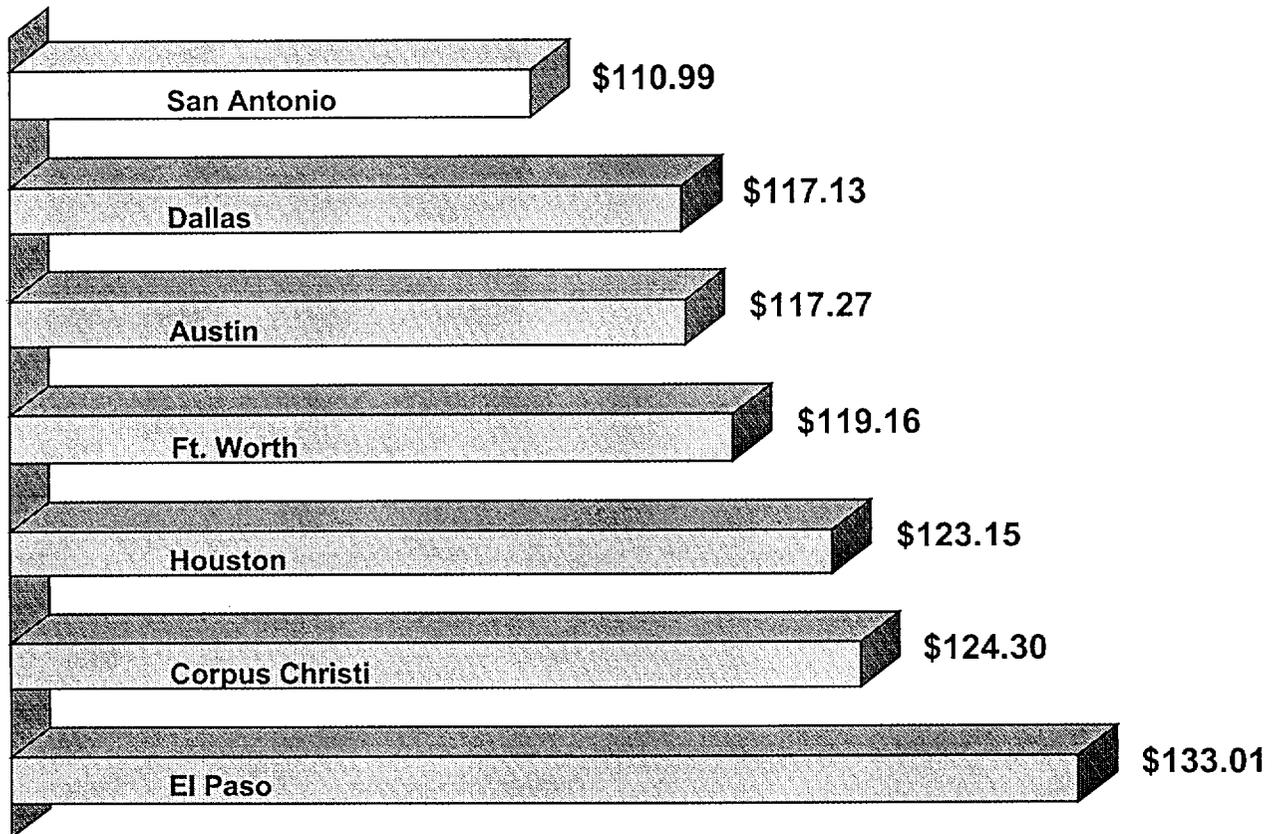
CPS owns approximately 1,200 railroad cars that are used to deliver coal from Wyoming to the J.K. Spruce and J.T. Deely Power Plants.



Comparison of Residential Gas and Electric Bills for Texas Cities

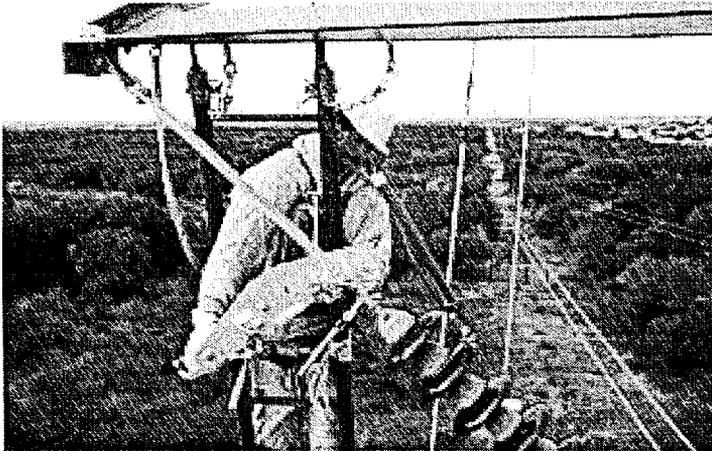
Monthly Average for Twelve Months Ending January 2001

Based on 1,000 kWh and 5 MCF

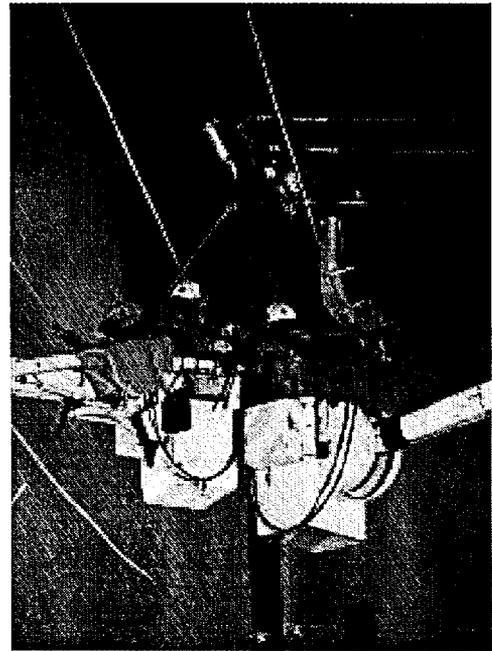




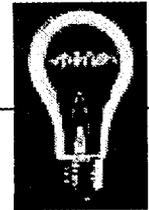
ELECTRIC TRANSMISSION AND DISTRIBUTION



CPS crews perform maintenance on transmission towers.



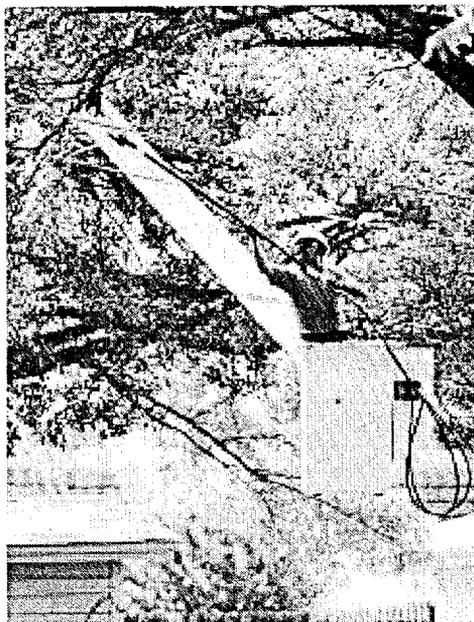
Storm team crews work to maintain system reliability.



ELECTRIC TRANSMISSION AND DISTRIBUTION



CPS Electric Transmission and Distribution Team includes (Left to Right) Dan Jones, Director, Market Policy and Planning; Ron Schaefer, Director, Operations; Fidel Marquez, Vice President, Transmission, Substation and Engineering; Steve Bartley, Senior Team Leader, Electric Transmission and Distribution Systems Business Unit; Les Barrow, Director, ERCOT and Special Projects; Milton B. Lee, II, Senior Vice President for Electric Transmission and Distribution Systems; Michael Vordham, Vice President, Distribution.



CPS tree trimming crews clear trees from overhead lines.



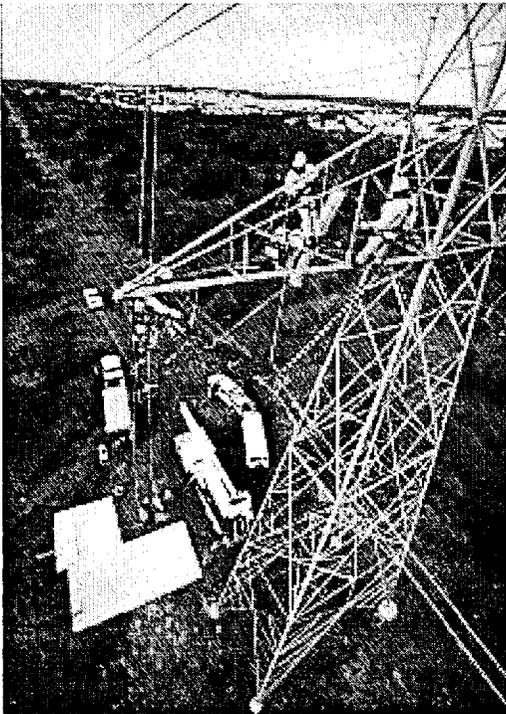
CPS Heavy Crew Foreman Rene Lares examines electric facilities plans.



ELECTRIC TRANSMISSION

Committed to ...

Effective Planning and the Safe and Reliable Delivery of Energy

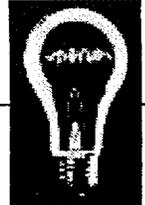


Transmission workers assure reliable performance of overhead lines.



CPS crewman operates aerial basket.

ELECTRIC TRANSMISSION



The CPS transmission line network represents the path for moving electric power from the generating plants to substations within the service area. These 786 miles of 138 kV and 582 miles of 345 kV high-voltage lines also transport power to and from neighboring utilities. Flexibility in the movement of power for the transmission system is provided by the plants' seven power-switching stations, seven other power-switching stations, and the 65 substations which feed into the distribution system.

CPS started the year by completing community presentations that included the transmission line routing and related substation siting process established in December 1999. This followed a six-month development effort involving input from the CPS Citizens Advisory Committee and the community at large. CPS adopted a process that evaluates and selects a site for new electric facilities where the need has been demonstrated, in a way that minimizes impact upon the human and natural environment.

Through the summer and fall of 2000, staff met with citizens to address the planning and site selection of facilities in the Northwest part of the service territory. For several years, staff analyses have indicated that reliability in the area known as Van Raub would require a new infrastructure. CPS affirmed that it would be constructing electric facilities in that part of the service area to meet current customer needs and expected growth in demand by 2002. Numerous public meetings to receive community input and to provide information about the project concluded in October 2000 when the final site was chosen.

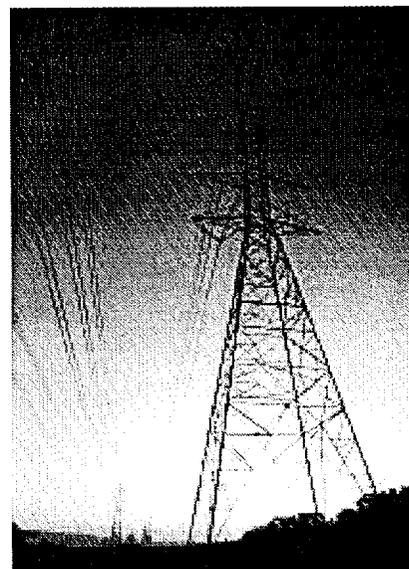
The CPS transmission system is also integrated in the larger electric grid of ERCOT covering 133 other utilities, municipalities, independent power producers, power marketers, and cooperatives over most of the State of Texas. ERCOT has been designated as the ISO by the PUCT under the mandate of the SB7 of 1999.

In 1996, the PUCT established the "postage stamp" rate, a statewide averaging method for determining transmission pricing and the transmission cost of service (TCOS) for ERCOT members, including CPS. Some portions of the rate prior to September 1999 are still under judicial and/or administrative review. CPS was assessed a net annual amount of approximately \$20.5 million in TCOS fees for fiscal 2001. Beginning in March 2000, these regulatory assessments were passed on to CPS customers based upon monthly energy usage.

A new filing under the transmission cost of service rules was submitted by the utility in May 2000. CPS was able to establish a finalized TCOS level to be set at \$48 million annually, effective January 25, 2001. This is an increase over the \$26.5 million that was approved in the 1996 rate case. It is projected to be a savings of close to \$15 million to our customers in the next fiscal year. CPS staff submitted expert testimony in the cases filed by other utilities, to ensure that the level of cost recovery was fairly established in the statewide cost assessment process.

Throughout the year, CPS worked with the ERCOT and member companies to develop new operating policies and procedures. A senior management member served on the ERCOT Board of Directors and CPS staff assisted with ERCOT's selection of the ISO's communications services. Targeted to start the summer of 2001, the IOU pilot project for retail competition has required extensive planning to determine the roles and responsibilities of wholesale market participants, such as CPS. In addition, the ISO budget and spending requirements and related participant assessment issues were also developed.

We plan to stay actively engaged with the PUCT and the ISO to ensure that the City of San Antonio and our customers are duly recognized and compensated for use of CPS' transmission facility investments. We remain committed to assuring a reliable and cost-effective transmission system for our customers.



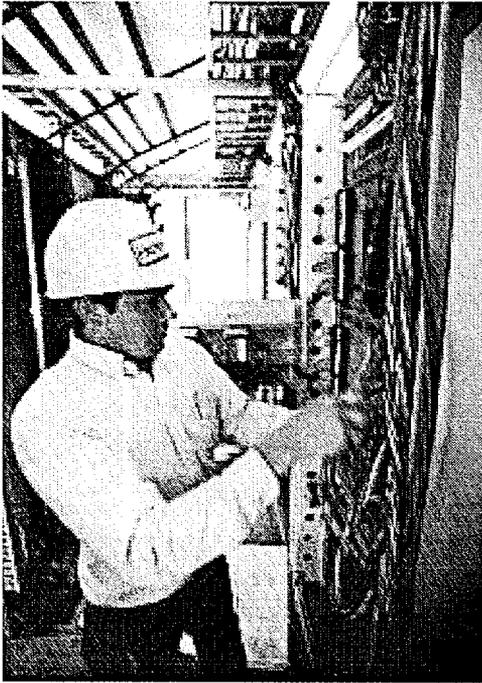
CPS transmission towers against San Antonio nightfall.



ELECTRIC DISTRIBUTION

Committed to ...

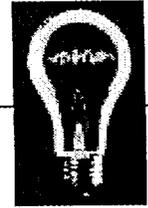
Distributing Energy Safely, Reliably, and Cost Effectively



Electrician Dennis Hampton checks equipment at CPS distribution substation.



CPS General Manager and CEO Jamie A. Rochelle and Paul Roberson, Executive Director for KellyUSA, celebrate the partnership that has developed between the two organizations.



ELECTRIC DISTRIBUTION

CPS' electric distribution system is the pathway for the ultimate delivery of energy to our customers. System additions are strategically planned to keep pace with the anticipated growth of the San Antonio metropolitan area. At year-end, the distribution system included 7,555 miles of overhead lines and 3,395 miles of underground lines.

CPS accelerated its role in transforming KellyUSA into a modern commercial business park. An agreement was completed in January 2000 between CPS and KellyUSA for the purchase and future operation by CPS of the realigned and commercialized electric distribution and gas facilities. Major tenants of KellyUSA include Boeing, Pratt & Whitney, General Electric, and Lockheed-Martin. At year-end, there are twenty-one commercial, industrial, and governmental entities that have signed contracts with CPS, benefiting the utility as well as the local economy.

To date, approximately 561 electric meters and 334 gas meters have been installed at KellyUSA for these entities. KellyUSA will receive an annual payment from the utility based upon a formula involving both electric and gas sales and revenue from customers at the facility.

CPS staff spent much of the year pursuing other military base acquisition and/or contract opportunities. In fiscal 2000, the utility purchased the residential gas facilities at Ft. Sam Houston. CPS has been working on a bid for acquiring the electric distribution infrastructure at Ft. Sam and Camp Stanley. Bids have also been submitted to the Department of Defense for the purchase of the distribution systems at Lackland AFB and Randolph AFB.

The Overhead Conversion Fund, which includes about one percent of retail electric sales revenue, was established by the CPS Board in 1995 to support beautification projects identified by the City of San Antonio and surrounding governmental jurisdictions. To date, approximately 33,000 feet of overhead lines have been identified and replaced with more attractive underground facilities.

Plans to convert overhead distribution lines to underground in the downtown area began in 1998. This three-year project was designed to make the downtown area more aesthetically attractive. Since inception, about 12,000 feet of overhead lines have been replaced at a cost of \$2.85 million. This project should be completed next year with the replacement of almost 7,900 feet of overhead lines.

Several years ago CPS began a ten to twelve year program to replace the existing Underground Residential Distribution System (URD) to improve service reliability. The URD Project is designed to upgrade or replace direct buried cable with longer-lasting and more reliable material. In this fiscal year, 90 miles of buried cable were replaced at a cost of approximately \$21 million. CableCure technology is used as a cost-effective maintenance alternative during the cable replacement project.

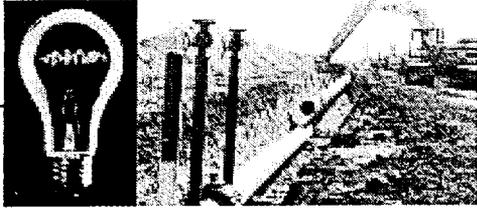
This highly specialized technology extends the life of existing buried cable through the injection of a silicone-based fluid. The use of this unique process results in an extension to 20 years of useful life for the URD cable with vendor guarantees against failure. Since its inception in 1992, CableCure has been used on about 23 miles of underground lines, at a cost of almost \$1.2 million. At year-end, CPS began an evaluation of the cost and resource requirements to accelerate this replacement program.

CPS continues the ongoing effort to improve its safety incident rate and system reliability measures. The System Average Interruption Duration Index (SAIDI) for 2001 was 1.124. The System Average Interruption Frequency Index (SAIFI) was 1.527.

We realize that the successful utilities will be those that meet or exceed the customers' ever increasing needs for system reliability and improved service. Through specific strategies and key action plans such as these, CPS will continue its commitment to provide customers with the utmost in the safe and reliable delivery of energy service.



Apprentice Electrician Peggy Jenschke helps with substation construction and maintenance.



GAS SYSTEM

Committed to ...

Safe and Dependable Natural Gas Delivery



Assistant Crew Leader Diana Ortiz welding gas pipe with a fusing machine.



Gas System Construction Foreman Dilia Villarreal oversees construction projects.



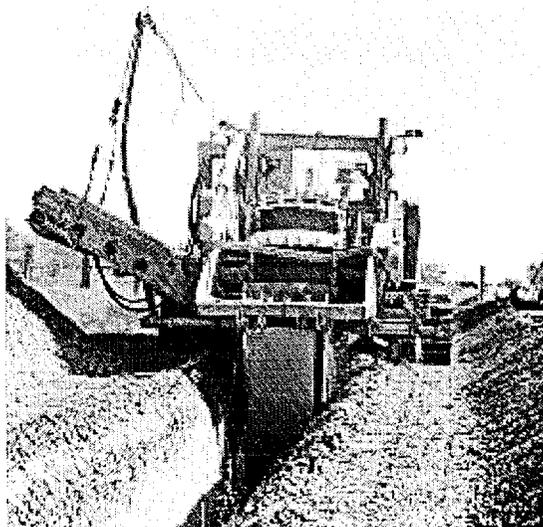
GAS SYSTEM

CPS is committed to providing its gas customers with safe, reliable and low-cost natural gas. This is demonstrated by the fact that the utility has not had a rate increase since 1991. Instead, our rates are designed with a monthly pass-through of CPS' actual cost of distribution gas, which does account for some seasonal changes in customer bills.

Gas distribution system customers will benefit from the South Gate Supply Pipeline that was completed this year. This facility will provide CPS with more alternatives for competitive pricing of gas from several large suppliers in the future.

CPS' Gas System operations were faced this year with the challenge of record high gas prices as the nation experienced a natural gas crisis in the fall of 2000 and winter of 2001. Natural gas exploration and production has not kept up with the growth of consumer demand nationally. Also, more natural gas-fueled power plants began operations this year, increasing demand from the electric utility industry. Historically colder weather played another major factor in the consumer demand for natural gas.

Despite nationwide cost increases and supplier shortages, CPS was able to successfully procure its gas supply and fully meet the demand of its gas customers with uninterrupted service. As a result of the natural gas supply demand and related price volatility, CPS gas system revenue of \$214.6 million was more than double that of fiscal 2000. Gas sales this year increased to 25.4 million MCF due to unexpected weather in the San Antonio area.



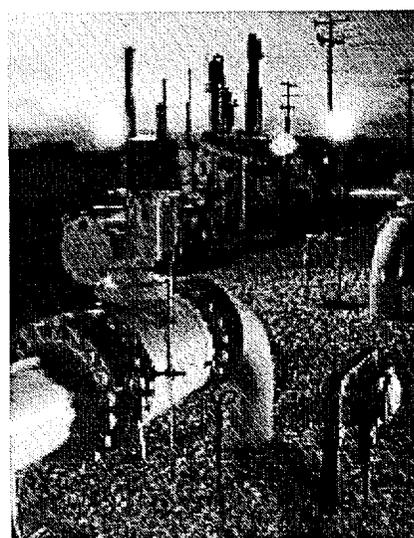
Special equipment such as this trenching machine was employed to lay gas lines for the South Gate Supply Line.

In response to extraordinarily higher bills and to aid our customers, CPS implemented various consumer assistance and awareness programs starting in October 2000. The City of San Antonio provided funds for a separate rebate in conjunction with the CPS programs. In addition, City staff modified the eligibility criteria and the evaluation process for designating recipients of Project Warm, a program that provides utility bill assistance to qualified CPS customers.

CPS enhanced its customer service operations schedule and energy audits while adding weatherization programs for residential, commercial and industrial customers estimated to cost up to \$6 million annually. Payment alternatives and various awareness programs on the natural gas crisis and gas conservation practices were also developed for our customers.

CPS is evaluating strategies to enhance the gas system. Although the system has consistently reflected modest customer growth over the last decade, we are looking for new expansion opportunities. System facilities increased by about 50 new miles of gas distribution mains for a total of 4,368 miles at year-end.

SB7, passed in June 1999, gave municipal utilities new opportunities to pursue gas, fuel, and energy-hedging programs for their customers. On the strength of this initiative, CPS is currently developing a gas hedging program designed to achieve price stability — further evidence of our commitment to provide customers with safe, reliable, and low-cost natural gas.



The new San Martin Metering Station connects the South Gate Supply Line to CPS power plants.



CUSTOMER AND ENERGY SERVICES

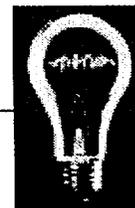
*Committed to ...
Fully Serving Our Customers*



CPS employees offer information about Windtricity™ at the Fall 2000 Customer Appreciation Day.



CPS offers free energy audits as a service to its customers.



CUSTOMER AND ENERGY SERVICES

CPS realizes that top-quality customer service is fundamental to every successful business. Our customers are the front line of this utility, so continuously addressing their needs and exceeding their expectations is the focus of our organization's strategies.

Our efforts to put customers first were recognized when CPS residential customers reported higher levels of satisfaction than ever before according to the J. D. Power & Associates 2000 Electric Utility Residential Customer Satisfaction Study. The utility's overall customer satisfaction scores rose from 104 points in 1999 to 110 in 2000. This was the highest score ever for CPS, representing an improvement from fifth in 1999 to third highest in the entire Southern Region in 2000.

Similarly, results from CPS' participation in the J. D. Power's Midsize Business Customer Satisfaction Study indicated that CPS ranked above the national industry average. These and other customer studies are providing continuous insight into the perceptions and needs of our customers, so that we can better deliver the efficient energy products they desire.

CPS offers a number of payment plans to better serve our customers. Our budget payment plan offers the flexibility to balance payments over the year, so bills are not excessive in any given month. To promote remittance convenience, CPS' electronic payment plan automatically deducts bill payments from customer bank accounts each month.

In response to the extreme weather conditions in the summer and winter months of this fiscal year, CPS implemented temporary procedures to delay service disconnection of unpaid bills. CPS also offered several extended payment options to those who were behind on payments.

In more difficult times, we make an extra effort to inform our customers about issues while providing them with critical information such as energy prices and conservation practices. Project Winter Wise was initiated in December to communicate energy-saving tips and to update the community on the natural gas crisis. CPS also implemented a new Gas Information Hotline and collected coats and blankets to give to those in need.

The Citizens Advisory Committee (CAC) was activated in 1997 as a forum to improve communications on important issues regarding CPS operations. This year the CAC has been busy addressing issues such as the Town Hall Meetings and the Van Raub Line and Substation site selection. Meeting monthly to discuss current topics, the CAC consistently acts as a liaison in relaying issues and concerns between CPS and the community.

On Earth Day in April 2000, CPS introduced the new Windtricity™ program to San Antonio. Wind-generated electricity is the first of CPS' renewable energy projects. In July, CPS entered into a long-term agreement to obtain wind energy from a newly-constructed wind turbine farm in West Texas, projected to be completed in late 2001. This wind farm will generate a capacity of 25 MWs, enough to power over 8,500 average Texas homes each year.

A fun and educational Customer Appreciation Day was held in October at the site of our future Northside Customer Service Center to commemorate Public Power Week. This event was sponsored by CPS to focus on the benefits of public power.

In support of San Antonio area development and as a service to surrounding communities, CPS held an annual seminar in December. The seminar's presentation content received high marks this year for successfully addressing the current interests and concerns of public officials in suburban cities.

CPS also recognizes the need to offer detailed, customer-focused services to the commercial and industrial customers that represent an integral component of our operations. Our Key Accounts Group addresses the needs and concerns of these customers while working to secure long-term contracts that are advantageous to both parties.

As we develop, market and sell energy and its related products, we continue to strive for efficiency while remaining fully committed to the people, businesses and communities we serve. We pledge to continuously make customer relations a top priority by keeping the lines of communications open and remaining responsive to the needs and concerns of our customers.

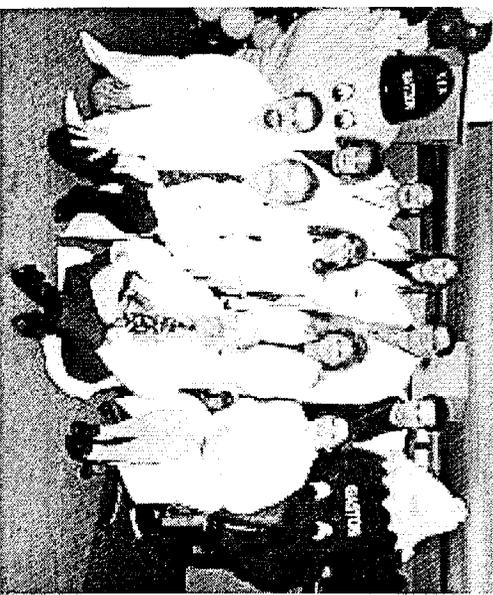


TECHNICAL SERVICES

*Committed to ...
Facilitating Open Communications and Involvement*



CPS was once again a United Way "Raiseter" in the fall 2000 campaign and employees pledged a record amount.



CPS representatives work to maximize ergonomic solutions in the workplace.



TECHNICAL SERVICES

CPS believes that information resources are the most important tools for business success. This is evidenced through the Business Information Systems (BIS) Project, which continued to progress through major milestones in fiscal 2001.

With proposals in hand from several prime contractors, the Board of Trustees approved the system integrator and software package to culminate the Proposal Evaluation Phase of the Project. The Customer Design Installation (CID) Phase proceeded with the documentation and design of the major functional business processes. BIS team training and change management assessments were ongoing during this time. By fiscal year-end, the CID Phase was completed and the Implementation Phase commenced.

“Go live” implementation is expected in December 2001 for the Financial Information System, the Materials Management System, and the Work Management System. The Customer Information System and Generation Maintenance Systems are expected to “go live” in February 2002. BIS will include an integrated suite of corporate business applications, providing CPS with greater processing capabilities and efficiencies in support of daily business operations. The BIS will replace legacy mainframe systems developed from the late 1960’s to the early 1980’s.

Information systems and operations staff continue to develop and expand the mobile data terminal installation at various field locations. These automated data collection systems will improve the response time to customer inquiries and capture better information for planning and scheduling.

This year, CPS officially launched Workstation 2000, a five-year plan to reconfigure employee offices for added comfort and safety. The new workstations are designed to optimize existing workspace, promote effective workgroups, and reduce ergonomically-related injuries.



Special Truck Driver Christine Lute helps with maintenance of CPS' fleet.

In May the Supervisory Control and Data Acquisition (SCADA) System, located at the Gas and Electric Operation Center, replaced our 1978 vintage mainframe and backup system. This new \$5.5 million system, which is the brain of the CPS Electric System, will be able to remotely control and manage the generation and distribution of electricity. This represents an important milestone for a project that commenced in mid-1996.

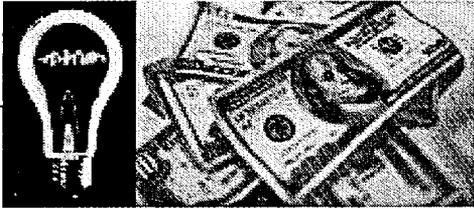
Starting on April 30, the CPS “Home and Lifestyle Show” aired for 26 weeks during the year. Written and produced by CPS staff, the new television show featured topics on home improvements, remodeling, energy conservation, safety, home buying, cooking and gardening. As San Antonio’s only locally produced home improvement program, the show is uniquely geared toward the local community, offering information specific to residents of the San Antonio area.

CPS employees have contributed 12,680 hours in community service in support of numerous charitable agencies. Since 1989 the Volunteers in Public Service (VIPS) have been actively making San Antonio a better place to live with their caring spirits and hardworking hands. From planting trees to setting up sport programs, to wrapping gifts for children under protective care, to helping the elderly and the needy, CPS staff and volunteers are working to better our community.

Community involvement is a key goal for CPS. The utility continuously demonstrates its commitment to improve the quality of life in our City. Concern for the community is best illustrated by the annual United Way Campaign, in which CPS has taken a leadership role as a pacesetter for the past two years. This year, CPS staff responded generously, pledging a record amount of \$643,002, a 12 percent increase over last year, and the fifth largest contribution in San Antonio.



CPS Director of Facilities Porter Dillard and Coordinator Mirta Garcia present Teresa Resendis (seated) with a new ergonomic office chair as part of the Parade of Office Efficiency.



FINANCE AND ADMINISTRATION

Committed to ...

Maintaining Our Strong Financial Position



CPS Board Chairman Clayton Gay Jr.; Mayor Howard Peak; General Manager and CEO Jamie Rochelle; and Director of Purchasing and Small Business Development Fred Villasenor proudly display the Dwight D. Eisenhower Award for Excellence.

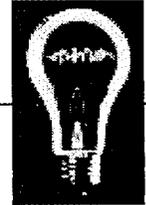


CPS Small Business and Purchasing staff with selected small business owners who are proudly displaying their achievement awards through participation in the Supplier Diversity Mentoring/Protégé program.



The CPS Financial Management Team includes (standing) Vern F. Lange, Director, Risk Management and Insurance; Patricia M. Major, CPA, CCM, CGFM, Assistant Secretary-Treasurer, Controller; (sitting) Richard E. Williamson, CGFM, CMA, CIA, Director, Finance; V. Gary Schaub, Secretary-Treasurer, Senior Vice President for Finance and Administration.

FINANCE AND ADMINISTRATION



CPS is committed to preserving its financial health. This includes taking advantage of market opportunities and seeking prudent new financial ventures that will benefit the utility through cost or debt savings and revenue enhancements.

In early June, CPS closed on a lease/leaseback transaction for the J.K. Spruce Coal Plant. CPS received \$725 million representing current and future lease income. From these proceeds, CPS established an investment trust of \$539.3 million. In November, the funds in the trust were used to prepay the total cost of the leaseback. CPS also entered into a collateralized payment undertaking agreement for \$89 million that will generate funds sufficient to fund a cancellation option payment, should CPS elect to exercise that option. After deducting transaction expenses, CPS' gross benefit was approximately \$88 million, \$12.3 million of which was advanced to the City of San Antonio. CPS' remaining net benefit of \$75.7 million from the transaction will be amortized over the 32-year leaseback term.

CPS will continue to maintain and operate the Spruce Plant, retaining all revenues from sales of electricity produced by the facility. This historic transaction reflected CPS' proactive efforts to seek new ventures aimed at maximizing owners' equity of the utility for our customers, our bondholders, the City of San Antonio, and other stakeholders.

Through the continuing pursuit of our Debt and Asset Management Program, CPS is committed to lowering the debt component of our energy costs, maximizing the effective use of cash and available cash flow, and enhancing financial flexibility into the future. This year, we successfully completed two major financing transactions which demonstrated our ability to effectively manage and control the debt component of our pricing structure.

During November, \$215.7 million of the New Series 1992 Bonds were legally defeased with cash resources, resulting in debt service savings for CPS. The majority of the defeased bonds were originally issued to finance the South Texas Project. Funds from CPS' Repair and Replacement Account were deposited into an escrow account to provide for the payment of the defeased bonds as they mature.

With the highest bond ratings for a municipal electric utility in the United States, CPS successfully sold \$221.2 million in revenue bonds in December. The sale included \$170.8 million in Tax-Exempt Bonds at an average interest rate of 5.40 percent and \$50.4 million in Taxable Bonds at an average interest rate of 7.44 percent. The main purpose of the New Series 2000 Bonds was to reimburse the Repair and Replacement Account for cash funds spent on construction expenditures during the prior eighteen months. In addition, new money proceeds to finance transmission projects for the next two years was also part of the transaction and were deposited into the Bond Construction Fund.

CPS competed against 2,500 firms this year and was chosen to receive the Dwight D. Eisenhower Award for Excellence for our Supplier Diversity and Purchasing Program. We were the first electric and gas utility to be given this award since 1991. The Supplier Diversity Program, which presently has 2,938 classified vendors, was established in 1989 in an effort to support the local economy through purchases from San Antonio vendors. During fiscal 2001, CPS offered local vendors an opportunity to bid on procurements totaling over \$338 million, of which approximately \$267 million, or 79 percent, was awarded.

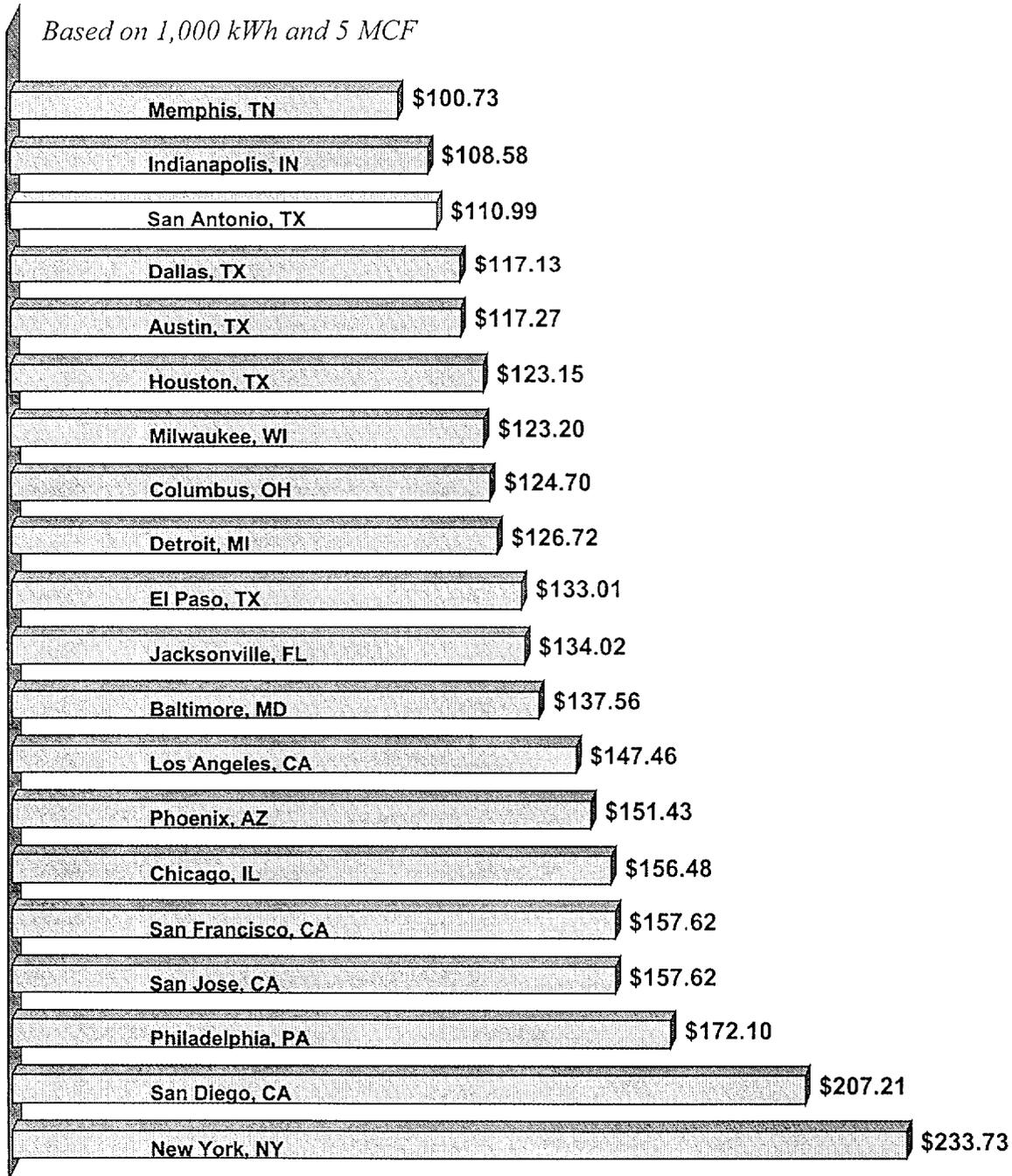
To further show our commitment to the community, CPS introduced the Mentoring and Protégé Program in 1998 to assist small, minority and woman-owned businesses. The program is designed to give small business owners and managers who offer the specified commodities and/or services used in the utility industry the tools they need to be successful in the business world. Currently, 15 companies participate and benefit from the Protégé Program and a total of 19 companies have graduated from the program.

In conclusion, a Compensation Project Team was organized to compare CPS jobs with the external market and determine competitive rates of compensation. CPS management staff throughout the utility reviewed market matches for salaried jobs comparable to that of CPS. The Compensation Project Team established job guidelines for all salaried employees. This new system will better allow CPS to attract and retain technically qualified staff during the next few years of utility restructuring in Texas.

Comparison of Residential Gas and Electric Bills for the 20 Largest U.S. Cities

Monthly Average for Twelve Months Ending January 2001

Based on 1,000 kWh and 5 MCF



FINANCIAL REVIEW

Revenue and Sales

For the fifth consecutive year, gross revenue exceeded one billion dollars, and set a new annual record of \$1.391 billion for fiscal 2001. During the year, record electric and gas sales occurred, and fuel, power, and distribution gas cost recoveries were at significantly higher levels. Across the nation and the state, electric and gas sales reflected both unusually warm summer and cold winter months. The high demand by customers nationally and locally created unforeseen demand for natural gas for electric generation and distribution. As a result, CPS and others incurred extraordinary unit costs for natural gas.

Operating Revenue of \$1.339 billion increased 28.7 percent from the previous year. The electric system accounted for 80.9 percent of CPS' gross revenue. The 20.4 percent increase in electric system revenue reflects greater electric fuel cost recoveries and purchase power costs as well as customer growth and added sales from unprecedented weather conditions. In March 2000, CPS began recovering regulatory fees from customers for the Public Utility Commission of Texas (PUCT) and the Independent System Operator (ISO) amounting to \$33.7 million for the year.

Electric system sales increased by 8.6 percent to total 17.8 billion kilowatt hours (kWh) due primarily to the warmer summer weather and new electric customers. Colder winter weather also contributed somewhat to greater sales through all-electric customer usage. The electric system customer base rose by more than 15,100 to total about 578,300 customers at year-end, most of which are residential.

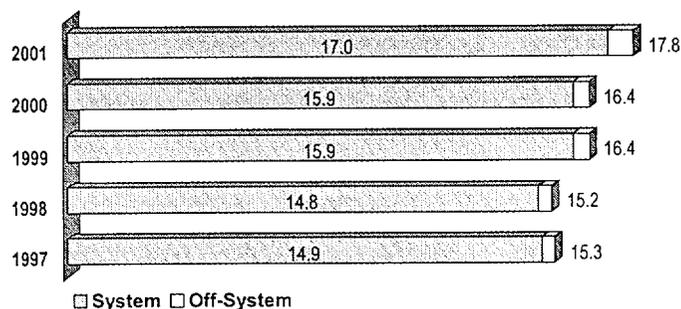
Electric off-system sales to other utilities and power marketers increased 79.5 percent reflecting CPS' growing initiatives in the wholesale market. Sales of 844.4 million kWh from off-system sales added \$54.7 million to gross revenue, an increase of \$28.2 million this year.

Gas Operating Revenue of \$214.6 million more than doubled from the previous year. The unit cost of natural gas for distribution rose dramatically during the last quarter of fiscal 2001. Reduced natural gas supply and increased demand nationwide and regionally abruptly drove up the natural gas costs. Gas sales totaled 25.4 million MCF, an increase of 19.5 percent. Greater customer usage this year was due to more extreme winter temperatures. Over 1,900 new customers, mainly residential, were added during fiscal 2001 bringing the total to more than 305,800 gas customers.

Nonoperating revenue of \$51.6 million increased 31.3 percent from the same period a year ago. This was a reflection of higher investment yields and fund balances from a year ago, which included the net lease transaction proceeds.

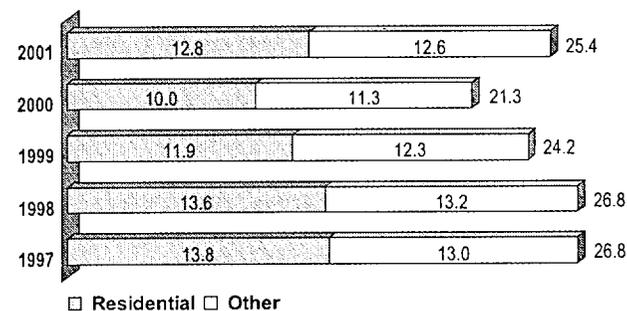
ELECTRIC SALES

Fiscal Year Ending January 31
In Billion kWh



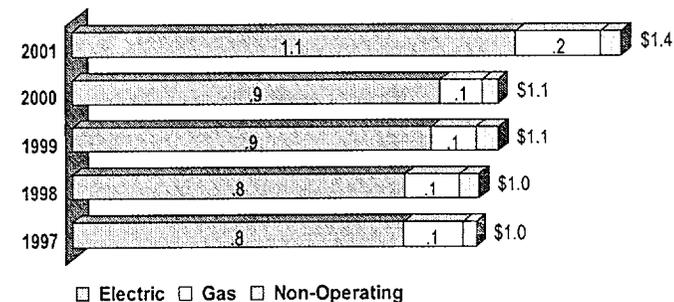
GAS SALES

Fiscal Year Ending January 31
In Million MCF



GROSS REVENUE

Fiscal Year Ending January 31
In Billions of Dollars



Expenditures

Operating expenses of \$951.5 million rose \$265.4 million primarily due to greater fuel, purchased power, and distribution gas costs, as well as depreciation and regulatory expenses. Total operating expenses increased 38.7 percent from last year.

Electric fuel and purchased power costs of \$310.8 million accounted for about 39.4 percent of the increase in operating expenses. The average electric unit cost of fuel of \$16.53 per megawatt hour was 39.5 percent greater than last year due to higher natural gas and greater purchased power costs.

Energy requirements were 7.0 percent higher due to weather conditions and additional customers, which include off-system sales. Nuclear generation was slightly less this year due to a refueling outage and planned steam generator replacements last spring at Unit 1 of the South Texas Project (STP) nuclear plant. Coal-fired generation decreased somewhat this year due to planned repairs at the J.T. Deely Plant. Purchased power was used to meet about 2.6 percent of customer energy requirements due to less nuclear and coal generation. These factors contributed to higher unit fuel and power costs. Less nuclear and coal generation resulted in more gas-fueled generation at a much higher unit cost.

Distribution gas costs of \$149.4 million rose \$96.1 million from last year. Contributing to the higher costs was a 21.1 percent increase in purchased volume requirements due to greater customer demand in the last quarter. The average unit distribution gas cost rose \$3.17 to \$5.62 per million BTU, reflecting the volatile gas market and greater demand for natural gas since June 2000.

STP operating and maintenance expenses, other than fuel, of \$71.0 million decreased 12.2 percent for fiscal 2001. Many costs for the steam generator replacements were capitalized this year, which resulted in reduced maintenance expenses. This reduction also reflects the refueling of Unit 2 during the fall of last year. STP expenses this year also reflected accounting charges for a voluntary early retirement and severance program in the first quarter of fiscal 2001.

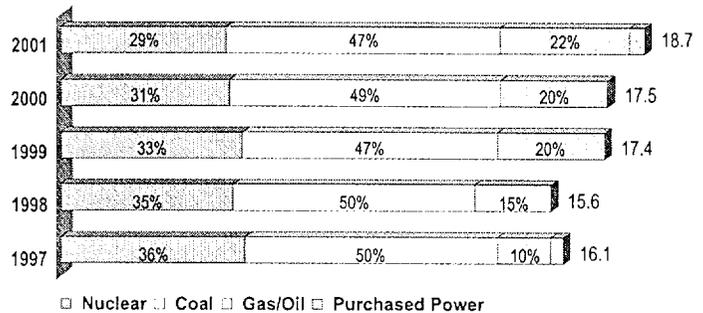
CPS operating and maintenance costs, other than fuel, gas and STP, amounted to \$193.6 million, which was a \$15.0 million increase. The 8.4 percent increase can be attributed to costs for operation and maintenance of the new von Rosenberg Plant and various other planned power plant overhauls. The corporate Business Information Systems Project (BIS) incurred costs for the preliminary and planning phases as well as training and project management that were expensed this year. Spending increased substantially for sales promotion, customer information and education, and company-wide activities in preparation for utility restructuring and a more competitive environment.

In March 2000, CPS began recovering the PUCT and ISO assessments from its customers. About \$29.3 million was recovered for fiscal 2001, an increase of \$27.3 million from the prior year.

ELECTRIC GENERATION & PURCHASED POWER

Fiscal Year Ending January 31

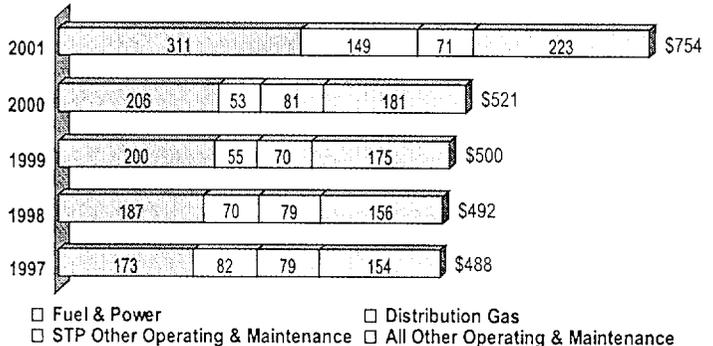
In Billion kWh



OPERATING & MAINTENANCE EXPENSES

Fiscal Year Ending January 31

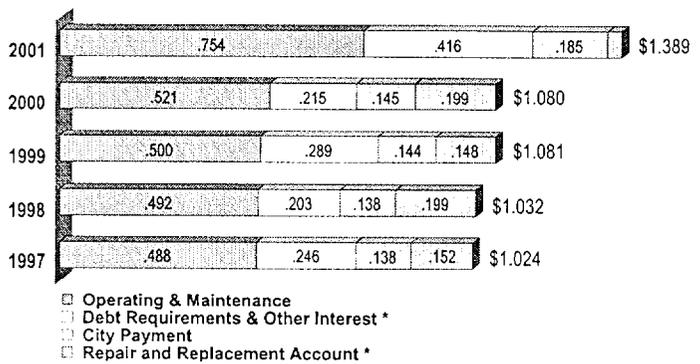
In Millions of Dollars



APPLICATION OF REVENUE PER BOND ORDINANCE

Fiscal Year Ending January 31

In Billions of Dollars



* 2001 includes cash defeasance of debt

Depreciation expense increased about 19.5 percent from last year to total \$197.3 million. The increase is a result of additions to plant in service including the von Rosenberg Plant, the South Gate Supply Line, KellyUSA properties, and accruals for dismantling of certain storeroom and general property locations.

Interest and debt-related costs were slightly less than a year ago. The allowance for funds used during construction decreased slightly as a result of the completion of major projects earlier this year. CPS incurred \$2.6 million in costs for the cash defeasance of part of the New Series 1992 Bonds. Income before operating transfers increased 18.5 percent to \$276.0 million.

Payments to the City of San Antonio exceeded last year's amount by \$39.5 million, setting a new record of \$185.0 million. The City uses these proceeds to help provide services that benefit the community of San Antonio. City benefits since October 1942, when CPS was purchased, have exceeded \$2.7 billion and the City's equity in CPS rose to \$2.14 billion at year-end.

Construction, Net Removal Costs and Nuclear Fuel Purchases

Total expenditures for new construction, net removal costs, and nuclear fuel purchases were \$260.7 million for fiscal year 2001. CPS spent over \$24.7 million on underground electric distribution system initiatives, such as the replacement project, to improve service reliability for customers. About \$21 million was expended on underground electric distribution service for new customers. This year Overhead Conversion Fund expenditures amounted to \$8.8 million. This fund is used to support aesthetic and beautification projects related to overhead electric distribution funding, mainly in the City of San Antonio.

About \$9.3 million was spent to complete the Arthur von Rosenberg Plant, which began commercial operation in June 2000. Capital costs for STP were about \$11.9 million, primarily due to the four steam generator replacements at Unit 1.

Gas main and service construction costs for new customers amounted to \$6.3 million. New construction of electric transmission lines, substations, and right-of-way accounted for \$9.0 million in costs this year.

BIS project expenditures were \$11.2 million in 2001. These costs included hardware, software, integration consultants, internal labor and benefits. This enterprise-wide replacement of legacy systems is planned to be completely operational by spring 2002.

Over \$4.5 million was used for improvements on the distribution related control systems. A combined \$5.6 million was spent to enhance CPS' communication systems, fiber optic facilities, and distribution automation pilot programs.

Financing

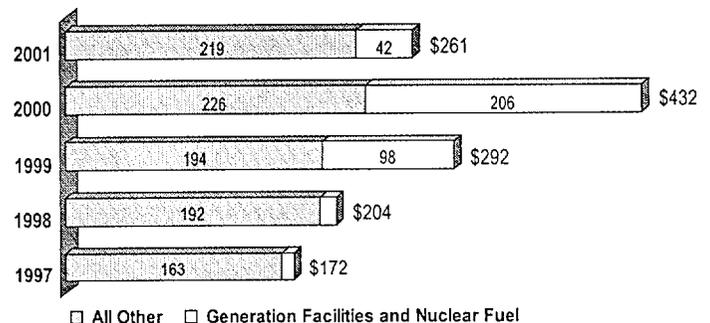
Tax-Exempt Commercial Paper sold in June and January totaled \$118.0 million, \$78.0 million of which was used to fund construction projects in fiscal 2001. In November, CPS legally defeased \$215.7 million of the New Series 1992 Bonds, which resulted in future interest savings.

CPS successfully sold \$221.2 million in revenue bonds in December. The New Series 2000 Bond sale consisted of taxable and tax-exempt bonds. About \$184.9 million was used to reimburse the Repair and Replacement Account for 18 months of prior construction costs. In addition \$34.0 million of new money proceeds were received to finance future transmission projects.

Tax-Exempt Commercial Paper and bond proceeds were used to fund 55.5 percent of fiscal 2001 construction requirements. The overhead conversion fund, contributions in aid of construction, and revenue funded 12.7 percent. Other sources funded the remaining 31.8 percent of this construction.

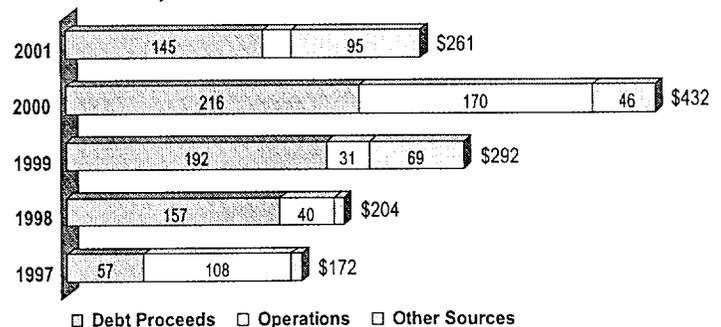
CONSTRUCTION, NET REMOVAL COSTS AND NUCLEAR FUEL PURCHASES EXPENDITURES SUMMARY

Fiscal Year Ending January 31
In Millions of Dollars



CONSTRUCTION, NET REMOVAL COSTS AND NUCLEAR FUEL PURCHASES FUNDING SUMMARY

Fiscal Year Ending January 31
In Millions of Dollars



2001 and 2000 reflect reimbursement of New Series 2000 Bond proceeds

FIVE YEAR HIGHLIGHTS – UNAUDITED *(Dollars In Thousands)*

For Year Ended January 31,	2001	2000	1999	1998	1997
OPERATIONS					
Gross revenue, per ordinances	\$ 1,389,239	\$ 1,079,969	\$ 1,081,404	\$ 1,032,202	\$ 1,024,315
Operating & maintenance expenses	754,146	520,915	500,083	491,813	488,352
Available for debt service	635,093	559,054	581,321	540,389	535,963
Payments to City of San Antonio	185,006	145,474	144,555	138,543	137,588
UTILITY PLANT					
Net book value	4,089,140	4,134,207	3,929,705	3,900,755	3,866,063
Depreciation expense	197,322	165,177	167,686	153,407	146,559
Additions to plant, nuclear fuel & net removal costs	260,748	431,563	292,450	204,201	172,126
FUNDING FOR NEW CONSTRUCTION, NET REMOVAL COSTS, & NUCLEAR FUEL PURCHASES					
Bond proceeds ⁽¹⁾	66,808	208,968	192,029	152,754	57,157
Commercial paper proceeds	78,000	6,500	0	4,500	0
Repair & Replacement Account ⁽¹⁾	11,819	162,952	26,312	37,966	106,667
Overhead Conversion Fund	8,891	7,420	5,051	1,589	1,374
Litigation settlement proceeds	82,913	34,206	61,900	—	—
Customer contributions	12,317	11,517	7,158	7,392	6,928
OTHER BALANCE SHEET DATA					
STP Decommissioning Trust Net Assets	119,840	95,493	89,465	72,783	70,964
Repair and Replacement Account	465,206	330,984	424,494	291,748	134,572
Total Assets ⁽²⁾	5,978,676	5,005,769	4,920,277	5,105,373	4,685,748
City of San Antonio's Equity	2,139,531	2,048,534	1,961,174	1,898,367	1,833,983
DEBT					
Outstanding					
Bonds	2,668,820	2,730,575	2,794,295	2,582,638	2,456,343
Commercial Paper	252,800	134,800	128,300	450,000	277,800
Weighted-Average Interest Rate					
Bonds	5.33%	5.24%	5.23%	5.53%	5.61%
Commercial Paper	3.95%	3.69%	3.09%	3.69%	3.48%
Debt Service					
Bonds ⁽³⁾	208,567	208,925	185,044	193,626	218,227
Commercial Paper	8,182	4,709	15,474	15,841	22,975
Debt Service Coverage – Bonds	3.05x	2.68x	3.14x	2.79x	2.47x
Ratings – Bonds/Commercial Paper					
Fitch, Inc.	AA+/F-1+	AA+/F-1+	AA+/F-1+	AA+/F-1+	AA+/F-1+
Moody's Investors Service, Inc.	Aa1/P-1	Aa1/P-1	Aa1/P-1	Aa1/P-1	Aa1/P-1
Standard & Poor's Rating Services	AA/A-1+	AA/A-1+	AA/A-1+	AA/A-1+	AA/A-1+
RELIABILITY INDICES ⁽⁴⁾					
System Average Interruption Duration Index (SAIDI)					
	1.124	0.728	0.886	0.842	—
System Average Interruption Frequency Index (SAIFI)					
	1.527	1.162	0.919	1.130	—

(1) 2001 and 2000 reflect the allocation of the New Series 2000 bond proceeds to reimburse the Repair and Replacement Account prior construction funding.

(2) All years include the CPS STP Decommissioning Trust Net Assets.

(3) Excludes cash defeasance in 2001 and 1999.

(4) Available for the past four fiscal years.

FIVE YEAR OPERATIONS REVIEW – UNAUDITED

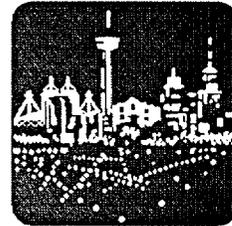
For Year Ended January 31,	2001	2000	1999	1998	1997
OPERATING REVENUE (In thousands)					
Electric:					
Residential	\$ 516,203	\$ 428,450	\$ 428,482	\$ 392,889	\$ 398,061
Commercial and industrial	411,773	353,055	344,064	329,241	322,595
Street lighting	12,786	11,977	11,655	11,404	11,073
Public authorities	105,815	94,475	90,182	87,198	85,488
Sales for resale	15,548	12,581	11,818	11,731	11,268
Off-system sales	54,677	26,499	17,147	6,667	6,828
Miscellaneous	7,612	6,592	6,291	5,718	6,386
Total	<u>\$ 1,124,414</u>	<u>\$ 933,629</u>	<u>\$ 909,639</u>	<u>\$ 844,848</u>	<u>\$ 841,699</u>
Gas:					
Residential	\$ 122,385	\$ 59,748	\$ 66,142	\$ 79,791	\$ 87,362
Commercial and industrial	75,888	39,425	39,756	47,547	50,360
Public authorities	14,704	6,694	7,391	9,197	9,284
Miscellaneous	1,579	1,153	948	1,058	974
Total	<u>\$ 214,556</u>	<u>\$ 107,020</u>	<u>\$ 114,237</u>	<u>\$ 137,593</u>	<u>\$ 147,980</u>
SALES (In thousands)					
Electric kWh:					
Residential	7,180,459	6,492,199	6,571,130	5,990,225	6,142,014
Commercial and industrial	7,284,582	6,928,944	6,850,843	6,467,755	6,409,608
Street lighting	103,428	100,534	99,919	97,775	97,339
Public authorities	2,083,527	2,108,671	2,059,882	1,972,320	1,946,948
Sales for resale	348,717	327,277	320,986	287,996	290,265
Off-system sales	844,436	470,335	454,114	351,745	381,331
Total	<u>17,845,149</u>	<u>16,427,960</u>	<u>16,356,874</u>	<u>15,167,816</u>	<u>15,267,505</u>
Gas MCF:					
Residential	12,777	10,027	11,925	13,607	13,752
Commercial and industrial	10,574	9,485	10,196	10,875	10,963
Public authorities	2,065	1,762	2,074	2,293	2,071
Total	<u>25,416</u>	<u>21,274</u>	<u>24,195</u>	<u>26,775</u>	<u>26,786</u>
ELECTRIC GENERATION					
Total kWh ⁽¹⁾ (In thousands)	18,214,197	17,457,003	17,373,503	15,738,497	15,659,321
Capacity, kW (Gas)	2,942,000	2,430,000	2,430,000	2,430,000	2,430,000
Capacity, kW (Coal)	1,385,000	1,385,000	1,385,000	1,385,000	1,385,000
Capacity, kW (Nuclear)	700,000	700,000	700,000	700,000	700,000
ENERGY PURCHASES (In thousands)					
Electric kWh	480,894	14,835	0	0	52,450
Distribution Gas MCF	25,905	21,664	23,998	26,308	27,673
ELECTRIC PEAK DEMAND kW	4,091,000	3,729,000	3,684,000	3,448,000	3,356,000
NUMBER OF CUSTOMERS					
Electric	578,296	563,127	550,956	539,400	528,739
Gas	305,811	303,871	302,719	301,181	300,185
RESIDENTIAL AVERAGES					
Electric:					
Revenue per customer	\$ 1,026.56	\$ 874.10	\$ 892.38	\$ 833.89	\$ 862.33
kWh per customer	14,280	13,245	13,685	12,714	13,306
Revenue per kWh	7.20¢	6.60¢	6.52¢	6.56¢	6.48¢
Gas:					
Revenue per customer	\$ 430.49	\$ 211.34	\$ 235.00	\$ 284.93	\$ 313.44
MCF per customer	44.9	35.5	42.4	48.6	49.3
Revenue per MCF	\$ 9.58	\$ 5.96	\$ 5.55	\$ 5.86	\$ 6.35
NUMBER OF EMPLOYEES	3,994	3,810	3,639	3,475	3,427

(1) Excludes joint systems operating generation.

City Public Service Board of San Antonio, Texas

Financial Statements
Years ended January 31, 2001 and 2000

(With Independent Auditors' Report Thereon)



Audited Financial Statements

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Independent Auditors' Report

The Board of Trustees
City Public Service Board of San Antonio, Texas

We have audited the accompanying balance sheets of the City Public Service Board of San Antonio, Texas (City Public Service), a component unit of the City of San Antonio, Texas, as of January 31, 2001 and 2000, and the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of City Public Service's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of City Public Service Employees' Pension Plan or City Public Service Decommissioning Master Trust for the South Texas Project. The financial information related to the City Public Service Employees' Pension Plan is included in footnote 6 of the notes to financial statements. The assets of the City Public Service Decommissioning Master Trust for the South Texas Project of \$119,840,000 and \$95,493,000 as of January 31, 2001 and 2000, respectively, were combined with City Public Service as a blended component unit. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion on the City Public Service financial statements, insofar as it relates to the amounts and disclosures included for the City Public Service Employees' Pension Plan and the City Public Service Decommissioning Master Trust for the South Texas Project, is based on the reports of other auditors.

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 and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of City Public Service as of January 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP Palatka Williams CPA Seal & Carter, A.C.

March 16, 2001



Balance Sheets

	January 31,	
	2001	2000
	<i>(In thousands)</i>	
Assets		
UTILITY PLANT, at cost <i>(Notes 1, 9, 10, and 14)</i> :		
Plant in service —		
Electric	\$ 5,172,843	\$ 4,886,513
Gas	418,252	413,847
General	238,519	226,509
Total plant in service	5,829,614	5,526,869
Less-accumulated depreciation	1,948,230	1,808,877
Plant in service, net	3,881,384	3,717,992
Construction work in progress	142,090	345,751
Utility property leased	18,647	18,713
Held for future use	12,599	12,599
Nuclear fuel, less accumulated amortization of		
\$223,816 in 2001 and \$207,991 in 2000	34,420	39,152
Utility plant, net	4,089,140	4,134,207
RESTRICTED CASH AND INVESTMENTS <i>(Notes 1, 2, and 3)</i> :		
South Texas nuclear project decommissioning		
master trust <i>(Notes 1 and 9)</i>	119,840	95,493
Bond construction fund, TECP, and bond debt service requirements	72,957	90
Repair and replacement account	465,206	330,984
Cash restricted for customer service deposits	26,879	25,757
Other	67,045	67,000
Total restricted cash and investments	751,927	519,324
CURRENT ASSETS:		
Cash and temporary investments <i>(Notes 1 and 2)</i>	204,175	116,177
Customer accounts receivable, less allowance for doubtful accounts		
of \$5,567 in 2001 and \$975 in 2000	130,079	70,953
Other receivables	55,496	37,666
Inventories and supplies, at average cost —		
Materials and supplies	73,479	66,977
Fuel stock	24,267	33,634
Prepayments and other	26,583	11,097
Total current assets	514,079	336,504
OTHER ASSETS AND DEFERRED COSTS:		
Prepaid rent – leaseback <i>(Notes 1 and 12)</i>	595,341	0
Other <i>(Note 1)</i>	28,189	15,734
Total other assets and deferred costs	623,530	15,734
TOTAL ASSETS	\$ 5,978,676	\$ 5,005,769

The accompanying notes are an integral part of these financial statements.



	January 31,	
	2001	2000
	<i>(In thousands)</i>	
Equity and Liabilities		
LONG-TERM DEBT:		
New series bonds <i>(Notes 3 and 4)</i>	\$ 2,597,065	\$ 2,663,360
Unamortized discount on new series bonds	(3,485)	(17,675)
Unamortized costs of bond reacquisition	(158,691)	(191,830)
New series requirements, net	2,434,889	2,453,855
Commercial paper <i>(Note 5)</i>	252,800	134,800
Long-term debt, net	<u>2,687,689</u>	<u>2,588,655</u>
EQUITY:		
Reserved retained earnings <i>(Note 3)</i> —		
Repair and replacement account	464,050	330,984
Electric overhead conversion fund <i>(Note 1)</i>	38,721	38,732
Total reserved retained earnings	502,771	369,716
Unreserved retained earnings invested in or designated for plant and working capital	1,636,760	1,678,818
Total equity	<u>2,139,531</u>	<u>2,048,534</u>
CURRENT LIABILITIES:		
Current maturities of revenue bonds <i>(Note 4)</i>	71,755	67,215
Accounts payable and accrued liabilities	168,607	122,537
Deferred lease revenue <i>(Notes 1 and 12)</i>	22,561	0
Total current liabilities	<u>262,923</u>	<u>189,752</u>
OTHER LIABILITIES AND DEFERRED CREDITS:		
Payable from restricted assets —		
Customer service deposits	26,879	25,757
South Texas nuclear project decommissioning master trust <i>(Notes 1 and 9)</i>	119,840	95,493
Other <i>(Note 1)</i>	24,686	24,862
Deferred lease revenue <i>(Notes 1 and 12)</i>	678,696	0
Customer advances for construction <i>(Note 1)</i>	18,771	16,745
Other liabilities and credits <i>(Note 1)</i>	19,661	15,971
Total other liabilities and deferred credits	<u>888,533</u>	<u>178,828</u>
COMMITMENTS AND CONTINGENCIES <i>(Notes 3, 6, 7, 8, 9 and 13)</i>	0	0
TOTAL EQUITY AND LIABILITIES	<u>\$ 5,978,676</u>	<u>\$ 5,005,769</u>

The accompanying notes are an integral part of these financial statements.



Statements of Revenues, Expenses and Changes in Retained Earnings

	Years Ended January 31,	
	2001	2000
	<i>(In thousands)</i>	
OPERATING REVENUE <i>(Note 1)</i> :		
Electric	\$ 1,124,414	\$ 933,629
Gas	214,556	107,020
Total operating revenue	<u>1,338,970</u>	<u>1,040,649</u>
OPERATING EXPENSES <i>(Note 1)</i> :		
Fuel, purchased power and distribution gas	460,210	259,477
Other operating and general	189,142	178,075
Maintenance	75,459	81,339
Regulatory assessments <i>(Note 13)</i>	29,335	2,024
Depreciation	197,322	165,177
Total expenses	<u>951,468</u>	<u>686,092</u>
OPERATING INCOME	387,502	354,557
NONOPERATING INCOME (EXPENSE) <i>(Note 1)</i> :		
Interest and other income	51,609	39,320
Interest expense	(151,154)	(151,470)
Amortization of debt reacquisition, issuance, discount and other costs	(21,961)	(22,859)
Allowance for funds used during construction	12,593	13,286
Costs for cash defeasance of debt <i>(Note 4)</i>	(2,586)	0
INCOME BEFORE OPERATING TRANSFERS	276,003	232,834
Payments to the City of San Antonio	(185,006)	(145,474)
NET INCOME	90,997	87,360
ACCUMULATED RETAINED EARNINGS AT BEGINNING OF YEAR ...	2,048,534	1,961,174
ACCUMULATED RETAINED EARNINGS AT END OF YEAR	<u>\$ 2,139,531</u>	<u>\$ 2,048,534</u>

The accompanying notes are an integral part of these financial statements.



Statements of Cash Flows

Years Ended January 31,

	2001	2000
	<i>(In thousands)</i>	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Operating income	\$ 387,502	\$ 354,557
Noncash items included —		
Depreciation expense	197,322	165,177
Nuclear fuel amortization	15,825	18,212
Other	0	(70)
Changes in current assets and liabilities:		
(Increase) decrease in customer accounts receivable	(59,126)	10,855
(Increase) decrease in other receivables	(18,406)	(11,325)
(Increase) decrease in inventories and supplies	2,865	(18,359)
(Increase) decrease in prepayments and other	(15,486)	(4,020)
Increase (decrease) in accounts payable and accrued liabilities	68,631	14,651
Changes in other assets, deferred costs, other liabilities, and deferred credits:		
(Increase) decrease in other assets	445	513
Increase (decrease) in customer service deposits payable	1,122	209
Increase (decrease) in decommissioning trust liability	24,347	6,028
Increase (decrease) in other liabilities and deferred credits	3,513	2,990
Net cash provided (used) by operating activities	<u>608,554</u>	<u>539,418</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Cash paid for additions to utility plant and net removal costs	(237,062)	(389,545)
Cash paid for nuclear purchases	(11,093)	(20,762)
Joint operations agreement proceeds to be used for construction	72,607	15,239
Litigation settlement proceeds to be used for construction	10,306	18,975
Contributions in aid and customer advances for construction	12,317	11,477
Proceeds from issuance of revenue bonds	227,235	0
Proceeds from issuance of commercial paper	118,000	6,500
Cash paid for defeasance of bonds	(198,115)	0
Principal payments on revenue bonds	(67,215)	(63,720)
Interest paid	(151,154)	(151,470)
Debt issue costs paid	(2,254)	0
Costs for cash defeasance of debt	(45)	0
Proceeds from lease transaction	725,000	0
Payments for leaseback transaction	(637,027)	0
Net cash provided (used) by capital and related financing activities	<u>(138,500)</u>	<u>(573,306)</u>
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES:		
Cash payments to the City of San Antonio	(184,747)	(145,474)
Cash payment to the City from lease/leaseback transaction	(12,316)	0
Other	0	538
Net cash provided (used) by non-capital financing activities	<u>(197,063)</u>	<u>(144,936)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(1,104,592)	(948,862)
Proceeds from sales and maturities of investments	882,285	1,056,753
Net increase in nuclear decommissioning trust	(24,279)	(8,057)
Interest, non-operating income and other	29,040	36,145
Net cash provided (used) by investing activities	<u>(217,546)</u>	<u>135,979</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	55,445	(42,845)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	6,738	49,583
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 62,183	\$ 6,738
Reconciliation of Cash and Investments:		
Restricted Cash and Investments:		
Cash and cash equivalents	\$ 41,281	\$ 757
Investments	710,646	518,567
Total	<u>751,927</u>	<u>519,324</u>
Current Assets:		
Cash and cash equivalents	20,902	5,981
Investments	183,273	110,196
Total	<u>204,175</u>	<u>116,177</u>
Total Restricted and Current Assets:		
Cash and cash equivalents	62,183	6,738
Investments	893,919	628,763
Total	<u>\$ 956,102</u>	<u>\$ 635,501</u>

The accompanying notes are an integral part of these financial statements.



NOTES TO FINANCIAL STATEMENTS JANUARY 31, 2001 AND 2000

1. Summary of Significant Accounting Policies

REPORTING ENTITY — City Public Service Board of San Antonio (CPS), a municipal utility owned by the City of San Antonio (the City) provides electricity and natural gas to San Antonio and surrounding areas. As a municipal utility, CPS is exempt from payment of income taxes, state franchise and sales taxes, and real and personal property taxes. CPS provides certain payments and benefits to the City as required by bond ordinances.

BASIS OF ACCOUNTING — The financial statements of CPS are presented in accordance with generally accepted accounting principles for proprietary funds of governmental entities. Accounting records generally follow the Uniform System of Accounts for Electric and Gas Utilities issued by the National Association of Regulatory Utility Commissioners.

CPS complies with all applicable pronouncements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, CPS has elected not to follow the pronouncements of the Financial Accounting Standards Board (FASB) issued after November 30, 1989.

FISCAL YEAR — The fiscal year ended January 31, 2001, is referred to herein as 2001; the fiscal years ended January 31, 2000, January 31, 1999, and January 31, 1998, are referred to herein as 2000, 1999, and 1998, respectively.

REVENUE AND EXPENSES — Revenues are recorded when billed. Customers' meters are read, and bills are rendered, monthly. Rate schedules include fuel and gas cost adjustment clauses that permit recovery of fuel and gas costs in the month incurred. CPS reports fuel and distribution gas costs on the same basis as it recognizes revenue. CPS' fuel cost adjustment clause permits recovery of regulatory assessments. Beginning in March 2000, CPS began recovering assessments from the Public Utility Commission of Texas (PUCT) for transmission access charges and from the Texas Independent System Operator (ISO) for operating costs.

UTILITY PLANT — The costs of utility plant additions and replacements are capitalized. Maintenance and replacements of minor items are charged to operating expenses. The cost of depreciable plant retired is eliminated from the plant accounts, and such costs plus removal expense less salvage value are charged to accumulated depreciation.

Utility plant is stated at the cost of construction, including costs of contracted services, direct equipment material and labor, indirect costs, including general engineering, labor, equipment, and material overhead, and an allowance for funds used during construction (AFUDC). CPS computes AFUDC using rates which approximate the cost of borrowed funds, or the short-term investment rate for other funds used for construction. AFUDC is applied to projects estimated to cost in excess of \$250,000 and to require thirty days or more to complete. Proceeds from customers, litigation settlements, and insurance recoveries to partially fund construction expenditures are credited against utility plant costs.

CPS computes depreciation using the straight-line method over the estimated service lives of the various classes of depreciable property. Depreciation as a percentage of total utility plant was 3.35 percent in 2001 and 3.00 percent in 2000.

RESTRICTED CASH AND INVESTMENTS — These funds are generally for uses other than current operations. They may be designated or segregated to acquire or construct non-current assets. Funds consist primarily of customer service deposits, unspent bond issue or commercial paper proceeds, debt service required for the New Series Bonds, and funds for future construction or contingencies. This category also includes customer assistance programs and funds appropriated for insurance retentions.



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The CPS Board authorized that funds be designated for converting overhead electric facilities to underground. One percent of the prior fiscal year's electric revenue from cities and unincorporated areas served by CPS are appropriated for this program.

CPS reports the STP Decommissioning Trust Investments at fair value since they mature more than one year from date of purchase. CPS recorded an adjustment in 2001 to report all investments in other fund portfolios with original maturities of greater than one year from their purchase date at fair value. Fair value is determined by using generally accepted financial reporting services and publications and approved dealers and brokers as necessary. The current year increase in fair value of \$1.3 million has been included in nonoperating income for 2001. All other investments are stated at amortized cost, which approximates fair value. These investments will mature within one year from their purchase date. The specific identification method is used to determine cost in computing gain or loss on sales of securities. Amortization of premium and accretion of discount are recorded over the terms of the investments that mature within one year.

OTHER ASSETS AND DEFERRED COSTS — In June 2000, CPS entered into a lease/leaseback transaction with Unicom Corporation (Unicom). The long-term portion of prepaid rent related to this transaction has been recorded as a deferred cost. In addition, \$12.3 million less expenses of \$350 thousand has been paid to the City of San Antonio, in accordance with the New Series Bond Ordinance, for its 14% share of the net benefit from the transaction. This is recorded as a prepaid item to be amortized over the life of the lease. See note 12 for more information.

Non-current assets include unamortized debt issuance expenses, which are amortized over the period of the outstanding bonds. Other assets include the long-term receivable from the San Antonio Water Systems for the sale of water rights in 2000.

Non-current deferred costs also include a special assessment fee by the Department of Energy (DOE) for decommissioning of U.S. nuclear fuel enrichment facilities. CPS recorded this in fiscal 1994 to be amortized over a 15-year period to nuclear fuel expense.

OTHER LIABILITIES AND DEFERRED CREDITS — The long-term portion of the deferred revenue associated with the lease of the J.K. Spruce Plant is recorded as a deferred credit. See note 12 for more information.

Other liabilities and deferred credits generally include the decommissioning trust liability, customer service deposits and advance payments from customers for construction, and the DOE special assessments. See other assets and deferred costs. The long-term portion of the payable to the Greater Kelly Development Authority (GKDA) for the purchase of realigned electric and gas properties in 2000 has also been recorded with other liabilities.

STATEMENT OF CASH FLOWS — For purposes of reporting cash flows, CPS considers all highly liquid debt instruments purchased with a maturity of approximately three months or less to be cash equivalents.

There was a material noncash capital and related financing activity in 2000 related to the acquisition of utility infrastructure facilities from the military through the GKDA. As of January 2000, CPS recorded estimated liabilities with a net present value of \$8 million for acquisition of electric and gas infrastructures acquired from local military bases. For more information, see Other Liabilities and Deferred Credits.

2. Cash and Investments

CPS' cash deposits at January 31, 2001 and 2000 were entirely insured or collateralized by banks for the account of CPS. For deposits that were collateralized, the securities were U.S. Government or Government Agency or U.S. Government guaranteed obligations held in book entry form by the Federal Reserve Bank in CPS' name. CPS' cash book values were approximately \$6.8 million at January 31, 2001 and \$6.7 million at January 31, 2000. CPS' bank balances were \$24.1 million at January 31, 2001 and \$12.3 million at January 31, 2000.



At January 31, 2001 and 2000, CPS' investments excluding the Decommissioning Trust, were all in U.S. Government or Government Agency obligations and were held in book entry form by the Federal Reserve Bank in the name of the safekeeping depository for the account of CPS. The scope of allowable CPS investments as defined by CPS Board Resolution and Policy, Bond Ordinances, Tax-Exempt Commercial Paper Ordinance and State Law, includes U.S. Government or Government Agency or U.S. Government guaranteed obligations, collateralized mortgage obligations issued by the U.S., fully secured certificates of deposit issued by a state, national bank, or savings bank domiciled in the State of Texas, direct repurchase agreements, reverse repurchase agreements, defined bankers acceptances and commercial paper, no-load money market mutual funds, and other types of specific secured or guaranteed investments. However, CPS' current investment strategy limits investments primarily to direct obligations of the U.S. Government or its agencies and money market mutual funds. The carrying value of investments were \$830.8 million with a total fair value of \$838.1 million at January 31, 2001, and were \$534.2 million with a fair value of \$536.8 million at January 31, 2000.

At January 31, 2001 and 2000, CPS' investments in the Decommissioning Trust were held by an independent trustee. Trust investments are generally limited to U.S. Government or Government Agency or U.S. Government guaranteed obligations by CPS Board Resolution and Policy, Trust Agreement, and State Law. Investment securities were carried at fair values of \$118.5 million for 2001 and \$94.6 million for 2000. These funds included U.S. Treasury Strips, purchased with the intent of holding until maturity, with a fair value of \$41.0 million and \$35.2 million, respectively, for 2001 and 2000. They are subject to market risk and their market value will vary as interest rates fluctuate. This could affect the value at which these securities are recorded.

3. Revenue Bond Ordinance Requirements

As of January 31, 2001, the Bond Ordinances for New Series bonds issued on and after August 6, 1992 contain, among others, the following provisions:

Gross Revenue is applied as follows: (a) for maintenance and operating expenses of the systems, (b) for payments of the New Series Bonds, (c) for the payment of any obligations inferior in lien to the New Series Bonds which may be issued, (d) for an amount equal to 6 percent of the gross revenues of the systems to be deposited in the Repair and Replacement Account, (e) for cash payments and benefits to the City not to exceed 14 percent of the gross revenues of the systems, and (f) any remaining net revenues in the General Account to the Repair and Replacement Account.

4. Revenue Bonds

A summary of revenue bonds is as follows:

Maturities	Weighted-Average Interest Rate on Outstanding Bonds at January 31, 2001	January 31	
		2001	2000
		<i>(In thousands)</i>	
Tax-Exempt New Series Bonds, 1992–2000, 2002–2021	5.236%	\$2,521,350	\$2,631,965
Taxable New Series Bonds, 1998–2000, 2002–2021	6.666%	147,470	98,610
Total new series bonds outstanding	5.327%	2,668,820	2,730,575
Less: Current maturities of bonds		71,755	67,215
Total new series bonds outstanding, net of current maturities		<u>\$2,597,065</u>	<u>\$2,663,360</u>



Principal and interest amounts due (in thousands) for each of the next five years and thereafter to maturity are:

Year	Principal	Interest	Total
2002	\$ 71,755	\$ 140,904	\$ 212,659
2003	77,825	137,404	215,229
2004	100,740	133,754	234,494
2005	120,335	128,598	248,933
2006	126,635	122,352	248,987
Thereafter to maturity	2,171,530	892,084	3,063,614
Total	\$2,668,820	\$1,555,096	\$4,223,916

In November 2000, \$215.7 million par value of 1992 New Series bonds were legally defeased with cash. The net accounting loss of \$2.6 million reported included the par value of debt less \$198.1 million paid for the actual defeasance, plus unamortized reacquisition and bond issue costs of \$20.2 million.

In 2001, CPS issued \$221.2 million in revenue bonds which consisted of \$170.8 million in Tax-Exempt Bonds at an average interest rate of 5.4%, and \$50.4 million in Taxable Bonds at an average interest rate of 7.44%. The bonds were sold at a combined net premium of \$6.0 million. Of the net proceeds from the New Series 2000 Bonds, \$184.9 million was used to reimburse the Repair and Replacement Account for prior construction expenditures. In addition, \$34.0 million of new money proceeds were deposited into the Bond Construction Fund to finance transmission projects.

5. Commercial Paper

In 1988, the City Council of San Antonio, Texas (City Council) adopted an ordinance authorizing the issuance of up to \$300 million in TECP. This ordinance as amended provides for funding to assist in the financing of eligible projects, including fuel acquisition and capital improvements to the utility systems (the Systems), and to refinance or refund any outstanding obligations which are secured by and payable from a lien on and/or a pledge of net revenues of the Systems. The program's scheduled maximum maturities will not extend beyond November 1, 2028.

The TECP has been classified as long-term in accordance with the refinancing terms under a revolving credit agreement with a consortium of banks, which supports the commercial paper. Under the terms of the agreement, CPS may borrow up to an aggregate amount not to exceed \$350 million for the purpose of paying amounts due under the TECP. The credit agreement has a term of two years, currently extended until November 1, 2002, and may be renewed for additional periods.

To date, there have been no borrowings under the credit agreement. The TECP is secured by the net revenues of the Systems. Such pledge of net revenues is subordinate and inferior to the pledge securing payment of existing New Series bonds and any to be issued in the future.

CPS sold \$118 million of TECP in fiscal year 2001; \$78 million has been used to fund construction expenditures through January 2001.

A summary of TECP is as follows:

	January 31	
	2001	2000
TECP outstanding (<i>In thousands</i>)	\$252,800	\$134,800
Weighted-average interest rate of outstanding TECP, approximate	3.95%	3.69%
Average life of outstanding TECP approximate number of days	92	86



6. Benefit Plans

The City Public Service Pension Plan is a self-administered, single-employer, defined-benefit contributory pension plan (Plan) covering substantially all employees who have completed one year of service. Normal retirement is age 65; however, early retirement is available with 25 years of benefit service and to those employees who are ages 55 or older with at least 10 years of benefit service.

Retirement benefits are based on length of service and compensation, and benefits are reduced for retirement before age 55. The Plan is sponsored by and may be amended by CPS. Plan net assets, having a market value of \$823.5 million at December 31, 2000 and \$830.6 million at December 31, 1999, are held in a separate trust that is periodically audited and which statements include historical trend information. For further information, contact the Employee Benefits Division at CPS.

The current policy of CPS is to establish funding levels, considering annual actuarial evaluations and recommendations of the Administrative/Investment Committee, using both employee and employer contributions. Generally, participating employees contribute 5 percent of their total compensation and are normally fully vested in CPS' contribution after completing 7 years of credited service or at age 40.

Employee contributions commence with the effective date of participation, and continue until attaining normal or early retirement age or termination of employment. The balance of Plan contributions are the responsibility of CPS giving consideration to actuarial information, budget controls, legal requirements, compliance and industry and/or community norms.

CPS adopted two Restoration Plans effective January 1, 1998, to supplement Pension benefits paid from the Plan due to federal tax restrictions on benefit amounts. The benefits due under the Restoration Plans have been recognized by CPS.

The total employer and employee pension funding, which includes amortization of past service costs using the unit credit cost actuarial method, is summarized as follows:

	2001	2000
	<i>(In thousands)</i>	
Employee contributions	\$ 7,197	\$ 6,692
CPS contributions	5,633	12,471
Total contributions	<u>\$ 12,830</u>	<u>\$ 19,163</u>
Covered payroll	<u>\$ 148,936</u>	<u>\$ 138,488</u>
Total payroll	<u>\$ 164,143</u>	<u>\$ 152,225</u>

The actuarially determined contribution requirements for 2001 and 2000 were computed using an assumed rate of return of 8.5 percent. For 2001 and 2000 the past-service costs were amortized over a targeted 10 years, as compared to a 15-year amortization for 1999. No changes in actuarial cost methods or actuarial assumptions were made in 2000 or 2001, which would affect the comparability of results with the prior year.

CPS' contributions to the Plan amounted to 3.8 percent of covered payroll in 2001, 9.0 percent in 2000 and 11.1 percent in 1999.



A schedule of funding progress under GASB Statement No. 27 guidelines follows:

	Actuarial Valuation Date (Unaudited)		
	1/1/00	1/1/99	1/1/98
	<i>(In millions)</i>		
1. Actuarial Value of Assets	\$648.1	\$563.4	\$507.6
2. Actuarial Accrued Liability(AAL)	610.8	565.0	520.5
3. Unfunded AAL (UAAL): (2) - (1)	(37.3)	1.6	12.9
4. Funded Ratio (1) ÷ (2)	106.1%	99.7%	97.5%
5. Covered Payroll	148.9	138.5	129.1
6. UAAL as a Percentage of Covered Payroll: (3) ÷ (5)	(25.1%)	1.2%	10.0%

Methods used for the January 1, 2000, 1999, and 1998 actuarial valuations include (a) the five-year smoothed market method for asset valuation, (b) the projected unit credit for pension cost, and (c) the level dollar for amortization. The remaining amortization periods for 2000, 1999, and 1998 are 11.01 years, 1.0 years, and 2.84 years respectively and are calculated using the level dollar open amortization method.

Significant actuarial assumptions used for the January 1, 2000, 1999, and 1998 actuarial valuations include (a) a rate of return on the investment of present and future assets of 8.5% per year compounded annually, (b) projected salary increases averaging 5.0%, and (c) post-retirement cost-of-living increases of 2.0%. The projected salary increases include an inflation rate of 4.0%.

As calculated under GASB Statement No. 27 guidelines, CPS' annual pension cost and net pension obligation for the fiscal periods ended January 31, 2001, January 31, 2000, and January 31, 1999 were as follows:

	2001	2000	1999
	<i>(In thousands)</i>		
Annual required contribution (ARC)	\$ 5,397	\$ 12,288	\$ 14,642
Interest on net pension obligation (NPO)	8	42	0
Adjustment to ARC	(13)	(490)	0
Annual pension cost (APC)	5,392	11,840	14,642
CPS Contributions in relation to ARC	(5,392)	(12,231)	(14,152)
Increase (decrease) in NPO	0	(391)	490
Net pension obligation beginning of year	99	490	0
Net pension obligation end of year	99	99	490
Percentage of APC contributed	100.0%	103.0%	96.7%

Employees who retired prior to 1983 are receiving annuity payments from an insurance carrier as well as receiving some benefits directly from CPS. CPS' costs for fiscal 2001 and 2000 were \$312 thousand and \$353 thousand respectively, and were recorded when paid.

7. Other Postemployment Benefits

CPS provides certain health care and life insurance benefits for retired employees. Most former CPS employees are eligible for these benefits upon retirement from CPS. Plan assets are held as part of CPS' Group Health and Life Insurance Plans. Plan funding is from both participant and employer contributions determined by annual actuarial and in-house calculations. Retired employees contribute to the health plan in varying amounts depending upon an equity formula that considers age and years of service. The Plans may be amended by CPS. The annual cost of retiree health care and life insurance benefits funded by CPS is recognized as an expense of CPS as employer contributions are made to the programs. These costs approximated \$2.7 million for 2001 and \$2.3 million for 2000. CPS reimbursed certain retirees and their spouses enrolled in Medicare Part B a percentage of the monthly premium. Costs totaled \$219 thousand for 2001 and \$234 thousand for 2000.



Retired employees and covered dependents contributed \$1.1 million and \$941 thousand for their health care and life insurance benefits in fiscal 2001 and 2000, respectively. In fiscal 2001, there were approximately 2,070 retirees and covered dependents eligible for health care and life insurance benefits, as compared to approximately 1,985 in 2000.

In view of the potential economic significance of these benefits, CPS has reviewed the present value of the postemployment benefit obligations for current retirees. The January 1 valuations are \$45.2 million in 2000 and \$42.0 million in 1999 for health and \$16.0 million in 2000 and \$15.2 in 1999 for life insurance benefits. The actuarial analysis of the present value of postemployment benefit obligations for other participants fully eligible for benefits are estimated to be \$31.6 million for health, \$4.7 million for life insurance and \$2.6 million for disability benefits. CPS began partial accrual and funding of projected future benefits in 1992. Funding totaled \$2.6 million in fiscal 2001, \$3.7 million in 2000 and \$5.2 million in 1999.

For the health plan, the actuarial cost method used is the Projected Unit Credit Actuarial Cost Method. For the life insurance and disability plans, CPS uses a present value method to determine the cost of benefits.

Significant actuarial assumptions used in the calculations for the January 1, 2000 and 1999 actuarial valuations include (a) a rate of return on the investment of present and future assets of 8.5% per year for the health and life plans and 7% per year for the disability, (b) projected salary increases for the plans ranging from 3.3% to 12.0% depending on age for base and other salaries, and (c) medical cost increases projected at 6% for 2001 and 2000.

8. Risk Management

CPS is exposed to various risks of loss including those related to torts, theft or destruction of assets, errors and omissions, and natural disasters. CPS purchases commercial liability and property insurance coverages to provide protection in event of large/catastrophic claims. CPS performs actuarial studies periodically to determine its insurance retentions. An actuarial study was last performed in 2000.

In addition, CPS is exposed to risks of loss due to death of, injuries to, or illnesses of, its employees. At January 31, 2001 and 2000, CPS has accumulated approximately \$139.1 million and \$143.4 million, respectively, in external trusts for these risks. The trust accounts and related claims liabilities are not included in CPS' financial statements. CPS has recorded \$18.3 million of expense related to these risk programs for the year ended January 31, 2001 and \$17.4 million for the year ended January 31, 2000.

In 2001, CPS recorded \$12.0 million additional depreciation expense for dismantling of storeroom and general property locations. CPS recorded estimated costs for landfill and fly ash pond closure, dismantling, and remediation of \$0.4 million in 2001. Closure and postclosure costs were estimated for the Class I non-hazardous waste landfill in accordance with EPA regulations.

Based upon the guidance of GASB Statement No. 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, the following information is provided regarding the changes in the insurance reserves for property, and employee and public liability claims for the years ended January 31, 2001 and 2000:

	Property Insurance	Employee & Public Liability Claims
Balance – 1/31/99	\$ 10,252,109	\$ 3,539,632
Payments	(101,458)	(3,486,267)
Incurred Claims	7,500	5,549,242
Balance – 1/31/00	10,158,151	5,602,607
Payments	(620,130)	(2,880,072)
Incurred Claims	405,800	3,116,989
Balance – 1/31/01	<u>\$ 9,943,821</u>	<u>\$ 5,839,524</u>



9. South Texas Project (STP)

CPS is one of four participants in the STP, which consists of two 1,250-megawatt nuclear generating units in Matagorda County, Texas. The other participants in the STP are Reliant Energy, formerly known as Houston Lighting and Power Company, Central Power and Light Company, and the City of Austin. In-service dates for STP were August 1988 for Unit 1 and June 1989 for Unit 2. CPS' 28-percent ownership in the STP represents 700 megawatts of plant capacity. At January 31, 2001 and 2000, CPS' investment in the STP utility plant was approximately \$1.7 billion, net of accumulated depreciation.

Effective November 17, 1997, the Participation Agreement among the owners of STP was Amended and Restated and the STP Nuclear Operating Company, a Texas non-profit non-member corporation created by the participants, assumed responsibility as the licensed operator of STP. The participants share costs in proportion to ownership interests, including all liabilities and expenses of STP Nuclear Operating Company.

CPS amortizes its share of nuclear fuel for the South Texas Project (STP) to fuel expense on a unit-of-production method. Under the Nuclear Waste Policy Act of 1982, the federal government assumed responsibility for the permanent disposal of spent nuclear fuel. CPS is charged a fee for disposal of spent nuclear fuel, which is based upon CPS' share of the STP generation that is available for sale to CPS customers. This charge is included in fuel expense monthly.

NUCLEAR INSURANCE — The Price-Anderson Act, a comprehensive statutory arrangement providing limitations on nuclear liability and governmental indemnities, is in effect until August 1, 2002. The limit of liability under the Price-Anderson Act for licensees of nuclear power plants is \$9.34 billion per incident. The maximum amount that each licensee may be assessed following a nuclear incident at any insured facility is \$83.9 million, subject to adjustment for inflation, for the number of operating nuclear units and for each licensed reactor, payable at \$10 million per year per reactor for each nuclear incident. CPS and each of the other participants of STP are subject to such assessments, which will be borne on the basis of their respective ownership interests in STP. For purposes of these assessments, STP has two licensed reactors. The participants have purchased the maximum limits of nuclear liability insurance, as required by law, and have executed indemnification agreements with the NRC, in accordance with the financial protection requirements of the Price-Anderson Act.

A Master Worker Nuclear Liability policy, with a maximum limit of \$400 million for the nuclear industry as a whole, provides protection from nuclear-related claims of workers employed in the nuclear industry after January 1, 1988 who do not use the workers' compensation system as sole remedy and bring suit against another party.

NRC regulations require licensees of nuclear power plants to obtain on-site property damage insurance in a minimum amount of \$1.06 billion. NRC regulations also require that the proceeds from this insurance be used first to ensure that the licensed reactor is in a safe and stable condition so as to prevent any significant risk to the public health or safety, and then to complete any decontamination operations that may be ordered by the NRC. Any funds remaining would then be available for covering direct losses to property.

The owners of STP currently maintain \$2.75 billion of nuclear property insurance, which is above the legally required amount of \$1.06 billion, but is less than the total amount available for such losses. The \$2.75 billion of nuclear property insurance consists of \$500 million in primary property damage insurance and \$2.25 billion of excess property damage insurance, both subject to a retrospective assessment being paid by all members of Nuclear Electric Insurance Limited (NEIL). In the event that property losses as a result of an accident at any nuclear plant insured by NEIL exceed the accumulated fund available to NEIL, a retrospective assessment could occur. The maximum aggregate assessment under current policies for both primary and excess property damage insurance is \$12.9 million during any one-policy year.



NUCLEAR DECOMMISSIONING — CPS, together with the other owners of the STP, files with the NRC a certificate of financial assurance for the decommissioning of the nuclear power plant. The certificate assures that CPS will meet the minimum decommissioning funding requirements mandated by the NRC. The STP owners agreed in the financial assurance plan that their estimate of decommissioning costs would be reviewed and updated periodically. In 1994, the owners conducted a review of decommissioning costs. The results estimated CPS' share of decommissioning costs at approximately \$270 million in 1994 dollars, which also exceeded NRC minimum requirements. In 1999, the owners conducted an additional review of decommissioning, and results showed that CPS' share of decommissioning costs are now approximately \$311 million in 1998 dollars.

In 1991, CPS started accumulating the decommissioning funds in an external trust, in accordance with the NRC's regulations. The Decommissioning Trust assets and related liabilities are included in CPS' financial statements as a component unit. At January 31, 2001, CPS has accumulated approximately \$119.8 million of funds in the external trust. Based on the annual calculation of financial assurance required by the NRC, CPS' trust balance exceeded the calculated financial assurance amounts of \$61.0 million at December 31, 2000 and \$51.5 million at December 31, 1999.

Based upon the 1994 decommissioning cost study, the annual levelized funding into the trust of \$9.4 million and \$8.8 million for 2001 and 2000, respectively, was expensed by CPS. As of January 2001, CPS increased its annualized funding amount to \$15.9 million.

10. Lignite Mining Lease and Assignment Agreement

CPS has an agreement with the Aluminum Company of America (ALCOA) dated December 28, 1998 regarding CPS' lignite reserves in Bastrop and Lee Counties, Texas. ALCOA began making advance royalty payments to CPS under the agreement in January, 1999. The base term of the agreement runs through 2013. ALCOA has the option to exercise six additional five-year extensions of the agreement. Thus, if ALCOA exercises all six extensions, the agreement will remain in effect until 2043. The agreement provides for royalty payments to CPS based on the amount of lignite mined by ALCOA, subject to certain minimum amounts per year once mining has commenced. The current estimate of the amount of the lignite to be mined by ALCOA under the agreement is 180 million tons over a 30-year period, although ALCOA may mine more or less than this amount. CPS will amortize the basis of the lignite at approximately \$18.8 million as royalty payments are received. As of January 2001, mining of the lignite by ALCOA has not commenced. CPS received advance royalty payments of \$1.0 million in 2001 and \$1.1 million in 2000.

11. Joint Operations Agreement

A 1997 Joint Operations Agreement resulted from the litigation settlement with Reliant Energy, formerly known as Houston Lighting & Power, over its management of STP during the construction and early operating periods. The Joint Operations Agreement is an arrangement to jointly dispatch CPS' and Reliant's generating plants to take advantage of the most efficient plants and favorable fuel prices of each utility. CPS receives, in monthly cash payments, ninety percent of the savings realized from the jointly operated systems. This joint operation agreement must result in at least \$10 million in cumulative savings per year to CPS, or Reliant will make up the difference in cash. A similar payment will be made by Reliant to ensure benefits to CPS of \$150 million in savings during the ten-year life of this agreement. As of January 31, 2001 CPS' total cumulative savings were \$137.6 million.

12. Lease/Leaseback

On June 2, 2000, CPS entered into a financial transaction with an affiliate of Unicom involving CPS' J.K. Spruce Unit No. 1 coal-fired electric generation unit. The transaction included a headlease for a term of approximately 65 years in combination with a leaseback of the facility by CPS for approximately 32 years. CPS retains fee simple title to and operating control of the facility and retains all revenues generated from sales of electricity produced from the facility. CPS received the appraised fair value of the unit, \$725.0 million, which will be amortized over 381 months. The transaction expenses and leaseback costs of \$637.0 million were recorded as prepaid items and are being amortized over 381 months. The utility has the option to cancel the headlease after the leaseback expires by making a payment to



Unicom's affiliate. CPS entered into a collateralized payment undertaking agreement that will generate funds sufficient to fund the cancellation option payment.

CPS' net benefits were approximately \$88.0 million. The City was paid \$12.3 million in accordance with the New Series Bond Ordinance, or its 14% share of this net benefit. This payment is recorded as a prepayment on the balance sheet and will be amortized over 381 months. As a result, net proceeds from the transaction of approximately \$75.7 million will be reported over the 32-year leaseback term. In 2001, the net amount recorded as income by CPS was \$1.8 million.

13. Commitments and Contingencies

In the normal course of business, CPS is involved in legal proceedings related to alleged personal and property damages, breach of contract, condemnation appeals and discrimination cases. In addition, CPS power generation activities and other utility operations are subject to extensive state and federal environmental regulation. In the opinion of management of CPS, the outcome of such proceedings will not have a material adverse effect on the financial position or results of operations of CPS.

Purchase and construction commitments amounted to approximately \$1.8 billion at January 31, 2001. This amount includes approximately \$671.9 million that is expected to be paid for natural gas purchases to be made under the contract currently in effect through the June 2002; the actual amount to be paid will depend upon CPS' actual requirements during the contract period and the price of gas. Commitments also include \$84.6 million for pipeline quality gas to be produced from the City of San Antonio "Nelson Gardens" landfill under the contract which is currently in effect to the beginning of the year 2017. Also included is \$47.4 million for coal purchases through December 2003, \$357 million for coal transportation through December 2004, and \$6.8 million for treated cooling water through December 2005, based upon the minimum firm commitment under these contracts.

Additional purchase commitments at January 31, 2001, which are related to STP, include approximately \$302.8 million for raw uranium, associated fabrication and conversion services. This amount represents services that will be needed for refueling through the year 2028.

The Public Utility Commission of Texas (PUCT) has promulgated new rules designed to comply with legislative changes affecting the utility industry. The Transmission Pricing and Access Rule (Rule) mandates that electric utilities charge customers for wholesale open transmission access according to a formula based on the amount of load served by each utility. This rate structure is in flux because transmission costs of service for major transmission owning utilities whose costs CPS will share are in the process of being determined by the PUCT, but potentially could cost CPS \$20 to \$25 million per year or more in additional transmission costs. Under a phased-in feature of this plan, CPS' costs for calendar years 1997, 1998, and 1999 were approximately \$1.3, \$1.4, and \$5.9, million respectively. CPS' cost for calendar year 2000 was approximately \$20.5 million. In March 2000, CPS began recovering these costs from customers.

CPS challenged the initial Rule's validity in State District Court. CPS appealed the State District Court's opinion upholding the Rule's validity, and the court of Appeals overturned the District Court's decision. The case was appealed by the Attorney General to the Texas Supreme Court, and the Supreme Court heard arguments on December 6, 2000, and the Supreme Court's decision is pending. This case will have only a limited effect for CPS in mitigating the impact of the PUCT's current Rules because the primary amounts CPS could potentially be refunded are only those deficit amounts from 1997, 1998, and 1999, referred to above.



14. Segment Information

	2001			2000		
	Electric	Gas	Total	Electric	Gas	Total
	<i>(In thousands)</i>			<i>(In thousands)</i>		
OPERATING REVENUE	\$ 1,124,414	\$ 214,556	\$ 1,338,970	\$ 933,629	\$ 107,020	\$ 1,040,649
EXPENSES:						
Operating and maintenance expenses	551,182	173,629	724,811	437,755	81,135	518,890
Regulatory transition assessment	29,335	0	29,335	2,024	0	2,024
Depreciation	181,210	16,112	197,322	151,593	13,585	165,178
Total expenses	761,727	189,741	951,468	591,372	94,720	686,092
OPERATING INCOME	\$ 362,687	\$ 24,815	387,502	\$ 342,257	\$ 12,300	354,557
Interest and other income			51,609			39,320
Net interest and debt expense			(160,522)			(161,043)
Costs for cash defeasance of debt			(2,586)			0
INCOME BEFORE OPERATING TRANSFERS ..			276,003			232,834
Payments to the City of San Antonio			(185,006)			(145,474)
NET INCOME			\$ 90,997			\$ 87,360
CAPITAL EXPENDITURES	\$ 210,264	\$ 38,381	\$ 248,645	\$ 349,346	\$ 82,650	\$ 431,996
ASSETS:						
Plant in service, net of accumulated depreciation:						
Production – all STP facilities	\$ 1,545,604	\$ 0	\$ 1,545,604	\$ 1,557,245	\$ 0	\$ 1,557,245
Production – other facilities	690,347	0	690,347	615,841	0	615,841
Transmission facilities	214,086	0	214,086	194,728	0	194,728
Distribution facilities	919,680	260,347	1,180,027	850,406	266,433	1,116,839
General facilities	62,954	18,517	81,471	46,720	15,593	62,313
Subtotal net plant in service	3,432,671	278,864	3,711,535	3,264,940	282,026	3,546,966
Identifiable construction work in progress	107,937	10,829	118,766	250,553	50,428	300,981
Nuclear fuel, net of accumulated amortization	34,420	0	34,420	39,152	0	39,152
Held for future use Utility &						
Property Leased	31,246	0	31,246	31,312	0	31,312
Total identifiable utility plant	\$ 3,606,274	\$ 289,693	3,895,967	\$ 3,585,957	\$ 332,454	3,918,411
Net common utility plant and common CWIP			193,173			215,796
Total net utility plant			4,089,140			4,134,207
Other identifiable assets	\$ 910,408	\$ 26,715	937,123	\$ 283,899	\$ 6,642	290,541
Total identifiable assets and common plant/CWIP ..			5,026,263			4,424,748
Unidentifiable assets			952,413			581,021
TOTAL ASSETS			\$ 5,978,676			\$ 5,005,769
TOTAL EQUITY AND LIABILITIES			\$ 5,978,676			\$ 5,005,769
NET WORKING CAPITAL			\$ 251,156			\$ 146,752





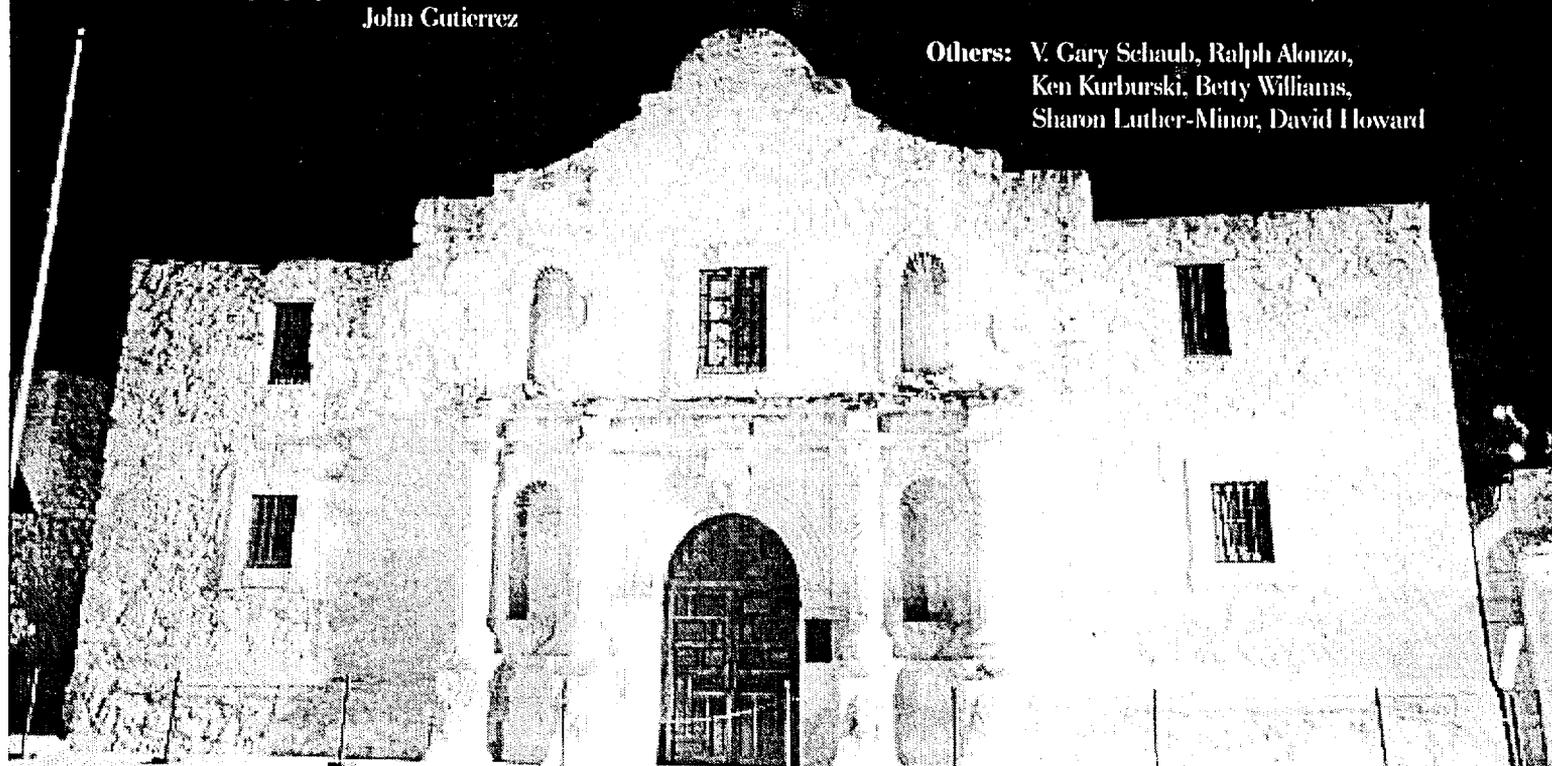
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*Two Distinct Businesses
One Great Year*

INFINITE POSSIBILITIES – *Everyone knows*

you can't compare apples and oranges.

Both are tasty – and good for you. But

they're different – like Reliant Energy's

two distinct businesses, regulated energy

delivery and competitive energy services.

A winning combination today, but strong

enough to stand apart.

**Our vision is to create two separate
companies. Both positioned for leadership.**

Each with a distinct investment appeal.

Traditional value. Emerging opportunities.

**It's a healthy balance for today with infinite
possibilities for the future.**

Company Description

Reliant Energy, Incorporated (NYSE: REI), based in Houston, Texas, is an international energy delivery and energy services company with more than \$29 billion in annual revenue and total assets exceeding \$32 billion. The company has more than 23,000 megawatts of power generation in operation in the United States and is one of only three companies to rank among both the five largest power marketers and the five largest natural gas marketers in the nation. The company also has wholesale trading and marketing operations and more than 3,400 MW of power generation in Western Europe. Reliant Energy's retail marketing and distribution operations serve nearly four million electricity and natural gas customers in the U.S., and its Internet infrastructure and communications company serves business customers in Texas.

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Operating Income (Loss) by Segment

	Year Ended December 31,	
	<i>(Millions of Dollars)</i>	
	2000	1999
Electric Operations	\$ 1,230	\$ 981
Natural Gas Distribution	113	158
Pipelines and Gathering	137	131
Wholesale Energy	482	27
European Energy	89	32
Other Operations	(172)	(71)
Total Operating Income	\$ 1,879	\$ 1,258

Financial Highlights

(In Thousands, Except Per Share Amounts)

	2000 ⁽¹⁾	1999 ⁽²⁾	1998 ⁽³⁾
Revenues	\$ 29,339,384	\$ 15,223,094	\$ 11,229,519
Operating Income	\$ 1,879,134	\$ 1,258,311	\$ 1,279,895
Net Income (Loss), As Reported	\$ 447,111	\$ 1,482,081	\$ (141,482)
Net Income, As Adjusted	\$ 837,774	\$ 508,394	\$ 485,141
Common Stock, Per Share			
Earnings Attributable To Common Stockholders, As Reported:			
Net Income (Loss), Basic	\$ 1.57	\$ 5.20	\$ (0.50)
Net Income (Loss), Diluted	\$ 1.56	\$ 5.18	\$ (0.50)
Earnings Attributable To Common Stockholders, As Adjusted:			
Net Income, Basic	\$ 2.94	\$ 1.78	\$ 1.71
Net Income, Diluted	\$ 2.92	\$ 1.78	\$ 1.71
Book Value	\$ 19.10	\$ 18.70	\$ 15.16
Market Price - Year End	\$ 43.31	\$ 22.88	\$ 32.06
Dividends	\$ 1.50	\$ 1.50	\$ 1.50
Capitalization			
Long-term Debt (Excludes Current Maturities)	\$ 4,996,095	\$ 4,868,643	\$ 6,674,226
Trust Preferred Securities	\$ 705,355	\$ 705,272	\$ 342,232
Preferred Stock	\$ 9,740	\$ 9,740	\$ 9,740
Common Stock Equity	\$ 5,472,320	\$ 5,296,592	\$ 4,312,128
Total Capitalization	\$ 11,183,510	\$ 10,880,247	\$ 11,338,326
Total Assets	\$ 32,076,746	\$ 26,456,466	\$ 18,967,371
Capital Expenditures	\$ 1,842,385	\$ 1,165,639	\$ 712,492
Business Acquisitions	\$ 2,121,481	\$ 1,060,000	\$ 292,398
Price To Earnings Ratio, As Adjusted	14.73	12.85	18.75
Common Stock Outstanding ⁽⁴⁾ (in thousands)	286,465	283,308	284,494
Number Of Common Stockholders	76,489	81,903	86,419
Number Of Employees	15,633	14,256	12,916

Net income for 2000, 1999 and 1998 has been adjusted to reflect the results of the company's Latin American segment as discontinued operations.

(1) The company recorded an after-tax loss from discontinued operations of \$331 million in 2000. Net income for 2000 has also been adjusted for an aggregate \$67 million accounting loss on indexed debt securities as well as an extraordinary gain of \$7 million related to the early extinguishment of \$272 million of long-term debt.

(2) The company recorded an after-tax loss from discontinued operations of \$9 million in 1999. Net income for 1999 has also been adjusted for an aggregate \$1166 billion, non-cash accounting gain on indexed debt securities and on the company's investment in AOL Time Warner common stock and a \$183 million extraordinary loss for the accounting impairment of certain electric operations generation related regulatory assets.

(3) The company recorded after-tax income from discontinued operations of \$137 million in 1998. Net income for 1998 has also been adjusted for a \$764 million, non-cash accounting loss on indexed debt securities and on the company's investment in AOL Time Warner common stock.

(4) Excludes treasury stock of 4,811,193, 3,624,618 and 102,805 shares at December 31, 2000, 1999 and 1998, respectively. Also excludes ESOP shares of 8,638,889, 10,679,489 and 11,674,063 at December 31, 2000, 1999 and 1998, respectively.



Dear Fellow Shareholder:

Two thousand was an outstanding year for our company in virtually all respects. Reliant Energy gained recognition as a major player in the rapidly evolving energy industry with attractive growth businesses in addition to our strong and stable regulated energy delivery operations.

Our success in transforming Reliant Energy from a regional electric utility into an international energy delivery and energy services company garnered positive coverage in the national business press and in numerous security analyst reports.

*For the first time in our company's history, we were among **Business Week's** "50 Best Companies in the S&P 500," and we ranked number one in our industry. We also were included in **Fortune** magazine's list of "100 Fastest-Growing Companies." At the end of the year, two-thirds of the Wall Street investment analysts who publish research on Reliant Energy had "buy" or "accumulate" ratings on our stock.*

A number of financial, operational and strategic achievements during 2000 helped us earn this positive recognition:

- ▶ **Strong Earnings:** We achieved a 65 percent increase in adjusted earnings, well above analysts' initial expectations and our own target of 10 to 12 percent growth.
- ▶ **Stock Performance:** Our stock price rose nearly 89 percent during 2000, and our shareholders enjoyed a total return of 99 percent.
- ▶ **Wholesale Expansion:** We doubled our non-regulated generating capacity in the U.S. We now have more than 9,000 MW in operation in five key power regions. We also achieved strong growth in our trading and marketing business with increases of 38 percent in physical natural gas sales and 81 percent in physical electricity sales.
- ▶ **Retail Position:** Our unregulated retail electric business has built its capabilities to serve and retain a large portion of the 1.7 million customers that it will initially gain when the Texas electric market opens to competition on January 1, 2002. We plan to build a significant retail electric business on this foundation.

- ▶ **Innovation:** We received recognition from *Information Week* magazine as the leading innovator in the utility industry for our use of the Internet. We've launched Internet initiatives to enhance customer service and convenience, increase efficiency in our business operations and provide potential new revenue sources.
- ▶ **Reliability:** Despite an abnormally hot summer that caused power shortages in other parts of Texas and the nation, Reliant Energy HL&P's service to customers was unaffected by the extreme weather conditions.

Business Separation Planned

Reliant Energy now has two very successful, but very different, types of business operations: regulated energy delivery and competitive energy services. Our competitive businesses appeal to a different set of investors than our regulated activities. During 2000, we developed a plan to split into two independent, publicly traded companies, one focusing on rate-regulated operations and the other encompassing our competitive businesses.

The separation will enable each entity to focus on its business and market opportunities and will give shareholders a choice of two distinct investments. We expect the regulated company to appeal to income-oriented investors. The competitive entity will strive to capitalize on unregulated acquisition, development and commercial opportunities resulting from the restructuring of energy markets, and it should appeal to investors who are more growth-oriented and tolerant of risk.

The separation also satisfies regulatory requirements for an appropriate division of our regulated and unregulated activities as we move toward a competitive electricity market in Texas. The Public Utility Commission of Texas already has approved our separation plan.

The first step of the separation will be an initial public offering of up to 20 percent of the stock of the unregulated businesses. We plan to distribute the remaining shares of the unregulated company to Reliant Energy shareholders once we receive the necessary approvals. We've taken many steps to prepare for the separation. We're already managing the businesses separately and have created the leadership team and the organizational structure for each company.

California Electricity Market

The electricity supply crisis in California has created uncertainty that has caused volatility in the stock prices of unregulated generation companies active in that market, including Reliant Energy.

The problems in California are complex, and the root causes are unique. California restructured its electric industry at a time when demand for electricity was growing rapidly. Due, in part, to stringent environmental regulations and local opposition to new plant construction, essentially no new generating capacity has been built in the state for more than a decade, and the supply of electricity has not kept pace with demand. California has become an increasingly large net importer of power. Its imports have increased the state's supply risk due to limited transmission capacity, increased demand in other Western states and uncertain, weather-dependent hydrogeneration capacity.

Certain provisions of the state's restructuring legislation also contributed to the problem. California required its utilities to divest much of their generating capacity and restricted their ability to purchase power under long-term contracts. As a result, the state's investor-owned utilities became overly dependent on the spot market where prices are more volatile during times of shortage. Spiraling fuel costs further contributed to the circumstances driving wholesale power prices sharply higher, while a retail rate freeze prevented the utilities from recovering these higher costs from their customers.

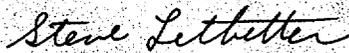
The retail rate freeze compounded the supply problem in several ways. It prevented consumers from receiving accurate price signals that could have encouraged energy conservation. It also caused a serious deterioration in the financial condition of the state's two largest utilities, creating substantial credit risk that further reduced the amount of available supply. Finally, California's deregulation plan was structured in a way that did not foster the development of a competitive retail electric market.

As a producer of electric power in California and a direct stakeholder in the state's economic well being, we are actively participating in efforts to solve California's current power crisis and to develop a permanent regional solution. Long before the problems escalated into a crisis, we were seeking a dialogue with market participants and political leaders to provide our thoughts regarding measures that might have prevented the situation from reaching a crisis stage.

We continue to believe that effective deregulation, which is structured to create healthy competition at both the wholesale and the retail levels, results in the lowest possible cost to consumers.

I'm pleased with the results of the past year and excited about the future. As our industry continues to restructure and evolve, Reliant Energy will continue its transformation for success in the new environment. We're prepared to face the challenges, adapt to the changes and capitalize on the new opportunities that are being created in order to deliver superior value to our shareholders.

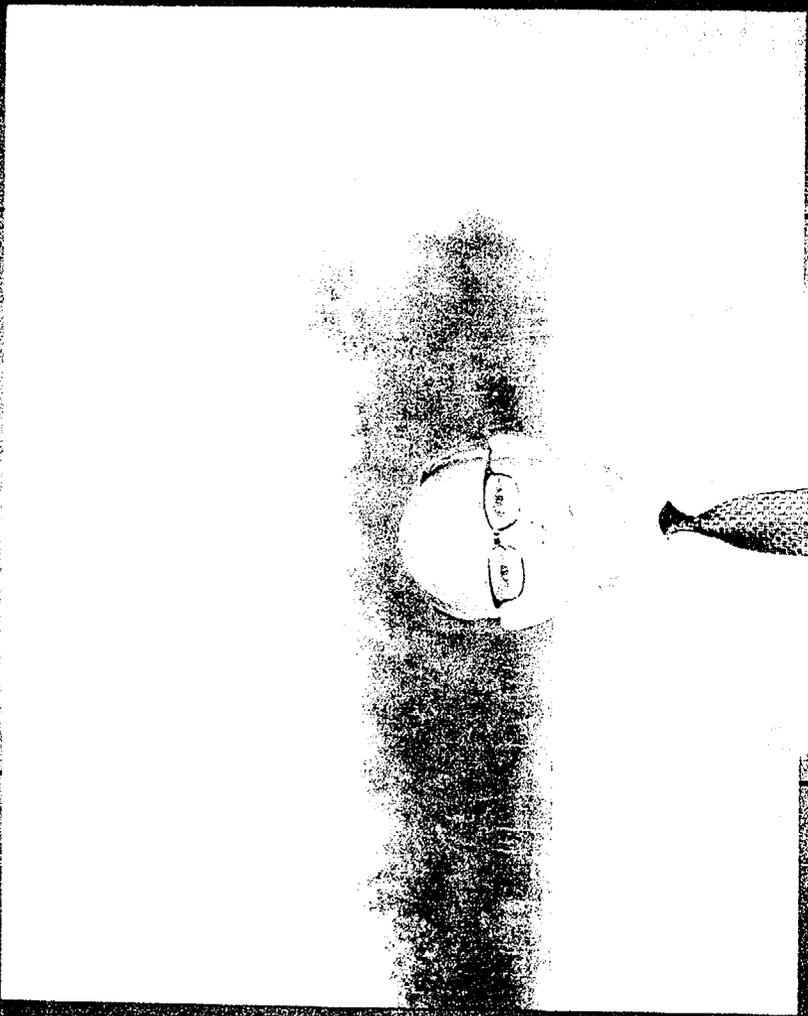
Sincerely,



Steve Letbetter

Chairman, President and CEO

Steve Letbetter has been chairman, president and CEO of Reliant Energy since January 2000. He held executive-level positions in accounting, finance and regulatory relations at the company's electric utility before becoming president and COO of that company in 1993. He was named president and COO of Reliant Energy in January 1997 and president and CEO in June 1999.



Financial Assessment

Both our regulated energy delivery and competitive energy services businesses contributed greatly to very strong earnings in 2000.

Early in 2000, we increased our growth target for the year to 10 to 12 percent above 1999 adjusted earnings per share. At the time, that placed us at the top of the growth range for integrated electric companies. We far exceeded our target with adjusted earnings of \$838 million, or \$2.94 per basic share, a 65 percent increase over 1999.

Reliant Energy performed well across our business segments with strong contributions from both regulated and competitive activities.

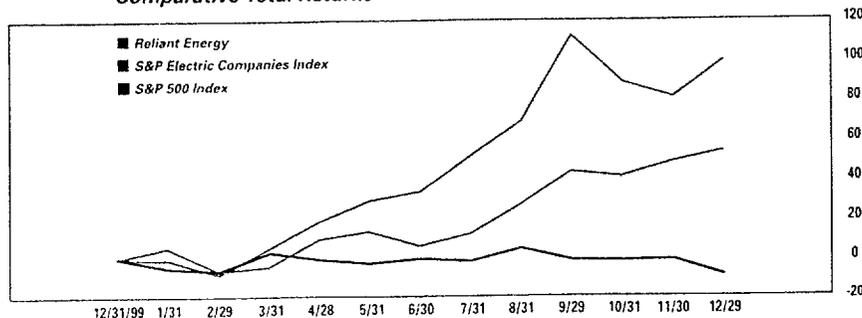
Our regulated electric distribution company, Reliant Energy HL&P, continued its exceptional performance, driven by strong customer growth and demand for power in its service territory. Operating income rose 25 percent in 2000 to \$1.23 billion, up from \$981 million in 1999.

Our competitive wholesale business, which combines strategic generating assets with energy trading, marketing, power origination and risk management activities, produced operating income of \$482 million and equity income of \$43 million in 2000, up from \$27 million of operating income and a \$1 million equity loss in 1999. Additional power generation operations in the mid-Atlantic, midcontinent and southwest regions, combined with higher energy sales and prices, and improved results from wholesale trading of electricity and natural gas across the country, contributed to the increase.

Reliant Energy's stock price reflected the company's financial performance and the progress we made in advancing our strategies and business position. Our stock price rose 89 percent during 2000, and our total return was 99 percent, outperforming major indexes by a wide margin. By comparison, the S&P Electric Companies index provided a 53 percent total return during 2000, while the S&P 500 Index produced a negative return for the year.

We benefited from gas and power market conditions during 2000 that may not be repeated in 2001. Still, given the unique growth opportunities we see at both the wholesale and retail levels, we feel very good about the outlook for our businesses and our ability to achieve our financial goals.

Comparative Total Returns



OPERATING INCOME 1999



Electric Operations	74%
Natural Gas Distribution	12%
Pipelines and Gathering	10%
Wholesale Energy	2%
European Energy	2%

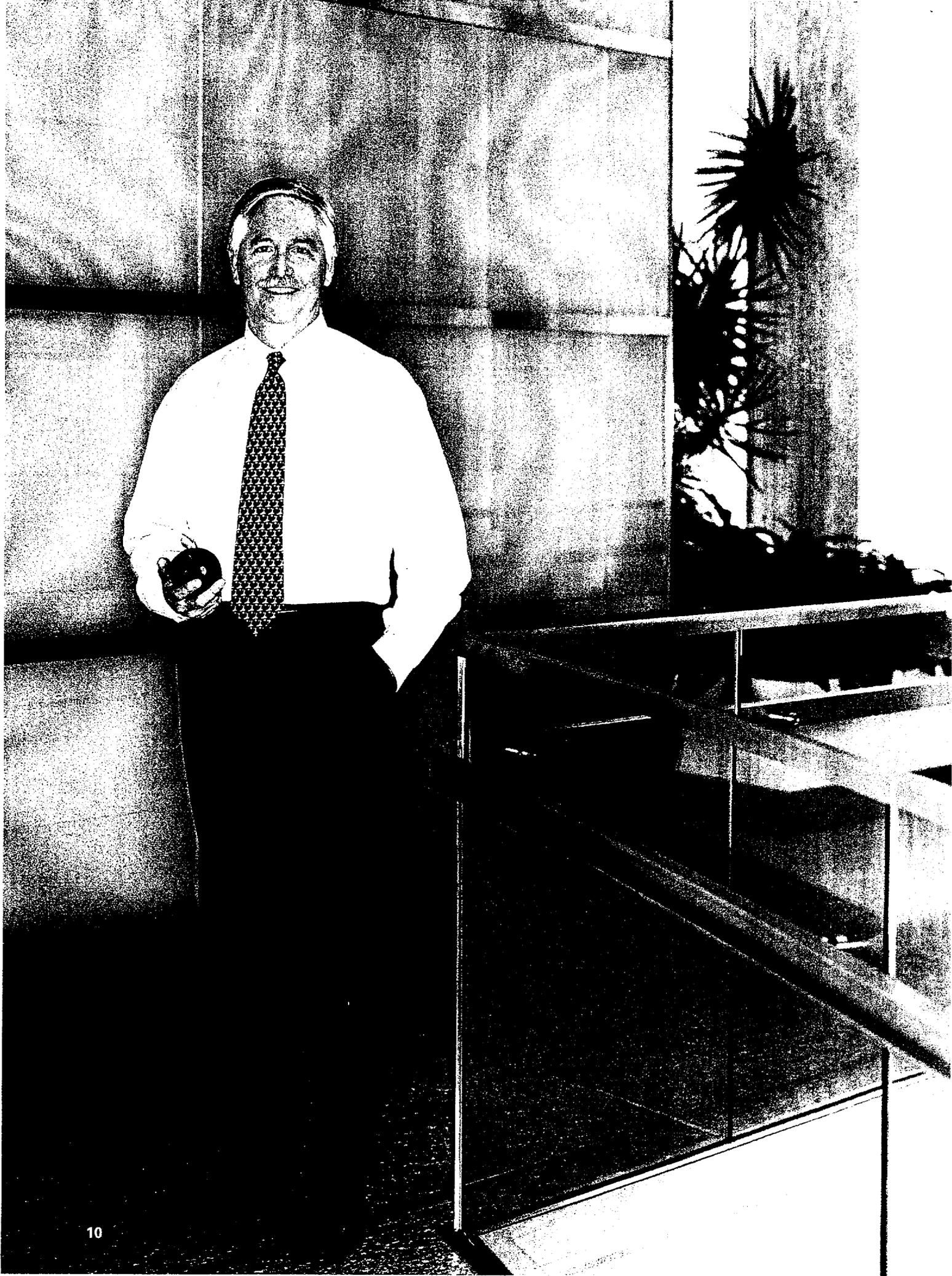
OPERATING INCOME 2000



Electric Operations	60%
Natural Gas Distribution	6%
Pipelines and Gathering	7%
Wholesale Energy	23%
European Energy	4%

Pictured at left

Stephen W. Naeve is vice chairman and CFO. In his 29-year career with Reliant Energy, he has held executive-level positions in planning and strategic management and has served as treasurer of Reliant Energy HL&P. He became senior vice president and CFO of Reliant Energy in 1995.



Regulated Energy Delivery

Reliant Energy's regulated energy delivery businesses strive to maximize the economic value of assets through skillful, cost-effective operations, superior service and reliability, and excellent regulatory relations.

Our aspiration is to be America's leading energy delivery company. Our goals are to earn our authorized returns in our regulated businesses and produce stable earnings and solid cash flow. We will work to enhance financial results without excessive risk by capturing growth opportunities built around our core businesses.

We have a large and diverse set of assets that includes a well-run and well-maintained electric transmission and distribution company serving the rapidly growing Houston metropolitan area. Our gas distribution companies have strong regional franchises in attractive, geographically diverse markets, including the growing Minneapolis and Houston areas. Through innovative management and by being a low-cost provider, our natural gas pipelines have delivered consistent financial results.

We will work to maximize the economic value of our energy delivery assets by achieving operating synergies, working for attractive rate designs and taking advantage of growth opportunities within our current service territories. Our strategy for success is built on delivering superior customer service, building a high-performance culture and operating world-class energy delivery systems. To maintain and enhance our financial strength, we pay close attention to the use of our resources and place a high priority on spending wisely.

Our energy delivery businesses provide vital services at regulated rates. As such, they produce stable earnings and cash flows that are less subject to the unpredictable ups and downs of market forces than some other types of businesses. This investment profile has strong appeal and advantages for many investors. As a stand-alone company, Reliant Energy's regulated business will be one of the nation's largest, most diverse transmission and distribution companies.

Electricity distribution

Electricity transmission

Natural gas distribution

Natural gas pipelines

Natural gas gathering

ERCOT power generation

Pictured at left

David M. McClanahan is vice chairman of Reliant Energy and president and COO of the Reliant Energy Delivery Group. His 29-year career with the company includes executive management positions in finance, regulatory relations and accounting.



Competitive Energy Services

Reliant Energy's competitive energy services businesses pursue profitable opportunities in deregulated wholesale and retail markets where we believe our skills-based commercial approach provides us with a competitive advantage.

Restructuring of the electricity industry is creating attractive opportunities for Reliant Energy to participate in growth businesses at the wholesale and retail levels in the U.S. and Western Europe.

At the wholesale level, our objective is to become one of the leading U.S. commercial gas and power merchants by combining one of the largest and most strategic power generation portfolios in the country with top-tier energy trading and marketing capabilities.

Our strategy is to capitalize on our market position in target regions of the U.S. as we continue expanding our regional asset portfolios and commercial positions. We're creating commercial regional portfolios of base-load, intermediate and peaking capacity through a combination of acquisitions, development projects and long-term contracts. We complement our generation operations with trading, marketing and risk management skills, which provide commercial insights and a keen understanding of our markets.

In the European wholesale market, we're reducing costs and increasing operating flexibility associated with our Dutch generating assets. We're commercializing these assets using a combination of short-term trading, longer-term origination and innovative fuels management. We're building on our incumbent position in the Netherlands and our commercial platform to enter other European markets.

On the retail side, our goal is to establish a significant business in Texas when the electricity market opens to retail competition in January 2002. We're working to maximize retention of our sizeable retail electric customer base in the Houston area, and we are aggressively pursuing customers in other parts of Texas.

As attractive retail markets develop in other regions of the U.S., we will capitalize on the skills and systems we're building for the competitive retail market in Texas and on our wholesale expertise. Our trading, marketing and risk management skills assist us in procuring power efficiently and in developing enhanced products and services to offer retail electric customers of all sizes. For larger users of electricity, we provide a full suite of commodity, energy management and financial services.

We're also involved in communication services, eBusiness and venture capital investments, which enhance our service offerings and provide future growth opportunities that complement our energy businesses.

Overall, our goal is to become a leading multi-regional provider of energy and complementary services to wholesale and retail customers in the U.S. and to wholesale customers in target regions of Western Europe.

Unregulated power generation

Energy trading and marketing

European operations

Unregulated retail

Communications

Internet and eBusiness

New ventures

Pictured at left

Robert W. Harvey, (far left) Reliant Energy vice chairman since 1999, is responsible for Reliant Energy's Emerging Businesses Group and its European operations. Previously, as director in the Houston office of McKinsey & Company, he assisted energy companies with corporate strategy, mergers and acquisitions, and operations effectiveness.

Joe Bob Perkins is president and COO of Reliant Energy's Wholesale Group. Previously, he served as president and COO of the company's power generation subsidiary. He joined Reliant Energy in 1996 as vice president Corporate Planning and Development. He also held executive positions at Coral Energy and Coral Power.



Electricity Industry Restructuring

Even before the Texas Legislature passed the Texas Electric Choice Act in 1999, an international trend toward electricity industry restructuring and customer choice had dramatically altered Reliant Energy's business environment. Industry restructuring has been the driving force behind Reliant Energy's transformation from a regional electric utility into an international energy delivery and energy services company, and it was a major factor in the decision to split into two stand-alone companies.

Preparing for Competition in Texas

Electricity industry restructuring will continue to have a profound impact on Reliant Energy, changing the shape of the company, the markets in which it operates and the businesses it pursues. Since enactment of the Texas Electric Choice Act, the company has shifted its focus from legislation to implementation, working on several fronts to ensure a successful transition to competition.

Externally, the company has worked with other interested parties to develop rules that will foster a healthy competitive electricity market in Texas. Although the legislation laid out a framework for retail electric competition in Texas, it left important details on implementation to be developed by the Public Utility Commission of Texas (PUCT).

As specific rules have evolved, Reliant Energy and its electric utility, Reliant Energy HL&P, have modified their internal organizational structures, policies and procedures to comply with provisions designed to create fair competition for new market entrants. Reliant Energy's plan to split into two companies satisfies a key requirement to create an appropriate separation of its regulated and unregulated activities.

With the retail pilot program scheduled to begin June 1, 2001, and full competition beginning January 1, 2002, Reliant Energy has three major priorities:

- ▶ Maintain the Texas Electric Choice Act of 1999, which has broad-based support, as the legislation that will govern Texas electricity restructuring.
- ▶ Work to ensure that the rules adopted by the PUCT for implementation of electricity restructuring reflect the intent of the Texas Electric Choice Act.
- ▶ Ensure that the company's systems and those of all other market participants are ready for electricity competition to begin on schedule and to function smoothly.

Retail Competition

Reliant Energy's unregulated retail affiliates are preparing to compete to retain customers in the Houston metropolitan area and to attract customers in other parts of the state. Two affiliates, Reliant Energy Retail Services and Reliant Energy Solutions,

have been certified by the PUCT as retail electric providers (REPs) and will participate in the pilot project.

When full retail competition begins on January 1, 2002, up to 1.5 million residential and small commercial customers within Reliant Energy HL&P's service territory who do not choose another REP will automatically begin receiving electricity service from Reliant Energy Retail Services. These customers will benefit from a rate that is 6 percent lower than the rates charged prior to competition, adjusted for fuel and purchased energy prices. This rate, known as the "price to beat," will be available to customers for five years.

The price to beat applies only to residential and small commercial customers. Large commercial and industrial customers will receive service from Reliant Energy Solutions or one of its competitors. Electricity service may be provided to these customers at any negotiated price.

Federal Legislation

During 2000, the 106th U.S. Congress introduced several bills designed to restructure the electricity industry for the entire country. None of the legislation passed out of committee. Reliant Energy supports federal restructuring legislation designed to accomplish the following:

- ▶ Open the national electricity market to competition fully and fairly;
- ▶ Increase overall electricity industry efficiency;
- ▶ Remove federal impediments to competition;
- ▶ Repeal outdated federal laws that are not appropriate in today's competitive environment;
- ▶ Ensure that transmission grids are opened fully; and
- ▶ Clarify the authority of the federal government and the states.



Regulated Energy Delivery

Delivering possibilities is what the Reliant Energy Delivery Group does every day of every year. More than 4 million customers depend on the Reliant Energy Delivery Group's electricity and natural gas distribution companies, Reliant Energy HL&P/Entex, Reliant Energy Arkla, Reliant Energy Entex and Reliant Energy Minnegasco, for top-quality service, convenience and reliability. In addition, the company's natural gas pipelines and gathering systems move more than one trillion cubic feet of gas per year.

Reliant Energy HL&P/Entex

- ▶ Electricity and natural gas distribution
- ▶ Serves the Houston metropolitan area
- ▶ 1.71 million electricity customers; 44,000 new customers in 2000
- ▶ 957,000 natural gas customers
- ▶ 800,000 common (electricity and natural gas) customers
- ▶ 14,000 MW of electric generation
- ▶ 3,600 miles of electric transmission lines
- ▶ 32,251 miles of electric distribution lines
- ▶ 15,640 miles of natural gas main lines
- ▶ 10,479 miles of natural gas service lines

Reliant Energy Arkla

- ▶ Natural gas distribution
- ▶ Serves 621 communities in Arkansas, Oklahoma, Louisiana and Texas
- ▶ 738,000 customers
- ▶ 19,429 miles of main lines
- ▶ 3,733 miles of service lines

Reliant Energy Entex

- ▶ Natural gas distribution
- ▶ Serves 337 communities in Texas, Louisiana and Mississippi
- ▶ 555,000 customers
- ▶ 13,380 miles of main lines
- ▶ 7,574 miles of service lines

Reliant Energy Minnegasco

- ▶ Largest natural gas distribution company in Minnesota
- ▶ Serves more than 240 communities including the Minneapolis metropolitan area
- ▶ 696,000 customers; 15,500 new customers in 2000
- ▶ 11,177 miles of main lines; 249 miles added in 2000
- ▶ 10,400 miles of service lines

Reliant Energy Delivery Group

The Reliant Energy Delivery Group, created in 1999 to capture operating synergies between Reliant Energy's distribution businesses, is composed of an electricity transmission and distribution company, three natural gas distribution companies, two interstate natural gas pipelines and a natural gas gathering operation.

In the Houston metropolitan area, the company's electricity and natural gas distribution businesses serve more than 1.7 million customers, of which 800,000 are common customers. Their operations have been combined under common management into Reliant Energy HL&P/Entex.

During 2000, the operations of Reliant Energy Arkla were restructured and combined under a single management structure with the operations of Reliant Energy Entex outside the Houston area. This change has allowed the companies to streamline management and consolidate support functions. The restructuring puts both companies in a position to maximize operating efficiencies in the field, with a focus on system integrity and superior customer service.

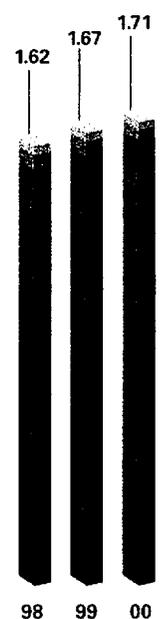
The Delivery Group's interstate pipelines and natural gas gathering systems are operated under a common management team. This has enhanced their ability to improve operating efficiencies and reduce costs as well as take advantage of growth opportunities.

The Delivery Group is not focused only on operational matters. It is recognized in the areas it serves as a company that cares about the community. In 2000 alone, company employees logged more than 70,000 volunteer hours of community work.

The Delivery Group also works to build diversity into its workforce and its business relationships, and is focused on building a workforce that reflects the local community. Delivery Group companies seek to do business with all segments of the community and have received special recognition for their efforts. In 2000, the company won the Houston Minority Business Council's Corporate Commitment award for the second time.

The Delivery Group is characterized by its continuing efforts to improve reliability, share best practices among the companies and improve service quality, which is its number one priority. The overall strategy for maintaining outstanding service quality is to emphasize the key areas of reliability, customer service and convenience, and efficiency, recognizing that these qualities often translate into strong customer loyalty.

Electric Customers
(in millions)



■ Residential
■ Commercial
■ Industrial
■ Other

Reliant Energy Distribution Companies Deliver Reliability

Reliable service is the cornerstone on which the Delivery Group is built. In the company's electric operations, reliability is at the highest level ever, as measured by the frequency and duration of outages. This achievement is primarily the result of employees taking aggressive steps to identify problem areas and by addressing them through the utilization of new technologies that allow improved service response.

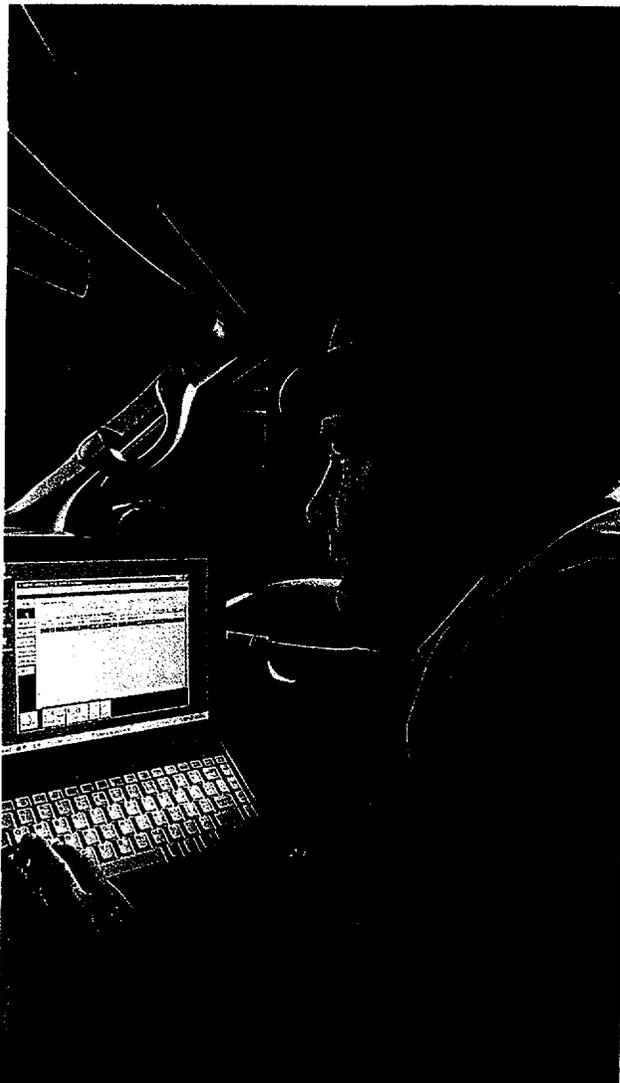
The company has initiated a three-year technology implementation project to upgrade the computerized Reliant Energy HL&P outage analysis system. As a result of this project, the company is now able to provide customers with faster, more accurate and more complete information about power outages and the status of service restoration efforts.

The technology upgrades also resulted in the revamping of the company's mobile data system, allowing maintenance and repair work orders to be sent directly to service trucks via computer. Field personnel, in turn, can send work-completion information and other data back through the system. This voice-free communication improves service response and leaves the radio frequency open for other uses.

The new mobile data system is a major initiative that totally changed the way the company responds to trouble calls. The company now has innovative one-person roving units that can quickly be dispatched to trouble areas without being pulled off other jobs.

Reliant Energy HL&P is also implementing technology that will enable it to communicate with retail electric providers (REPs) when electricity competition begins on January 1, 2002. The new system will ensure that all REPs are capable of keeping their customers informed about service problems and the anticipated duration of power outages.

A new reliability database that went into operation in early 2000 enables the company to pinpoint where dollars need to be spent in order to keep operating systems at the highest reliability level possible. The database, now being used across various departments, is a valuable work management tool that collects trouble and maintenance data at a central point and identifies where dollars would be spent most prudently. Pinpointing trouble and directing financial and labor resources to address each particular problem, rather than using a scattergun approach, saves the company time and avoids wasteful spending.



Reliant Energy Entex employees deliver quick and accurate service to customers from computer-equipped vehicles.

Reliant Energy Delivers Service and Convenience

In addition to providing responsive service every day, the Delivery Group strives to find new ways to enhance convenience for customers. Each of Reliant Energy's distribution companies has developed innovative ways to deliver high-quality service by harnessing new technology and the Internet where practical.

Reliant Energy HL&P/Entex expanded and enhanced its Internet presence in 2000, using this technology to allow Houston-area residential customers to pay their bills and conduct routine business transactions online. These eBusiness initiatives give customers the ability to pay bills without checks or postage and the convenience of doing business with Reliant Energy wherever and whenever they want.

Reliant Energy Minnegasco has established two new services to help business customers manage and make the most of their natural gas service. Enform, an Internet site designed specifically for commercial customers, provides detailed billing and energy usage information for one or multiple accounts. The Smart Business Hotline is a call center that provides business customers a single point of contact with customer service representatives who are familiar with special business programs and services.

Reliant Energy Entex expanded its Internet home page to target customers by region, allowing the company to deliver customized customer service and marketing information. An additional Internet site supports a new marketing campaign targeted at fleet managers and at expanding the use of compressed natural gas as an environmentally safe and cost-effective automotive fuel.

At Reliant Energy Minnegasco, the company's popular Home Service Plus[®] (HSP) introduced an exterior home maintenance service in 2000 to complement its other services and conveniences. HSP, the largest appliance repair service in Minnesota, served a record number of customers in 2000 with service plans covering more than a million appliances. The HSP home security monitoring service saw continued growth in 2000, making it one of the largest security businesses in the Twin Cities metropolitan area.

Reliant Energy Delivers Efficiency

The Delivery Group's innovative methods of increasing operating efficiencies are an important part of efforts to hold down costs and remain financially strong. The individual distribution companies compare their performance to industry standards, set performance goals and find ways to reduce costs without affecting the quality of service.

Electric Sales
(in billion kwh)



- Residential
- Commercial
- Industrial
- Other

Regulated Natural Gas Distribution Companies Throughput
(in bcf)



- Residential & Commercial Sales
- Industrial Sales
- Transportation



Beautiful gas lighting is making a comeback in parts of Arkansas as evidenced by rows of lights outside the Arkansas Democrat Gazette building in Little Rock.

Reliant Energy Minnegasco demonstrated outstanding operations efficiency during 2000 by achieving an operations and maintenance expenditure per customer that was 7 percent below its targeted per-customer cost.

Reliant Energy HL&P/Entex implemented a Best Practices initiative on the electricity side of the business using ideas developed by employee teams. The initiatives augment communication with customers, help employees work more efficiently, and give employees training and tools that enable them to do their jobs better. The company also increased efficiencies in the Houston metropolitan area for 800,000 common Reliant Energy electricity and natural gas customers by combining meter reading, trenching projects, and some managerial positions and work locations.

Reliant Energy HL&P/Entex also launched a Gas Process Redesign Project in October 2000 to create process improvements, organizational modifications and productivity enhancements, and to provide innovative ways to address service quality issues.

The Delivery Group is striving to build among its employees a culture that focuses on quality of service, innovation, personal accountability and continuous improvement. The approach for achieving and maintaining this culture is to operate well-run businesses, to take advantage of growth opportunities, to acquire and retain talented and experienced employees who understand regulated electric and natural gas businesses, and to produce a solid cash flow.

Pipelines and Gathering Deliver Innovation

Reliant Energy's Delivery Group operates two interstate natural gas pipelines as well as gas gathering and pipeline services. The two interstate pipelines, Reliant Energy Gas Transmission Company and Mississippi River Transmission Corporation, own approximately 8,200 miles of pipelines and move approximately one trillion cubic feet of gas per year. Together, they form one of the largest natural gas pipelines in the midcontinental U.S., serving Arkansas, Kansas, Louisiana, Mississippi, Missouri, Oklahoma and Texas. Reliant Energy Field Services, Inc. operates approximately 4,000 miles of gathering pipeline and moves more than 750 million cubic feet of gas per day.

At the end of 2000, Reliant Energy Gas Transmission Company renewed and received regulatory approval for various contracts for firm transportation and storage service with its affiliate and largest customer, Reliant Energy Arkla. These renewals extended the term of service to 2005 in Reliant Energy Arkla's major market areas. Also, Reliant

Energy Gas Transmission Company increased deliveries of natural gas to American Electric Power Company's 882 MW Wilkes generating plant in Marion County, Texas, by as much as 100 million cubic feet per day.

Following implementation of the industry's first-ever hourly firm transportation service in 1999, Reliant Energy Gas Transmission Company continued to innovate in 2000 with a service that allows customers to submit nominations at any time to be effective at the top of the hour. The company also implemented an Internet-based service to communicate real-time consumption so end-use customers can improve their management of natural gas supplies and deliveries.

Reliant Energy Field Services, Inc. introduced a service for monitoring remote wellhead operations using its proprietary ServiceStar product. This product is currently installed on approximately 1,200 wells and more than 125 field compressors.

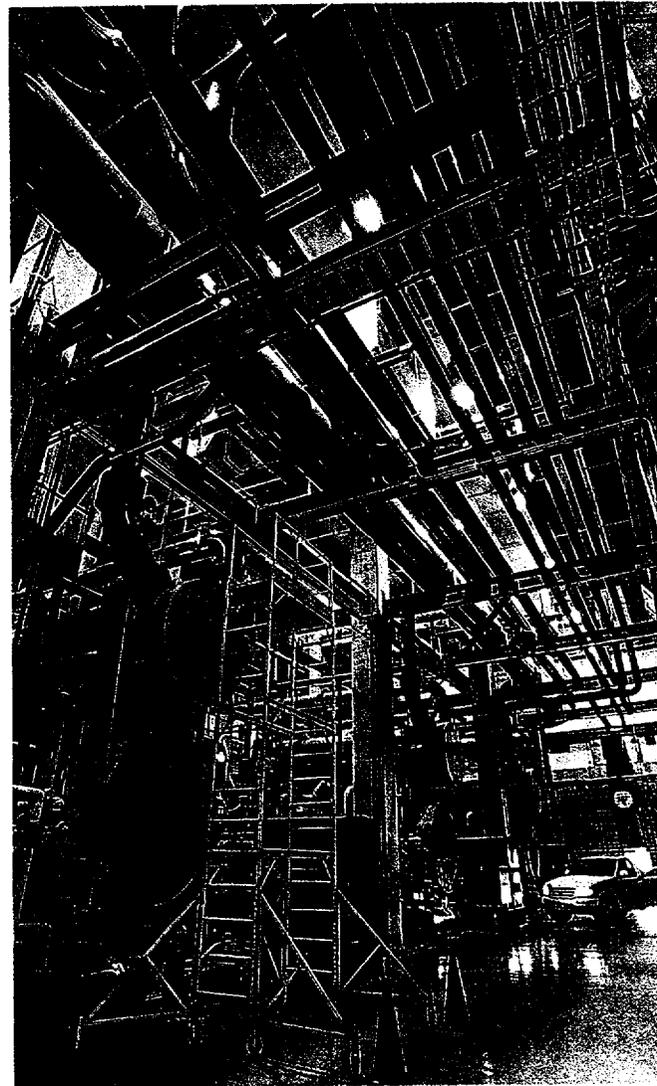
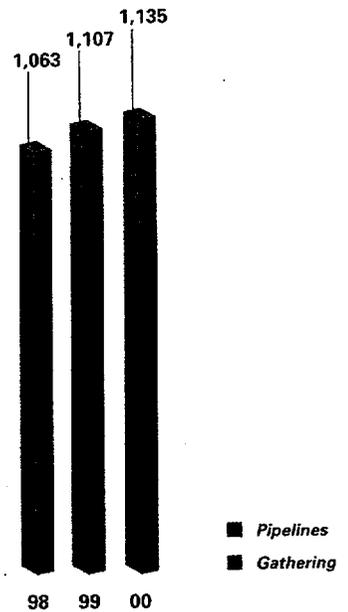
Reliant Energy Thermal Systems Delivers Comfort and Convenience

Reliant Energy Thermal Systems provides a comprehensive range of energy products and services such as design, construction and operation for specific energy systems for commercial facilities. Reliant Energy Thermal Systems also operates Northwind Houston L.P., a limited partnership with Exelon Thermal Technologies of Chicago, which builds and operates district cooling systems. District cooling frees building owners and managers from having to own and operate their own air conditioning systems.

During 2000, Reliant Energy Thermal Systems began a three-year contract to provide a comprehensive package of energy and facility management services to the Astrodome Complex in Houston, which is now named Reliant Park. The company will operate and maintain the cooling and heating plants, maintain plumbing, electrical and lighting systems, manage utilities and provide new plant consulting services for Reliant Stadium, Reliant Astrodome, Reliant Arena, Reliant Hall and Reliant Center.

Northwind Houston's district cooling system pipes chilled water to customers in downtown Houston. Northwind has signed 11 contracts to provide cooling services for new or redeveloped facilities.

Pipelines and Gathering Throughput
(in bcf)





Competitive Energy Services

Reliant Energy has grown rapidly to become a leading provider of innovative energy products and services to wholesale and retail customers in the U.S. and Western Europe. Electricity industry restructuring is creating an attractive environment for the company's competitive wholesale and emerging businesses.

Wholesale Energy

Reliant Energy's Wholesale Group combines strategic generation assets with trading, marketing and risk management operations that complement its asset portfolios. The combination provides sophisticated commercial insights, an advantaged understanding of the key regions in which the company is active, and the ability to offer a broad range of products and services to meet customers' needs.

In just three years, the company's unregulated power generation portfolios in the U.S. have grown from zero at the end of 1997 to more than 9,000 MW at the end of 2000. The company also has projects under construction that will add approximately 2,800 MW to serve various regions of the country, including Western markets, which have a critical need for additional power.

Building the Wholesale Group

Reliant Energy's Wholesale Group encompasses the company's wholesale energy merchant business in the U.S. and Canada, including its unregulated generating assets and its trading, marketing, power origination and risk management operations.

Reliant Energy is developing a wholesale network in the U.S. with electricity generation portfolios and commercial gas and power capabilities in key power regions of the country. With more than 9,000 MW of capacity in five target regions, the company is one of the largest unregulated generation owners in the country. It also is one of the nation's leading gas and power traders and marketers.

After Reliant Energy's planned separation of its regulated and unregulated businesses, the unregulated company will have an option, in 2004, to purchase approximately 14,000 MW of generation that Reliant Energy HL&P currently operates in the Houston area.

Power Generation Assets

In the mid-Atlantic region, which includes the Pennsylvania, New Jersey and Maryland (PJM) market, Reliant Energy owns or leases 21 generating facilities totaling 4,262 MW. In the Southwest region, which includes California, Nevada, Arizona and New Mexico, the company has six plants totaling 4,045 MW. The company also has a 344 MW plant in Illinois, a 619 MW plant in Florida and a 50 percent interest in a 100 MW plant in Texas. Projects totaling approximately 2,800 MW of generating capacity currently are under construction, and numerous other projects are under development.

During 2000, Reliant Energy completed acquisitions and development projects that added nearly 4,800 MW, more than doubling its non-regulated generating capacity in the U.S. The largest addition was the acquisition of 21 power plants in the mid-Atlantic, which increased Reliant Energy's generation capability by 4,262 MW and gave the company a strong wholesale merchant position in the strategically important mid-Atlantic region.

The Reliant Energy mid-Atlantic acquisition was announced in February 2000 and completed in May 2000. Operational and commercial integration was effectively achieved prior to peak summer demand due to the skill and hard work of new and existing Reliant Energy employees.



The first 255 MW at the Shelby County peaking plant in Illinois became operational in July 2000, only 129 days after permitting.

In addition, Reliant Energy:

- ▶ Built a 344 MW peaking plant in Shelby County, Illinois, putting the first five units, totaling 255 MW, in operation only 129 days after permitting. Three additional units, totaling 89 MW, are scheduled to go on line in April 2001.
- ▶ Began commercial operation at El Dorado Energy, a 490 MW plant in Nevada. The plant is a 50-50 partnership with Sempra Energy.
- ▶ Announced plans to build a 548 MW facility, Reliant Energy Arrow Canyon, north of Las Vegas. Like El Dorado Energy, the plant will be air-cooled, thereby reducing the water required to about 10 percent of the amount normally required by a water-cooled plant.
- ▶ Advanced construction of plants that will add nearly 2,700 MW of generation capacity in 2002. These include: Desert Basin, a 563 MW plant at Casa Grande, Arizona; Channelview, a 781 MW base-load plant near Houston, Texas; Aurora, an 873 MW peaking plant in Illinois; and Osceola, a 460 MW peaking plant near Orlando, Florida.
- ▶ Formed Reliant Energy Renewables, Inc., a green energy affiliate that began with wind power and methane gas generation projects in Texas. The wind power project, the largest single installation of its kind in the world, will be in West Texas, about 70 miles south of Odessa. It will produce more than 200 MW of power. The methane gas-to-electricity generation project will involve various existing landfill sites in Texas, including two in the Houston area. It will produce 44 MW of power.

Reliant Energy has contracted to purchase wind power from a project on 3,141 foot King Mountain in West Texas.

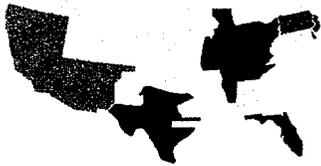


Trading, Marketing and Power Origination

The Wholesale Group's North American trading, marketing, power origination and risk management operations complement the company's U.S. asset positions by providing a full range of wholesale energy management services. The company has built a top-tier trading and marketing organization in just three years.

Services include the sales and marketing of energy, capacity and ancillary services. The company's customers include natural gas distribution companies, electric utilities, municipalities, cooperatives, power generators, marketers, other retail energy providers, aggregators and selected large-volume industrial customers.

EMERGING REGIONS



REGION	CAPACITY (MW)
SOUTHWEST	
Operating	4,045
Construction	553
Advanced Development	1,391
	5,999
MIDATLANTIC	
Operating	4,262
Advanced Development	1,310
	5,572
MIDCONTINENT	
Operating	255
Construction	962
Advanced Development	793
Long-term Contracts	350
	2,360
FLORIDA	
Operating	619
Construction	460
Long-term Contracts	1,360
	2,439
TEXAS	
Operating	50
Construction	781
Long-term Contracts	100
Renewables	260
	1,191

Reliant Energy's net interest or amount under contract as of March 15, 2001

The Wholesale Group has steadily increased physical natural gas volumes from 3.2 billion cubic feet per day in 1998 to 6.9 billion cubic feet per day in 2000. Physical electricity sales, which include sales from the company's plants, have grown from 65 million megawatt-hours (MWh) per year to 202 million MWh per year over the same time period.

The Wholesale Group's capabilities include a strong emphasis on financial trading and risk management services. The company expects its ratio of financial to physical trading to increase.

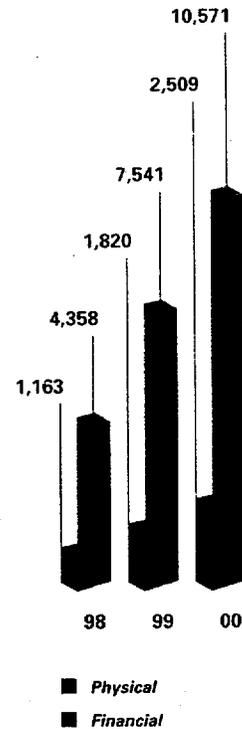
The Wholesale Group's power origination teams are dedicated to developing and providing long-term, innovative products designed to meet the specific energy requirements of cus-

tomers. They also work to sell long-term products from the company's power generation assets and acquire contracts that complement the company's commercial portfolios.

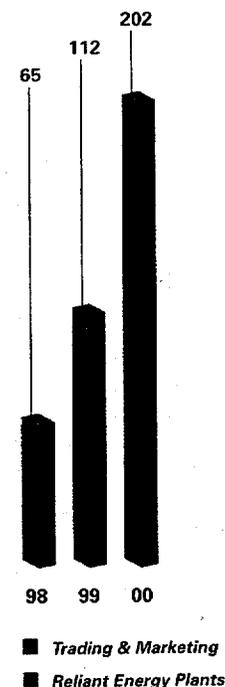
During 2000, the company signed a long-term contract with Rayburn Country Electric Cooperative, Inc. covering a comprehensive package of electricity supply and services. Reliant Energy will supply more than 450 MW of firm power, ancillary and energy services that will benefit more than 120,000 end-users of Rayburn Country's five area distribution cooperatives.

Additionally, Reliant Energy has entered into agreements to purchase future supplies of power from facilities to be constructed in Florida for operation in 2002. The company will purchase the rights to utilize and dispatch generating capacity totaling approximately 1,100 MW.

Annual Gas Sales Volume
(in bcf)



Annual Power Sales Volume
(in million mwh)



Reliant Energy Builds European Business

Reliant Energy formed Reliant Energy Europe in late 1999 to build a wholesale energy merchant business in Western Europe, one of the most important energy markets outside of the U.S.

With the purchase, in October 1999, of N.V. UNA, the third-largest Dutch generating company, Reliant Energy gained approximately 3,400 megawatts of generation and an established vehicle to enter and expand in other European markets.

UNA's five electric power generation facilities in the Amsterdam, Utrecht and Velsen regions generated more than 20 percent of the Netherlands' electricity production in 2000. UNA's generating stations also supply a number of municipalities with hot water for district heating.

The Netherlands is transitioning to a fully competitive power market. The retail market for industrial customers opened to competition on January 1, 1999; the wholesale power market opened to full competition on January 1, 2001. For the remaining retail market, competition will be phased in by early 2003.

Reliant Energy Europe established Reliant Energy Trading and Marketing B.V. to commercialize the output of the UNA generation and to pursue trading and marketing opportunities in evolving European markets. The company has opened wholesale energy trading and marketing offices in Amsterdam and Utrecht in the Netherlands, in Frankfurt, Germany, and in London, England.

Reliant Energy Europe's trading and marketing operations are initially focused on selling power to large industrial and commercial customers as well as to distribution companies in the Netherlands and Germany. The company also trades natural gas, coal and low-sulfur fuel oil to support its generation operations.

Looking forward, Reliant Energy Europe is using its trading activities to monitor developments in other deregulating European markets.

Reliant Energy's European plants are working to improve environmental performance through improved systems, processes, firing technology and emission controls.



Emerging Businesses

During 2000, Reliant Energy formed the Emerging Businesses Group. Included within the group are Reliant Energy Retail Services, Reliant Energy Solutions, Reliant Energy Communications, Reliant Energy Ventures and the company's eBusiness activities. Each of these businesses represents an exciting growth opportunity for the company, and all are capitalizing on the rapid changes occurring in the energy services and communications arenas.

Reliant Energy Retail Services is building a solid infrastructure to attract, serve, and retain residential and small commercial customers in deregulating electricity markets, while Reliant Energy Solutions provides products and services to large commercial and industrial customers.

Reliant Energy Communications and the company's eBusiness organization pursue opportunities created by new technology and the rapid growth of the Internet. Reliant Energy Ventures charts a course for future company growth by identifying and investing in new technologies and promising new businesses that are related to the company's core businesses.

Reliant Energy Retail Operations

Reliant Energy is establishing a significant retail electric business in Texas in preparation for the market opening to competition on January 1, 2002. It is planning to expand in other parts of the U.S. thereafter as attractive retail opportunities develop.

The company will provide energy products and services to residential and small commercial customers through Reliant Energy Retail Services. It will market to large commercial, institutional and industrial customers through Reliant Energy Solutions. In January 2001, both entities received certification from the Public Utility Commission of Texas (PUCT) as retail electric providers (REPs) authorized to sell power in Texas' deregulated electricity market.

Reliant Energy will start with a substantial customer base in the Houston market. As the unregulated affiliate of the incumbent electric utility, Reliant Energy Retail Services will serve all of the approximately 1.5 million Reliant Energy HL&P residential and small commercial customers who do not choose another electricity supplier.

Reliant Energy will be participating in the Texas Electric Choice Pilot Program, which is scheduled to begin on June 1, 2001, and run through December 31, 2001. During this time, electric utility affiliates and other entities that have been certified by the PUCT as REPs will be able to market their products and services to a limited number of customers amounting to 5 percent of the electric load in each customer category. During the pilot, Reliant Energy Retail Services will market to customers outside the Reliant Energy HL&P service territory.

Consumers are being contacted and encouraged to participate in the pilot program through targeted direct mail, telemarketing and advertising campaigns. The pilot program also will allow the PUCT to evaluate the readiness of the various electric power regions within Texas to implement full customer choice.

With its strong customer relationships, brand name recognition and experience in serving the Houston area for more than 100 years, Reliant Energy will build on its secure foundation to accomplish four main objectives for its retail business:

- ▶ Maximize retention of customers in the Houston area;
- ▶ Attract Texas customers outside of Reliant Energy's Houston service territory;

- ▶ Enhance its competitive retail position by leveraging the company's wholesale trading, marketing and risk management expertise; and
- ▶ Use its retail experience to pursue opportunities in targeted markets outside Texas.

The Road to Success in Texas

In preparation for retail electric competition, Reliant Energy Retail Services is building an infrastructure of business systems needed to serve and retain existing customers and is creating the marketing organization needed to attract customers in other parts of the state. As of December 31, 2000, Reliant Energy had invested \$50 million in these business systems.

In addition to 1.5 million residential and small commercial customers in the Houston area, there are approximately 4.4 million electricity customers in Texas to whom Reliant Energy Retail Services can market. The company is developing marketing and advertising programs that will be used to acquire new customers in other Texas cities and to retain customers in the greater Houston area. Reliant Energy Retail Services also is using the Internet to acquire new customers, manage customer services and market new products.

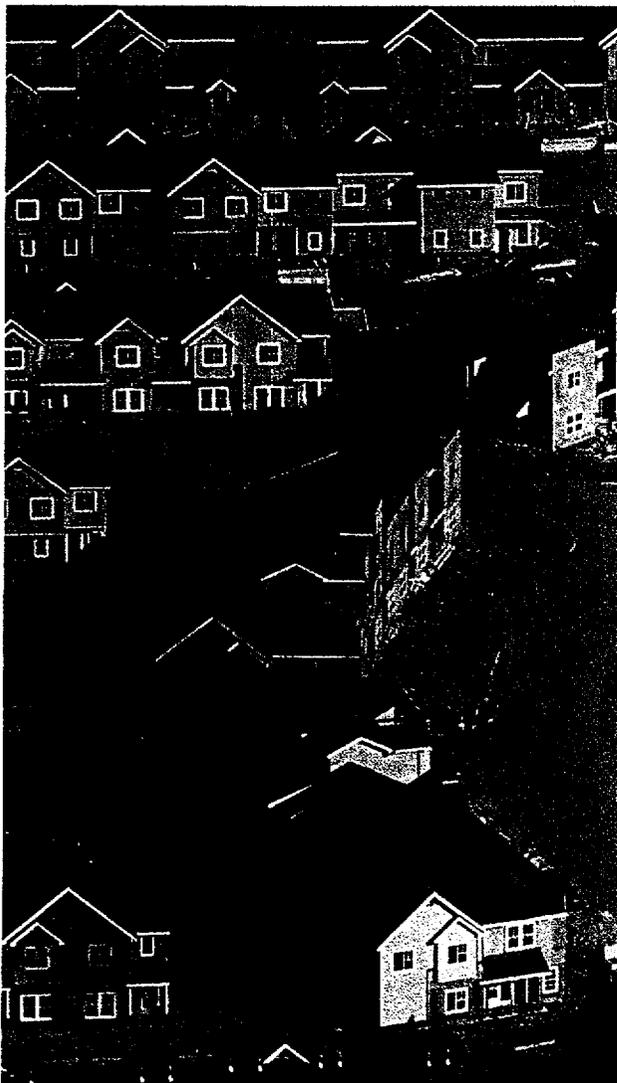
Reliant Energy Retail Services will be able to market electricity to 4.4 million potential residential and small commercial customers in Texas outside the Houston metropolitan area.

Reliant Energy Solutions

Reliant Energy Solutions provides energy and related products and services to large commercial, institutional and industrial customers. Under Texas' restructuring of the electricity industry, all of these customers will be able to negotiate their electricity prices with any certified retail electric provider when the market opens to full retail competition.

Services offered to this market segment include customized, integrated energy solutions such as: energy supply, risk management, finance, energy infrastructure optimization, demand-side management and eBusiness services. Capabilities include the replacement or upgrade of energy-intensive capital equipment, energy and equipment monitoring and control, substation development, and power quality services.

Reliant Energy Solutions will continue to market to institutional, government, manufacturing, industrial and large commercial customers, from multi-site retailers and restaurants to Internet data centers, and to refining and petrochemical companies. These customer segments include approximately 2,000 companies in the state of Texas consuming almost 100 million megawatt-hours of electricity per year.



Since its formation in 1996, Reliant Energy Solutions has completed more than 220 energy services projects in seven states, delivering significant energy savings to its customers. In addition to Houston, the company has offices in the Dallas/Fort Worth area and Long Beach, California.

In preparation for retail electric competition in Texas, Reliant Energy Solutions has developed integrated

offerings that meet both the energy supply and energy services needs of its customer base. Luby's, a national restaurant chain with 226 locations, was the first company to take advantage of this complete package of services. Under an agreement signed in June 2000, Reliant Energy Solutions will provide electricity to 106 of Luby's Texas-based restaurants when electric deregulation occurs. Reliant Energy Solutions also will be the exclusive provider of energy services for Luby's restaurants nationwide in deregulated areas. Other companies that have contracted with Reliant Energy Solutions include: Air Liquide America, Baker Hughes, Eastman Chemical and Farmland Industries.

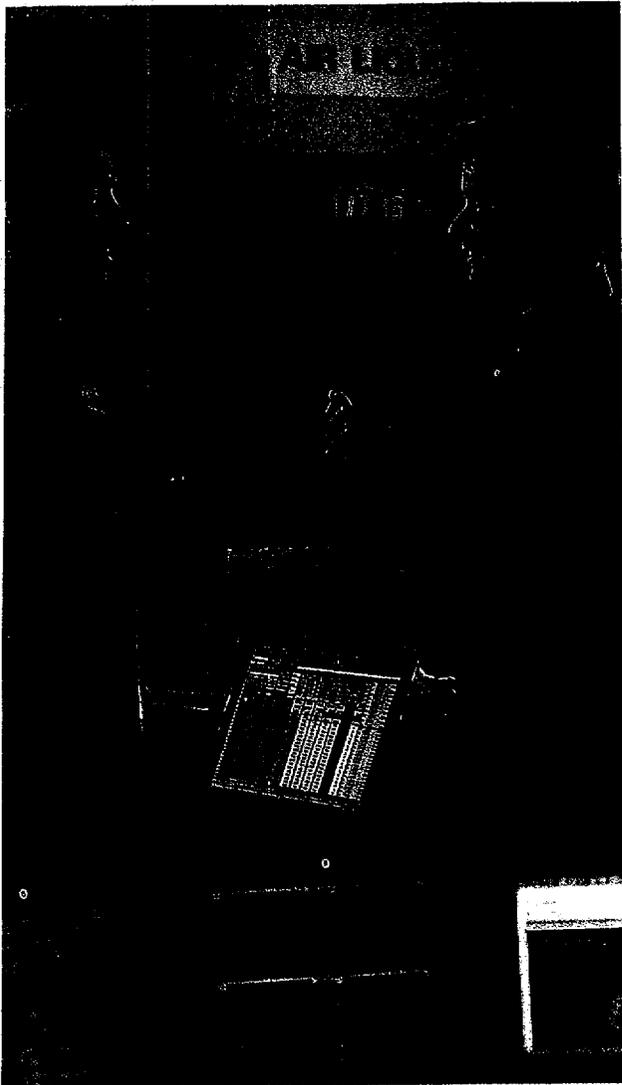
Retail Companies Plan Expansion

Reliant Energy is well positioned for success, with an initial retail base of up to 1.7 million customers in Texas plus access to a high-quality portfolio of generating assets and sophisticated trading, marketing and risk management skills.

Reliant Energy Retail Services and Reliant Energy Solutions have built a solid foundation to tap attractive growth opportunities in deregulating electric power markets. The company will apply the skills and systems that are being built to serve and retain its Houston-area customers to help it expand into other competitive markets within the state and to other parts of the country as



Reliant Energy's acquisition of naming rights for five facilities at a Houston sports, entertainment and convention complex now known as Reliant Park is a focal point for branding and marketing its unregulated businesses. The complex includes Reliant Stadium, currently under construction, which will host the 2004 Super Bowl.



Reliant Energy Solutions provides energy services to Air Liquide America, S.A., a wholly owned subsidiary of Air Liquide, a world-wide industrial and medical gases and services production and supply company.

attractive opportunities arise.

Reliant Energy was the first company chosen by the Texas General Land Office (GLO) to purchase natural gas from the GLO and arrange for discounted electric service to qualifying public retail customers. This program is designed to maximize earnings on public lands for public education and reduce electricity costs to schools.

Under terms of the contract, Reliant Energy purchases natural gas from the state and arranges for the generation and delivery of more than 350 MW of electricity to public schools in the Houston area. The company also handles billing and customer service and assists in marketing the program.

The program, called the State Power Program, now has all 45 Houston-area school districts participating along with 36 other customers, including community colleges and other municipal and government agencies. In 2000, Reliant Energy Solutions and the GLO were the only competitive providers of retail electric power in Texas.

Reliant Energy eBusiness

Reliant Energy recognizes the vital importance and vast potential of the Internet to its businesses today and in the future. In the past year, the company has taken aggressive action to integrate the Internet into its businesses and was named the leading innovator of the utility industry by Information Week magazine in its September 2000 issue.

Reliant Energy's eBusiness goal is to become the industry leader in using the Internet to create value. The company has five guiding principles for its eBusiness activities:

- ▶ Maximize benefits of the Internet for the customer;
- ▶ Integrate eBusiness activities with individual business units' strategies;
- ▶ Utilize Reliant Energy's existing assets and the Internet to create additional shareholder value;
- ▶ Capitalize on current eBusiness partnerships and build new relationships; and
- ▶ Identify and gain competitive advantage from promising new Internet and eBusiness technologies.

Leveraging the Internet

Utilizing Reliant Energy's brand recognition, its investment in customer service and its standing as one of the leading energy companies in the country, the company has built a solid foundation to actively participate in numerous Internet business models.

During 2000, Reliant Energy was a founding partner with other leading companies in several Internet-based ventures designed to create value-added services for customers, enhance efficiency and provide a potential source of future earnings.

IntercontinentalExchange

(www.IntercontinentalExchange.com) In July 2000, Reliant Energy and five other leading wholesale natural gas and power companies announced an equity investment in this web-based system for trading commodities, creating the world's largest online, over-the-counter market for energy and metals.

IntercontinentalExchange began trading precious metals in August. Energy trading in oil, power, natural gas and refined products began in November, with initial volumes exceeding expectations.

Industry experts are predicting rapid growth for online trading. Of the 2.7 billion megawatt-hours and 154 billion cubic feet of physical natural gas per day that were traded in 1999, Forrester Research reported that only 0.2 percent of electricity trades and 2 percent of natural gas trades were conducted online. Forrester predicts that those figures will increase to 25 percent and 11 percent, respectively, by 2004.

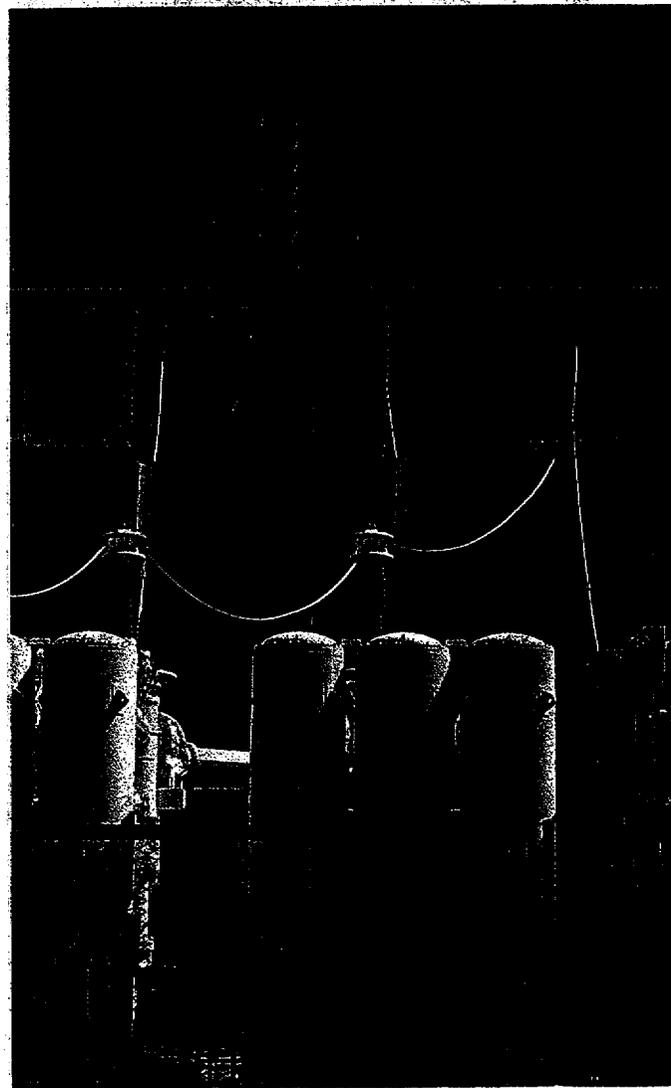
Pantellos (www.pantellos.com) In June 2000, Reliant Energy and 20 other leading power, gas and pipeline companies formed Pantellos, a for-profit energy industry eProcurement marketplace. Officially operational on January 1, 2001, the goal of this business-to-business exchange is to streamline purchasing processes in order to shorten purchase cycles and increase accessibility between buyers and sellers.

Reliant Energy began purchasing through Pantellos on January 3, 2001. Launch of the company's iBuy Internet site, which connects Pantellos, Reliant Energy and its suppliers, was the culmination of a five-month long effort of analyzing purchasing processes and identifying opportunities for cost savings through use of the Internet.

Reliant Energy Solutions Portal

(http://solutions.reliantenergy.com) Reliant Energy has launched a website where commercial and industrial customers can buy energy and risk management products.

Wire for transmission and distribution lines will ultimately be among the items available through the Pantellos online marketplace. Reliant Energy is a founding member and has an equity interest in Pantellos.



learn more about how they use energy and gain tips on operational improvements that can reduce their costs. In addition, this site will help these sophisticated customers take advantage of opportunities to shift or reduce demand, which empowers key buyers to respond quickly to changing prices in a competitive marketplace.

Reliant Energy Communications

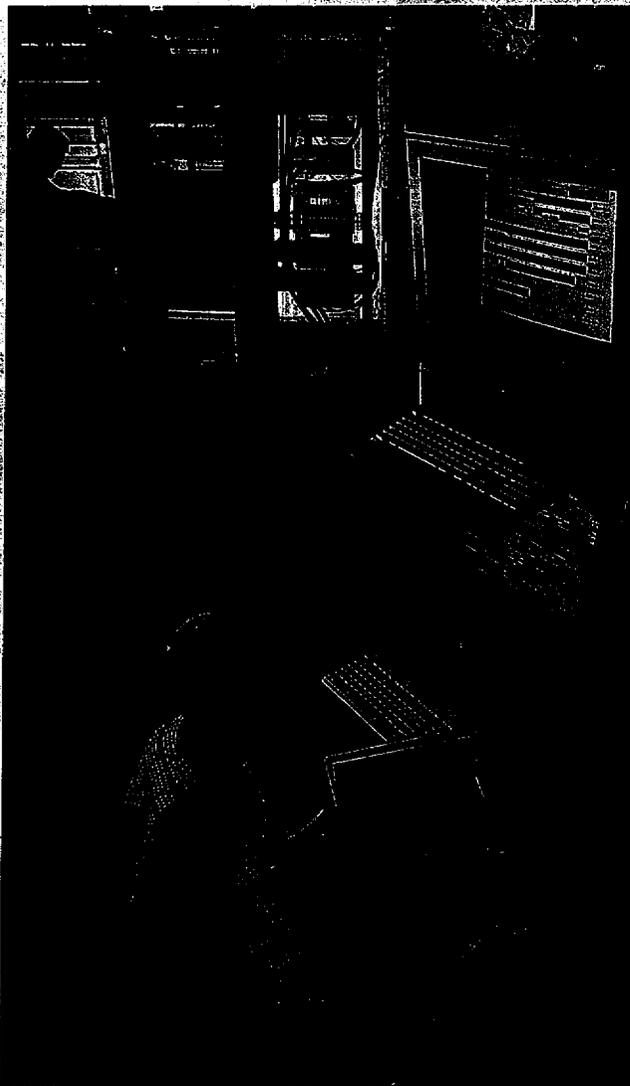
Reliant Energy Communications is an integrated communications provider offering enhanced web, data and voice services to businesses and government agencies. Its products and services include Internet connectivity, web hosting and design, co-location facilities and managed data services. Enhanced data services include private line, ATM, frame relay and high-speed DSL lines. Switched voice products include local dial tone and long distance services. While its initial focus was on the Houston business community, Reliant Energy Communications is expanding into other Texas cities, including Austin and San Antonio.

Reliant Energy Communications' new Internet Data Center in Houston will position the company to capture new opportunities in the rapidly growing web hosting market, which is expected to reach \$20 billion in 2004.

Reliant Energy Ventures

Reliant Energy Ventures manages Reliant Energy's existing technology investments and identifies and invests in promising new technologies and businesses that relate to the company's core businesses and markets. Reliant Energy Ventures uses the company's advantaged perspective from its energy services operations to invest in early-stage companies and technologies. Focus areas for investments include distributed generation, power quality, clean energy, energy industry software and systems, and broadband equipment and infrastructure.

In September 2000, Reliant Energy Ventures agreed to make a \$25 million equity investment in Grande Communications, Inc., a Texas-based company building a deep fiber broadband network that will offer bundled Internet, communication and entertainment services to homes and businesses. The company has committed, under certain conditions, to invest a similar amount in a future Grande Communications equity financing. Grande Communications has announced plans to build a broadband network in Houston. This will be in addition to the network already under development to serve the Central Texas cities of Austin, San Marcos and San Antonio.



The financial information presented on pages 34 through 42 regarding Reliant Energy, Incorporated and its subsidiaries is condensed. This information should be read in conjunction with the Company's complete financial statements (including notes) as well as management's discussion and analysis of financial condition and results of operations, which are presented in Appendix A to the 2001 Proxy Statement.

Investors may also request, without charge, the Company's Annual Report on Form 10-K for the year ended December 31, 2000, by writing or calling Reliant Energy Investor Services at 1-888-468-3020. Additional investor information can be found on the inside back cover of this report.

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Condensed Five-Year Comparison of Selected Financial Data

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

The following table presents selected financial data with respect to our consolidated financial condition and results of consolidated operations and should be read in conjunction with our consolidated financial statements and the related notes in Appendix A of the 2001 Proxy Statement. In December 2000, our Board of Directors approved a plan to dispose of our Latin America business segment through the sale of its assets. Accordingly, we are reporting the results of our Latin America business segment as discontinued operations for all periods presented. The selected financial data includes the financial statement effect of Reliant Energy Mid-Atlantic (REMA) since the May 2000 acquisition, UNA since the October 1999 acquisition and Reliant Energy Resources Corp. since the August 1997 acquisition. These acquisitions were accounted for under the purchase method. Please read Note 3 to our consolidated financial statements for additional information regarding the REMA and UNA acquisitions and Note 19 to our consolidated financial statements for additional information regarding the discontinued operations.

(in millions, except per share amounts)

	Year Ended December 31,				
	2000 ⁽¹⁾	1999 ⁽²⁾	1998 ⁽³⁾	1997 ⁽⁴⁾	1996
Revenues	\$ 29,339	\$ 15,223	\$ 11,230	\$ 6,786	\$ 4,033
Income (loss) from continuing operations before extraordinary items and preferred dividends	\$ 771	\$ 1,674	\$ (278)	\$ 390	\$ 408
(Loss) income from discontinued operations, net of tax	(172)	(9)	137	31	(3)
Loss on disposal of discontinued operations, net of tax	(159)	—	—	—	—
Extraordinary items, net of tax	7	(183)	—	—	—
Net income (loss) attributable to common stockholders	\$ 447	\$ 1,482	\$ (141)	\$ 421	\$ 405
Basic earnings (loss) per common share:					
Continuing operations before extraordinary items	\$ 2.71	\$ 5.87	\$ (0.98)	\$ 1.54	\$ 1.67
(Loss) income from discontinued operations, net of tax	(0.61)	(0.03)	0.48	0.12	(0.01)
Loss on disposal of discontinued operations, net of tax	(0.56)	—	—	—	—
Extraordinary items, net of tax	0.03	(0.64)	—	—	—
Basic earnings (loss) per common share	\$ 1.57	\$ 5.20	\$ (0.50)	\$ 1.66	\$ 1.66
Diluted earnings (loss) per common share:					
Continuing operations before extraordinary items	\$ 2.68	\$ 5.85	\$ (0.98)	\$ 1.54	\$ 1.67
(Loss) income from discontinued operations, net of tax	(0.60)	(0.03)	0.48	0.12	(0.01)
Loss on disposal of discontinued operations, net of tax	(0.55)	—	—	—	—
Extraordinary items, net of tax	0.03	(0.64)	—	—	—
Diluted earnings (loss) per common share	\$ 1.56	\$ 5.18	\$ (0.50)	\$ 1.66	\$ 1.66

See Notes to the Company's Consolidated Financial Statements

Condensed Five-Year Comparison of Selected Financial Data (Continued)

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

	Year Ended December 31,				
	2000 ⁽¹⁾	1999 ⁽²⁾	1998 ⁽³⁾	1997 ⁽⁴⁾	1996
Cash dividends declared per common share	\$ 1.50	\$ 1.50	\$ 1.50	\$ 1.50	\$ 1.50
Dividend payout ratio from					
continuing operations	55%	26%	—	97%	90%
Return on average common equity	8.3%	30.8%	(3.1%)	9.7%	10.2%
Ratio of earnings from continuing					
operations to fixed charges	2.35	5.43	—	2.42	2.82
At year-end:					
Book value per common share	\$ 19.10	\$ 18.70	\$ 15.16	\$ 17.28	\$ 16.41
Market price per common share	\$ 43.31	\$ 22.88	\$ 32.06	\$ 26.75	\$ 22.63
Market price as a percent of book value	227%	122%	211%	155%	138%
Total assets	\$ 32,077	\$ 26,456	\$ 18,967	\$ 18,268	\$ 12,277
Long-term debt obligations, including current maturities	\$ 6,619	\$ 9,223	\$ 7,049	\$ 5,307	\$ 3,280
Trust preferred securities	\$ 705	\$ 705	\$ 342	\$ 362	\$ —
Cumulative preferred stock	\$ 10	\$ 10	\$ 10	\$ 10	\$ 135
Capitalization:					
Common stock equity	43%	35%	37%	46%	53%
Cumulative preferred stock	—	—	—	—	2%
Trust preferred securities	5%	5%	3%	3%	—
Long-term debt, including current maturities	52%	60%	60%	51%	45%
Business acquisitions	\$ 2,103	\$ 1,060	\$ 292	\$ 1,423	\$ —
Capital expenditures	\$ 1,842	\$ 1,166	\$ 712	\$ 328	\$ 324

(1) 2000 income includes an aggregate non-cash accounting loss on indexed debt securities and the company's AOL Time Warner investment of \$67 million (after-tax), or \$0.23 earnings per basic and diluted share. The extraordinary item in 2000 is a gain related to the early extinguishment of \$272 million of long-term debt. For additional information on the indexed debt securities and the AOL Time Warner investment, please read Note 8 to the company's consolidated financial statements.

(2) 1999 income includes an aggregate non-cash, unrealized accounting gain on indexed debt securities and the company's Time Warner (now AOL Time Warner) investment of \$1.2 billion (after-tax), or \$4.09 earnings per basic share and \$4.08 earnings per diluted share. For additional information on the indexed debt securities and AOL Time Warner investment, please read Note 8 to the company's consolidated financial statements. The extraordinary item in 1999 is a loss related to an accounting impairment of some generation related regulatory assets of the company's Electric Operations business segment. For additional information, please read Note 4 to the company's consolidated financial statements.

(3) 1998 income includes a non-cash, unrealized accounting loss on indexed debt securities of \$764 million (after-tax), or \$2.69 loss per basic and diluted share. For additional information on the indexed debt securities, please read Note 8 to the company's consolidated financial statements. Fixed charges exceeded earnings by \$367 million in 1998.

(4) 1997 income includes a non-cash, unrealized accounting loss on indexed debt securities of \$79 million (after-tax), or \$0.31 loss per basic and diluted share. For additional information on the indexed debt securities, please read Note 8 to the company's consolidated financial statements.

See Notes to the Company's Consolidated Financial Statements

Statements of Consolidated Operations

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars, except per share amounts)

	Year Ended December 31,		
	2000	1999	1998
Revenues	\$ 29,339,384	\$ 15,223,094	\$ 11,229,519
Expenses:			
Fuel and cost of gas sold	15,071,801	6,699,792	4,815,752
Purchased power	8,627,853	4,137,414	2,215,049
Operation and maintenance	2,356,207	1,781,030	1,583,122
Taxes other than income taxes	498,061	441,242	469,429
Depreciation and amortization	906,328	905,305	866,272
Total	27,460,250	13,964,783	9,949,624
Operating Income	1,879,134	1,258,311	1,279,895
Other Income (Expense):			
(Loss) gain on AOL Time Warner investment	(204,969)	2,452,406	—
Gain (loss) on indexed debt securities	101,851	(629,523)	(1,176,211)
Income (loss) of equity investment of unconsolidated subsidiaries	42,860	(793)	(601)
Other, net	83,765	59,766	67,619
Total	23,507	1,881,856	(1,109,193)
Interest and Other Charges:			
Interest	700,083	498,451	502,432
Distribution on trust preferred securities	54,358	51,220	29,201
Total	754,441	549,671	531,633
Income (Loss) from Continuing Operations Before Income Taxes, Extraordinary Items and Preferred Dividends	1,148,200	2,590,496	(360,931)
Income Tax Expense (Benefit)	377,064	915,973	(82,563)
Income (Loss) from Continuing Operations Before Extraordinary Items and Preferred Dividends	771,136	1,674,523	(278,368)
(Loss) income from discontinued operations (net of tax of \$45,721, \$16,856 and (\$52,131))	(172,375)	(8,792)	137,276
Loss on disposal of discontinued operations, including provision of \$4,843 for operating loss during phase-out period (less applicable tax of \$12,846)	(158,706)	—	—
Extraordinary gain (loss), net of tax of \$0 and \$98,679	7,445	(183,261)	—
Income (Loss) Before Preferred Dividends	447,500	1,482,470	(141,092)
Preferred Dividends	389	389	390
Net Income (Loss) Attributable to Common Stockholders	\$ 447,111	\$ 1,482,081	\$ (141,482)
Basic Earnings (Loss) Per Share:			
Income (Loss) from Continuing Operations			
Before Extraordinary Items	\$ 2.71	\$ 5.87	\$ (0.98)
(Loss) Income from Discontinued Operations, net of tax	(0.61)	(0.03)	0.48
Loss on Disposal of Discontinued Operations, net of tax	(0.56)	—	—
Extraordinary Gain (Loss), net of tax	0.03	(0.64)	—
Net Income (Loss) Attributable to Common Stockholders	\$ 1.57	\$ 5.20	\$ (0.50)
Diluted Earnings (Loss) Per Share:			
Income (Loss) from Continuing Operations			
Before Extraordinary Items	\$ 2.68	\$ 5.85	\$ (0.98)
(Loss) Income from Discontinued Operations, net of tax	(0.60)	(0.03)	0.48
Loss on Disposal of Discontinued Operations, net of tax	(0.55)	—	—
Extraordinary Gain (Loss), net of tax	0.03	(0.64)	—
Net Income (Loss) Attributable to Common Stockholders	\$ 1.56	\$ 5.18	\$ (0.50)

See Notes to the Company's Consolidated Financial Statements

Statements of Consolidated Comprehensive Income

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars)

	Year Ended December 31,		
	2000	1999	1998
Net income (loss) attributable to common stockholders	\$ 447,111	\$ 1,482,081	\$ (141,482)
Foreign currency translation adjustments			
from continuing operations	(1,220)	(587)	—
Foreign currency translation adjustments			
from discontinued operations			
(net of tax of \$16,371, \$23,143 and \$17,656)	(30,405)	(42,392)	(32,790)
Reclassification adjustment for foreign			
currency translation losses realized			
in net income (net of tax of \$57,296)	106,408	—	—
Unrealized loss on available-for-sale securities			
(net of tax of \$1,492, \$373 and \$5,877)	(2,264)	(1,224)	(10,370)
Reclassification adjustment for impairment			
loss on available-for-sale securities			
realized in net income (net of tax of \$9,276)	17,228	—	—
Additional minimum non-qualified pension			
liability adjustment (net of tax of \$11,127)	(19,135)	—	—
Comprehensive Income (Loss)	\$ 517,723	\$ 1,437,878	\$ (184,642)

See Notes to the Company's Consolidated Financial Statements

Consolidated Balance Sheets

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars)

	December 31,	
	2000	1999
Assets		
Current Assets:		
Cash and cash equivalents	\$ 175,972	\$ 80,767
Investment in AOL Time Warner common stock	896,824	3,979,461
Accounts receivable, net	2,623,492	1,078,736
Accrued unbilled revenues	592,618	172,629
Inventory	483,213	340,459
Price risk management assets	4,460,843	722,429
Margin deposits on energy trading activities	521,004	33,721
Prepayments and other current assets	253,335	128,194
Total current assets	10,007,301	6,536,396
Property, Plant and Equipment, net	15,260,155	13,133,559
Other Assets:		
Goodwill and other intangibles, net	3,080,707	3,041,751
Regulatory assets	1,926,103	1,739,507
Price risk management assets	752,186	173,590
Equity investments in unconsolidated subsidiaries	108,727	78,041
Net assets of discontinued operations	194,858	1,078,185
Other	746,709	675,437
Total other assets	6,809,290	6,786,511
Total Assets	\$ 32,076,746	\$ 26,456,466
Liabilities and Stockholders' Equity		
Current Liabilities:		
Short-term borrowings	\$ 5,004,494	\$ 2,876,311
Current portion of long-term debt	1,623,202	4,354,230
Accounts payable	3,077,926	1,025,245
Taxes accrued	172,449	215,680
Interest accrued	103,489	115,192
Dividends declared	110,893	110,811
Price risk management liabilities	4,442,811	718,228
Margin deposits from customers on energy trading activities	284,603	3,800
Accumulated deferred income taxes	309,008	415,591
Business purchase obligation	—	431,570
Other	610,379	348,041
Total current liabilities	15,739,254	10,614,699
Other Liabilities:		
Accumulated deferred income taxes	2,548,891	2,541,109
Unamortized investment tax credit	265,737	270,243
Price risk management liabilities	737,540	142,305
Benefit obligations	491,964	394,550
Business purchase obligation	—	596,303
Other	1,109,850	1,017,010
Total other liabilities	5,153,982	4,961,520
Long-term Debt	4,996,095	4,868,643
Commitments and Contingencies		
Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trusts Holding Solely Junior Subordinated Debentures of the Company		
	705,355	705,272
Stockholders' Equity	5,482,060	5,306,332
Total Liabilities and Stockholders' Equity	\$ 32,076,746	\$ 26,456,466

See Notes to the Company's Consolidated Financial Statements

Statements of Consolidated Cash Flows

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars)

	Year Ended December 31,		
	2000	1999	1998
Cash Flows from Operating Activities:			
Net income (loss) attributable to common stockholders	\$ 447,111	\$ 1,482,081	\$ (141,482)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	906,328	905,305	866,272
Deferred income taxes	(41,892)	625,211	(434,717)
Investment tax credit	(18,330)	(58,706)	(20,123)
Loss (gain) on AOL Time Warner investment	204,969	(2,452,406)	—
(Gain) loss on indexed debt securities	(101,851)	629,523	1,176,211
Extraordinary items	(7,445)	183,261	—
Undistributed (earnings) losses of unconsolidated subsidiaries	(24,931)	793	601
Proceeds from sale of debt securities	123,428	—	—
Impairment of marketable equity securities	26,504	—	—
Net cash provided by (used in) discontinued operations	437,620	(24,547)	(184,567)
Changes in other assets and liabilities:			
Accounts receivable, net	(1,933,033)	(325,777)	129,943
Inventory	(74,603)	51,480	(138,237)
Federal tax refund	86,155	—	140,532
Fuel cost (under) over recovery	(515,278)	73,567	125,104
Margin deposits on energy trading activities, net	(206,480)	(59,467)	42,630
Accounts payable	2,040,724	206,409	(98,249)
Other assets	(302,588)	(71,259)	(131,050)
Other liabilities	229,138	(89,417)	61,774
Other, net	70,078	33,487	32,426
Net cash provided by operating activities	1,345,624	1,109,538	1,427,068
Cash Flows from Investing Activities:			
Capital expenditures	(1,842,385)	(1,165,639)	(712,492)
Business acquisitions, net of cash acquired	(2,121,481)	(1,060,000)	(292,398)
Proceeds from sale-leaseback transactions	1,000,000	—	—
Payment of a business purchase obligation	(981,789)	—	—
Investment in AOL Time Warner securities	—	(537,055)	—
Investments in unconsolidated subsidiaries	(5,755)	(36,582)	(40,928)
Net cash provided by (used in) discontinued operations	641,768	(55,100)	(189,656)
Other, net	21,824	(21,543)	(2,677)
Net cash used in investing activities	(3,287,818)	(2,875,919)	(1,238,151)

See Notes to the Company's Consolidated Financial Statements

Statements of Consolidated Cash Flows (continued)

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars)

	Year Ended December 31,		
	2000	1999	1998
Cash Flows from Financing Activities:			
Proceeds from long-term debt, net	\$ 1,092,373	\$ 2,060,680	\$ 1,267,107
Payments of long-term debt	(678,709)	(935,908)	(697,714)
Proceeds from sale of trust preferred securities, net	—	362,994	—
Increase (decrease) in short-term borrowings, net	2,170,314	822,468	(314,717)
Proceeds from sale of common stock	53,809	30,452	4,542
Payment of common stock dividends	(426,859)	(427,255)	(426,265)
Purchase of treasury stock	(27,306)	(90,708)	—
Net cash (used in) provided by discontinued operations	(120,173)	400	(10,555)
Other, net	(31,138)	(204)	(28,090)
Net cash provided by (used in) financing activities	2,032,311	1,822,919	(205,692)
Effect of Exchange Rate Changes on Cash	5,088	—	—
Net Increase (Decrease) in Cash and Cash Equivalents	95,205	56,538	(16,775)
Cash and Cash Equivalents at Beginning of Year	80,767	24,229	41,004
Cash and Cash Equivalents at End of Year	\$ 175,972	\$ 80,767	\$ 24,229

Supplemental Disclosure of Cash Flow Information:

Cash Payments:

Interest (net of amounts capitalized)	\$ 786,660	\$ 504,821	\$ 502,889
Income taxes	496,603	401,703	472,609

See Notes to the Company's Consolidated Financial Statements

Statements of Consolidated Stockholders' Equity

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

(Thousands of Dollars and Shares)

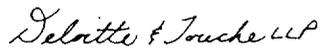
	2000		1999		1998	
	Shares	Amount	Shares	Amount	Shares	Amount
Preference Stock, none outstanding	—	\$ —	—	\$ —	—	\$ —
Cumulative Preferred Stock						
Balance, beginning of year	97	9,740	97	9,740	97	9,740
Balance, end of year	97	9,740	97	9,740	97	9,740
Common Stock, no par; authorized 700,000,000 shares						
Balance, beginning of year	297,612	3,182,751	296,271	3,136,826	295,357	3,112,098
Issuances related to benefit and investment plans	2,302	74,447	1,341	46,062	914	24,734
Other	—	(8)	—	(137)	—	(6)
Balance, end of year	299,914	3,257,190	297,612	3,182,751	296,271	3,136,826
Treasury Stock						
Balance, beginning of year	(3,625)	(93,296)	(103)	(2,384)	(93)	(2,066)
Shares acquired	(1,184)	(27,306)	(3,524)	(90,708)	—	—
Other	(2)	(254)	2	(204)	(10)	(318)
Balance, end of year	(4,811)	(120,856)	(3,625)	(93,296)	(103)	(2,384)
Unearned ESOP stock						
Balance, beginning of year	(10,679)	(199,226)	(11,674)	(217,780)	(12,389)	(229,827)
Issuances related to benefit plan	2,040	38,068	995	18,554	715	12,047
Balance, end of year	(8,639)	(161,158)	(10,679)	(199,226)	(11,674)	(217,780)
Retained Earnings						
Balance, beginning of year		2,500,181		1,445,081		2,013,055
Net income (loss)		447,111		1,482,081		(141,482)
Common stock dividends – \$1.50 per share		(426,942)		(426,981)		(426,492)
Balance, end of year		2,520,350		2,500,181		1,445,081
Accumulated Other Comprehensive Loss						
Balance, beginning of year		(93,818)		(49,615)		(6,455)
Foreign currency translation adjustments from continuing operations		(1,220)		(587)		—
Foreign currency translation adjustments from discontinued operations		(30,405)		(42,392)		(32,790)
Reclassification adjustment for foreign currency translation losses realized in net income		106,408		—		—
Unrealized loss on available-for-sale securities		(2,264)		(1,224)		(10,370)
Reclassification adjustment for impairment loss on available-for-sale securities realized in net income		17,228		—		—
Additional minimum non-qualified pension liability adjustment		(19,135)		—		—
Balance, end of year		(23,206)		(93,818)		(49,615)
Total Stockholders' Equity		\$ 5,482,060		\$ 5,306,332		\$ 4,321,868

See Notes to the Company's Consolidated Financial Statements

To the Stockholders of Reliant Energy, Incorporated:

We have audited the consolidated balance sheets of Reliant Energy, Incorporated and its subsidiaries (the Company) as of December 31, 2000 and 1999, and the related statements of consolidated operations, consolidated comprehensive income, consolidated stockholders' equity, and consolidated cash flows for each of the three years in the period ended December 31, 2000. Such consolidated financial statements and our report thereon dated March 16, 2001, expressing an unqualified opinion (which are not included herein), are included in Appendix A to the Proxy Statement for the 2001 Annual Meeting of Shareholders. The accompanying condensed consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on such condensed consolidated financial statements in relation to the complete consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements of the Company is fairly stated in all material respects in relation to the basic consolidated financial statements from which it has been derived.



Deloitte & Touche LLP
Houston, Texas
March 16, 2001

- JAMES A. BAKER, III 70, Senior Partner of Baker Botts LLP,
Houston, Texas,
director since 1996.
- RICHARD E. BALZHISER, PHD 68, President Emeritus of
the Electric Power Research Institute,
Palo Alto, California,
director since 1996.
- MILTON CARROLL 50, Chairman, President and
Chief Executive Officer
of Instrument Products, Inc.,
Houston, Texas, director since 1992.
- JOHN T. CATER 65, Private Investor and former
Chairman of Compass Bank,
Houston, Texas, director since 1983.
- O. HOLCOMBE CROSSWELL 60, President of Griggs Corporation,
Houston, Texas, director since 1997.
- ROBERT J. CRUIKSHANK 70, Private Investor and Retired Senior
Partner with Deloitte & Touche, LLP,
Houston, Texas, director since 1993.
- LINNET F. DEILY 55, Vice Chairman,
Office of the President of
The Charles Schwab Corporation,
San Francisco, California,
director since 1993.
- T. MILTON HONEA 68, Retired Chairman of the Board,
President and Chief Executive Officer
of NorAm Energy Corp., Santa Barbara,
California, director since 1997.
- R. STEVE LETBETTER 52, Chairman, President and
Chief Executive Officer of the Company,
director since 1995.
- LAREE E. PEREZ 47, Vice President of
Loomis Sayles & Company, L.P.,
Albuquerque, New Mexico,
director since 2000.

OFFICE OF THE CHAIRMAN**R. STEVE LETBETTER**

52, Chairman, President
and Chief Executive Officer

ROBERT W. HARVEY

45, Vice Chairman

DAVID M. McCLANAHAN

51, Vice Chairman and President
and Chief Operating Officer,
Reliant Energy Delivery Group

STEPHEN W. NAEVE

53, Vice Chairman and
Chief Financial Officer

JOE BOB PERKINS

40, President and
Chief Operating Officer,
Reliant Energy Wholesale Group

RELIANT ENERGY**B. BRUCE GIBSON**

47, Senior Vice President,
Government Affairs

PRESTON R. JOHNSON, JR.

45, Senior Vice President,
Human Resources

HUGH RICE KELLY

58, Executive Vice President,
General Counsel and
Corporate Secretary

IANNE McCREA

48, Senior Vice President,
Information Technology and
Chief Information Officer

MARY P. RICCIARDELLO

45, Senior Vice President
and Chief Accounting Officer

STEPHEN C. SCHAEFFER

53, Senior Vice President,
Regulatory

ROBERT L. WALDROP

54, Senior Vice President,
Communications

REX T. CLEVINGER

43, Vice President, Finance

DANIEL N. HANNON

40, Vice President,
Corporate Planning

DELIVERY GROUP**GARY M. CERNY**

45, President and
Chief Operating Officer,
Reliant Energy Minnegasco

DALE C. EARWOOD

45, President, Pipelines/Gathering

CONSTANTINE S. LIOLLIO

42, President and
Chief Operating Officer,
Reliant Energy Arkla/Entex

THOMAS R. STANDISH

51, President and
Chief Operating Officer,
Reliant Energy HL&P/Entex

WHOLESALE GROUP**JACK L. FARLEY**

37, President, Western Region

SHAHID J. MALIK

40, President, Trading

CURTIS A. MORGAN

40, President, Eastern Region

GARY W. LUCE

41, Group Senior Vice President,
Commercial Development,
Structuring and Transaction Support

EMERGING BUSINESSES GROUP**JAMES A. AJELLO**

48, President and
Chief Operating Officer,
Reliant Energy Solutions Group

WATERS S. DAVIS, IV

47, President and
Chief Operating Officer,
Reliant Energy Retail Group

MARK B. SLAUGHTER

42, President, Reliant Energy
Communications, Inc.

EUROPE**ITO VAN LANSCHOT**

51, President and
Chief Operating Officer
Reliant Energy Europe

RELIANT ENERGY INVESTOR INFORMATION

Annual Meeting

The annual meeting of shareholders will be held at 9 a.m., central time, on May 2, 2001, in the Reliant Energy Plaza Auditorium, 1111 Louisiana Street, Houston, Texas. All shareholders are invited to attend. A formal notice of the meeting will be mailed to shareholders in April with a proxy statement. The proxy statement describes business items to be considered at the annual meeting, and includes a proxy card that you may use to vote on nominees for director and other matters.

Investor Services

If you have questions about your Reliant Energy investor account, or if you would like to order any publications listed on this page, please contact:

In Houston: (713) 207-3060

Toll Free: (800) 231-6406

Fax: (713) 207-3169

A list of publications and investor services may be found on the company's website at:
www.reliantenergy.com/investing

Investor Services representatives are available from 8 a.m. to 4:30 p.m., central time, Monday through Friday to help you with questions about Reliant Energy common stock, preferred stock, first mortgage bonds and enrollment in the Reliant Energy Investor's Choice Plan. You also can enroll in Investor's Choice online at:
www.netstockdirect.com

The Investor's Choice Plan provides easy, inexpensive options, including direct purchase and sale of Reliant Energy common stock; dividend reinvestment; statement-based accounting and monthly or quarterly automatic investing by electronic transfer. You can become a registered Reliant Energy shareholder by making an initial investment of at least \$250 through Investor's Choice.

Reliant Energy Investor Services serves as transfer agent, registrar and dividend and interest disbursing agent for Reliant Energy common stock, preferred stock and first mortgage bonds.

Information Requests

Call (888) 468-3020 toll-free for additional copies of:

2000 Annual Report

2001 Proxy statement

Form 10-K

Video and audio materials

Dividend Payments

Common stock dividends are generally paid on the 10th of March, June, September and December to holders of record on the 16th of February, May, August and November, respectively. Dividends are subject to declaration by the Board of Directors, and they establish the amount of each quarterly common stock dividend and fix record and payment dates.

Institutional Investors

Security analysts and other investment professionals should contact Reliant Energy Investor Relations at (713) 207-3042 or (713) 207-6308.

Stock Listing

Reliant Energy, Incorporated common stock is traded under the symbol REI on the New York and Chicago stock exchanges.

Auditors

Deloitte & Touche LLP, Houston, Texas

Corporate Offices, Street Address

Reliant Energy, Incorporated
1111 Louisiana Street
Houston, Texas 77002

Mailing Address

P. O. Box 4567
Houston, Texas 77210-4567

Telephone: (713) 207-3000

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About This Summary Annual Report

The 2003 Reliant Energy annual report provides condensed financial disclosure. Full audited financial statements are found in Appendix A to the 2003 Proxy Statement. This report contains forward-looking statements that are based on information currently available to management and should be judged as such. Actual results could differ significantly from those predicted here. Additional copies of this report and financial statements may be requested free of charge from Reliant Energy Investor Services at 800-231-6406.



Reliant Energy, Incorporated

Appendix A 2000 Financial Statements

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RELIANT ENERGY, INCORPORATED

2000 FINANCIAL INFORMATION

This Appendix A is derived from Item 5 (Market for Reliant Energy's and RERC Corp.'s Common Equity and Related Shareholder Matters), Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations), Item 7A (Quantitative and Qualitative Disclosures About Market Risk) and Item 8 (Financial Statements and Supplementary Data) of the Annual Report on Form 10-K of Reliant Energy, Incorporated and its subsidiaries for the year ended December 31, 2000 (Form 10-K). A copy of the Form 10-K may be obtained without charge by contacting the Investor Relations department of Reliant Energy, Incorporated at 1111 Louisiana, Houston, Texas 77002. Reference is made to the Form 10-K for additional information about our business and operations.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

From time to time we make statements concerning our expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are not historical facts. These statements are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those expressed or implied by these statements. In some cases, you can identify our forward-looking statements by the words "anticipates," "believes," "continue," "could," "estimates," "expects," "intends," "may," "plans," "potential," "predicts," "should," "will" or other similar words.

The following list identifies some of the factors that could cause actual results to differ from those expressed or implied by our forward-looking statements:

- state, federal and international legislative and regulatory developments, including deregulation, re-regulation and restructuring of the electric utility industry and changes in or application of environmental and other laws and regulations to which we are subject,
- the timing of the implementation of our business separation plan,
- the effects of competition, including the extent and timing of the entry of additional competitors in our markets,
- industrial, commercial and residential growth in our service territories,
- our pursuit of potential business strategies, including acquisitions or dispositions of assets or the development of additional power generation facilities,
- state, federal and other rate regulations in the United States and in foreign countries in which we operate or into which we might expand our operations,
- the timing and extent of changes in commodity prices and interest rates,
- weather variations and other natural phenomena,
- political, legal and economic conditions and developments in the United States and in foreign countries in which we operate or into which we might expand our operations, including the effects of fluctuations in foreign currency exchange rates,
- financial market conditions and the results of our financing efforts, and
- the performance of our projects.

For a discussion of some additional factors that could cause actual results to differ materially from those expressed or implied in forward-looking statements, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Certain Factors Affecting Our Future Earnings.” Any forward-looking statements should be considered in light of these important factors and in conjunction with the other documents filed by Reliant Energy with the SEC.

We have based our forward-looking statements on management’s beliefs and assumptions based on information available at the time the statements are made. We caution you that assumptions, beliefs, expectations, intentions and projections about future events may and often do vary materially from actual results. Therefore, actual results may differ materially from those expressed or implied by our forward-looking statements.

The following sections contain forward-looking statements:

- Management’s Discussion and Analysis of Financial Condition and Results of Operations —
 - Results of Operations by Business Segment —
 - European Energy
 - Certain Factors Affecting Our Future Earnings —
 - Business Separation and Restructuring
 - Competitive, Regulatory and Other Factors Affecting Our Electric Operations
 - Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations
 - Competitive, Regulatory and Other Factors Affecting Our European Energy Operations
 - Competitive and Other Factors Affecting RERC Operations
 - Environmental Expenditures
 - Liquidity and Capital Resources —
 - Company Consolidated Capital Requirements
 - Future Sources and Uses of Cash Flows
 - New Accounting Pronouncements
- Quantitative and Qualitative Disclosures About Market Risk.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis should be read in combination with our consolidated financial statements and the notes thereto, which we refer to, collectively, as "our consolidated financial statements."

Reliant Energy, Incorporated, a Texas corporation, was incorporated in 1906. In this discussion, we refer to Reliant Energy, Incorporated as "Reliant Energy" and to Reliant Energy and its subsidiaries as "we" or "us," unless the context clearly indicates otherwise. Reliant Energy Resources Corp., a Delaware corporation and wholly owned subsidiary of Reliant Energy, was incorporated in 1996. In this discussion, we refer to Reliant Energy Resources Corp. as "RERC Corp." and to RERC Corp. and its subsidiaries as "RERC," unless the context clearly indicates otherwise.

We are a diversified international energy services and energy delivery company that provides energy and energy services in North America and Western Europe. We operate one of the United States' largest electric utilities in terms of kilowatt-hour (KWh) sales, and our three natural gas distribution divisions together form one of the United States' largest natural gas distribution operations in terms of customers served. We invest in the acquisition, development and operation of international and domestic non-rate regulated power generation facilities. We own two interstate natural gas pipelines that provide gas transportation, supply, gathering and storage services, and we also engage in wholesale energy marketing and trading.

In this section we discuss our results of operations on a consolidated basis and individually for each of our business segments. We also discuss our liquidity and capital resources. Our financial reporting segments include Electric Operations, Natural Gas Distribution, Pipelines and Gathering, Wholesale Energy, European Energy and Other Operations. For segment reporting information, please read Notes 1 and 18 to our consolidated financial statements.

Effective December 1, 2000 (measurement date), our Board of Directors approved a plan to dispose of our Latin America business segment and sale of its assets. Accordingly, we are reporting the results of our Latin America business segment as discontinued operations for all periods presented in our consolidated financial statements in accordance with Accounting Principles Board Opinion No. 30. For information regarding the disposal of our Latin America business segment, please read Note 19 to our consolidated financial statements.

In 2000, we submitted our business separation plan to the Public Utility Commission of Texas (Texas Utility Commission). We later amended the plan to contemplate the restructuring of our businesses into two separate publicly traded companies in order to separate our unregulated businesses from our regulated businesses (Business Separation Plan). In December 2000, the Business Separation Plan was approved by the Texas Utility Commission, although as of March 19, 2001 a final order has not been issued. For additional information regarding the Business Separation Plan, please read Note 4(b) to our consolidated financial statements.

On July 27, 2000, we announced our intention to form a company, Reliant Resources, Inc. (Reliant Resources), to own and operate a substantial portion of our unregulated operations and to offer no more than 20% of the common stock of this company in an initial public offering. Reliant Energy incorporated Reliant Resources as a wholly owned subsidiary in August 2000. Effective as of December 31, 2000, Reliant Energy transferred substantially all of its unregulated operations to Reliant Resources. We currently expect Reliant Resources will conduct an initial public offering in 2001.

On May 12, 2000, one of our subsidiaries purchased entities owning electric power generating assets and development sites located in Pennsylvania, New Jersey and Maryland having an aggregate net generating capacity of approximately 4,262 megawatts (MW). With the exception of development entities that were sold to another Reliant Energy subsidiary in July 2000, the assets of the entities acquired are owned or leased by wholly owned subsidiaries of Reliant Energy Mid-Atlantic Power Holdings, LLC (REMA). The purchase price for the May 2000 transaction was \$2.1 billion. We accounted for the acquisition as a purchase, and accordingly, our results of operations include the results of operations for REMA only for the period after the

acquisition date. For additional information about this acquisition, including our accounting treatment of the acquisition, please read Note 3(a) to our consolidated financial statements.

Effective October 1999, we acquired N.V. UNA, a Dutch electric generation company (UNA), for a total purchase price of \$1.9 billion based on the October 7, 1999 exchange rate of 2.06 Dutch Guilders (NLG) per U.S. dollar. We accounted for this acquisition as a purchase. For additional information about this acquisition, including our accounting treatment of the acquisition, please read Note 3(b) to our consolidated financial statements.

All dollar amounts in the tables that follow are in millions, except for per share and operational data.

Consolidated Results of Operations

	Year Ended December 31,		
	1998	1999	2000
Revenues	\$11,230	\$ 15,223	\$ 29,339
Operating Expenses	(9,950)	(13,965)	(27,460)
Operating Income	1,280	1,258	1,879
(Loss) Income of Equity Investments	(1)	(1)	43
Other Income, net	68	60	83
Gain (Loss) on AOL Time Warner Investment	—	2,452	(205)
(Loss) Gain on Indexed Debt Securities	(1,176)	(629)	102
Interest Expense and Other Charges	(532)	(550)	(754)
(Loss) Income from Continuing Operations Before Income Taxes and Extraordinary Items	(361)	2,590	1,148
Income Tax Benefit (Expense)	83	(916)	(377)
Income (Loss) from Discontinued Operations, net of tax of (\$52), \$17 and \$46	137	(9)	(172)
Loss on Disposal of Discontinued Operations, net of tax of \$13	—	—	(159)
Extraordinary (Loss) Gain, net of tax of \$99 and \$0	—	(183)	7
Net (Loss) Income Attributable to Common Stockholders	\$ (141)	\$ 1,482	\$ 447
Basic (Loss) Earnings Per Share	\$ (0.50)	\$ 5.20	\$ 1.57
Diluted (Loss) Earnings Per Share	\$ (0.50)	\$ 5.18	\$ 1.56

2000 Compared to 1999.

Net Earnings. We reported consolidated earnings of \$447 million (\$1.57 per basic share) for 2000 compared to \$1.482 billion (\$5.20 per basic share) for 1999. The reported income for 2000 included the following extraordinary and unusual items:

- an aggregate after-tax, non-cash accounting loss of \$67 million on our indexed debt securities and our related AOL Time Warner, Inc. (AOL Time Warner) investment,
- an extraordinary gain of \$7 million related to the early extinguishment of \$272 million of long-term debt,
- an after-tax loss of \$172 million from discontinued operations of our Latin America business segment, and
- an after-tax loss of \$159 million on the disposal of discontinued operations of our Latin America business segment.

The 1999 results included the following extraordinary and unusual items:

- an aggregate after-tax, non-cash accounting gain of \$1.166 billion on our indexed debt securities and our AOL Time Warner investment,

- an after-tax extraordinary loss of \$183 million relating to an accounting impairment of some generation related regulatory assets of Electric Operations, and
- an after-tax loss of \$9 million from discontinued operations of our Latin America business segment.

In 1997, in order to monetize a portion of the cash value of our investment in Time Warner Inc. (TW) convertible preferred stock (TW Preferred), we issued 22.9 million of 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 Stock (TW Common). On July 6, 1999, we converted our investment in TW Preferred into 45.8 million shares of TW Common. Prior to the conversion, our investment in the TW Preferred was accounted for under the cost method at a value of \$990 million. Effective on the conversion date, the shares of TW Common were classified as trading securities under Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (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 our investment in Time Warner securities. On the July 1, 2000 maturity date, we tendered 37.9 million shares of TW Common to fully settle our obligations in connection with our ACES obligation. On September 21, 1999, we issued approximately 17.2 million of 2.0% Zero-Premium Exchangeable Subordinated Notes due 2029 (ZENS) having an original principal amount of \$1.0 billion. At maturity the holders of the ZENS will receive in cash the higher of the original principal amount of the ZENS (subject to adjustment) or an amount based on the then-current market value of TW Common, or other securities distributed with respect to TW Common. We used \$537 million of the net proceeds from the offering of the ZENS to purchase 9.2 million additional shares of 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, we owned approximately 8 million shares of TW Common that were in excess of the 37.9 million shares needed to economically hedge our ACES obligation. 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 our 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. Our investment in TW (now AOL Time Warner) securities has been held to facilitate our ability to meet our obligations under the ACES and ZENS.

The following table sets forth summarized financial information regarding our investment in TW securities and our ACES and ZENS obligations (in millions):

	<u>TW Investment</u>	<u>ACES</u>	<u>ZENS</u>
Balance at December 31, 1997	\$ 990	\$ 1,174	
Loss on indexed debt securities	—	1,176	
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	2,452	—	—
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	(2,877)	(2,877)	—
Balance at December 31, 2000	<u>\$ 897</u>	<u>\$ —</u>	<u>\$1,000</u>

For additional information regarding our investment in AOL Time Warner, our indexed debt securities and the effect of adoption of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, on January 1, 2001 on our ZENS obligation, please read Note 8 to our consolidated financial statements.

In June 1999, the Texas legislature adopted the Texas Electric Choice Plan (Legislation). Also, in 1999, in connection with the implementation of the Legislation, we evaluated the recovery of our generation related regulatory assets and liabilities. We determined that a pre-tax accounting loss of \$282 million existed because we believed only the economic value of our generation related regulatory assets (as defined by the Legislation) would be recovered. Therefore, we recorded a \$183 million after-tax extraordinary loss in the fourth quarter of 1999. If events were to occur that made the recovery of some of the remaining generation related regulatory assets no longer probable, we would write off the remaining balance of such assets as a non-cash charge against earnings. For information regarding the \$183 million extraordinary loss, please read “— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Electric Operations — Other Regulatory Factors” and Note 4(a) to our consolidated financial statements.

In the fourth quarter of 2000, prior to the measurement date, our Latin America business segment sold its investments in El Salvador and a portion of its investments in Colombia for an aggregate \$303 million in after-tax proceeds. The measurement date is the date we began reporting our Latin America business segment as discontinued operations. We recorded a \$127 million after-tax loss in connection with the sale of these investments which was included in our after-tax loss from discontinued operations of \$172 million (net of an income tax benefit of \$46 million) in 2000. Subsequent to the measurement date, we sold our investments in Brazil and our remaining investments in Colombia for an aggregate \$487 million in after-tax proceeds. We recorded a \$114 million after-tax loss in connection with the sale of these investments which was included in our after-tax loss on disposal of discontinued operations of \$159 million (net of income taxes of \$13 million) in 2000. Our Latin America business segment's remaining investments include a wholly owned cogeneration facility and a distribution company, both located in Argentina, and a minority interest in a coke calcining plant in India. We anticipate that the sale of the remainder of these assets will be completed by December 2001. The total provision for the disposal of discontinued operations of \$159 million includes a \$5 million reserve for anticipated operating losses through the completion of the sales, which includes \$4 million of operating losses from the measurement date through December 31, 2000.

Our consolidated net income, after adjusting for extraordinary and unusual items (as described above) in both years, was \$838 million (\$2.94 per basic share) for 2000 compared to \$508 million (\$1.78 per basic share) for 1999. The \$330 million increase was primarily due to increased earnings from our Wholesale Energy and Electric Operations segments and additional earnings from our European Energy segment, which was established in the fourth quarter of 1999. The increase was partially offset by lower earnings in 2000 compared to 1999 from our Natural Gas Distribution segment and increased losses from our Other Operations segment.

Operating Income. For an explanation of changes in our operating income, please read the discussion below of operating income (loss) by segment.

Income (Loss) of Equity Investments. Our Wholesale Energy segment reported income from equity investments in 2000 of \$43 million compared to equity losses of \$1 million in 1999. The equity income in 2000 primarily resulted from an investment in an electric generation plant in Boulder City, Nevada. The plant became operational in May 2000.

Other Income, net. Other income, net was \$60 million and \$83 million in 1999 and 2000, respectively. The increase in other income in 2000 of \$23 million compared to 1999 was primarily due to the following items:

- an increase in interest income of \$57 million primarily related to income tax refunds received in 2000 and margin deposits on energy trading activities,
- a pre-tax gain of \$18 million in 2000 on the sale of our interest in one of our development stage electric generation projects,
- partially offset by an impairment loss of \$27 million on marketable equity securities classified as “available-for-sale” in 2000, distributions of \$9 million from venture capital investments in marketable securities classified as “trading” in 1999 and a decline of \$19 million in dividend income from our AOL Time Warner investment. For additional information, please read Note 8 to our consolidated financial statements.

During 2000, we incurred a pre-tax impairment loss of \$27 million on marketable equity securities classified as "available-for-sale" by Other Operations. Management's determination to recognize this impairment resulted from a combination of events occurring in 2000 related to this investment. Such events affecting the investment included changes occurring in the investment's senior management, announcement of significant restructuring charges and related downsizing for the entity, reduced earnings estimates for this entity by brokerage analysts and the bankruptcy of a competitor of the entity in the first quarter of 2000. These events coupled with the stock market value of our investment in these securities continuing to be below our cost basis, caused management to believe the decline in fair value to be other than temporary. For additional discussion of this investment, please read Note 2(1) to our consolidated financial statements.

Interest Expense and Other Charges. In 1999 and 2000, interest expense and other charges were \$550 million and \$754 million, respectively. Increased interest expense and other charges in 2000 compared to 1999 were primarily due to increased levels of short-term borrowings. These increases were associated in part with borrowings to fund the purchase obligation for the acquisition of UNA in the fourth quarter of 1999 and the first quarter of 2000, the acquisition of the REMA entities in the second quarter of 2000, other acquisitions, capital expenditures and increased margin deposits on energy trading activities.

Income Tax Expense. The effective tax rate for 1999 and 2000 was 35.4% and 32.8%, respectively. After adjusting for the unrealized accounting gains and losses on our investment in AOL Time Warner and indexed debt securities, the adjusted effective tax rate for 1999 and 2000 was 33.9% and 33.0%, respectively. The decrease in the effective tax rate in 2000 compared to 1999 was primarily due to a Dutch tax holiday. In 2000 and prior years, under Dutch corporate income tax laws, the earnings of UNA were subject to a zero percent Dutch corporate income tax rate as a result of the Dutch tax holiday related to the Dutch electric industry. In 2002, all of European Energy's earnings in the Netherlands will be subject to the standard Dutch corporate income tax rate, which currently is 35%.

1999 Compared to 1998.

Net Earnings. We reported consolidated earnings in 1999 of \$1.482 billion (\$5.20 per basic share) compared to a consolidated net loss of \$141 million (\$0.50 per share) for 1998. The 1999 results included the extraordinary and unusual items discussed above under "— 2000 Compared to 1999 — Net Earnings." The reported loss for 1998 included a \$764 million (after-tax) non-cash, unrealized accounting loss on indexed debt securities (as discussed above) and after-tax income from discontinued operations of \$137 million.

Our consolidated net income, after adjusting for extraordinary and unusual items (as discussed above) in both years, was \$508 million (\$1.78 per share) for 1999 compared to \$486 million (\$1.71 per share) for 1998. The \$22 million increase was primarily due to earnings of our European Energy segment, which acquired UNA in the fourth quarter of 1999, and lower losses from our Other Operations segment. These improvements were partially offset by lower earnings in 1999 for our Natural Gas Distribution, Pipelines and Gathering, and Wholesale Energy segments.

Operating Income. For an explanation of changes in our operating income, please read the discussion below of operating income (loss) by business segment.

(Loss) Income of Equity Investments. Our Wholesale Energy segment reported a loss from equity investments of \$1 million in both 1998 and 1999.

Other Income, net. Other income, net was \$68 million and \$60 million in 1998 and 1999, respectively. The decrease in other income in 1999 of \$8 million compared to 1998 was primarily due to a decline in dividend income from our AOL Time Warner investment of \$15 million from 1998 (please read Note 8 to our consolidated financial statements), partially offset by distributions of \$9 million from a venture capital investment of marketable securities classified as "trading" in 1999, as discussed above.

Interest Expense and Other Charges. In 1998 and 1999, interest expense and other charges were \$532 million and \$550 million, respectively. Increased interest expense and other charges in 1999 compared to 1998 were primarily due to higher levels of short-term borrowings, long-term debt and trust preferred securities. These increases were associated in part with the acquisition of UNA in the fourth quarter of 1999,

our additional investment in AOL Time Warner in 1999, other acquisitions of businesses and capital expenditures. The increase in 1999 was partially offset by a decrease in the average interest rate on our long-term debt.

Income Tax Expense. The effective tax rate for 1998 and 1999 was 22.9% and 35.4%, respectively. After adjusting for the unrealized accounting gains and losses on our investment in AOL Time Warner and indexed debt securities, the adjusted effective tax rate for 1998 and 1999 was 40.4% and 33.9%, respectively. The decrease in effective tax rate in 1999 compared to 1998 was primarily due to the discontinuance of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS No. 71), for the generation operations of our Electric Operations segment. For information regarding the discontinuance of SFAS No. 71 to the generation operations of our Electric Operations segment, see Note 4(a) to our consolidated financial statements.

RESULTS OF OPERATIONS BY BUSINESS SEGMENT

The following table presents operating income (loss) for each of our business segments for 1998, 1999 and 2000 (in millions). Some amounts from the previous years have been reclassified to conform to the 2000 presentation of the financial statements. These reclassifications do not affect consolidated earnings.

Operating Income (Loss) by Business Segment

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
Electric Operations	\$1,002	\$ 981	\$1,230
Natural Gas Distribution	167	158	113
Pipelines and Gathering	146	131	137
Wholesale Energy	42	27	482
European Energy	—	32	89
Other Operations	(77)	(71)	(172)
Total Consolidated	<u>\$1,280</u>	<u>\$1,258</u>	<u>\$1,879</u>

Electric Operations

Our Electric Operations segment conducts operations through an unincorporated division of Reliant Energy under the name "Reliant Energy HL&P." This segment generates, purchases, transmits and distributes electricity to approximately 1.7 million customers in a 5,000 square mile area on the Texas Gulf Coast, including Houston.

In 1999, the Texas legislature adopted the Legislation, which substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail competition beginning on January 1, 2002. Prior to adoption of the Legislation, our Electric Operations segment's earnings were capped at an agreed overall rate of return formula on a calendar year basis as part of the transition to competition plan (Transition Plan) approved by the Texas Utility Commission effective January 1, 1998. As a result of the Transition Plan, any earnings prior to the Legislation above the maximum allowed return cap on invested capital were offset by additional depreciation of our Electric Operations segment's electric generation assets. For more information regarding the Legislation, please read Note 4(a) to our consolidated financial statements. For more information regarding the Transition Plan, please read Notes 2(g) and 4(c) to our consolidated financial statements.

For a discussion of the factors that may affect the future results of operations of our Electric Operations segment, please read "— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Electric Operations."

The following table provides summary data regarding the results of operations of our Electric Operations segment for 1998, 1999 and 2000 (in millions, except electric sales data):

	Year Ended December 31,		
	1998	1999	2000
Operating Revenues:			
Base revenues(1)	\$ 2,969	\$ 2,968	\$ 3,141
Reconcilable fuel revenues(2)	1,381	1,515	2,353
Total operating revenues	<u>4,350</u>	<u>4,483</u>	<u>5,494</u>
Operating Expenses:			
Fuel and purchased power	1,455	1,569	2,412
Operation and maintenance	890	916	963
Depreciation and amortization	663	667	507
Other operating expenses	340	350	382
Total operating expenses	<u>3,348</u>	<u>3,502</u>	<u>4,264</u>
Operating Income	<u>\$ 1,002</u>	<u>\$ 981</u>	<u>\$ 1,230</u>
Electric Sales (gigawatt-hours (GWh)):			
Residential	21,216	21,144	22,727
Commercial	16,388	16,616	17,594
Industrial — Firm	26,542	26,020	27,707
Industrial — Interruptible	5,115	5,460	5,542
Other	3,472	2,867	1,724
Total	<u>72,733</u>	<u>72,107</u>	<u>75,294</u>

- (1) Includes miscellaneous revenues, non-reconcilable fuel revenues and purchased power-related revenues.
- (2) Includes revenues collected through a fixed fuel factor and surcharges net of adjustments for over/under recovery of fuel.

2000 Compared to 1999. Our Electric Operations segment operating income for 2000 increased \$249 million compared to 1999. The increase was primarily due to decreased depreciation and amortization expense, strong customer growth and warmer weather, partially offset by increased operation and maintenance expenses and other taxes.

Base revenues increased \$173 million in 2000 due to continued customer growth and demand growth from the effects of weather as compared to 1999. Growth in usage per customer and number of customers contributed \$132 million of the increase in base revenues in 2000.

Our 55% increase in reconcilable fuel revenue in 2000 resulted primarily from increased fuel costs as discussed below. The Texas Utility Commission provides for recovery of some fuel and purchased power costs through a fixed fuel factor included in electric rates. Revenues collected through this factor are adjusted monthly to equal expenses; therefore, these revenues and expenses have no effect on earnings unless fuel costs are determined not to be recoverable. The adjusted over/under recovery of fuel costs is recorded on our consolidated balance sheets as other liabilities or regulatory assets, respectively. For information regarding the effect of the Legislation on fuel recovery beginning in 2002, please read Note 4 to our consolidated financial statements for information regarding Reliant Energy HL&P fuel filings.

Fuel and purchased power expenses in 2000 increased by \$843 million, or 54%, over 1999 expenses. The increase is primarily the result of higher reconcilable costs for natural gas (\$2.47 and \$3.98 per million British thermal units (MMBtu) in 1999 and 2000, respectively), higher costs for purchased power (\$26.46 and \$44.26 per megawatt hour (MWh) in 1999 and 2000, respectively) and higher sales due to customer growth and increased demand, which led to increased production.

Operation, maintenance and other operating expenses increased \$79 million in 2000 compared to 1999 primarily due to the following items:

- a \$25 million increase due to transmission expenses resulting from the wholesale rates established by the Electric Reliability Council of Texas, Inc. (ERCOT),
- a \$22 million increase in state franchise taxes and municipal franchise fees due to increased earnings and cash receipts,
- a \$24 million assessment for the 1999 and 2000 System Benefit Fund, which was established by the Legislation to insure that public schools were not impacted by the loss of taxes related to the lower property values of generation assets, substantially offset by a decrease in property taxes of \$21 million, and
- a \$22 million increase in other operation and maintenance expense.

Depreciation and amortization expense decreased \$160 million primarily due to our discontinuance of recording additional depreciation and redirected depreciation pursuant to the Transition Plan, the extension of electric generation assets' depreciable lives, fully amortizing some investments in lignite reserves associated with a cancelled generation station and ceasing amortization of regulatory assets pursuant to the Legislation. For additional information regarding items that affect depreciation and amortization expense of Electric Operations pursuant to the Legislation and the Transition Plan, please read Notes 2(g) and 4(a) to our consolidated financial statements.

1999 Compared to 1998. Electric Operations' operating income for the year ended December 31, 1999 was \$981 million compared to \$1,002 million for the same period in 1998. The \$21 million decrease was primarily due to the effects of milder weather and additional base rate credits provided under the Transition Plan, partially offset by continued strong customer growth.

Electric Operations' base revenues were \$2,968 million for 1999, a decrease of \$1 million from 1998. The effects of milder weather in 1999 compared to 1998 and additional base rate credits in 1999 were offset by continued strong customer growth and increased usage per customer.

Electric Operations' fuel and purchased power expenses in 1999 increased by \$114 million, or 8%, over 1998 expenses. The increase is a result of higher costs for natural gas (\$2.18 and \$2.47 per MMBtu in 1998 and 1999, respectively) and higher costs for lignite (\$1.19 and \$1.42 per MMBtu in 1998 and 1999, respectively). The 1998 fuel costs include a \$12 million charge to non-reconcilable fuel due to some fuel costs being determined not to be recoverable.

Operation, maintenance and other operating expenses increased \$36 million in 1999 compared to 1998, including \$38 million due to transmission tariffs within ERCOT. A portion of these transmission expenses was offset by an increase of \$28 million in transmission tariff revenue. State franchise taxes increased \$13 million in 1999 compared to 1998.

Natural Gas Distribution

Natural Gas Distribution's operations consist of intrastate natural gas sales to, and natural gas transportation for, residential, commercial and industrial customers in Arkansas, Louisiana, Minnesota, Mississippi, Oklahoma and Texas and some non-rate regulated retail marketing of natural gas.

For a discussion of the factors that may affect future results of operations of our Natural Gas Distribution segment, please read "— Certain Factors Affecting Our Future Earnings — Competitive and Other Factors Affecting RERC Operations — Natural Gas Distribution."

The following table provides summary data regarding the results of operations of Natural Gas Distribution for 1998, 1999 and 2000 (in millions, except throughput data):

	Year Ended December 31,		
	1998	1999	2000
Operating Revenues	\$2,426	\$2,788	\$4,412
Operating Expenses:			
Natural gas	1,655	1,936	3,503
Operation and maintenance	378	470	553
Depreciation and amortization	131	137	145
Other operating expenses	95	87	98
Total operating expenses	<u>2,259</u>	<u>2,630</u>	<u>4,299</u>
Operating Income	<u>\$ 167</u>	<u>\$ 158</u>	<u>\$ 113</u>
Throughput Data (in billion cubic feet (Bcf)):			
Residential and commercial sales	286	286	318
Industrial sales	56	53	55
Transportation	44	47	50
Retail	<u>347</u>	<u>400</u>	<u>431</u>
Total Throughput	<u>733</u>	<u>786</u>	<u>854</u>

2000 Compared to 1999. Our Natural Gas Distribution segment operating income decreased \$45 million in 2000 from 1999. Increases in revenues and natural gas expenses were due primarily to the increase in the price of natural gas. In addition, operating revenues increased \$6 million related to gains from the effect of a financial hedge of our Natural Gas Distribution segment's earnings against unseasonably warm weather during peak heating months. Slightly increased operating margins (revenues less fuel costs) in 2000 were offset by higher operating expenses and higher depreciation expense in 2000. Operation and maintenance expenses increased in 2000 primarily due to the following items:

- costs incurred in connection with some non-rate regulated retail natural gas business activities outside our established market areas, which have been discontinued,
- additional provisions against receivable balances resulting from the implementation of a new billing system for Reliant Energy Arkla, an unincorporated division of RERC Corp. (Arkla) and
- increased employee benefit costs relating to an updated actuarial valuation of employee benefit plans.

Generally, our utility operations of the Natural Gas Distribution segment are allowed to flow through the costs of natural gas to our customers through purchased gas adjustment provisions in rates pursuant to regulations of the states in which they operate. Differences between actual gas costs and the amount collected from customers are deferred on the balance sheet so that there is no impact on operating income.

1999 Compared to 1998. Our Natural Gas Distribution segment operating income decreased \$9 million in 1999 compared to 1998 primarily due to increased operating expenses, partially offset by slightly improved operating margins in 1999. Operating expenses increased primarily due to increased employee benefit costs and costs associated with the implementation of an enterprise-wide information system.

Pipelines and Gathering

Our Pipelines and Gathering segment operates two interstate natural gas pipelines, as well as provides gathering and pipeline services.

For a discussion of the factors that may affect future results of operations of our Pipelines and Gathering segment, please read "— Certain Factors Affecting Our Future Earnings — Competitive and Other Factors Affecting RERC Operations — Pipelines and Gathering."

The following table provides summary data regarding the results of operations of our Pipelines and Gathering segment for 1998, 1999 and 2000 (in millions, except throughput data):

	Year Ended December 31,		
	1998	1999	2000
Operating Revenues	\$ 346	\$ 331	\$ 384
Operating Expenses:			
Natural gas	52	41	76
Operation and maintenance	85	91	100
Depreciation and amortization	48	53	56
Other operating expenses	15	15	15
Total operating expenses	<u>200</u>	<u>200</u>	<u>247</u>
Operating Income	<u>\$ 146</u>	<u>\$ 131</u>	<u>\$ 137</u>
Throughput Data (Bcf):			
Natural gas sales	16	15	14
Transportation	825	836	845
Gathering	237	270	288
Elimination(1)	<u>(15)</u>	<u>(14)</u>	<u>(12)</u>
Total Throughput	<u>1,063</u>	<u>1,107</u>	<u>1,135</u>

(1) Elimination of volumes both transported and sold.

2000 Compared to 1999. Our Pipelines and Gathering segment's operating income for 2000 increased \$6 million, primarily due to increased gas gathering and processing revenues. Natural gas expense increased \$35 million in 2000, primarily due to the increased cost of natural gas per unit. Operation and maintenance expense increased \$9 million in 2000, primarily due to the implementation of various projects throughout the year.

1999 Compared to 1998. Our Pipelines and Gathering segment's operating income for 1999 decreased \$15 million, primarily due to the settlement of a dispute related to some gas purchase contracts that resulted in the recognition of \$6 million of revenues in 1998, a reduction in depreciation and amortization in 1998 of \$5 million related to a rate case settlement and an increase in operating expenses in 1999, primarily due to employee benefit expenses.

Operating revenue decreased by \$15 million in 1999, primarily due to the settlement of outstanding gas purchase contract litigation in 1998 as discussed above. Natural gas expense decreased \$11 million in 1999, primarily due to expiration of gas supply contracts. Operation and maintenance expense increased \$6 million in 1999, primarily due to increases in employee benefit expenses. Depreciation and amortization expense increased \$5 million in 1999 due to a rate settlement recorded in 1998 as discussed above. The rate settlement, effective January 1998, provided for a \$5 million reduction in depreciation rates retroactive to July 1996.

During 1998 and 1999, our Pipelines and Gathering segment's largest unaffiliated customer was a natural gas utility that serves the greater St. Louis metropolitan area in Illinois and Missouri. Revenues from this customer were generated pursuant to several long-term firm storage and transportation agreements that begin to expire at various dates beginning October 2001 through May 2002. We are currently negotiating the terms and conditions of a renewal of these agreements with the unaffiliated customer.

During 2000, we obtained regulatory approval and Reliant Energy Gas Transmission Company (REGT) renewed various contracts for firm transportation and storage with Arkla. These renewals extended the term of service to 2005 in Arkla's market areas.

Wholesale Energy

Our Wholesale Energy segment includes our non-rate regulated power generation operations in the United States and our wholesale energy trading, marketing, power origination and risk management operations in North America.

As of December 31, 2000, our Wholesale Energy segment owned or leased electric power generation facilities with an aggregate net generating capacity of 9,231 MW in the United States. Our Wholesale Energy segment acquired its first power generation facilities in April 1998, and has increased its aggregate net generating capacity since then through a combination of acquisitions, contractual agreements and the development of new generating projects. As of December 31, 2000, we had 2,766 MW of additional net generating capacity under construction. For additional information regarding the acquisition of our Mid-Atlantic generating assets completed in May 2000, including the accounting treatment of this acquisition, please read Note 3(a) to our consolidated financial statements.

For a discussion of the factors that may affect the future results of operations of our Wholesale Energy segment, please read “— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations.”

The following table provides summary data regarding the results of operations of our Wholesale Energy segment for 1998, 1999 and 2000 (in millions, except operations data).

	Year Ended December 31,		
	1998	1999	2000
Operating Revenues	\$4,416	\$7,912	\$19,234
Operating Expenses:			
Fuel and cost of gas sold	2,421	3,975	10,402
Purchased power	1,829	3,729	7,825
Operation and maintenance	106	154	403
Depreciation and amortization	14	21	109
Other operating expenses	4	6	13
Total Operating Expenses	<u>4,374</u>	<u>7,885</u>	<u>18,752</u>
Operating Income	<u>\$ 42</u>	<u>\$ 27</u>	<u>\$ 482</u>
Operations Data:			
Net Generating Capacity (MW)	3,800	4,469	9,231
Electricity Wholesale Power Sales (million megawatt hours (MMWh))	65	112	202
Natural Gas Sales (Bcf)	1,163	1,820	2,509

2000 Compared to 1999. Our Wholesale Energy segment’s operating income increased \$455 million for 2000 compared to 1999. The increase was primarily due to increased energy sales volumes, higher prices for energy and ancillary services, and improved operating results from trading and marketing activities, as well as expansion of our Wholesale Energy segment’s generation operations into regions other than the Western United States, including the Mid-Atlantic United States (Pennsylvania, New Jersey and Maryland), Florida and Texas.

Our Wholesale Energy segment’s operating revenues increased \$11.3 billion (143%) for 2000 compared to 1999. The increase was primarily due to an increase in prices and volumes for both gas and power sales in 2000 as compared to 1999. Our fuel and cost of gas sold and purchased power costs increased \$6.4 billion and \$4.1 billion, respectively, in 2000 compared to 1999. The increase in fuel and cost of gas sold was primarily due to an increase in gas volumes purchased and to increases in plant output and in the price of gas. The increase in purchased power cost was primarily due to a higher average cost of power and higher power volumes purchased. Operation and maintenance expenses increased \$249 million in 2000 compared to 1999. This increase was primarily due to costs associated with the maintenance of facilities acquired or placed into commercial operation during the period, lease expense associated with the Mid-Atlantic generating facilities

sale/leaseback transactions, higher run rates at existing facilities, increased costs associated with developing new power generation projects and higher staffing levels to support increased sales and expanded trading and marketing efforts. Depreciation and amortization expense for 2000 increased \$88 million as compared to 1999, primarily as a result of our acquisition of the Mid-Atlantic generating facilities and other generating facilities in 2000.

Our Wholesale Energy segment's operations in California have been affected by the crisis conditions of California's wholesale market, most significantly the financial distress of two of California's public utilities and the subsequent downgrading of those utilities' credit ratings and defaults on payments for wholesale power purchased in the fourth quarter of 2000. The California legislature has passed emergency legislation appropriating funds to be used by the California Department of Water Resources (CDWR) for the purchase of wholesale electricity, but these funds have been used to pay only for some of the electricity currently needed by the utilities' customers. We have not been paid for much of the power we sold in November and December 2000 through the California Power Exchange (Cal PX) and to the California Independent System Operator (Cal ISO). In the fourth quarter of 2000, we recorded a pre-tax provision of \$39 million against receivable balances related to energy sales in the California market. For additional information regarding the uncertainties in the California wholesale energy market, please read "— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations — California" as well as Notes 14(g) and 14(h) to our consolidated financial statements.

1999 Compared to 1998. Our Wholesale Energy segment reported operating income of \$27 million in 1999 compared to \$42 million in 1998. The \$15 million decrease was due primarily to a decline in market prices for electricity in the California market caused by milder than normal weather and increased hydroelectric generation sold by competitors into the California market. This decline more than offset significant increases in operating income of our trading and marketing operations in 1999. The increases in trading and marketing operating income resulted primarily from increases in volumes of gas, power and heating oil trading and slightly higher margins (revenue less cost of power sold) on power trading.

Operating revenues were \$7.9 billion in 1999, a 79% increase from 1998 revenues of \$4.4 billion. The increase in revenues was primarily due to increased trading volumes for power, gas and heating oil. Higher sales prices for both power and gas also contributed to increased revenues.

Fuel and cost of gas sold and purchased power costs increased \$1.6 billion and \$1.9 billion, respectively, in 1999 compared to 1998. These increases were primarily due to the corresponding increase in trading sales volumes. An increase in power and gas prices also contributed to the increase in costs. Operation and maintenance expenses in 1999 increased \$48 million compared to 1998. The increase was primarily due to costs associated with the maintenance of the assets in California, which we acquired in April and July 1998. Depreciation and amortization in 1999 increased \$7 million from 1998 due primarily to a full year of depreciation and amortization for our California operations as well as additional assets placed into operation during 1999.

European Energy

Our European Energy segment includes the operations of UNA and its subsidiaries and our European trading, marketing and risk management operations. We created this segment in the fourth quarter of 1999 with the acquisition of UNA and the formation of our European trading, marketing and risk management operations. Our European Energy segment generates and sells power from its generation facilities in the Netherlands and participates in the emerging wholesale energy trading and marketing industry in Northwest Europe.

Effective October 7, 1999, we acquired UNA, for a net purchase price of \$1.9 billion. From October 1, 1999, our operating results include the results of operations of UNA. The impact of UNA's results of operations from October 1 through October 7, 1999 was immaterial to our consolidated results of operations. For additional information regarding the acquisition of UNA, please read Note 3(b) to our consolidated financial statements.

In connection with our evaluation of the acquisition of UNA, we also began to assess and formulate an employee severance plan to be undertaken as soon as reasonably possible post-acquisition. The intent of this plan was to make UNA competitive in the Dutch electricity market when it became deregulated on January 1, 2001. This plan was finalized, approved and completed in September 2000. At that time, we recorded the severance liability as a purchase price adjustment in the amount of \$19 million.

UNA and the other major Dutch generators historically have operated under an agreement, which is referred to as the "Protocol," pursuant to which the generators provided capacity and energy to distributors for a total combined payment of NLG 3.4 billion (\$1.5 billion, based on the December 31, 2000 exchange rate of 2.34 NLG per U.S. dollar), plus compensation for actual fuel costs over the period from 1997 through 2000. Effective January 1, 2001, these agreements expired in all material aspects.

Beginning January 1, 2001, the Dutch wholesale electric market was completely opened to competition and as a result, we expect a decline in power prices. Consistent with our expectations at the time we made the acquisition, we anticipate that UNA will experience a significant decline in revenues in 2001 attributable to the deregulation of the market and termination of the Protocol. For additional information on these and other factors that may affect the future results of operations of our European Energy segment, please read "— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our European Energy Operations."

The following table provides summary data for the results of operations of our European Energy segment for the three months ended December 31, 1999 and the year ended December 31, 2000 (in millions, except electric sales data):

	Three Months Ended December 31, 1999	Year Ended December 31, 2000
Operating Revenues	\$ 153	\$ 579
Operating Expenses:		
Fuel and purchased power	68	294
Operation and maintenance	32	121
Depreciation and amortization	21	75
Total Operating Expenses	<u>121</u>	<u>490</u>
Operating Income	<u>\$ 32</u>	<u>\$ 89</u>
Electric Sales (GWh)	2,846	11,659

For the year ended December 31, 2000, our European Energy segment reported operating income of \$89 million. We reported operating income of \$32 million for the three months ended December 31, 1999.

For information regarding foreign currency matters, please read Note 5 to our consolidated financial statements and "Quantitative and Qualitative Disclosures About Market Risk."

Other Operations

Our Other Operations segment includes the operations of our unregulated retail electric business, a communications business offering enhanced data, voice and other services to customers in Texas, an eBusiness group, non-operating investments, certain real estate holdings and unallocated corporate costs.

Other Operations had an operating loss of \$172 million for 2000 compared to a \$71 million operating loss for 1999. This increased loss was primarily due to increased expenses incurred in preparing for retail competition in Texas beginning in January 2002 and eBusiness and communications start-up expenses. In addition, in 2000 we made a contribution to a charitable foundation and incurred expenses associated with acquiring the naming rights for the new football stadium for the Houston Texans, the National Football League's newest franchise, and the entertainment and convention facilities included in the stadium complex. For additional information about the naming rights, please read Note 14(e) to our consolidated financial statements.

Other Operations had an operating loss of \$71 million for 1999 compared to a \$77 million operating loss for 1998. The decreased loss was primarily due to decreased state franchise taxes partially offset by increased general insurance liability and information system expenses.

CERTAIN FACTORS AFFECTING OUR FUTURE EARNINGS

Our earnings for the past three years are not necessarily indicative of our future earnings and results. The level of our future earnings depends on numerous factors including:

- state and federal legislative, as well as international regulatory developments, including deregulation, re-regulation and restructuring of the electric utility industry and changes in or application of environmental and other laws and regulations to which we are subject,
- the timing of the implementation of our Business Separation Plan,
- industrial, commercial and residential growth in our service territories,
- our pursuit of potential business strategies, including acquisitions or dispositions of assets or the development of additional power generation facilities,
- state, federal and other rate regulations in the United States and in foreign countries in which we operate or into which we might expand our operations,
- the timing and extent of changes in commodity prices and interest rates,
- weather variations and other natural phenomena,
- our ability to cost-effectively finance and refinance,
- the determination of the amount of our Texas generating assets' stranded costs and the recovery of these costs,
- the ability to consummate and the timing of the consummation of acquisitions and dispositions,
- the performance of our generation projects undertaken,
- the successful operation of deregulating power markets, including the resolution of the crisis in the California market, and
- risks incidental to our overseas operations, including the effects of fluctuations in foreign currency exchange rates.

In order to adapt to the increasingly competitive environment, we continue to evaluate a wide array of potential business strategies, including business combinations or acquisitions involving other utility or non-utility businesses or properties, dispositions of currently owned businesses, as well as developing new generation projects, products, services and customer strategies.

Business Separation and Restructuring

In anticipation of electric deregulation in Texas, and pursuant to the Legislation, we submitted a business separation plan in January 2000 to the Texas Utility Commission. Pursuant to the Business Separation Plan, we will restructure our businesses into two separate publicly traded companies in order to separate our unregulated businesses from our rate-regulated businesses. Reliant Resources holds substantially all of our unregulated businesses. As further described in Note 4 to our consolidated financial statements, Reliant Energy will undergo a restructuring of its corporate organization to achieve a public utility holding company structure (Restructuring). This holding company is referred to herein as the "Regulated Holding Company" and will hold essentially all of what are currently our regulated businesses. We expect Reliant Resources will conduct an initial public offering of not more than 20% of its common stock (Offering) in 2001. Also, we anticipate that the Regulated Holding Company will distribute to its shareholders the remaining shares of Reliant Resources common stock it would own after the Offering (Distribution) within 12 months of the

completion of the Offering, subject to receipt of a favorable tax ruling and other regulatory approvals. For additional information regarding the Business Separation Plan and the Restructuring, please read Note 4(b) to our consolidated financial statements.

We have sought a ruling from the Internal Revenue Service that the Distribution will be tax-free to the Regulated Holding Company and its shareholders. At this time, we do not have a ruling from the Internal Revenue Service regarding the tax treatment of the Distribution. If we do not obtain a favorable tax ruling, the Distribution is not likely to be made in the expected time frame or, perhaps, at all. In order for the Distribution to be tax-free, various requirements must be met, including ownership by its parent of at least 80% of all classes of Reliant Resources' outstanding capital stock at the time of the Distribution.

Additionally, in connection with the Distribution, Reliant Energy plans to restructure its remaining businesses to achieve a public utility holding company structure and to register the Regulated Holding Company as a public utility holding company under the Public Utility Holding Company Act of 1935, as amended (1935 Act). Creation of the Regulated Holding Company will require the approval of Reliant Energy's shareholders. For additional information regarding the Regulated Holding Company, please read Note 4(b) to our consolidated financial statements. The Restructuring will also require the approval of the Louisiana Public Service Commission and the Nuclear Regulatory Commission. We cannot assure you that those approvals will be obtained. After the Restructuring, the Regulated Holding Company will become a registered public utility holding company under the 1935 Act.

Competitive, Regulatory and Other Factors Affecting Our Electric Operations

Competition and Deregulation. In June 1999, the Texas legislature adopted the Legislation, which substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail competition. Retail pilot projects for up to 5% of each utility's load in all customer classes will begin in June 2001 and retail electric competition for all other customers will begin on January 1, 2002. Our retail operations will be conducted by indirect wholly owned subsidiaries of Reliant Resources. Under the market framework established by the Legislation, we will initially be required to sell electricity to Houston area residential and small commercial customers at a specified price, which is referred to in the Legislation as the "price to beat," whereas other retail electric providers will be allowed to sell electricity to these same customers at any price. We will not be permitted to offer electricity to these customers 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 residential or small commercial customers, as applicable, within the affiliated transmission and distribution utility's certificated service territory, as of January 1, 2002, is committed to be served by other retail electric providers. In addition, as long as we continue to provide retail service, the Legislation requires us to make the price to beat available to residential and small commercial customers in Reliant Energy HL&P's service territory through January 1, 2007. Because we will not be able to compete for residential and small commercial customers on the basis of price in Reliant Energy HL&P's service area, and because we expect that the retail market framework established by the Legislation will encourage competition from new retail electric providers, we could lose a significant number of these customers to other providers. When the pilot projects begin in June 2001, and until full retail electric competition begins, the Legislation provides that 5% of our customers may elect to purchase electricity from other retail electric providers. Our affiliated retail electric providers cannot participate in the pilot projects in Reliant Energy HL&P's service area.

On March 31, 2000, Reliant Energy HL&P filed its "Wires Case" with the Texas Utility Commission as required by the Legislation. This filing represents the "unbundling" or separating of costs related to providing transmission and distribution service. The Wires Case will set the regulated rates of delivering electricity when electric competition begins, including pilot programs. The regulated wires rate, or non-bypassable delivery charge, will include the transmission and distribution rate, a system benefit fund fee, a nuclear decommissioning fund charge, a municipal franchise fee, a transition charge associated with any securitization of regulatory assets or a portion of stranded costs and a competition transition charge, if any. Hearings were conducted in phases and all have been concluded as of January 2001. Reliant Energy HL&P is currently awaiting a

"Proposal for Decision" on the final phase of the case, which is expected in late March 2001. The Texas Utility Commission is expected to render an interim order in late April 2001 establishing the rates to be charged for the pilot project beginning in June 2001, with the final wires rates anticipated to be established in August 2001. Reliant Energy HL&P will collect from retail electric providers the rates approved from its Wires Case to cover the cost of providing transmission and distribution service and any other non-bypassable charges.

Generally, retail electric providers will procure or buy electricity from the wholesale generators at unregulated rates, sell electricity at retail to their customers and pay the transmission and distribution utility a regulated tariffed rate for delivering the electricity to their customers. The results of our retail electric operations will be largely dependent upon the amount of gross margin, or "headroom," available in the "price to beat." The available headroom will equal the difference between the price to beat and the sum of the charges, fees and transmission and distribution utility rate approved by the Texas Utility Commission and the price we pay for power to meet our price to beat load. The larger the amount of headroom, the more incentive new market entrants should have to provide retail electric services in Reliant Energy HL&P's service territory. The Texas Utility Commission's regulations allow us to adjust our price to beat fuel factor based on the percentage change in the price of natural gas. In addition, we may also request an adjustment as a result of changes in our price of purchased energy. In such a request, we may adjust the fuel factor to the extent necessary to restore the amount of headroom that existed at the time our initial price to beat fuel factor was set by the Texas Utility Commission. We may not request that our price to beat be adjusted more than twice a year. Currently, we do not know nor can we estimate the amount of headroom in our initial price to beat or in the initial price to beat for the affiliated retail electric provider in each other Texas retail electric market. Similarly, we cannot estimate with any certainty the magnitude and frequency of the adjustments required, if any, and the eventual impact of such adjustments on the amount of headroom.

In preparation for this competition, we expect to make significant changes in the electric utility operations currently conducted through Reliant Energy HL&P. For additional information regarding these changes, the Legislation, retail competition, its application to our Electric Operations segment and the "price to beat," please read Note 4 to our consolidated financial statements.

Also, market volatility in the price of fuel for our generation operations, as well as in the price of purchased power, could have an effect on our cost to generate or acquire power. For additional information regarding commodity prices and supplies, please read "— Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations — Price Volatility."

Other Regulatory Factors. Pursuant to the Legislation, Reliant Energy HL&P will be entitled to recover its stranded costs (*i.e.*, the excess of net book value of generation assets, as defined by the Legislation, over the market value of those assets) and its regulatory assets related to generation. The Legislation prescribes specific methods for determining the amount of stranded costs and the details for their recovery. However, during the base rate freeze period from 1999 through 2001, earnings above the utility's authorized rate of return formula may be applied in a manner to accelerate depreciation of generation related plant assets for regulatory purposes. In addition, depreciation expense for transmission and distribution related assets may be redirected to generation assets for regulatory purposes during that period. The Legislation also provides for Reliant Energy HL&P, or a special purpose entity, to issue securitization bonds for the recovery of generation related regulatory assets and a portion of stranded costs. Any stranded costs not recovered through the sale of securitization bonds may be recovered through a non-bypassable charge to transmission and distribution customers. For additional information regarding these securitization bonds, please read "— Liquidity and Capital Resources — Future Sources and Uses of Cash — Securitization."

The Texas Utility Commission recently stated on record that it would consider requiring electric utilities to reverse the amount of redirected depreciation and accelerated depreciation previously taken if in its estimation the utility has overmitigated its stranded costs. The reversal could occur through a lower rate for the transmission and distribution utility and/or through credits contained in the transmission and distribution utility's rate. Any order requiring the reversal of these amounts would likely be included in the Texas Utility Commission proceeding establishing the initial rate of the transmission and distribution utility or in the case of

our Electric Operations segment, the Wires Case. We do not expect the final transmission and distribution rate in the Wires Case to be established until August 2001.

At June 30, 1999, we performed an impairment test of Reliant Energy HL&P's previously regulated electric generation assets pursuant to SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (SFAS No. 121), on a plant specific basis. Under SFAS No. 121, an asset is considered impaired, and should be written down to fair value, if the future undiscounted net cash flows expected to be generated by the use of the asset are insufficient to recover the carrying amount of the asset. For assets that are impaired pursuant to SFAS No. 121, we determined the fair value for each generating plant by estimating the net present value of future cash inflows and outflows over the estimated life of each plant. The difference between fair value and net book value was recorded as a reduction in the current book value. We determined that \$797 million of electric generation assets were impaired as of June 30, 1999. Of these amounts, \$745 million related to the South Texas Project Electric Generating Station, a nuclear generating plant (South Texas Project), and \$52 million related to two gas-fired generation plants. The Legislation provides for recovery of this impairment through regulated cash flows during the transition period and through non-bypassable charges to transmission and distribution customers. As such, a regulatory asset has been recorded for an amount equal to the impairment loss. We recorded amortization expense related to the recoverable impaired plant costs and other assets created from discontinuing regulatory accounting of \$221 million in the third and fourth quarters of 1999 and \$329 million in 2000. We expect to fully amortize this regulatory asset as it is recovered from regulated cash flows in 2001.

The impairment analysis requires estimates of possible future market prices, load growth, competition and many other factors over the lives of the plants. The resulting impairment loss is highly dependent on these underlying assumptions. In addition, after January 10, 2004, Reliant Energy HL&P must finalize and reconcile stranded costs (as defined by the Legislation) in a filing with the Texas Utility Commission. Any positive difference between the regulatory net book value and the fair market value of the generation assets (as defined by the Legislation) will be collected through future non-bypassable charges. Any over-mitigation of stranded costs may be refunded through future non-bypassable charges. This final reconciliation allows alternative methods of third party valuation of the fair market value of these assets, including outright sale, stock valuations and asset exchanges. Because generally accepted accounting principles require us to estimate fair market values on a plant-by-plant basis in advance of the final reconciliation, the financial impacts of the Legislation with respect to the final determination of stranded costs in 2004 are subject to material changes. Factors affecting such change may include estimation risk, uncertainty of future energy and commodity prices and the economic lives of the plants. If events occur that make the recovery of all or a portion of the regulatory assets associated with the generation plant impairment loss and other assets created from discontinuance of regulatory accounting pursuant to the Legislation no longer probable, we will write off the corresponding balance of these assets as a non-cash charge against earnings. One of the results of discontinuing the application of regulatory accounting for the generation operations is the elimination of the regulatory accounting effects of excess deferred income taxes and investment tax credits related to these operations. We believe it is probable that some parties will seek to return these amounts to ratepayers and, accordingly, we have recorded an offsetting liability.

In accordance with the Legislation, beginning on January 1, 2002, and ending at December 31, 2003, any difference between market power prices received in the generation capacity auction and the Texas Utility Commission's earlier estimates of those market prices will be included in the 2004 stranded costs true-up. The Texas Utility Commission's estimate serves as a preliminary identification of stranded costs for recovery through securitization. This component of the true-up is intended to ensure that neither the customers nor we are disadvantaged economically as a result of the two-year transition period by providing this pricing structure.

Since the time of our original impairment calculation in June 1999 when we discontinued application of SFAS No. 71 for our generation operations, natural gas prices have risen 295% from June 1999 to December 31, 2000 resulting in increases in estimated market prices for power during 2002 and 2003. Generally, for Reliant Energy HL&P's generation portfolio, sustained increases in natural gas prices result in an increase in the fair value of Reliant Energy HL&P's generation portfolio, due to our mix of lower variable cost of electric generation. Therefore, as electric power prices increase, the amount of our estimated stranded

costs decline and the estimate of our 2002 and 2003 capacity true-up amounts which may be owed to customers increases.

For additional information regarding the impairment of regulatory assets and electric generating plant and equipment as well as the recovery of stranded costs, please read Note 4(a) to our consolidated financial statements. For additional information regarding our filings to recover under-recovered fuel costs, please read Note 4(d) to our consolidated financial statements.

Other. For additional information regarding litigation over franchise fees, please read Note 14(g) to our consolidated financial statements.

Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations

Competition. As of December 31, 2000, our Wholesale Energy business segment owned and operated 9,231 MW of electric generation assets that serve wholesale energy markets located in the Mid-Atlantic, Southwest and Midcontinent regions of the United States and the states of Florida and Texas. Competitive factors affecting the results of operations of these generation assets include new market entrants and construction by others of more efficient generation assets.

The wholesale power industry has numerous competitors, some of which may have more operating experience, more acquisition and development experience, larger staffs and/or greater financial resources than we do. Like us, many of our competitors are seeking attractive opportunities to acquire or develop power generation facilities, both in the United States and abroad. This competition may adversely affect our ability to make investments or acquisitions.

Also, industry restructuring requires or encourages the disaggregation of many vertically-integrated utilities into separate generation, transmission and distribution, and retail businesses. As a result, a significant number of additional competitors could become active in the wholesale power generation segment of our industry.

Furthermore, other competitors operate power generation projects in the regions where we have invested in electric generation assets. While demand for electric energy services is generally increasing throughout the United States, the rate of construction and development of new, more efficient electric generation facilities may exceed increases in demand in some regional electric markets. Although local permitting and siting issues often reduce the risk of a rapid growth in supply of generation capacity in any particular region, projects are likely to be built over time. The commencement of commercial operation of these new facilities in the regional markets where we have facilities will likely increase the competitiveness of the wholesale power market in those regions, which could have a material effect on our business and lower the value of some of our electric generation assets.

Finally, our trading, marketing, power origination and risk management operations compete with other energy merchants based on the ability to aggregate supplies at competitive prices from different sources and locations and to efficiently utilize transportation from third-party pipelines and transmission from electric utilities. These operations also compete against other energy marketers on the basis of their relative skills, financial position and access to credit sources. This competitive factor reflects the tendency of energy customers, wholesale energy suppliers and transporters to seek financial guarantees and other assurances that their energy contracts will be satisfied. As pricing information becomes increasingly available in the energy trading and marketing business and as deregulation in the electricity markets continues to accelerate, we anticipate that our trading, marketing, power origination and risk management operations will experience greater competition and downward pressure on per-unit profit margins.

Regulation. The regulatory environment applicable to the electric power industry has recently undergone substantial changes as a result of restructuring initiatives at both the state and federal levels. These initiatives have had a significant impact on the nature of the industry and the manner in which its participants conduct their business. Our Wholesale Energy segment has targeted the deregulating wholesale and retail segments of the electric power industry created by these initiatives. These changes are ongoing and we cannot predict the future development of deregulation in these markets or the ultimate effect that this changing regulatory environment will have on our business.

Moreover, existing regulations may be revised or reinterpreted, new laws and regulations may be adopted or become applicable to us or our facilities, and future changes in laws and regulations may have a detrimental effect on our business. Certain restructured markets, particularly California, have recently experienced supply problems and price volatility. These supply problems and volatility have been the subject of a significant amount of press coverage, much of which has been critical of the restructuring initiatives. In some markets, including California (please read “— California” below), proposals have been made by governmental agencies and/or other interested parties to slow the pace of deregulation or to re-regulate areas of these markets that have previously been deregulated. If the current trend towards competitive restructuring of the wholesale and retail power markets is reversed, discontinued or delayed, the business growth prospects of our Wholesale Energy segment would be slowed and the financial outlook for our existing positions could be impacted.

The Federal Energy Regulatory Commission (FERC) issued Order No. 2000 in December 1999. Order No. 2000, which applies to all FERC jurisdictional transmission companies (Transco), describes the FERC’s intention to oversee the establishment of large regional transportation organizations (RTOs) and sets forth the minimum characteristics and functions of RTOs. Among the basic minimum characteristics are that the RTOs must be independent and must be of sufficient scope and geographical configuration. Order No. 2000 also encourages RTOs to work with each other to minimize or eliminate “seams” issues between RTOs in order that inter-regional transactions will flow more freely. The FERC’s goal is to encourage the growth of a robust competitive wholesale market for electricity. Although Transcos are not required to join RTOs, they are encouraged to do so. Under Order No. 2000, RTOs are to be operational by December 15, 2001. However, there can be no assurance that this timeline or the FERC’s goals will be achieved. At least 14 separate organizations, covering the substantial majority of all FERC jurisdictional Transcos, are in various stages of organization and have made at least preliminary filings with the FERC. If RTOs are established as envisioned by FERC Order 2000, “rate pancaking,” or multiple transmission charges that apply to a single point-to-point delivery of energy, will be eliminated within a region, and wholesale transactions within the region, and between regions will be facilitated. The end result could be a more competitive, transparent market for the sale of energy and a more economic and efficient use and allocation of resources.

Price Volatility. Our Wholesale Energy business segment sells electricity from our non-Texas power generation facilities into the spot market or other competitive power markets or on a contractual basis. Our Wholesale Energy business segment is not guaranteed any rate of return on our capital investments through mandated rates, and our revenues and results of operations are likely to depend, in large part, upon prevailing market prices for electricity and fuel in our regional markets and other competitive markets. These market prices may fluctuate substantially over relatively short periods of time. In addition, the FERC, which has jurisdiction over wholesale power rates, as well as independent system operators that oversee some of these markets, may impose price limitations, bidding rules and other mechanisms to address some of the volatility in these markets. Most of our Wholesale Energy business segment’s domestic power generation facilities purchase fuel under short-term contracts or on the spot market. Fuel prices may also be volatile, and the price we can obtain for power sales may not change at the same rate as changes in fuel costs. These factors could have an adverse impact on our revenues and results of operations.

Volatility in market prices for fuel and electricity may result from:

- weather conditions,
- seasonality,
- electricity usage,
- illiquid markets,
- transmission or transportation constraints or inefficiencies,
- availability of competitively priced alternative energy sources,
- demand for energy commodities,
- natural gas, crude oil and refined products, and coal production levels,

- natural disasters, wars, embargoes and other catastrophic events, and
- federal, state and foreign energy and environmental regulation and legislation.

Trading, Marketing, Power Origination and Risk Management Operations. To lower our Wholesale Energy business segment's financial exposure related to commodity price fluctuations, its trading, marketing, power origination and risk management operations routinely enter into contracts to hedge a portion of its purchase and sale commitments, weather positions, fuel requirements and inventories of natural gas, coal, crude oil and refined products, and other commodities. As part of this strategy, our Wholesale Energy business segment routinely utilizes fixed-price forward physical purchase and sales contracts, futures, financial swaps and option contracts traded in the over-the-counter markets or on exchanges. However, our Wholesale Energy business segment does not expect to cover the entire exposure of its assets or its positions to market price volatility and the coverage will vary over time. To the extent our Wholesale Energy business segment has unhedged positions, fluctuating commodity prices can impact our financial results and financial position, either favorably or unfavorably.

At times, our Wholesale Energy business segment has open trading positions in the market, within established guidelines, resulting from the management of its trading portfolio. To the extent open trading positions exist, fluctuating commodity prices can impact our financial results and financial position, either favorably or unfavorably.

The risk management procedures our Wholesale Energy business segment has in place may not always be followed or may not always work as planned. As a result of these and other factors, we cannot predict with precision the impact that our risk management decisions may have on our businesses, operating results or financial position. Although our Wholesale Energy business segment devotes a considerable amount of management effort to these issues, their outcome is uncertain.

Our trading, marketing, power origination and risk management operations are also exposed to the risk that counterparties who owe it money or physical commodities, such as energy or gas, as a result of market transactions will not perform their obligations. Should the counterparties to these arrangements fail to perform, our trading, marketing, power origination and risk management operations might be forced to acquire alternative hedging arrangements or replace the underlying commitment at then-current market prices. In this event, our trading, marketing, power origination and risk management operations might incur additional losses to the extent of amounts, if any, already paid to the counterparties.

California. During the summer and fall of 2000, 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, decreases in net electric imports, structural market flaws including over-reliance on the electric spot market, and limitations on supply as a result of maintenance and other outages. Although wholesale prices increased, California's deregulation legislation kept retail rates frozen below 1996 levels. This caused two of California's public utilities, which are our customers based on our deliveries to the Cal PX and the Cal ISO, to amass billions of dollars of uncollected wholesale power costs and to ultimately default in January and February 2001 on payments owed for wholesale power purchased through the Cal PX and from the Cal ISO.

As of December 31, 2000, we were owed \$101 million by the Cal PX and \$181 million by the Cal ISO. In the fourth quarter of 2000, we recorded a pre-tax provision of \$39 million against receivable balances related to energy sales in the California market. From January 1, 2001 through February 28, 2001, we have collected \$105 million of these receivable balances. As of March 1, 2001, we were owed a total of \$358 million by the Cal ISO, the Cal PX, the CDWR and California Energy Resources Scheduling for energy sales in the California wholesale market from the fourth quarter of 2000 through February 28, 2001. Management will continue to assess the collectibility of these receivables based on further developments affecting the California electricity market and the market participants described herein. Additional provisions to the allowance may be warranted in the future.

In response to the filing of a number of complaints challenging the level of wholesale prices, the FERC initiated a staff investigation and issued an order on December 15, 2000 implementing a series of wholesale market reforms, including an interim price review procedure for prices above a \$150/MWh "breakpoint" on sales to the Cal ISO and through the Cal PX. The order does not prohibit sales above the "breakpoint," but the seller is subject to weekly reporting and monitoring requirements. For each reported transaction, potential refund liability extends for a period of 60 days following the date any such transaction is reported to the FERC. On March 9, 2001, the FERC issued a further order establishing a proxy market clearing price of \$273/MWh for January 2001, and on March 16, 2001 the FERC issued a further order adjusting the proxy market clearing price to \$430/MWh for February 2001. New market monitoring and mitigation measures to replace the \$150/MWh breakpoint and reporting obligation are being developed by the FERC to take effect on May 1, 2001.

In the FERC's March 9 and March 16 orders, the FERC outlined criteria for determining amounts subject to possible refund based on the proxy market clearing price for January and February 2001 and indicated that approximately \$12 million of the \$125 million charged by us in January 2001 in California to the Cal ISO and the Cal PX and approximately \$7 million of the \$47 million charged by us in February 2001 in California to the Cal ISO and the Cal PX were subject to possible refunds. In the March 9 and March 16 orders, the FERC set forth procedures for challenging possible refund obligations. Because we believe that there is cost or other justification for prices charged above the proxy market clearing prices established in the March 9 and March 16 orders, we intend to pursue such a challenge with respect to our potential refund amounts identified in such orders. Any refunds we may ultimately be obligated to pay are to be credited against unpaid amounts owed to us for our sales in the Cal PX or to the Cal ISO. The December 15 order established that a refund condition would be in place for the period beginning October 2, 2000 through December 31, 2002. The December 15 order also eliminated the requirement that California's public utilities sell all of their generation into and purchase all of their power from the Cal PX and directed that the Cal PX wholesale tariffs be terminated effective April 2001. The Cal PX has since suspended its day-ahead and day-of markets and filed for bankruptcy protection on March 9, 2001. Motions for rehearing have been filed on a number of issues related to the December 15 order and such motions are still pending before the FERC.

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 Public Utilities Commission, the California Electricity Oversight Board, the California Bureau of State Audits and the California Office of the Attorney General all have separate ongoing investigations into the high prices and their causes. None of these investigations have been completed and no findings have been made in connection with any of them.

Despite the market restructuring ordered under the December 15 order, the California public utilities have continued to accrue unrecovered wholesale costs. As a result, the credit ratings of two of these public utilities were severely downgraded to below investment grade in January 2001. As their credit lines became unavailable, the two utilities defaulted on payments due to the Cal PX and the Cal ISO, which operate financially as pass-through entities, coordinating payments from buyers and sellers of electricity. As a result, the Cal PX and Cal ISO were not able to pay final invoices to market participants totaling over \$1 billion.

The default of two of California's public utilities on amounts owed the Cal PX and the Cal ISO for purchased power has further exacerbated the current crisis in the California wholesale markets and resulted in substantial uncollected receivables owed to us by the Cal ISO and the Cal PX. The Cal PX's efforts to recover the available collateral of the utilities, in the form of block forward contracts, have been frustrated by the emergency acts of California's Governor, who seized control of the contracts upon the expiration of temporary restraining orders prohibiting such action. Although obligated to pay reasonable value for the contracts, the state of California has not yet made any payment for the contracts. Various actions have been filed challenging the Governor's ability to seize these contracts.

Upon the default of the two utilities of amounts due to the Cal PX, the Cal PX issued "charge-backs" allocating the utilities' defaults to the other market participants. Proceedings were brought both in federal

court and at the FERC seeking a suspension of the charge-backs and challenging the reasonableness of the Cal PX's actions. The Cal PX has since agreed to a preliminary injunction suspending any of its charge-back activities in order to allow the FERC to address the charge-back issues. Amounts owed to us were debited in invoices by the Cal PX for charge-backs in the amount of \$29 million and, on February 14, 2001, we filed our own lawsuit against the Cal PX in the United States District Court for the Central District of California, seeking a recovery of those amounts and a stay of any further charge-backs by the Cal PX. The filing of bankruptcy by the Cal PX will automatically stay for some period the various court and administrative cases against the Cal PX.

The two defaulting utilities have both filed lawsuits challenging the refusal of state regulators to allow wholesale power costs to be passed through to retail customers under the "filed rate doctrine." The filed rate doctrine provides that wholesale power costs approved by the FERC are entitled to be recovered through rates. Additionally, to address the failing financial condition of the two defaulting utilities and the utilities' potential bankruptcy, the California Legislature passed emergency legislation, effective January 18, 2001 and February 2, 2001, appropriating funds to be used by the CDWR for the purchase of wholesale electricity on behalf of the utilities and authorizing the sale of bonds to fund future purchases under long-term power contracts with wholesale generators. The CDWR began the process of soliciting bids from generators for long-term contracts and continued the purchasing of short-term power contracts. No bonds have yet been issued by the CDWR to support long-term power purchases or to provide credit support for short-term purchases.

As noted above, two of California's public utilities have defaulted in their payment obligations to the Cal PX and the Cal ISO as a result of the refusal of state regulators to allow them to recover their wholesale power costs. This refusal by state regulators has also caused the utilities to default on numerous other financial obligations, which could result in either the voluntary or involuntary bankruptcy of the utilities. While a bankruptcy filing would result in further post-petition purchases of wholesale electricity being considered administrative expenses of the debtor, a substantial delay could be experienced in the payment of pre-petition receivables pending the confirmation of a reorganization plan. The California legislature is currently considering legislation under which a state entity would be formed to purchase and operate a substantial share of the transmission lines in California in an effort to provide cash to the utilities and thereby avoid potential bankruptcy filings by the utilities. A number of the creditors for the two California public utilities have indicated, however, that unless California moves quickly with such a plan, an involuntary bankruptcy filing may be made by one or more of such creditors.

Because California's power reserves remain at low levels, in part as a result of the lack of creditworthy buyers of power given the defaults of the California utilities, the Cal ISO has relied on emergency dispatch orders requiring generators to provide at the Cal ISO's direction all power not already under contract. The power supplied to the Cal ISO has been used to meet the needs of the customers of the utilities, even though two of those utilities do not have the credit required to receive such power and may be unable to pay for it. We have contested the obligation to provide power under these circumstances. The Cal ISO sought a temporary restraining order compelling us to continue to comply with the emergency dispatch orders despite the utilities' defaults. Although the payment issue is still disputed, on February 21, 2001, we and the CDWR entered into a contract expiring March 23, 2001 for the purchase of all of our available capacity not already under contract and the litigation has been temporarily stayed. The CDWR is current in its payments under this contract, but we are still owed \$108 million for power provided in compliance with the emergency dispatch orders for the six weeks prior to the agreement. Depending on the outcome of the court proceedings initiated by the Cal ISO seeking to enjoin us from ceasing power deliveries to the Cal ISO, we may be forced to continue selling power without the guarantee of payment.

Additionally, we are seeking a prompt FERC determination that the Cal ISO is not complying with the credit provisions of its tariff and a related order of the FERC issued on February 14, 2001, requiring the Cal ISO not to make purchases in the real time market unless a creditworthy purchaser is responsible for such purchases.

For additional information regarding the situation in California, please read “— Results of Operations by Business Segment — Wholesale Energy — 2000 Compared to 1999,” as well as Notes 14(g) and 14(h) to our consolidated financial statements.

Competitive, Regulatory and Other Factors Affecting Our European Energy Operations

Competition. The European energy market is highly competitive. In addition, over the next several years, we expect an increasing consolidation of the participants in the European generating market.

Our European wholesale operations compete in the Netherlands, primarily against the three other largest Dutch generating companies, various cogenerators of electric power, various alternate sources of power and non-Dutch generators of electric power, primarily from France and Germany. In 2000, UNA and the three other largest Dutch generating companies supplied approximately 50% of the electricity consumed in the Netherlands. Smaller Dutch producers supplied about 25% of the consumed electricity, and the remainder was imported. At present, the Dutch electricity system has three operational interconnection points with Germany and two interconnection points with Belgium. There are also a number of projects that are at various stages of development and that may increase the number of interconnections in the future (post 2005) including interconnections with Norway and the United Kingdom. The Belgian interconnections are used to import electricity from France, but a larger portion of Dutch electricity imports comes from Germany.

Our European trading and marketing operations will also be subject to increasing levels of competition. As of December 31, 2000, there were 32 trading and marketing companies registered with the Amsterdam Power Exchange. Competition among power generators for customers is intense, and we expect competition to increase with the deregulation of the market. Please read “— Deregulation.” The primary elements of competition affecting both the generation and trading and marketing operations of our European Energy business segment are price, credit support, and supply and delivery reliability.

Deregulation. The Dutch electricity market was opened to limited wholesale and retail competition on January 1, 1999 as retail competition for large industrial customers began. The Dutch wholesale electric market was completely opened to competition on January 1, 2001. Consistent with our expectations at the time we made the acquisition, we anticipate that our European Energy business segment may experience a significant decline in gross margin in 2001 attributable to the deregulation of the market and termination of an agreement with the other Dutch generators and the Dutch distributors. The next customer segment, composed primarily of commercial customers, will be liberalized by 2002. The remainder of the market, mainly residential, will be open to competition by 2003. The timing of these market openings is subject to change, however, at the discretion of the Dutch Minister of Economic Affairs. In addition, the results of our European Energy segment will be negatively impacted beginning in 2002 due to the imposition of a standard Dutch corporate income tax rate, which is currently 35%, on the income of UNA. In 2000 and prior years, UNA's Dutch corporate income tax rate was zero percent.

Other. Another factor that could have a significant impact on the Dutch energy industry, including the operations of our European Energy business segment, is the ultimate resolution of stranded costs issues in the Netherlands. Prior to 2001, UNA and the other Dutch generators sold their generating output through the coordinating body for the Dutch electricity generating sector, B.V. Nederlands Elektriciteit Administratiekantoor (NEA). Over the years, NEA has incurred “stranded” costs as a result of, among other things, a perceived need to cover anticipated shortages in energy production supply. NEA stranded costs consist primarily of investments in alternative energy sources and fuel and power purchase contracts currently estimated to be uneconomical. Legislation has been approved by the Dutch parliament which would transfer the liability for the stranded costs from NEA to its four shareholders, one of which is UNA. For information regarding this legislation, please read Note 14(i) to our consolidated financial statements.

In connection with our acquisition of UNA, the selling shareholders of UNA agreed to indemnify UNA for some stranded costs in an amount not to exceed NLG 1.4 billion (\$599 million based on an exchange rate of 2.34 NLG per U.S. dollar as of December 31, 2000), which may be increased in some circumstances at our option up to NLG 1.9 billion (\$812 million). Of the total consideration we paid for the shares of UNA, NLG 900 million (\$385 million) has been placed by the selling shareholders under the direction of the Dutch

Minister of Economic Affairs in an escrow account to secure the indemnity obligations by the former shareholders of UNA. Although our management believes that the indemnity provision will be sufficient to fully satisfy UNA's ultimate share of any stranded costs obligation, this judgment is based on numerous assumptions regarding the ultimate outcome and timing of the resolution of the stranded cost issue, the former shareholders' timely performance of their obligations under the indemnity arrangement, and the amount of stranded costs, which at present is not determinable. Any shortfall in the indemnity provision could have a material adverse effect on our results of operations.

Our European operations are subject to various risks incidental to investing or operating in foreign countries. These risks include economic risks, such as fluctuations in currency exchange rates, restrictions on the repatriation of foreign earnings and/or restrictions on the conversion of local currency earnings into U.S. dollars. For example, we estimate that the impact of the devaluation of the Euro relative to the U.S. dollar during 2000 negatively impacted U.S. dollar net income in the amount of approximately \$8 million.

Impact of Currency Fluctuations on Company Earnings. For information about our exposure through our investment in Europe to losses resulting from fluctuations in currency rates, please read "Quantitative and Qualitative Disclosures About Market Risk."

Competitive and Other Factors Affecting RERC Operations

Natural Gas Distribution. Our Natural Gas Distribution business segment competes primarily with alternate energy sources such as electricity and other fuel sources. In some areas, intrastate pipelines, other gas distributors and marketers also compete directly with our Natural Gas Distribution business segment for gas sales to end-users. In addition, as a result of federal regulatory changes affecting interstate pipelines, natural gas marketers operating on these pipelines may be able to bypass our Natural Gas Distribution business segment's facilities and market, sell and/or transport natural gas directly to commercial and industrial customers.

Generally, the regulations of the states in which our Natural Gas Distribution business segment operates allow us to pass through changes in the costs of natural gas to our customers through purchased gas adjustment provisions in rates. There is, however, an inherent timing difference between our purchases of natural gas and the ultimate recovery of these costs. Consequently, we may incur additional "carrying" costs as a result of this timing difference and the resulting, temporary under-recovery of our purchased gas costs. To a large extent, these additional carrying costs are not recovered from our customers.

Pipelines and Gathering. Our Pipelines and Gathering segment competes with other interstate and intrastate pipelines in the transportation and storage of natural gas. The principal elements of competition among pipelines are rates, terms of service, and flexibility and reliability of service. Our Pipelines and Gathering segment competes indirectly with other forms of energy available to its customers, including electricity, coal and fuel oils. The primary competitive factor is price. Changes in the availability of energy and pipeline capacity, the level of business activity, conservation and governmental regulations, the capability to convert to alternative fuels, and other factors, including weather, affect the demand for natural gas in areas we serve and the level of competition for transportation and storage services. Since FERC Order No. 636, REGT's and Mississippi River Transmission Corporation's (MRT) commodity sales activity has been minimal. Commodity transactions are usually related to system management activity which we have been able to manage with little exposure. We have not been nor do we anticipate to be, negatively impacted from the recent price levels and the tightening of supply. In addition, competition for our gathering operations is impacted by commodity pricing levels in its markets because these prices influence the level of drilling activity in those markets.

Natural Gas Pipeline Company of America has proposed, and is soliciting customers for a 30" pipeline paralleling MRT's East Line in Illinois to a point 17 miles East of St. Louis Metro, with a proposed in-service date of June 2002. MRT has renewed or is engaged in negotiations to renew service agreements under multi-year terms, including service and potential expansion needs along MRT's existing East Line in Illinois. Our Pipelines and Gathering business segment derives approximately 14% of its revenues from its contract with

Laclede Gas Company (Laclede), which has been under an annual evergreen term provision since 1999. In the event we are not able to renegotiate a long-term extension to the contract with Laclede, and Laclede engages another pipeline for the transportation services it currently obtains from us, the operating and financial results of our Pipelines and Gathering business segment would be materially adversely affected.

Fluctuations in Commodity Prices and Derivative Instruments

For information regarding our exposure to risk as a result of fluctuations in commodity prices and derivative instruments, please read "Quantitative and Qualitative Disclosures About Market Risk."

Indexed Debt Securities (ZENS) and Our AOL Time Warner Investment

For information on our indexed debt securities and our investment in AOL Time Warner common stock, please read "Quantitative and Qualitative Disclosures About Market Risk" and Note 8 to our consolidated financial statements.

Environmental Expenditures

We are subject to numerous environmental laws and regulations, which require us to incur substantial costs to operate existing facilities, construct and operate new facilities, and mitigate or remove the effect of past operations on the environment. For additional information regarding environmental contingencies, please read Note 14(g) to our consolidated financial statements.

Clean Air Act Expenditures. We expect the majority of capital expenditures associated with environmental matters to be incurred by our Electric Operations and Wholesale Energy business segments in connection with emission limitations for Nitrogen Oxides (NO_x) under the Federal Clean Air Act, or to enhance operational flexibility under Clean Air Act requirements. In 2000, emission reduction requirements for NO_x were finalized for our electric generating facilities in Texas and the Mid-Atlantic region. We currently estimate that up to \$534 million will be required to comply with the requirements through the end of 2003, with an estimated \$215 million to be incurred in 2001. The Texas regulations require additional reductions that must be completed by March 2007. Estimates for the Texas units for the period 2004 through 2007 have not been defined, but could be up to \$230 million. We are currently litigating the economic and technical viability of the Texas post-2004 reduction requirements, but cannot predict the outcome of this litigation. In addition, the Legislation created a program mandating air emissions reductions for some generating facilities of our Electric Operations segment. The Legislation provides for stranded costs recovery for costs associated with this obligation incurred before May 1, 2003. For additional information regarding the Legislation, please read Note 4(a) to our consolidated financial statements. Additional NO_x emission controls for our generating units located in California may result in expenditures of up to \$30 million through 2002.

Site Remediation Expenditures. From time to time we have received notices from regulatory authorities or others regarding our status as a potentially responsible party in connection with sites found to require remediation due to the presence of environmental contaminants. Based on currently available information, we believe that remediation costs will not materially affect our financial position, results of operations or cash flows. There can be no assurance, however, that future developments, including additional information about existing sites or the identification of new sites, will not require material revisions to our estimates. For information about specific sites that are the subject of remediation claims, please read Note 14(g) to our consolidated financial statements.

Water, Mercury and Other Expenditures. Regulatory authorities are in the process of implementing regulations and quality standards in connection with the discharge of pollutants into waterways. Once these regulations and quality standards are enacted, we will be able to determine if our operations are in compliance, or if we will have to incur costs in order to comply with the quality standards and regulations. Until that time, however, we are not able to predict the amount of these expenditures, if any. To date, however, our expenditures associated with respect to permits, registrations and authorizations for operation of facilities under the statutes regulating the discharge of pollutants into surface water have not been material. With regard to mercury remediation and other environmental matters, such as the disposal of solid wastes, our

expenditures have not been, and are not expected to be material, based on our experiences and that of others in our industries.

Other Contingencies

For a description of other legal and regulatory proceedings affecting us, please read Notes 4 and 14 to our consolidated financial statements.

LIQUIDITY AND CAPITAL RESOURCES

Company Consolidated Capital Requirements

Our liquidity and capital requirements are affected primarily by capital programs, working capital needs and debt service requirements. Our Wholesale Energy segment expects to continue to participate as a bidder in future acquisitions of independent power projects and privatizations of generation facilities, which are excluded from the following table. Our capital requirements are expected to be met with excess cash flows from operations and the proceeds of project financings, equity offerings and borrowings. Additional capital expenditures are dependent upon the nature and extent of future project commitments, some of which may be substantial. The capital requirements for 2000 were, and as estimated for 2001 through 2005 as of March 19, 2001 are, as follows (in millions):

	2000	2001	2002	2003	2004	2005
Electric Operations (with nuclear fuel) (1)	\$ 643	\$ 947	\$ 428	\$ 450	\$ 427	\$ 379
Natural Gas Distribution	195	176	175	180	169	172
Pipelines and Gathering	61	51	52	38	38	33
Wholesale Energy(1) (2)	1,966	591	532	186	146	129
European Energy	995	5	26	—	21	17
Other Operations	91	126	97	101	109	98
Payments of long-term debt, sinking fund requirements and minimum capital lease obligations	679	630	789	1,238	48	332
Mid-Atlantic generating assets operating lease payments	1	259	137	77	84	75
Major maintenance cash outlays for non-rate regulated electric generating assets	73	65	78	77	82	89
Total	<u>\$4,704</u>	<u>\$2,850</u>	<u>\$2,314</u>	<u>\$2,347</u>	<u>\$1,124</u>	<u>\$1,324</u>

(1) Beginning in 2002 capital requirements for current generation operations of Reliant Energy HL&P are included in Wholesale Energy rather than in Electric Operations.

(2) In August 2000, we sold to and leased back from owner-lessors, interests in three Mid-Atlantic generating facilities. As consideration for the sale, we received \$1.0 billion in cash, which was used to repay indebtedness outstanding under credit facilities. The expenditures for the acquisitions of these Mid-Atlantic generating facilities have been excluded from the 2000 capital requirements.

The net cash provided by/used in operating, investing and financing activities for 1998, 1999 and 2000 is as follows (in millions):

	Year Ended December 31,		
	1998	1999	2000
Cash provided by (used in):			
Operating activities	\$1,427	\$1,110	\$1,346
Investing activities	(1,238)	(2,876)	(3,288)
Financing activities	(206)	1,823	2,032

Cash Provided by Operating Activities

Net cash provided by operations in 2000 increased \$236 million compared to 1999. This increase primarily resulted from:

- proceeds from the sale of an investment in marketable debt securities by UNA,
- improved operating results of our Wholesale Energy segment's California generating facilities,
- incremental cash flows provided by UNA, acquired in the fourth quarter of 1999,
- cash flows from the Mid-Atlantic generating facilities, acquired in the second quarter of 2000,
- increased sales from our Electric Operations segment due to growth in usage and number of customers, and
- partially offset by increased Electric Operations' under-recovered fuel costs and Wholesale Energy's margin deposits on energy trading activities.

Net cash provided by operations in 1999 decreased \$317 million compared to 1998 primarily due to a \$141 million federal tax refund received in 1998 and other changes in working capital.

Cash Used in Investing Activities

Net cash used in investing activities increased \$412 million during 2000 compared to 1999. This increase was primarily due to:

- the funding of the remaining purchase obligation for UNA of \$982 million on March 1, 2000,
- the purchase of the Mid-Atlantic generation facilities for \$2.1 billion on May 12, 2000, and
- increased capital expenditures.

Proceeds of \$1.0 billion from the sale-leaseback of three of our Mid-Atlantic generation facilities in 2000, the sale of a substantial portion of our Latin American investments in 2000 and the purchase of \$537 million of AOL Time Warner securities in 1999 partially offset these increases.

Net cash used in investing activities increased \$1.6 billion in 1999 compared to 1998. This increase was primarily due to:

- the cash payment of \$833 million in 1999 related to the acquisition of UNA,
- the cash payment of \$188 million in 1999 for the acquisition of our generating facility located in Florida,
- the purchase of \$537 million of AOL Time Warner securities in 1999, and
- increased capital expenditures.

Cash Used in/Provided by Financing Activities

Cash flows provided by financing activities increased \$209 million in 2000 compared to 1999, primarily due to cash received from short-term borrowings partially offset by a decline in proceeds from long-term debt and the sale of trust preferred securities.

Cash flows provided by financing activities increased \$2.0 billion in 1999 compared to 1998, primarily due to cash received from short-term borrowings, the net issuance of long-term debt and the issuance of trust preferred securities aggregating \$2.1 billion (please read Notes 10 and 11 to our consolidated financial statements), partially offset by \$91 million of purchases of our common stock. The net borrowings incurred during 1999 were utilized to purchase AOL Time Warner securities, to make the \$833 million cash payment related to the acquisition of UNA, to support increased capital expenditures and to fund our working capital requirements.

Future Sources and Uses of Cash Flows

Credit Facilities. As of December 31, 2000, we had credit facilities in effect, including facilities of various financing subsidiaries and operating subsidiaries, that provided for an aggregate of \$8.4 billion in committed credit. As of December 31, 2000, \$6.7 billion was outstanding under these facilities including commercial paper of \$3.7 billion and letters of credit of \$899 million. The remaining unused credit facilities totaled \$1.7 billion. The credit facilities under which Reliant Energy borrows or provides credit support contain various business and financial covenants requiring us to, among other things, maintain leverage (as defined in the credit facilities) below specified ratios. Certain credit facilities at the subsidiary level also contain various financial covenants limiting leverage and requiring the subsidiary to maintain its interest coverage ratio (as defined in the credit facilities) above a specified ratio during stated periods. We are in compliance with the covenants under all of these credit agreements. We do not expect any of these covenants to materially limit our ability to borrow or obtain letters of credit under these facilities. For additional discussion, please read Note 10(a) to our consolidated financial statements.

Of the \$8.4 billion of committed credit facilities described above, \$5.0 billion will expire in 2001. To the extent that we continue to need access to this amount of committed credit, we expect to extend or replace these facilities on normal commercial terms on a timely basis.

Between December 2000 and March 2001, Reliant Resources entered into a total of eleven bilateral credit facilities with financial institutions, which provide for an aggregate of \$1.6 billion in committed credit. The facilities became effective subsequent to December 31, 2000 and expire on October 2, 2001. Concurrent with the effectiveness of these facilities, \$500 million of credit facilities of a financing subsidiary were canceled. Interest rates on the borrowings are based on the London inter-bank offered rate (LIBOR) plus a margin, a base rate or a rate determined through a bidding process. These facilities contain various business and financial covenants requiring Reliant Resources to, among other things, maintain a ratio of net debt to the sum of net debt, subordinated affiliate debt and shareholder's equity not to exceed 0.60 to 1.00. These covenants are not anticipated to materially restrict Reliant Resources from borrowing funds or obtaining letters of credit under these facilities. The credit facilities are subject to facility and usage fees that are calculated based on the amount of the facility commitments and on the amounts outstanding under the facilities, respectively.

Shelf Registrations. At December 31, 2000, Reliant Energy had shelf registration statements providing for the issuance of \$230 million aggregate liquidation value of our preferred stock, \$580 million aggregate principal amount of our debt securities and \$125 million of trust preferred securities and related junior subordinated debt securities. In addition, Reliant Energy had a shelf registration for 15 million shares of its common stock which, would have been worth \$650 million as of December 31, 2000 based on the closing price of its common stock as of this date. In January 2001, RERC Corp. filed a shelf registration statement for \$600 million of unsecured unsubordinated debt securities of which \$550 million was issued in February 2001.

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.

Money Fund. We have a "money fund" through which Reliant Energy and some of its participating subsidiaries can borrow or invest on a short-term basis. Funding needs are aggregated and borrowing or investing is based on the net cash position. The money fund's net funding requirements are generally met with commercial paper.

Securitization. Reliant Energy HL&P filed an application with the Texas Utility Commission requesting a financing order authorizing the issuance by a special purpose entity organized by us, pursuant to the Legislation, of transition bonds relating to Reliant Energy HL&P's generation related regulatory assets. In May 2000, the Texas Utility Commission issued a financing order to Reliant Energy authorizing the issuance of transition bonds in an amount not to exceed \$740 million plus actual up-front qualified costs. Payments on

the transition bonds will be made out of funds derived from non-bypassable transition charges assessed to Reliant Energy HL&P's transmission and distribution customers. The offering of the transition bonds will be registered under the Securities Act of 1933 and is expected to be consummated during 2001. The transition bonds will be offered and sold only by means of a prospectus. These financial statements do not constitute an offer to sell or the solicitation of an offer to buy nor will there be any sale of the transition bonds in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such state.

The expected timing of the transition bond offering assumes that the Texas Supreme Court will have rejected a constitutional challenge to the statute permitting the financing orders. That challenge was brought in a Texas state district court by Power Choice, Inc. in connection with a different financing order, issued by the Texas Utility Commission to another utility. The district court affirmed the constitutionality of the statute. Power Choice took a direct appeal to the Texas Supreme Court under a statute providing for expedited judicial review. The Texas Supreme Court heard oral argument on November 29, 2000, and as of March 19, 2001, a decision has not been rendered at this time.

Reliant Energy Latin America Divestitures. We have received an aggregate of \$790 million in after-tax proceeds from the sale of some investments held by the Latin America business segment. For additional information, please read Note 19 to our consolidated financial statements.

Fuel Filing. As of December 31, 2000, Reliant Energy HL&P was under-collected on fuel recovery by approximately \$558 million. In two separate filings, Reliant Energy HL&P received approval to implement fuel surcharges to collect the under-recovery of fuel expenses, as well as to adjust the fuel factor to compensate for significant increases in the price of natural gas.

On March 15, 2001, Reliant Energy HL&P filed to revise its fuel factor and address our undercollected fuel costs of \$389 million, which is the accumulated amount since September 2000 through February 2001 plus estimates for March and April, 2001. Reliant Energy HL&P is requesting to revise its fixed fuel factor to be implemented with the May 2001 billing cycle and has proposed to defer the collection of the \$389 million until the 2004 stranded costs true-up proceeding. For additional information regarding the 2004 stranded costs true-up proceeding, please read “— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Electric Operations” and Note 4(a) to our consolidated financial statements.

Initial Public Offering of Reliant Resources. On July 27, 2000, Reliant Energy announced its intention to form Reliant Resources, which will own and operate a substantial portion of Reliant Energy's unregulated operations, and to offer no more than 20% of the common stock of Reliant Resources in an initial public offering in 2001. Reliant Energy expects the Offering to be followed by a distribution to Reliant Energy's or its successor's shareholders the remaining common stock of Reliant Resources within 12 months of the Offering. For additional information, please read “— Certain Factors Affecting Our Future Earnings — Business Separation and Restructuring” and Note 4(b) to our consolidated financial statements.

Acquisition of UNA. In the fourth quarter of 1999, we funded \$833 million of the UNA purchase obligation. On March 1, 2000, we funded the \$982 million remaining UNA purchase obligation. We obtained a portion of the funds for this purchase from a Euro 600 million (\$596 million) three-year term loan facility established in February 2000.

Indemnification of UNA Stranded Costs. In connection with the acquisition of UNA, the selling shareholders of UNA agreed to indemnify UNA for specified stranded costs in an amount not to exceed NLG 1.4 billion (\$599 million based on a December 31, 2000 exchange rate of 2.34 NLG per U.S. dollar). This amount may be increased in some circumstances at our option up to NLG 1.9 billion (\$812 million). Of the total consideration we paid for the shares of UNA, NLG 900 million (\$385 million) has been placed in an escrow account to secure these indemnity obligations by the former shareholders of UNA under the direction of the Dutch Ministry of Economic Affairs. We believe that the indemnity provision will be sufficient to cover UNA's ultimate share of any stranded costs obligation. We base this belief on numerous assumptions regarding the ultimate outcome and timing of the resolution of the stranded costs issue, the former

shareholders' timely performance of their obligations under the indemnity arrangement, and the amount of stranded costs, which at present is not determinable. For further discussion of UNA stranded costs, please read Note 14(i) to our consolidated financial statements.

Acquisition of Mid-Atlantic Assets. On May 12, 2000, we completed the acquisition of our Mid-Atlantic assets from Sithe Energies, Inc. for an aggregate purchase price of \$2.1 billion. The acquisition was originally financed through commercial paper borrowings at one of our financing subsidiaries. In August 2000, we entered into separate sale/leaseback transactions with each of the three owner-lessors for our respective 16.45%, 16.67% and 100% interests in the Conemaugh, Keystone and Shawville generating stations, respectively, which we acquired as part of the Mid-Atlantic acquisition. For additional discussion of these lease transactions, please read Notes 3(a) and 14(c) to our consolidated financial statements. As consideration for the sale of our interest in each of the facilities, we received a total of \$1.0 billion in cash that was used to repay commercial paper borrowings at one of our financing subsidiaries. We will continue to make lease payments through 2029. The lease terms expire in 2034. Cash lease payments are scheduled as follows (in millions):

2001	\$ 259
2002	137
2003	77
2004	84
2005	75
2006 and beyond	<u>1,188</u>
Total	<u>\$1,820</u>

Channelview Project. Our 781 MW gas-fired, combined cycle, cogeneration plant located in Channelview, Texas, which is currently under construction, is expected to cost \$463 million, including \$129 million in commitments for the purchase of combustion turbines. Of this amount, \$280 million had been incurred as of December 31, 2000. The project continues to be financed through funds received under the terms of a committed equity bridge facility, which totals \$92 million, a non-recourse debt facility aggregating \$369 million and projected construction revenues of \$2 million.

Other Generating Projects. As of December 31, 2000, we had an additional three non-rate regulated generating facilities under construction. Total estimated costs of constructing these facilities are \$867 million, including \$366 million in commitments for the purchase of combustion turbines. As of December 31, 2000, we had incurred \$614 million of the total projected costs of these projects, which were funded primarily through short-term borrowings from various financing subsidiaries of Reliant Energy. We believe that our level of cash, our borrowing capability and proceeds from the initial public offering as discussed above will be sufficient to fund these commitments. In addition, we have options to purchase additional combustion turbines for a total estimated cost of \$544 million for future generation projects. We believe that our current level of cash, our borrowing capability and proceeds from the initial public offering will be sufficient to fund these options should we choose to exercise them.

Naming Rights to Houston Sports Complex. In October 2000, we 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 us with significant sponsorship rights. The aggregate cost of the naming rights will be approximately \$300 million. During the fourth quarter of 2000, we 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. Starting in 2002, when the new stadium is operational, we will pay \$10 million each year through 2032 for annual advertising under this agreement.

California Trade Receivables. During the summer and fall of 2000, prices for wholesale electricity in California increased dramatically as a result of a combination of factors, including higher natural gas prices

and emissions allowance costs, reduction in available hydroelectric generation resources, increased demand, decreases in net electric imports, structural market flaws including over-reliance on the spot market, and limitations on supply as a result of maintenance and other outages. Although wholesale prices increased, California's deregulation legislation kept retail rates frozen below 1996 levels. This caused two of California's public utilities, which are our customers based on our deliveries to the Cal PX and the Cal ISO, to amass billions of dollars of uncollected wholesale power costs and ultimately default in January and February 2001 on payments owed for wholesale power purchased through the Cal PX and from the Cal ISO. As of December 31, 2000, we were owed \$101 million by the Cal PX and \$181 million by the Cal ISO. In the fourth quarter of 2000, we recorded a pre-tax provision of \$39 million against receivable balances related to energy sales in the California market. From January 1, 2001 through February 28, 2001, we have collected \$105 million of these receivable balances. As of March 1, 2001, we were owed \$358 million by the Cal ISO, the Cal PX, the CDWR and California Energy Resource Scheduling, for energy sales in the California wholesale market, which includes power sales in the wholesale California market from the fourth quarter of 2000 through February 28, 2001. For additional information regarding uncertainties in the California wholesale market, please read "— Certain Factors Affecting Our Future Earnings — Competitive, Regulatory and Other Factors Affecting Our Wholesale Energy Operations — California" as well as Notes 14(g) and 14(h) to our consolidated financial statements.

Treasury Stock Purchases. As of December 31, 2000, we were authorized under our common stock repurchase program to purchase an additional \$271 million of our common stock. Our purchases under our repurchase program depend on market conditions, might not be announced in advance and may be made in open market or privately negotiated transactions.

Environmental Issues. We anticipate investing up to \$711 million in capital and other special project expenditures between 2001 and 2005 for environmental compliance. Of this amount, we anticipate expenditures to be approximately \$217 million and \$259 million in 2001 and 2002, respectively.

Other Sources/Uses of Cash. Our liquidity and capital requirements are affected primarily by capital expenditures, debt service requirements and various working capital needs. We expect to continue to participate as a bidder in future acquisitions of independent power projects and privatizations of generation facilities. We expect any resulting capital requirements to be met with excess cash flows from operations, as well as proceeds from debt and equity offerings, project financings and other borrowings. Additional capital expenditures depend upon the nature and extent of future project commitments, some of which may be substantial. We believe that our current level of cash and borrowing capability and proceeds from the Reliant Resources initial public offering discussed above, along with future cash flows from operations, will be sufficient to meet the existing operational needs of our businesses for the next 12 months.

NEW ACCOUNTING PRONOUNCEMENTS

Effective January 1, 2001, we were required to adopt SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended (SFAS No. 133), which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. This statement requires that derivatives be recognized at fair value in the balance sheet and that changes in fair value be recognized either currently in earnings or deferred as a component of other comprehensive income, depending on the intended use of the derivative, its resulting designation and its effectiveness. In addition, in June 2000, the Financial Accounting Standards Board (FASB) issued an amendment that narrows the applicability of the pronouncement to some purchase and sales contracts and allows hedge accounting for some other specific hedging relationships. Adoption of SFAS No. 133 resulted in a \$62 million cumulative after-tax increase to net income and a cumulative after-tax increase of accumulated other comprehensive loss of \$252 million in the first quarter of 2001. The adoption also increased current assets, long-term assets, current liabilities, and long-term liabilities by \$703 million, \$252 million, \$805 million and \$340 million, respectively, on our consolidated balance sheet. We will also reclassify \$788 million from current portion of long-term debt to other current liabilities due to the adoption.

The total impact of our adoption of SFAS No. 133 on earnings and accumulated other comprehensive loss is dependent upon certain pending interpretations, which are currently under consideration, including

those related to the "normal purchases and normal sales." The interpretations of this issue, and others, are currently under consideration by the FASB. While the ultimate conclusions reached on interpretations being considered by the FASB could impact the effects of our adoption of SFAS No. 133, we do not believe that such conclusions would have a material effect on our current estimate of the impact of the adoption.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Impact of Changes in Interest Rates, Equity Market Values, Foreign Currency Exchange Rates and Energy Commodity Prices

We are exposed to various market risks. These risks are inherent in our financial statements and arise from transactions entered into in the normal course of business. We utilize derivative financial instruments to mitigate the impact of changes in electricity and fuel prices on our operating results and cash flows. We utilize cross-currency swaps and options to hedge our net investments in foreign subsidiaries and other financial instruments to manage various other market risks.

Interest Rate Risk

We have long-term debt, Company obligated mandatorily redeemable preferred securities of subsidiary trusts holding solely our junior subordinated debentures (Trust Preferred Securities), securities held in our nuclear decommissioning trust, bank facilities, some lease obligations and our obligations under the ZENS, which subject us to the risk of loss associated with movements in market interest rates.

At December 31, 1999 and 2000, we had issued fixed-rate debt (excluding indexed debt securities) and Trust Preferred Securities aggregating \$5.7 billion and \$5.5 billion, respectively, in principal amount and having a fair value of \$5.5 billion each year. These instruments are fixed-rate and, therefore, do not expose us to the risk of loss in earnings due to changes in market interest rates (please read Notes 10 and 11 to our consolidated financial statements). However, the fair value of these instruments would increase by approximately \$281 million if interest rates were to decline by 10% from their levels at December 31, 2000. In general, such an increase in fair value would impact earnings and cash flows only if we were to reacquire all or a portion of these instruments in the open market prior to their maturity.

Our floating-rate obligations aggregated \$3.1 billion and \$5.8 billion at December 31, 1999 and 2000, respectively, (please read Note 10 to our consolidated financial statements), inclusive of (a) amounts borrowed under our short-term and long-term credit facilities (including the issuance of commercial paper supported by these facilities), (b) borrowings underlying a receivables facility and (c) amounts subject to a master leasing agreement under which lease payments vary depending on short-term interest rates. These floating-rate obligations expose us to the risk of increased interest and lease expense in the event of increases in short-term interest rates. If the floating rates were to increase by 10% from December 31, 2000 levels, our consolidated interest expense and expense under operating leases would increase by a total of approximately \$3 million each month in which such increase continued.

As discussed in Notes 14(l) to our consolidated financial statements, we contribute \$14.8 million per year to a trust established to fund our share of the decommissioning costs for the South Texas Project. The securities held by the trust for decommissioning costs had an estimated fair value of \$159 million as of December 31, 2000, of which approximately 40% were fixed-rate debt securities that subject us to risk of loss of fair value with movements in market interest rates. If interest rates were to increase by 10% from their levels at December 31, 2000, the decrease in fair value of the fixed-rate debt securities would not be material to us. In addition, the risk of an economic loss is mitigated. Any unrealized gains or losses are accounted for in accordance with SFAS No. 71 as a regulatory asset/liability because we believe that our future contributions, which are currently recovered through the rate-making process, will be adjusted for these gains and losses. For further discussion regarding the recovery of decommissioning costs pursuant to the Legislation, please read Note 4(a) to our consolidated financial statements.

As discussed in Note 10(b) to our consolidated financial statements, in November 1998, RERC Corp. sold \$500 million aggregate principal amount of its 6% Term Enhanced Remarketable Securities (TERM

Notes) which included an embedded option to remarket the securities. The option is expected to be exercised in the event that the ten-year Treasury rate in 2003 is below 5.66%. At December 31, 2000, we could terminate the option at a cost of \$34 million. A decrease of 10% in the December 31, 2000 level of interest rates would increase the cost of termination of the option by approximately \$13 million.

As discussed in Note 8 to our consolidated financial statements, upon adoption of SFAS No. 133 effective January 1, 2001, the ZENS obligation will be bifurcated into a debt component of \$122 million and a derivative component of \$788 million. The debt component of \$122 million is a fixed-rate obligation and, therefore, does not expose us to the risk of loss in earnings due to changes in market interest rates. However, the fair value of the debt component would increase by approximately \$17 million if interest rates were to decline by 10% from levels at December 31, 2000. Changes in the fair value of the derivative component will be recorded in our statements of consolidated operations and, therefore, we are exposed to changes in the fair value of the derivative component as a result of changes in the underlying risk-free interest rate. If the risk-free interest rate were to increase by 10% from December 31, 2000 levels, the fair value of the derivative component would increase by approximately \$12 million, which would be recorded as a loss in our statements of consolidated operations.

Equity Market Risk

As discussed in Note 8 to our consolidated financial statements, we own approximately 26 million shares of AOL Time Warner Inc. common stock (AOL TW Common), which are held by us to facilitate our ability to meet our obligations under the ZENS. Please read Note 8 to our consolidated financial statements for a discussion of the effect of adoption of SFAS No. 133 on our ZENS obligation and our historical accounting treatment of our ZENS obligation. Subsequent to adoption of SFAS No. 133, a decrease of 10% from the December 31, 2000 market value of AOL TW Common would result in a loss of approximately \$7 million, which would be recorded as a loss in our statements of consolidated operations.

As discussed above under “— Interest Rate Risk,” we contribute to a trust established to fund our share of the decommissioning costs for the South Texas Project, which held debt and equity securities as of December 31, 2000. The equity securities expose us to losses in fair value. If the market prices of the individual equity securities were to decrease by 10% from their levels at December 31, 2000, the resulting loss in fair value of these securities would not be material to us. Currently, the risk of an economic loss is mitigated as discussed above under “— Interest Rate Risk.”

Foreign Currency Exchange Rate Risk

Our European operations expose us to risk of loss in the fair value of our European investments due to the fluctuation in foreign currencies relative to our reporting currency, the U.S. dollar. We account for adjustments resulting from translation of our investments that have functional currencies other than the U.S. dollar as a charge or credit to a separate component of accumulated other comprehensive income (loss) in stockholders' equity. As of December 31, 2000, we have entered into foreign currency swaps and have issued Euro-denominated debt to hedge our net European investment. Changes in the value of the swaps and debt are recorded as foreign currency translation adjustments as a component of accumulated other comprehensive income (loss) in stockholders' equity. As of December 31, 2000, we had recorded a \$2 million loss in cumulative net translation adjustments. The cumulative translation adjustments will be realized in earnings and cash flows only upon the disposition of the related investments.

We have substantially hedged our net investment in our European subsidiaries through a combination of Euro-denominated borrowings and various derivative instruments. During the normal course of business, we review our currency hedging strategies and determine the hedging approach we deem appropriate based upon the circumstances of each situation.

Our European Energy segment has entered into financial instruments to purchase approximately \$120 million to hedge future fuel purchases payable in U.S. dollars. As of December 31, 2000, the fair value of these financial instruments was a \$6 million liability. An increase in the value of the Euro of 10% compared to

the U.S. dollar from its December 31, 2000 level would result in an additional loss in the fair value of these foreign currency financial instruments of \$12 million.

Commodity Price Risk

Trading and marketing operations often involve market risks associated with managing energy commodities and establishing open positions in the energy markets, primarily on a short-term basis. These risks fall into three different categories: price and volume volatility, credit risk of trading counterparties and adequacy of the control environment for trading. We routinely enter into futures, forward contracts, swaps and options to hedge purchase and sale commitments, fuel requirements and inventories of natural gas, coal, electricity, oil, emission allowances, weather derivatives and other commodities and to minimize the risk of market fluctuations on our trading, marketing, power origination and risk management operations. We assess the risk of our non-trading derivatives (Energy Derivatives) using a sensitivity analysis method, and we assess the risk of our trading derivatives (Trading Derivatives) using the value-at-risk (VAR) method, in order to maintain our total exposure within management-prescribed limits (both methods are described below).

The sensitivity analysis performed on our Energy Derivatives measures the potential loss in earnings based on a hypothetical 10% movement in energy prices. An increase of 10% in the market prices of energy commodities from their December 31, 1999 and 2000 levels would have decreased the fair value of our Energy Derivatives, from their levels on those respective dates, by \$12 million and \$149 million, respectively.

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

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

If any of the above-mentioned assumptions cease to be true, a loss on the financial instruments may occur, or the options might be worthless as determined by the prevailing market value on their termination or maturity date, whichever comes first.

Trading Derivatives held by our trading and marketing operations consist of physical forwards, swaps, options and exchange-traded futures and options in natural gas, electricity, crude oil and refined products and weather derivatives, and are exposed to losses in fair value due to changes in the price and volatility of the underlying derivatives. We utilize the variance/covariance model of VAR, which is a probabilistic model that measures the risk of loss to earnings in market sensitive instruments. The variance/covariance model relies on statistical relationships to describe how changes in different markets can affect a portfolio of instruments with different characteristics and market exposures. We use the delta-approximation method for reporting option positions. VAR models are relatively sophisticated; however, the quantitative risk information is limited by the parameters established in creating the model. The instruments being evaluated could have features that may trigger a potential loss in excess of calculated amounts if changes in commodity prices exceed the confidence level of the model used. The VAR methodology employs a seasonally adjusted volatility-based approach with the following critical parameters: volatility estimates, appropriate market-oriented holding periods and seasonally adjusted correlation estimates. The holding period (typically one day) is our estimate of the length of time that will be needed to liquidate the positions. The volatility and the correlation estimates measure the impact of adverse price movements both at an individual position level as well as at the total portfolio level. The confidence level established for our purposes is 95%. For example, if VAR is calculated at \$10 million, we may state with a 95% confidence level that if prices move against our positions, our pre-tax loss in liquidating

our portfolio would not exceed \$10 million based on the VAR assumptions over the defined holding period. With respect to Trading Derivatives, our highest, lowest and average monthly VAR during 2000 was \$15 million, \$1 million and \$6 million, respectively. During 1999, our highest, lowest and average monthly VAR was less than \$8 million.

We cannot assure you that market volatility, failure of counterparties to meet their contractual obligations, transactions entered into after the date of these financial statements or a failure of risk controls will not lead to significant losses from our marketing and risk management activities.

Risk Oversight

We control the scope of our trading, power origination, marketing and risk management operations through a comprehensive set of policies and procedures involving senior levels of our management. Our Board of Directors sets the risk limit parameters, and the audit committee of the board has oversight for the ongoing evaluation of the adequacy of the risk control organization and policies. A risk oversight committee, comprised of corporate and business segment officers, oversees all of our activities, which include commodity price, credit, foreign currency, equity and interest rate risk, including our trading, marketing, power origination and risk management operations. The committee also proposes VAR limits to our Board of Directors. Our Board of Directors ultimately sets our aggregate VAR limit. We have a corporate risk control organization, headed by a chief risk control officer, which is assigned responsibility for establishing and enforcing the policies, procedures and limits and evaluating the risks inherent in proposed transactions. Key risk control activities include credit review and approval, credit and performance risk measurement and monitoring, validation of transactions, portfolio valuation and daily portfolio reporting including mark-to-market valuation, VAR and other risk measurement metrics.

To the extent an open position exists, fluctuating commodity prices can impact financial results and financial position, either favorably or unfavorably. As a result, we cannot predict with precision the impact that our risk management decisions may have on our businesses, operating results or financial position.

**MARKET FOR RELIANT ENERGY'S COMMON EQUITY
AND RELATED STOCKHOLDER MATTERS.**

As of March 12, 2001, Reliant Energy's common stock was held of record by approximately 75,089 shareholders. Reliant Energy's common stock is listed on the New York and Chicago Stock Exchanges and is traded under the symbol "REI."

The following table sets forth the high and low sales prices of Reliant Energy's common stock on the New York Stock Exchange composite tape during the periods indicated, as reported by *Bloomberg*, and the dividends declared for these periods. Dividend payout was \$1.50 per share in both 1999 and 2000. The dividend declared during the fourth quarter of 2000 was paid in March 2001.

	Market Price		Dividend Declared Per Share
	High	Low	
1999			
First Quarter			\$0.375
January 6	\$32.25		
March 31		\$26.06	
Second Quarter			\$0.375
April 14		\$25.50	
May 25	\$31.69		
Third Quarter			\$0.375
September 3	\$28.63		
September 28		\$26.31	
Fourth Quarter			\$0.375
October 4	\$28.44		
December 31		\$22.88	
2000			
First Quarter			\$0.375
March 7		\$19.88	
March 16	\$24.38		
Second Quarter			\$0.375
April 7		\$22.56	
June 23	\$29.81		
Third Quarter			\$0.375
July 3		\$29.81	
September 29	\$46.50		
Fourth Quarter			\$0.375
October 2	\$48.19		
December 6		\$38.06	

The closing market price of Reliant Energy's common stock on December 31, 2000 was \$43.31 per share.

Future dividends will be subject to determination based upon our results of operations and financial condition, our future business prospects, any applicable contractual restrictions and other factors that our Board of Directors considers relevant.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA OF RELIANT ENERGY
RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED OPERATIONS
(Thousands of Dollars, except per share amounts)

	Year Ended December 31,		
	1998	1999	2000
Revenues	\$11,229,519	\$15,223,094	\$29,339,384
Expenses:			
Fuel and cost of gas sold	4,815,752	6,699,792	15,071,801
Purchased power	2,215,049	4,137,414	8,627,853
Operation and maintenance	1,583,122	1,781,030	2,356,207
Taxes other than income taxes	469,429	441,242	498,061
Depreciation and amortization	866,272	905,305	906,328
Total	<u>9,949,624</u>	<u>13,964,783</u>	<u>27,460,250</u>
Operating Income	<u>1,279,895</u>	<u>1,258,311</u>	<u>1,879,134</u>
Other Income (Expense):			
Gain (loss) on AOL Time Warner investment	—	2,452,406	(204,969)
(Loss) gain on indexed debt securities	(1,176,211)	(629,523)	101,851
(Loss) income of equity investment of unconsolidated subsidiaries	(601)	(793)	42,860
Other, net	67,619	59,766	83,765
Total	<u>(1,109,193)</u>	<u>1,881,856</u>	<u>23,507</u>
Interest and Other Charges:			
Interest	502,432	498,451	700,083
Distribution on trust preferred securities	29,201	51,220	54,358
Total	<u>531,633</u>	<u>549,671</u>	<u>754,441</u>
(Loss) Income from Continuing Operations Before Income Taxes, Extraordinary Items and Preferred Dividends	(360,931)	2,590,496	1,148,200
Income Tax (Benefit) Expense	<u>(82,563)</u>	<u>915,973</u>	<u>377,064</u>
(Loss) Income from Continuing Operations Before Extraordinary Items and Preferred Dividends	(278,368)	1,674,523	771,136
Income (loss) from discontinued operations (net of tax of \$(52,131), \$16,856 and \$45,721)	137,276	(8,792)	(172,375)
Loss on disposal of discontinued operations, including provision of \$4,843 for operating loss during phase-out period (less applicable tax of \$12,846)	—	—	(158,706)
Extraordinary (loss) gain, net of tax of \$98,679 and \$0	—	(183,261)	7,445
(Loss) Income Before Preferred Dividends	<u>(141,092)</u>	<u>1,482,470</u>	<u>447,500</u>
Preferred Dividends	390	389	389
Net (Loss) Income Attributable to Common Stockholders	<u>\$ (141,482)</u>	<u>\$ 1,482,081</u>	<u>\$ 447,111</u>
Basic (Loss) Earnings Per Share:			
(Loss) Income from Continuing Operations Before Extraordinary Items	\$ (0.98)	\$ 5.87	\$ 2.71
Income (Loss) from Discontinued Operations, net of tax	0.48	(0.03)	(0.61)
Loss on Disposal of Discontinued Operations, net of tax	—	—	(0.56)
Extraordinary (Loss) Gain, net of tax	—	(0.64)	0.03
Net (Loss) Income Attributable to Common Stockholders	<u>\$ (0.50)</u>	<u>\$ 5.20</u>	<u>\$ 1.57</u>
Diluted (Loss) Earnings Per Share:			
(Loss) Income from Continuing Operations Before Extraordinary Items	\$ (0.98)	\$ 5.85	\$ 2.68
Income (Loss) from Discontinued Operations, net of tax	0.48	(0.03)	(0.60)
Loss on Disposal of Discontinued Operations, net of tax	—	—	(0.55)
Extraordinary (Loss) Gain, net of tax	—	(0.64)	0.03
Net (Loss) Income Attributable to Common Stockholders	<u>\$ (0.50)</u>	<u>\$ 5.18</u>	<u>\$ 1.56</u>

See Notes to the Company's Consolidated Financial Statements

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME
(Thousands of Dollars)

	Year Ended December 31,		
	1998	1999	2000
Net (loss) income attributable to common stockholders	\$(141,482)	\$1,482,081	\$447,111
Foreign currency translation adjustments from continuing operations	—	(587)	(1,220)
Foreign currency translation adjustments from discontinued operations (net of tax of \$17,656, \$23,143 and \$16,371)	(32,790)	(42,392)	(30,405)
Reclassification adjustment for foreign currency translation losses realized in net income (net of tax of \$57,296)	—	—	106,408
Unrealized loss on available-for-sale securities (net of tax of \$5,877, \$373 and \$1,492)	(10,370)	(1,224)	(2,264)
Reclassification adjustment for impairment loss on available-for-sale securities realized in net income (net of tax of \$9,276) ...	—	—	17,228
Additional minimum non-qualified pension liability adjustment (net of tax of \$11,127)	—	—	(19,135)
Comprehensive (Loss) Income	<u>\$(184,642)</u>	<u>\$1,437,878</u>	<u>\$517,723</u>

See Notes to the Company's Consolidated Financial Statements

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Thousands of Dollars)

	December 31,	
	1999	2000
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 80,767	\$ 175,972
Investment in AOL Time Warner common stock	3,979,461	896,824
Accounts receivable, net	1,078,736	2,623,492
Accrued unbilled revenues	172,629	592,618
Inventory	340,459	483,213
Price risk management assets	722,429	4,460,843
Margin deposits on energy trading activities	33,721	521,004
Prepayments and other current assets	128,194	253,335
Total current assets	6,536,396	10,007,301
Property, Plant and Equipment, net	13,133,559	15,260,155
Other Assets:		
Goodwill and other intangibles, net	3,041,751	3,080,707
Regulatory assets	1,739,507	1,926,103
Price risk management assets	173,590	752,186
Equity investments in unconsolidated subsidiaries	78,041	108,727
Net assets of discontinued operations	1,078,185	194,858
Other	675,437	746,709
Total other assets	6,786,511	6,809,290
Total Assets	\$26,456,466	\$32,076,746
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Short-term borrowings	\$ 2,876,311	\$ 5,004,494
Current portion of long-term debt	4,354,230	1,623,202
Accounts payable	1,025,245	3,077,926
Taxes accrued	215,680	172,449
Interest accrued	115,192	103,489
Dividends declared	110,811	110,893
Price risk management liabilities	718,228	4,442,811
Margin deposits from customers on energy trading activities	3,800	284,603
Accumulated deferred income taxes	415,591	309,008
Business purchase obligation	431,570	—
Other	348,041	610,379
Total current liabilities	10,614,699	15,739,254
Other Liabilities:		
Accumulated deferred income taxes	2,541,109	2,548,891
Unamortized investment tax credit	270,243	265,737
Price risk management liabilities	142,305	737,540
Benefit obligations	394,550	491,964
Business purchase obligation	596,303	—
Other	1,017,010	1,109,850
Total other liabilities	4,961,520	5,153,982
Long-term Debt	4,868,643	4,996,095
Commitments and Contingencies (Note 14)		
Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trusts Holding Solely Junior Subordinated Debentures of the Company	705,272	705,355
Stockholders' Equity	5,306,332	5,482,060
Total Liabilities and Stockholders' Equity	\$26,456,466	\$32,076,746

See Notes to the Company's Consolidated Financial Statements

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS
(Thousands of Dollars)

	Year Ended December 31,		
	1998	1999	2000
Cash Flows from Operating Activities:			
Net (loss) income attributable to common stockholders	\$ (141,482)	\$ 1,482,081	\$ 447,111
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	866,272	905,305	906,328
Deferred income taxes	(434,717)	625,211	(41,892)
Investment tax credit	(20,123)	(58,706)	(18,330)
(Gain) loss on AOL Time Warner investment	—	(2,452,406)	204,969
Loss (gain) on indexed debt securities	1,176,211	629,523	(101,851)
Extraordinary items	—	183,261	(7,445)
Undistributed losses (earnings) of unconsolidated subsidiaries	601	793	(24,931)
Proceeds from sale of debt securities	—	—	123,428
Impairment of marketable equity securities	—	—	26,504
Net cash (used in) provided by discontinued operations	(184,567)	(24,547)	437,620
Changes in other assets and liabilities:			
Accounts receivable, net	129,943	(325,777)	(1,933,033)
Inventory	(138,237)	51,480	(74,603)
Federal tax refund	140,532	—	86,155
Fuel cost over (under) recovery	125,104	73,567	(515,278)
Margin deposits on energy trading activities, net	42,630	(59,467)	(206,480)
Accounts payable	(98,249)	206,409	2,040,724
Other assets	(131,050)	(71,259)	(302,588)
Other liabilities	61,774	(89,417)	229,138
Other, net	32,426	33,487	70,078
Net cash provided by operating activities	<u>1,427,068</u>	<u>1,109,538</u>	<u>1,345,624</u>
Cash Flows from Investing Activities:			
Capital expenditures	(712,492)	(1,165,639)	(1,842,385)
Business acquisitions, net of cash acquired	(292,398)	(1,060,000)	(2,121,481)
Proceeds from sale-leaseback transactions	—	—	1,000,000
Payment of a business purchase obligation	—	—	(981,789)
Investment in AOL Time Warner securities	—	(537,055)	—
Investments in unconsolidated subsidiaries	(40,928)	(36,582)	(5,755)
Net cash (used in) provided by discontinued operations	(189,656)	(55,100)	641,768
Other, net	(2,677)	(21,543)	21,824
Net cash used in investing activities	<u>(1,238,151)</u>	<u>(2,875,919)</u>	<u>(3,287,818)</u>
Cash Flows from Financing Activities:			
Proceeds from long-term debt, net	1,267,107	2,060,680	1,092,373
Payments of long-term debt	(697,714)	(935,908)	(678,709)
Proceeds from sale of trust preferred securities, net	—	362,994	—
(Decrease) increase in short-term borrowings, net	(314,717)	822,468	2,170,314
Proceeds from sale of common stock	4,542	30,452	53,809
Payment of common stock dividends	(426,265)	(427,255)	(426,859)
Purchase of treasury stock	—	(90,708)	(27,306)
Net cash (used in) provided by discontinued operations	(10,555)	400	(120,173)
Other, net	(28,090)	(204)	(31,138)
Net cash (used in) provided by financing activities	<u>(205,692)</u>	<u>1,822,919</u>	<u>2,032,311</u>
Effect of Exchange Rate Changes on Cash	—	—	5,088
Net (Decrease) Increase in Cash and Cash Equivalents	(16,775)	56,538	95,205
Cash and Cash Equivalents at Beginning of Year	41,004	24,229	80,767
Cash and Cash Equivalents at End of Year	<u>\$ 24,229</u>	<u>\$ 80,767</u>	<u>\$ 175,972</u>
Supplemental Disclosure of Cash Flow Information:			
Cash Payments:			
Interest (net of amounts capitalized)	\$ 502,889	\$ 504,821	\$ 786,660
Income taxes	472,609	401,703	496,603

See Notes to the Company's Consolidated Financial Statements

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED STOCKHOLDERS' EQUITY
(Thousands of Dollars and Shares)

	1998		1999		2000	
	Shares	Amount	Shares	Amount	Shares	Amount
Preference Stock, none outstanding	—	\$ —	—	\$ —	—	\$ —
Cumulative Preferred Stock						
Balance, beginning of year	97	9,740	97	9,740	97	9,740
Balance, end of year	97	9,740	97	9,740	97	9,740
Common Stock, no par, authorized						
700,000,000 shares						
Balance, beginning of year	295,357	3,112,098	296,271	3,136,826	297,612	3,182,751
Issuances related to benefit and investment plans	914	24,734	1,341	46,062	2,302	74,447
Other	—	(6)	—	(137)	—	(8)
Balance, end of year	296,271	3,136,826	297,612	3,182,751	299,914	3,257,190
Treasury Stock						
Balance, beginning of year	(93)	(2,066)	(103)	(2,384)	(3,625)	(93,296)
Shares acquired	—	—	(3,524)	(90,708)	(1,184)	(27,306)
Other	(10)	(318)	2	(204)	(2)	(254)
Balance, end of year	(103)	(2,384)	(3,625)	(93,296)	(4,811)	(120,856)
Unearned ESOP stock						
Balance, beginning of year	(12,389)	(229,827)	(11,674)	(217,780)	(10,679)	(199,226)
Issuances related to benefit plan	715	12,047	995	18,554	2,040	38,068
Balance, end of year	(11,674)	(217,780)	(10,679)	(199,226)	(8,639)	(161,158)
Retained Earnings						
Balance, beginning of year		2,013,055		1,445,081		2,500,181
Net (loss) income		(141,482)		1,482,081		447,111
Common stock dividends — \$1.50 per share		(426,492)		(426,981)		(426,942)
Balance, end of year		1,445,081		2,500,181		2,520,350
Accumulated Other Comprehensive Loss						
Balance, beginning of year		(6,455)		(49,615)		(93,818)
Foreign currency translation adjustments from continuing operations		—		(587)		(1,220)
Foreign currency translation adjustments from discontinued operations		(32,790)		(42,392)		(30,405)
Reclassification adjustment for foreign currency translation losses realized in net income		—		—		106,408
Unrealized loss on available-for-sale securities		(10,370)		(1,224)		(2,264)
Reclassification adjustment for impairment loss on available-for-sale securities realized in net income		—		—		17,228
Additional minimum non-qualified pension liability adjustment		—		—		(19,135)
Balance, end of year		(49,615)		(93,818)		(23,206)
Total Stockholders' Equity		<u>\$4,321,868</u>		<u>\$5,306,332</u>		<u>\$5,482,060</u>

See Notes to the Company's Consolidated Financial Statements

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Background and Basis of Presentation

Reliant Energy, Incorporated (Reliant Energy), formerly Houston Industries Incorporated, together with its subsidiaries (collectively, the Company), is a diversified international energy services company that provides energy and energy services in North America and Western Europe. Reliant Energy is both an electric utility company and a utility holding company.

The Company's financial reporting segments include the following: Electric Operations, Natural Gas Distribution, Pipelines and Gathering, Wholesale Energy, European Energy, and Other Operations. Electric Operations includes the operations of Reliant Energy HL&P, an electric utility. Natural Gas Distribution consists of intrastate natural gas sales to, and natural gas transportation for, residential, commercial and industrial customers and some non-rate regulated retail gas marketing operations. Pipelines and Gathering includes the interstate natural gas pipeline operations and the natural gas gathering and pipelines services businesses. Wholesale Energy is engaged in the acquisition, development and operation of non-rate regulated power generation facilities as well as the wholesale energy trading, marketing, power origination and risk management services in North America. European Energy is engaged in the operation of power generation facilities in the Netherlands as well as wholesale energy trading and marketing operations in Western Europe. Other Operations includes unallocated general corporate expenses, unregulated retail electric operations, a communications business, an eBusiness group and non-operating investments.

Effective December 1, 2000, Reliant Energy's Board of Directors approved a plan to dispose of the Latin America business segment through sales of its Latin American assets. Accordingly, the Company is reporting the results of the Company's Latin America business segment as discontinued operations for all periods presented in the Consolidated Financial Statements in accordance with Accounting Principles Board Opinion No. 30. For information regarding the disposal of the Latin America business segment, see Note 19.

On July 27, 2000, Reliant Energy announced its intention to form a company, Reliant Resources, Inc. (Reliant Resources), to own and operate a substantial portion of the Company's unregulated operations and to offer no more than 20% of the common stock of Reliant Resources in an initial public offering (Offering). Reliant Energy expects the Offering to be followed by a distribution to Reliant Energy's or its successor's shareholders of the remaining common stock of Reliant Resources (Distribution) within twelve months of the Offering. For additional information, see Note 4(b).

(2) Summary of Significant Accounting Policies

(a) Reclassifications and Use of Estimates.

Some amounts from the previous years have been reclassified to conform to the 2000 presentation of financial statements. These reclassifications do not affect earnings.

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

(b) Market Risk and Uncertainties.

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

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

(c) Principles of Consolidation.

The accounts of Reliant Energy and its wholly owned and majority owned subsidiaries are included in the Consolidated Financial Statements. All significant intercompany transactions and balances are eliminated in consolidation. The Company accounts for investments in entities in which the Company has an ownership interest between 20% and 50% and exercises significant influence using the equity method of accounting. For additional information regarding investments recorded using the equity method of accounting, see Note 7. Other investments, excluding marketable securities, are generally carried at cost.

(d) Revenues.

The Company records revenue for electricity and natural gas sales and services under the accrual method and these revenues are generally recognized upon delivery. Pipelines and Gathering record revenues as transportation services are provided. Energy sales and services not billed by month-end are accrued based upon estimated energy and services delivered. Domestic non-rate regulated electric power and other non-rate regulated energy services are sold at market-based prices through existing power exchanges or through third-party contracts. Energy revenues related to the Company's power generation facilities in Europe were generated under a regulated pricing structure, which includes compensation for the cost of fuel, capital and operation and maintenance expenses. The electric generation market in the Netherlands opened to wholesale competition on January 1, 2001. The Company's energy trading and marketing operations are accounted for under mark-to-market accounting as discussed in Note 5.

(e) Long-lived Assets and Intangibles.

The Company records property, plant and equipment at historical cost. The Company recognizes repair and maintenance costs incurred in connection with planned major maintenance, such as turbine and generator overhauls, control system upgrades and air conditioner replacements, under the "accrual in advance" method for its non-rate regulated power generation operations acquired or developed prior to December 31, 1999. Planned major maintenance cycles primarily range from two to ten years. Under the accrual in advance method, the Company estimates the costs of planned major maintenance and accrues the related expense over the maintenance cycle. As of December 31, 1999 and 2000, the Company's maintenance reserve was \$48 million and \$27 million, respectively, of which \$46 million and \$20 million, respectively, were included in other long-term liabilities and the remainder in other current liabilities. The Company expenses all other repair and maintenance costs as incurred. Property, plant and equipment includes the following:

	<u>Estimated Useful Lives (Years)</u>	<u>December 31,</u>	
		<u>1999</u>	<u>2000</u>
(in millions)			
Electric	1-58	\$16,598	\$18,754
Natural gas distribution	5-50	1,696	1,809
Pipelines and gathering	5-75	1,555	1,582
Other property	3-40	<u>140</u>	<u>247</u>
Total		19,989	22,392
Accumulated depreciation		<u>(6,855)</u>	<u>(7,132)</u>
Property, plant and equipment, net		<u>\$13,134</u>	<u>\$15,260</u>

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

The Company records goodwill for the excess of the purchase price over the fair value assigned to the net assets of an acquisition. Goodwill is amortized on a straight-line basis over 10 to 40 years. See Note 3 and the following table for additional information regarding goodwill and the related amortization periods.

	Estimated Useful Lives (Years)	December 31,	
		1999	2000
		(in millions)	
Reliant Energy Resources Corp. (RERC Corp.)	40	\$2,112	\$2,086
Reliant Energy Mid-Atlantic Power Holdings, LLC	35	—	7
N.V. UNA	30	897	897
Other	10-35	112	136
Total		3,121	3,126
Accumulated amortization		(136)	(222)
Foreign currency exchange impact		(61)	(107)
Total Goodwill, net		<u>\$2,924</u>	<u>\$2,797</u>

The Company recognizes specifically identifiable intangibles, including air emissions regulatory allowances, water rights and permits, when specific rights and contracts are acquired. As of December 31, 1999 and 2000, specific intangibles were \$118 million and \$284 million, respectively. The Company amortizes air emissions regulatory allowances primarily on a units-of-production basis as utilized. The Company amortizes other acquired intangibles on a straight-line basis over the lesser of their contractual or estimated useful lives that range between 20 and 35 years.

The Company periodically evaluates long-lived assets, including property, plant and equipment, goodwill and specifically identifiable intangibles, when events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. The determination of whether an impairment has occurred is based on an estimate of undiscounted cash flows attributable to the assets, as compared to the carrying value of the assets. To date, no impairment has been indicated, except as discussed in Note 4(a).

(f) Regulatory Assets.

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

The following is a list of regulatory assets/liabilities reflected on the Company's Consolidated Balance Sheets as of December 31, 1999 and 2000.

	December 31,	
	1999	2000
	(in millions)	
Recoverable impaired plant costs, net	\$ 587	\$ 281
Recoverable electric generation related regulatory assets, net	952	1,385
Regulatory tax liability, net	(45)	(49)
Unamortized loss on reacquired debt	69	66
Other long-term assets/liabilities	(14)	6
Total	<u>\$1,549</u>	<u>\$1,689</u>

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

Included in the above table are \$191 million and \$237 million of regulatory liabilities recorded as other long-term liabilities in the Company's Consolidated Balance Sheets as of December 31, 1999 and 2000, respectively, which primarily relate to the recovery of fuel costs as of December 31, 1999, and gains on nuclear decommissioning trust funds, regulatory tax liabilities and excess deferred income taxes as of December 31, 1999 and 2000.

Under a "deferred accounting" plan authorized by the Public Utility Commission of Texas (Texas Utility Commission), Electric Operations was permitted for regulatory purposes to accrue carrying costs in the form of allowance for funds used during construction (AFUDC) on its investment in the South Texas Project Electric Generating Station (South Texas Project) and to defer and capitalize depreciation and other operating costs on its investment after commercial operation until these costs were reflected in rates. In addition, the Texas Utility Commission authorized Electric Operations to defer allowable costs (including return) for future recovery. Pursuant to SFAS No. 92, "Regulated Enterprises — Accounting for Phase-in Plans," the Company deferred these costs. These costs are included in recoverable electric generation related regulatory assets. The amortization of all deferred plant costs (which totaled \$26 million for 1998) is included in the Company's Statements of Consolidated Operations as depreciation and amortization expense. Pursuant to the Legislation, see Note 4(a), the Company discontinued amortizing deferred plant costs effective January 1, 1999.

In 1998, 1999 and 2000, the Company, as permitted by the 1995 rate case settlement (Rate Case Settlement), also amortized \$4 million, \$22 million and \$11 million, respectively, of its investment in lignite reserves associated with a canceled generating station. The investment in these reserves was fully amortized during 2000.

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

If, as a result of changes in regulation or competition, the Company's ability to recover these assets and liabilities would not be assured, then pursuant to SFAS No. 101, "Regulated Enterprises Accounting for the Discontinuation of Application of SFAS No. 71" (SFAS No. 101) and SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" (SFAS No. 121), the Company would be required to write off or write down these regulatory assets and liabilities. In addition, the Company would be required to determine any impairment to the carrying costs of plant and inventory assets.

(g) Depreciation and Amortization Expense.

Depreciation is computed using the straight-line method based on economic lives or a regulatory mandated method. Depreciation for 1998, 1999 and 2000 was \$558 million, \$547 million and \$391 million, respectively. Amortization of goodwill for the same periods was \$55 million, \$62 million and \$86 million, respectively. Other amortization expense, including amortization of regulatory assets and air emissions regulatory allowances and other intangibles, was \$253 million, \$296 million and \$429 million in 1998, 1999 and 2000, respectively.

For information regarding amortization of deferred plant costs, investments in lignite reserves and amortization of recoverable impaired plant costs included in regulatory assets in the Company's Consolidated Balance Sheets, see Notes 2(f) and 4(a).

In June 1998, the Texas Utility Commission issued an order approving a transition to competition plan (Transition Plan) filed by Electric Operations in December 1997. In order to reduce Electric Operations' exposure to potentially stranded costs related to generation assets, the Transition Plan permitted the redirection of depreciation expense to generation assets that Electric Operations otherwise would apply to transmission, distribution and general plant assets. In addition, the Transition Plan provided that all earnings above a stated overall annual rate of return on invested capital be used to recover Electric Operations'

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

investment in generation assets. Electric Operations implemented the Transition Plan effective January 1, 1998 and pursuant to its terms, recorded an aggregate of \$104 million in additional depreciation and \$99 million in redirected depreciation for the first six months in 1999 and \$194 million in additional depreciation and \$195 million in redirected depreciation in 1998. Due to the discontinuance of SFAS No. 71 to Electric Operations' generation operations, the provisions for additional and redirected depreciation of the Transition Plan are no longer applied effective June 30, 1999. For additional information regarding the discontinuance of SFAS No. 71 to the Electric Operations' generation operations and the related legislation, see Note 4(a).

Pursuant to the Legislation, the Company is allowed to recover the generation related regulatory assets recorded as of December 31, 1998. Therefore, the Company discontinued amortizing some generation related regulatory assets effective as of January 1, 1999.

In connection with the discontinuation of SFAS No. 71 in June 1999, the Company reassessed the economic lives of Reliant Energy HL&P's generation plant and equipment in the fourth quarter of 1999. Some prospective depreciation rates were revised as a result of the Legislation. These changes in depreciation rates reduced depreciation expense for Reliant Energy HL&P's generation plant and equipment by \$40 million in 2000. The effect on both basic and diluted earnings per share for 2000 was \$0.09.

(h) Capitalization of Interest.

Interest and AFUDC related to debt for subsidiaries that apply SFAS No. 71 are capitalized as a component of projects under construction and will be amortized over the assets' estimated useful lives. During 1998, 1999 and 2000, the Company capitalized interest and AFUDC related to debt of \$6 million, \$19 million and \$45 million, respectively.

(i) Income Taxes.

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

(j) Allowance for Doubtful Accounts.

Accounts receivable, principally from customers, are net of an allowance for doubtful accounts of \$34 million and \$105 million at December 31, 1999 and 2000, respectively. The provision for doubtful accounts in the Company's Statements of Consolidated Operations for 1998, 1999 and 2000 was \$21 million, \$16 million and \$95 million, respectively. For information regarding the provision against receivable balances related to energy sales in the California market, see Note 14(h).

(k) Inventory.

Inventory consists principally of materials and supplies, coal and lignite, natural gas and heating oil. Inventories used in the production of electricity and in the retail natural gas distribution operations are valued at the lower of average cost or market except for coal and lignite, which are valued under the last-in, first-out

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

method. Heating oil and natural gas used in the trading and marketing operations are accounted for under mark-to-market accounting as discussed in Note 5. Below is a detail of inventory:

	December 31,	
	1999	2000
	(in millions)	
Materials and supplies	\$188	\$270
Coal and lignite	46	59
Natural gas	93	107
Heating oil	13	47
Total inventory	\$340	\$483

(1) Investment in Other Debt and Equity Securities.

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

As of December 31, 1999 and 2000, the Company held "available-for-sale" debt and equity securities in its nuclear decommissioning trust, which is reported at its fair value of \$145 million and \$159 million, respectively, in the Company's Consolidated Balance Sheets in other long-term assets. Any unrealized losses or gains are accounted for in accordance with SFAS No. 71 as a regulatory asset/liability.

In addition, as of December 31, 1999 and 2000, the Company held marketable equity securities of \$9 million and \$5 million, respectively, classified as "available-for-sale." At December 31, 1999 and 2000, the accumulated unrealized loss, net of tax, relating to these equity securities was \$17 million and \$2 million, respectively. During 2000, pursuant to SFAS No. 115, the Company incurred a pre-tax impairment loss equal to the \$27 million of cumulative unrealized losses for these securities, which was recorded in other income (expense) in the Company's Statement of Consolidated Operations. Management's determination to recognize this impairment resulted from a combination of events occurring in 2000 related to this investment. These events affecting the investment included changes occurring in the investment's senior management, announcement of significant restructuring charges and related downsizing for the entity, reduced earnings estimates for this entity by brokerage analysts and the bankruptcy of a competitor of the investment in the first quarter of 2000. These events, coupled with the stock market value of the Company's investment in these securities continuing to be below the Company's cost basis, caused management to believe the decline in fair value of these "available-for-sale" securities to be other than temporary.

As of December 31, 1999 and 2000, the Company held an investment in Time Warner Inc. (now AOL Time Warner, Inc.) common stock, which was classified as a "trading" security. For information regarding the Company's investment in AOL Time Warner, Inc. common stock, see Note 8.

As of December 31, 1999, the Company held \$129 million of debt securities that were classified as "trading." This investment was recorded in other assets in the Company's Consolidated Balance Sheets as of December 31, 1999. In addition, as of December 31, 1999, the Company held \$14 million of other equity securities that were classified as "trading." The Company held no investments classified as "trading" as of December 31, 2000, except as discussed above. For these securities, the Company recorded unrealized holding gains in other income in the Company's Statements of Consolidated Operations of \$7 million and \$6 million for 1999 and 2000, respectively. No unrealized gains or losses on "trading" securities were recorded in 1998.

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

(m) Project Development Costs.

Project development costs include costs for professional services, permits and other items that are incurred incidental to a particular project. The Company expenses these costs as incurred until the project is considered probable. After a project is considered probable, capitalizable costs incurred are capitalized to the project. When project operations begin, the Company begins to amortize these costs on a straight-line basis over the life of the facility. As of December 31, 1999 and 2000, the Company had recorded in the Company's Consolidated Balance Sheets project development costs of \$3 million and \$7 million, respectively.

(n) Environmental Costs.

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

(o) Foreign Currency Adjustments.

Local currencies are the functional currency of the Company's foreign continuing operations. Foreign subsidiaries' assets and liabilities have been translated into U.S. dollars using the exchange rate at the balance sheet date. Revenues, expenses, gains and losses have been translated using the weighted average exchange rate for each month prevailing during the periods reported. Cumulative adjustments resulting from translation have been recorded in stockholders' equity in other comprehensive income (loss).

(p) Statements of Consolidated Cash Flows.

For purposes of reporting cash flows, the Company considers cash equivalents to be short-term, highly liquid investments readily convertible to cash.

(q) Changes in Accounting Principles.

In March 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This statement requires capitalization of some costs of internal-use software. The Company adopted SOP 98-1 in the second quarter of 1998 without a material impact on the Company's results of operations or financial position.

The AICPA's SOP 98-5, "Reporting on the Costs of Start-Up Activities," was adopted by the Company in the fourth quarter of 1998. This statement requires that certain costs of start-up activities and organizational costs be expensed as incurred. The adoption of SOP 98-5 did not have a material impact on the Company's results of operations or financial position.

The Company adopted Emerging Issues Task Force Issue (EITF) 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" (EITF 98-10), on January 1, 1999. The adoption of EITF 98-10 had no material impact on the Company's results of operations or financial position.

Staff Accounting Bulletin No. 101, "Revenue Recognition" (SAB No. 101), was issued by the Securities and Exchange Commission (SEC) on December 3, 1999. SAB No. 101 summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition in financial

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statements. During 2000, the Company implemented SAB No. 101 without a material impact on the Company's results of operations or financial position.

(r) New Accounting Pronouncements.

Effective January 1, 2001, the Company was required to adopt SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended (SFAS No. 133), which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. This statement requires that derivatives be recognized at fair value in the balance sheet and that changes in fair value be recognized either currently in earnings or deferred as a component of other comprehensive income, depending on the intended use of the derivative, its resulting designation and its effectiveness. In addition, in June 2000, the Financial Accounting Standards Board (FASB) issued an amendment that narrows the applicability of the pronouncement to some purchase and sales contracts and allows hedge accounting for some other specific hedging relationships. Adoption of SFAS No. 133 resulted in an after-tax increase in net income of \$62 million and a cumulative after-tax increase in accumulated other comprehensive loss of \$252 million in the first quarter of 2001. The adoption also increased current assets, long-term assets, current liabilities and long-term liabilities by \$703 million, \$252 million, \$805 million and \$340 million, respectively, in the Company's Consolidated Balance Sheet. The Company will also reclassify \$788 million from the current portion of long-term debt to other current liabilities due to the adoption. For information regarding the effect of adoption of SFAS No. 133 on the Company's indexed debt obligation, see Note 8(c).

The total impact of our adoption of SFAS No. 133 on earnings and accumulated other comprehensive loss is dependent upon certain pending interpretations, which are currently under consideration, including those related to the "normal purchases and normal sales." The interpretations of this issue, and others, are currently under consideration by the FASB. While the ultimate conclusions reached on interpretations being considered by the FASB could impact the effects of its adoption of SFAS No. 133, the Company does not believe that such conclusions would have a material effect on its current estimate of the impact of the adoption.

(3) Business Acquisitions

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

On May 12, 2000, a subsidiary of the Company purchased entities owning electric power generating assets and development sites located in Pennsylvania, New Jersey and Maryland having an aggregate net generating capacity of approximately 4,262 megawatts (MW). With the exception of development entities that were sold to another subsidiary of the Company in July 2000, the assets of the entities acquired are held by Reliant Energy Mid-Atlantic Power Holdings, LLC (REMA). The purchase price for the May 2000 transaction was \$2.1 billion, subject to post-closing adjustments which management does not believe will be material. The Company accounted for the acquisition as a purchase with assets and liabilities of REMA reflected at their estimated fair values. On a preliminary basis, the Company's fair value adjustments related to the acquisition primarily included adjustments in property, plant and equipment, air emissions regulatory allowances, materials and supplies inventory, environmental reserves and related deferred taxes. The air emissions regulatory allowances of \$153 million are being amortized on a units-of-production basis as utilized. The excess of the purchase price over the fair value of net assets acquired of \$7 million was recorded as goodwill and is being amortized over 35 years. The Company expects to finalize these fair value adjustments no later than May 2001, based on valuation reports of property, plant and equipment and intangible assets, and does not anticipate additional material modifications to the preliminary adjustments. Funds for the acquisition of REMA were made available through commercial paper borrowings by a finance subsidiary, which borrowings were supported by bank credit facilities.

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

	<u>Purchase Price Allocation</u>	<u>Fair Value Adjustments</u>
Current assets	\$ 75	\$ (37)
Property, plant and equipment	1,941	670
Goodwill	7	(144)
Other intangibles	153	(10)
Other assets	4	(4)
Current liabilities	(45)	(8)
Other liabilities	(38)	(14)
	<u>\$2,097</u>	<u>\$ 453</u>

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

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

The Company's results of operations include the results of REMA only for the period beginning May 12, 2000. Prior to November 24, 1999, the acquired entities' operations were fully integrated with, and their results of operations were consolidated into, the regulated electric utility operations of a prior owner of the facilities. In addition, prior to November 24, 1999, the electric output of the facilities was sold based on rates set by regulatory authorities and is not indicative of REMA's future results. The following table presents selected actual financial information and unaudited pro forma information for 1999 and 2000, as if the acquisition had occurred on November 24, 1999 and January 1, 2000, as applicable. Pro forma information prior to November 24, 1999 would not be meaningful since historical financial results of the business and the revenue generating activities underlying that period as described above are substantially different from the wholesale generation activities that REMA has been engaged in after November 24, 1999. Pro forma amounts

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also give effect to the sale and leaseback of interests in three of the REMA generating plants, which were consummated in August 2000.

	Year Ended December 31,			
	1999		2000	
	Actual	Unaudited Pro forma	Actual	Unaudited Pro forma
	(in millions, except per share amounts)			
Revenues	\$15,223	\$15,253	\$29,339	\$29,506
Income from continuing operations before extraordinary items	1,674	1,664	771	762
Net income attributable to common stockholders	1,482	1,472	447	438
Basic earnings per share from continuing operations before extraordinary items	5.87	5.84	2.71	2.68
Diluted earnings per share from continuing operations before extraordinary items	5.85	5.82	2.68	2.65
Basic earnings per share	5.20	5.16	1.57	1.54
Diluted earnings per share	5.18	5.15	1.56	1.53

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

(b) N.V. UNA.

Effective October 7, 1999, the Company acquired N.V. UNA (UNA), a Dutch electric generation company, for a total net purchase price, payable in Dutch Guilders (NLG), of \$1.9 billion based on an exchange rate on October 7, 1999 of 2.06 NLG per U.S. dollar. The aggregate purchase price paid in 1999 by the Company consisted of \$833 million in cash. On March 1, 2000, under the terms of the acquisition agreement, the Company funded the remaining purchase obligation for \$982 million. The business purchase obligation was recorded in the Company's Consolidated Balance Sheet as of December 31, 1999, based on the exchange rate on December 31, 1999, of 2.19 NLG per U.S. dollar. A portion (\$596 million) of the business purchase obligation was classified as a non-current liability, as this portion of the obligation was financed with a three-year term loan facility obtained in the first quarter of 2000.

The Company recorded the UNA acquisition under the purchase method of accounting, with assets and liabilities of UNA reflected at their estimated fair values. As outlined in the table below, the Company's fair value adjustments related to the acquisition of UNA primarily included increases in property, plant and equipment, long-term debt, severance liabilities, post-employment benefit liabilities and deferred foreign taxes. Additionally, a \$19 million receivable was recorded in connection with the acquisition as the selling shareholders agreed to reimburse UNA for some obligations incurred prior to the purchase of UNA. Adjustments to property, plant and equipment are based primarily on valuation reports prepared by independent appraisers and consultants. The excess of the purchase price over the fair value of net assets acquired of \$897 million was recorded as goodwill and will be amortized on a straight-line basis over 30 years. The Company finalized these fair value adjustments during September 2000. The Company finalized a severance plan (UNA Plan) in connection with the UNA acquisition in September 2000 (commitment date) and in accordance with EITF 95-3 "Recognition of Liabilities in Connection with a Purchase Business Combination," recorded this liability of \$19 million in the third quarter of 2000. Payments under the UNA Plan will be primarily made in mid-2001.

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In connection with the acquisition of UNA, the Company developed a comprehensive business process reengineering and employee severance plan intended to make UNA competitive in the deregulated Dutch electricity market that began January 1, 2001. The UNA Plan's initial conceptual formulation was initiated prior to the acquisition of UNA in October 1999. The finalization of the UNA Plan was approved and completed in September 2000. The Company identified 195 employees who will be involuntarily terminated in UNA's following functional areas: plant operations and maintenance, procurement, inventory, general and administrative, legal, finance and support. The Company has notified all employees identified under the severance component of the UNA Plan that they are subject to involuntary termination and that the majority of terminations will occur over a period not to exceed twelve months from the date of finalization of the UNA Plan. The termination benefits under the UNA Plan are governed by UNA's Social Plan, a collective bargaining agreement between UNA and its various representative labor unions signed in 1998. The Social Plan provides defined benefits for involuntarily severed employees, depending upon age, tenure and other factors, and was agreed to by the management of UNA as a result of the anticipated deregulation of the Dutch electricity market. The Social Plan is still in force and binding on the current management of the Company and UNA. The Company is currently executing the UNA Plan as of the date of these Consolidated Financial Statements.

The net purchase price of UNA was allocated and the fair value adjustments to the seller's book value are as follows (in millions):

	<u>Purchase Price Allocation</u>	<u>Fair Value Adjustments</u>
Current assets	\$ 229	\$ 19
Property, plant and equipment	1,899	719
Goodwill	897	897
Current liabilities	(336)	—
Deferred taxes	(81)	(81)
Long-term debt	(422)	(87)
Other long-term liabilities	(244)	(35)
	<u>\$1,942</u>	<u>\$1,432</u>

The following table presents selected actual financial information for 1998 and 1999, and unaudited pro forma information for 1998 and 1999, as if the acquisition of UNA had occurred on January 1, 1998 and 1999, respectively. The unaudited pro forma results are based on assumptions deemed appropriate by the Company's management, have been prepared for informational purposes only and are not necessarily indicative of the consolidated results that would have resulted if the acquisition of UNA had occurred on January 1, 1998 and 1999, as applicable. Purchase related adjustments to results of operations include amortization of goodwill,

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interest expense and the effects on depreciation and amortization of the assessed fair value of some of UNA's net assets and liabilities.

	Year Ended December 31,			
	1998		1999	
	Actual	Unaudited Pro forma	Actual	Unaudited Pro forma
	(in millions, except per share amounts)			
Revenues	\$11,230	\$12,062	\$15,223	\$15,704
Income from continuing operations before extraordinary item				
item	(278)	(227)	1,674	1,648
Net (loss) income attributable to common stockholders	(141)	(90)	1,482	1,455
Basic earnings per share from continuing operations before extraordinary item	(0.98)	(0.80)	5.87	5.78
Diluted earnings per share from continuing operations before extraordinary item	(0.98)	(0.80)	5.85	5.76
Basic earnings per share	(0.50)	(0.32)	5.20	5.11
Diluted earnings per share	(0.50)	(0.32)	5.18	5.09

(4) Regulatory Matters

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

In June 1999, the Texas legislature adopted the Legislation, which substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail electric competition. Retail pilot projects for up to 5% of each utility's load in all customer classes will begin in June 2001, and retail electric competition for all other customers will begin on January 1, 2002. In preparation for that competition, the Company expects to make significant changes in the electric utility operations it conducts through its electric utility division, Reliant Energy HL&P. In addition, the Legislation requires the Texas Utility Commission to issue a number of new rules and determinations in implementing the Legislation.

The Legislation defines the process for competition and creates a transition period during which most utility rates are frozen at rates not in excess of their present levels. The Legislation provides for utilities to recover their generation related stranded costs and regulatory assets (as defined in the Legislation).

Retail Choice. Under the Legislation, on January 1, 2002, retail customers of most investor owned electric utilities in Texas will be entitled to purchase their electricity from any of a number of "retail electric providers," which will have been certified by the Texas Utility Commission. Retail electric providers will not own or operate generation assets and their sales rates will not be subject to traditional cost-of-service rate regulation. Retail electric providers that are affiliates of electric utilities may compete substantially statewide for these sales, but rates they charge within the affiliated electric utility's traditional service territory are subject to some limitations at the outset of retail choice, as described below. The Texas Utility Commission will prescribe regulations governing quality, reliability and other aspects of service from retail electric providers. Transactions between the regulated utility and its current and future competitive affiliates are subject to regulatory scrutiny and must comply with a code of conduct established by the Texas Utility Commission. The code of conduct governs interactions among employees of regulated and current and future unregulated affiliates as well as the exchange of information between these affiliates. The Company intends to compete in the Texas retail market and, as a result, has certified two of its subsidiaries as retail electric providers.

Unbundling. By January 1, 2002, electric utilities in Texas such as Reliant Energy HL&P will restructure their businesses in order to separate power generation, transmission and distribution, and retail activities into different units. Pursuant to the Legislation, the Company submitted a plan in January 2000 that was later amended to accomplish the required separation (the Business Separation Plan). For additional

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information regarding the Business Separation Plan, see Note 4(b). The transmission and distribution business will continue to be subject to cost-of-service rate regulation and will be responsible for the delivery of electricity to retail customers.

Generation. Power generators will sell electric energy to wholesale purchasers, including retail electric providers, at unregulated rates beginning January 1, 2002. To facilitate a competitive market, each power generation company affiliated with a transmission and distribution utility will be required to sell at auction 15% of the output of its installed generating capacity. The first auction will be held on or before September 1, 2001 for power delivered after January 1, 2002. This obligation continues until January 1, 2007 unless before that date the Texas Utility Commission determines at least 40% of the quantity of electric power consumed in 2000 by residential and small commercial load in the electric utility's service area is being served by retail electric providers other than the affiliated retail electric provider. See Note 4(b) for information regarding the capacity auctions and the effect of the Business Separation Plan on the Company. The Legislation also creates a program mandating air emissions reductions for non-permitted generating facilities. The Company anticipates that any stranded costs associated with this obligation incurred before May 1, 2003 will be recoverable through the stranded costs recovery mechanisms contained in the Legislation.

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

Stranded Costs. Reliant Energy HL&P will be entitled to recover its stranded costs (*i.e.*, the excess of net book value of generation assets (as defined by the Legislation) over the market value of those assets) and its regulatory assets related to generation. The Legislation prescribes specific methods for determining the amount of stranded costs and the details for their recovery. However, during the base rate freeze period from 1999 through 2001, earnings above the utility's authorized return formula will be applied in a manner to accelerate depreciation of generation related plant assets for regulatory purposes. In addition, depreciation expense for transmission and distribution related assets may be redirected to generation assets for regulatory purposes during that period.

The Texas Utility Commission has recently stated on record that it would consider requiring electric utilities to reverse the amount of redirected depreciation and accelerated depreciation previously taken if in its estimation the utility has overmitigated its stranded costs. The reversal could occur through a lower rate for the transmission and distribution utility and/or through credits contained in the transmission and distribution utility's rate. Any order requiring the reversal of these amounts would likely be included in the Texas Utility Commission proceeding establishing the initial rate of the transmission and distribution utility. The Company does not expect the final Reliant Energy HL&P transmission and distribution rate to be established until August 2001. For information regarding redirected depreciation, see "Accounting" in this Note 4(a).

The Legislation provides for Reliant Energy HL&P, or a special purpose entity, to issue securitization bonds for the recovery of generation related regulatory assets and a portion of stranded costs. These bonds will be sold to third parties and will be amortized through non-bypassable charges to transmission and distribution customers. Any stranded costs not recovered through the securitization bonds will be recovered through a non-bypassable charge to transmission and distribution customers. Costs associated with nuclear decommissioning

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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 non-bypassable charge to transmission and distribution customers. For further discussion of the effect of the Business Separation Plan on funding of the nuclear decommissioning trust fund, see Note 4(b).

In May 2000, the Texas Utility Commission issued a financing order to the Company authorizing the issuance of transition bonds in an amount not to exceed \$740 million plus actual up-front qualified costs. Payments on the transition bonds will be made out of funds derived from non-bypassable transition charges to Reliant Energy HL&P's transmission and distribution customers. The offering of the transition bonds will be registered under the Securities Act of 1933 and is expected to be consummated during 2001.

Capacity Auction True-up. In accordance with the Legislation, beginning on January 1, 2002, and ending when the true-up proceeding is completed, any difference between market power prices received in the generation capacity auction and the Texas Utility Commission's earlier estimates of those market prices will be included in the 2004 stranded costs true-up, as further discussed below. This component of the true-up is intended to ensure that neither the customers nor the Company are disadvantaged economically as a result of the two-year transition period by providing this pricing structure. For information regarding the effect of the Business Separation Plan on the generation capacity auctions, see Note 4(b).

Accounting. Historically, Reliant Energy HL&P has applied the accounting policies established in SFAS No. 71. In general, SFAS No. 71 permits a company with cost-based rates to defer some costs that would otherwise be expensed to the extent that it meets the following requirements: (a) its rates are regulated by a third-party; (b) its rates are cost-based; and (c) there exists a reasonable assumption that all costs will be recoverable from customers through rates. When a company determines that it no longer meets the requirements of SFAS No. 71, pursuant to SFAS No. 101 and SFAS No. 121, it is required to write off regulatory assets and liabilities unless some form of recovery continues through rates established and collected from remaining regulated operations. In addition, such company is required to determine any impairment to the carrying costs of deregulated plant and inventory assets in accordance with SFAS No. 121.

In July 1997, the EITF reached a consensus on Issue No. 97-4, "Deregulation of the Pricing of Electricity — Issues Related to the Application of FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises Accounting for the Discontinuation of Application of FASB Statement No. 71" (EITF No. 97-4). EITF No. 97-4 concluded that a company should no longer apply SFAS No. 71 to a segment which is subject to a deregulation plan at the time the deregulation legislation or enabling rate order contains sufficient detail for the utility to reasonably determine how the plan will affect the segment to be deregulated. In addition, EITF No. 97-4 requires that regulatory assets and liabilities be allocated to the applicable portion of the electric utility from which the source of the regulated cash flows will be derived.

The Company believes that the Legislation provides sufficient detail regarding the deregulation of the Company's electric generation operations to require it to discontinue the use of SFAS No. 71 for those operations. Effective June 30, 1999, the Company applied SFAS No. 101 to Reliant Energy HL&P's electric generation operations. Reliant Energy HL&P's transmission and distribution operations continue to meet the criteria of SFAS No. 71.

In 1999, the Company evaluated the effects that the Legislation would have on the recovery of its generation related regulatory assets and liabilities. The Company determined that a pre-tax accounting loss of \$282 million existed because it believes only the economic value of its generation related regulatory assets (as defined by the Legislation) will be recovered. Therefore, the Company recorded a \$183 million after-tax extraordinary loss in the fourth quarter of 1999. If events were to occur that made the recovery of some of the remaining generation related regulatory assets no longer probable, the Company would write off the remaining balance of such assets as a non-cash charge against earnings. Pursuant to EITF No. 97-4, the remaining

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recoverable regulatory assets will not be written off and will become associated with the transmission and distribution portion of the Company's electric utility business. For details regarding Reliant Energy HL&P's regulatory assets, see Note 2(f).

At June 30, 1999, the Company performed an impairment test of its previously regulated electric generation assets pursuant to SFAS No. 121 on a plant specific basis. Under SFAS No. 121, an asset is considered impaired, and should be written down to fair value, if the future undiscounted net cash flows expected to be generated by the use of the asset are insufficient to recover the carrying amount of the asset. For assets that are impaired pursuant to SFAS No. 121, the Company determined the fair value for each generating plant by estimating the net present value of future cash inflows and outflows over the estimated life of each plant. The difference between fair value and net book value was recorded as a reduction in the current book value. The Company determined that \$797 million of electric generation assets were impaired as of June 30, 1999. Of these amounts, \$745 million related to the South Texas Project and \$52 million related to two gas-fired generation plants. The Legislation provides for recovery of this impairment through regulated cash flows during the transition period and through non-bypassable charges to transmission and distribution customers. As such, a regulatory asset has been recorded for an amount equal to the impairment loss and is included on the Company's Consolidated Balance Sheets as a regulatory asset. The Company recorded amortization expense related to the recoverable impaired plant costs and other assets created from discontinuing SFAS No. 71 of \$221 million in the third and fourth quarters of 1999 and \$329 million in 2000. The Company expects to fully amortize this regulatory asset as it is recovered from regulated cash flows in 2001.

The impairment analysis requires estimates of possible future market prices, load growth, competition and many other factors over the lives of the plants. The resulting impairment loss is highly dependent on these underlying assumptions. In addition, after January 10, 2004, Reliant Energy HL&P must finalize and reconcile stranded costs (as defined by the Legislation) in a filing with the Texas Utility Commission. Any positive difference between the regulatory net book value and the fair market value of the generation assets (as defined by the Legislation) will be collected through future non-bypassable charges. Any over-mitigation of stranded costs may be refunded through future non-bypassable charges. This final reconciliation allows alternative methods of third party valuation of the fair market value of these assets, including outright sale, stock valuations and asset exchanges. Because generally accepted accounting principles require the Company to estimate fair market values on a plant-by-plant basis in advance of the final reconciliation, the financial impacts of the Legislation with respect to the final determination of stranded costs in 2004 are subject to material changes. Factors affecting such change may include estimation risk, uncertainty of future energy and commodity prices and the economic lives of the plants. If events occur that make the recovery of all or a portion of the regulatory assets associated with the generation plant impairment loss and other assets created from discontinuance of SFAS No. 71 pursuant to the Legislation no longer probable, the Company will write off the corresponding balance of these assets as a non-cash charge against earnings. One of the results of discontinuing the application of SFAS No. 71 for the generation operations is the elimination of the regulatory accounting effects of excess deferred income taxes and investment tax credits related to these operations. The Company believes it is probable that some parties will seek to return these amounts to ratepayers and accordingly, the Company has recorded an offsetting liability.

In order to reduce potential exposure to stranded costs related to generation assets, Reliant Energy HL&P redirected \$195 million and \$99 million of depreciation in 1998 and for the six months ended June 30, 1999, respectively, from transmission and distribution related plant assets to generation assets for regulatory and financial reporting purposes. This redirection was in accordance with the Company's Transition Plan. See Note 4(c) for additional information regarding the Transition Plan. The Legislation provides that depreciation expense for transmission and distribution related assets may be redirected to generation assets during the base rate freeze period from 1999 through 2001. For regulatory purposes, the Company has continued to redirect transmission and distribution depreciation to generation assets. Beginning June 30, 1999,

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redirected depreciation expense cannot be recorded by the electric generation operations portion of Reliant Energy HL&P for financial reporting purposes as this portion of electric operations is no longer accounted for under SFAS No. 71. During the six months ended December 31, 1999 and during 2000, \$99 million and \$218 million in depreciation expense, respectively, has been redirected from transmission and distribution for regulatory purposes and has been established as an embedded regulatory asset included in transmission and distribution related plant and equipment balances. As of December 31, 1999 and 2000, the cumulative amount of redirected depreciation for regulatory purposes is \$393 million and \$611 million, respectively.

The Company has reviewed its long-term purchase power contracts and fuel contracts for potential loss in accordance with SFAS No. 5, "Accounting for Contingencies" and Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing." Based on projections of future market prices for wholesale electricity, the analysis indicated no loss recognition is appropriate at this time.

Other Accounting Policy Changes. As a result of discontinuing SFAS No. 71, the accounting policies discussed below related to Electric Operations' generation operations have been changed effective July 1, 1999. Allowance for funds used during construction will no longer be accrued on generation related construction projects. Instead, interest will be capitalized on these projects in accordance with SFAS No. 34, "Capitalization of Interest Cost."

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

(b) Business Separation Plan.

General. As required by the Legislation, Reliant Energy submitted the Business Separation Plan in 2000 to the Texas Utility Commission. The Business Separation Plan was later amended to provide for the restructuring of the Company's businesses into two separate and publicly traded companies in order to separate its unregulated businesses from its regulated businesses. In December 2000, the plan was approved by the Texas Utility Commission. Reliant Resources holds Reliant Energy's unregulated businesses, including the Wholesale Energy segment, European Energy segment, communications business, eBusiness group, new ventures group and retail electric business. As further described below, Reliant Energy will undergo a restructuring of the Company's corporate organization to achieve a holding company structure. This holding company will hold primarily what are currently Reliant Energy's rate-regulated businesses. Reliant Resources expects to conduct the Offering in 2001. After the Offering, Reliant Energy will own approximately 80% of Reliant Resources common stock. Reliant Energy expects the Offering to be followed by a distribution to Reliant Energy's or its successor's shareholders of the remaining common stock of Reliant Resources within 12 months of the Offering (the Distribution Date).

The Offering and the Distribution are subject to further corporate approvals, market and other conditions, and government actions, including receipt of a favorable Internal Revenue Service ruling that the Distribution would be tax-free to Reliant Energy or its successor and its shareholders for U.S. federal income tax purposes, as applicable. There can be no assurance that the Offering and the Distribution will be completed as described or within the time periods outlined above.

Restructuring of Regulated Entities. Under the Business Separation Plan, Reliant Energy will restructure its regulated operations into a holding company structure in which a new corporate entity (Regulated

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Holding Company) will be formed as the parent with the Company's regulated businesses as subsidiaries. This Regulated Holding Company is expected to own (a) the Company's electric transmission and distribution operations, (b) its natural gas distribution businesses, (c) initially, its regulated electric generating assets in Texas, (d) its interstate pipelines, gas gathering and pipeline services operations, and (e) its interests in energy companies in Latin America until disposition of these investments (see Note 19). In these Notes, references to Reliant Energy in connection with events occurring or the performance of agreements after the restructuring generally refer to the Regulated Holding Company.

In connection with the formation of the new holding company for regulated businesses, Reliant Energy expects to transfer the stock of all of its subsidiaries to the new holding company and will transfer its regulated electric generating assets in Texas to an indirect wholly owned partnership (Texas Genco) until the stranded costs associated with those assets are valued in 2004. At that time, Reliant Resources will have the right to exercise an option to acquire those assets, as further discussed below. As a result of the stock and asset transfers described above, Reliant Energy will become solely a transmission and distribution company, with its other businesses becoming subsidiaries of the new holding company. Reliant Energy expects that the regulated holding company will be required to assume all of Reliant Energy's debt other than its first mortgage bonds, which would remain with Reliant Energy. The indebtedness of some wholly owned financing subsidiaries is expected to be refinanced by the regulated holding company by the end of 2002.

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

Aspects of the restructuring of Reliant Energy's regulated businesses are subject to the approval of Reliant Energy's shareholders and lenders and approvals from the SEC under the Public Utility Holding Company Act and from the United States Nuclear Regulatory Commission (NRC). There can be no assurance that the restructuring of the Company's regulated businesses will be completed as described above.

Agreements Related to Texas Generating Assets. Pursuant to the Business Separation Plan, Reliant Energy expects to cause Texas Genco to either issue and sell in an initial public offering or to distribute to its shareholders no more than 20% of the common stock of Texas Genco by June 30, 2002. In connection with the separation of its unregulated businesses from its regulated businesses, Reliant Energy will grant Reliant Resources an option to purchase all of the shares of capital stock of Texas Genco that will be owned by Reliant Energy after the initial public offering or distribution. The Texas Genco option may be exercised between January 10, 2004 and January 24, 2004. The per share exercise price under the option will be the average daily closing price on the national exchange for publicly held shares of common stock of Texas Genco for the 30 consecutive trading days with the highest average closing price during the 120 trading days immediately preceding January 10, 2004, plus a control premium, up to a maximum of 10%, to the extent a control premium is included in the valuation determination made by the Texas Utility Commission relating to the market value of Texas Genco's common stock equity. The exercise price is also subject to adjustment based on the difference between the per share dividends paid during the period there is a public ownership interest in Texas Genco and Texas Genco's per share earnings during that period. If the disposition to the public of common stock of Texas Genco is by means of a primary or secondary public offering, the public offering may be of as little as 17% (rather than 19%) of Texas Genco's outstanding common stock, in which case Reliant Energy will have the right to subsequently reduce its interest to a level not less than 80%. Reliant Resources will agree that if it exercises the Texas Genco Option and purchases the shares of Texas Genco common stock, Reliant Resources will also purchase all notes and other receivables from Texas Genco then held by Reliant Energy, at their principal amount plus accrued interest. Similarly, if Texas Genco holds notes or receivables from the Company, Reliant Resources will assume those obligations in exchange for a payment to Reliant Resources by the Company of an amount equal to the principal plus accrued interest.

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

The Texas Genco option agreement will require Reliant Energy to take commercially reasonable action as may be appropriate to cause Texas Genco to have a capital structure appropriate, in the judgment of Reliant Energy's Board of Directors, for the satisfactory marketing of Texas Genco common stock in an initial public offering or to establish a satisfactory trading market for Texas Genco common stock following a distribution of shares to Reliant Energy's shareholders. It also will contain covenants relating to the operation of the Texas Genco assets prior to the exercise or expiration of the option and require that Reliant Energy maintain ownership of all equity of Texas Genco until exercise or expiration of the Texas Genco option, subject to the initial public offering or distribution obligation.

Reliant Resources will provide engineering and technical support services and environmental, safety and industrial health services to support the operations and maintenance of Texas Genco's facilities. Reliant Resources will also provide systems, technical, programming and consulting support services and hardware maintenance (but excluding plant-specific hardware) necessary to provide dispatch planning, dispatch and settlement and communication with the independent system operator. The fees charged for these services will be designed to allow Reliant Resources to recover its fully allocated direct and indirect costs and reimbursement of out-of-pocket expenses. Expenses associated with capital investment in systems and software that benefit both the operation of Texas Genco's facilities and Reliant Resources' facilities in other regions will be allocated on an installed megawatt basis. The term of the technical services agreement will begin at the Distribution Date. The term of this agreement will end on the first to occur of (a) the closing date of the Reliant Resources' Texas Genco option, (b) Reliant Energy's sale of Texas Genco, or all or substantially all of the assets of Texas Genco, if Reliant Resources does not exercise the Texas Genco option, or (c) December 31, 2004, provided the Texas Genco option is not exercised. Texas Genco may extend the term of this agreement until December 31, 2005.

Pursuant to the Legislation, Texas Genco will be required to sell at auction 15% of the output of its installed generating capacity beginning January 1, 2002. The first auction will be held on or before September 1, 2001 for power delivered after January 1, 2002. This obligation continues until January 1, 2007, unless before that date the Texas Utility Commission determines that at least 40% of the quantity of electric power consumed in 2000 by residential and small commercial customers in the Reliant Energy HL&P traditional service area is being served by retail electric providers other than subsidiaries of Reliant Resources. Texas Genco plans to auction all of its remaining output during the time period prior to Reliant Resources' exercise of the Texas Genco option. Pursuant to the Business Separation Plan, Reliant Resources is entitled to purchase, at prices established in these auctions, up to 50% of the remaining capacity, energy and ancillary services auctioned by Texas Genco.

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

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if surplus funds remain in the decommissioning trust, the excess will be refunded to Reliant Energy's ratepayers.

Retail Agreement between Reliant Energy and Reliant Resources. Under a retail agreement, Reliant Resources will provide customer service call center operations, credit and collections and revenue reporting services for Reliant Energy's electric utility division and receiving and processing payments for the accounts of Reliant Energy's electric utility division and two of Reliant Energy's natural gas distribution divisions. Reliant Energy will provide the office space and equipment for Reliant Resources to perform these services. These services will terminate on January 1, 2002. The charges Reliant Energy will pay Reliant Resources for these services are generally intended to allow Reliant Resources to recover its fully allocated costs of providing the services, plus out-of-pocket costs and expenses.

Service Agreements between Reliant Energy and Reliant Resources. Reliant Resources plans to enter into agreements with Reliant Energy under which Reliant Energy will provide Reliant Resources, on an interim basis, with various corporate support services (including accounting, finance, investor relations, planning, legal, communications, governmental and regulatory affairs and human resources), information technology services and other previously shared services such as corporate security, facilities management, accounts receivable, accounts payable and payroll, office support services and purchasing and logistics.

These arrangements will continue after the Offering under a transition services agreement providing for their continuation until December 31, 2004, or, in the case of some corporate support services, until the Distribution Date. The charges Reliant Resources will pay Reliant Energy for these services are generally intended to allow Reliant Energy to recover its fully allocated costs of providing the services, plus out-of-pocket costs and expenses. In each case, Reliant Resources will have the right to terminate categories of services at an earlier date.

Pursuant to a lease agreement, Reliant Energy will lease Reliant Resources office space in its headquarters building in Houston, Texas for an interim period.

Other Agreements. In connection with the separation of Reliant Resources' businesses from those of Reliant Energy, Reliant Resources will also enter into other agreements providing, among other things, for mutual indemnities and releases with respect to Reliant Resources' respective businesses and operations, matters relating to corporate governance, matters relating to responsibility for employee compensation and benefits, and allocation of tax liabilities. In addition, Reliant Resources and Reliant Energy will enter into various agreements relating to ongoing commercial arrangements, including among other things the leasing of optical fiber and related maintenance activities, rights to build fiber networks along existing rights of way, and the provision of local exchange telecommunications and data services in the greater Houston metropolitan area and long distance telecommunications services.

Reliant Energy will agree that \$1.9 billion of intercompany indebtedness owed by Reliant Resources and its subsidiaries prior to the closing of the Offering will be converted into equity as a capital contribution to Reliant Resources.

(c) Transition Plan.

In June 1998, the Texas Utility Commission issued an order in Docket No. 18465 approving the Company's Transition Plan filed by Reliant Energy HL&P in December 1997. The Transition Plan included base rate credits to residential customers of 4% in 1998 and an additional 2% in 1999. Commercial customers whose monthly billing is 1,000 kva or less were entitled to receive base rate credits of 2% in each of 1998 and 1999. The Company implemented the Transition Plan effective January 1, 1998.

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(d) Reliant Energy HL&P Filings.

As of December 31, 2000, Reliant Energy HL&P had recorded as a regulatory asset under-recovered fuel cost of \$558 million. In two separate filings in 2000, Reliant Energy HL&P filed and received approval to implement a fuel surcharge to collect the under recovery of fuel expenses, as well as to adjust the fuel factor to compensate for significant increases in the price of natural gas.

On March 15, 2001, Reliant Energy HL&P filed to revise its fuel factor and address the Company's undercollected fuel costs of \$389 million, which is the accumulated amount since September 2000 through February 2001 plus estimates for March and April, 2001. Reliant Energy HL&P is requesting to revise its fixed fuel factor to be implemented with the May 2001 billing cycle and has proposed to defer the collection of the \$389 million until the 2004 stranded costs true-up proceeding, discussed in Note 4(a) above.

(5) Derivative Financial Instruments

(a) Price Risk Management and Trading Activities.

The Company offers energy price risk management services primarily related to natural gas, electric power and other energy related commodities. The Company provides these services by utilizing a variety of derivative financial instruments, including (a) fixed and variable-priced physical forward contracts, (b) fixed and variable-priced swap agreements, (c) options traded in the over-the-counter financial markets and (d) exchange-traded energy futures and option contracts (Trading Derivatives). Fixed-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between a fixed and variable price for the commodity. Variable-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between industry pricing publications or exchange quotations.

The Company applies mark-to-market accounting for all of its energy trading, marketing and price risk management operations. Accordingly, these Trading Derivatives are recorded at fair value with realized and unrealized gains (losses) recorded as a component of revenues. The recognized, unrealized balances are included in price risk management assets/liabilities.

The notional quantities, maximum terms and the estimated fair value of Trading Derivatives at December 31, 1999 and 2000 are presented below (volumes in billions of British thermal units equivalent (Bbtue) and dollars in millions):

	<u>Volume-Fixed Price Payor</u>	<u>Volume-Fixed Price Receiver</u>	<u>Maximum Term (years)</u>
1999			
Natural gas	1,278,953	1,251,319	9
Electricity	242,868	239,452	10
Oil and other	285,251	286,521	3
2000			
Natural gas	1,876,358	1,868,597	17
Electricity	526,556	523,942	6
Oil and other	52,820	42,380	2

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	<u>Fair Value</u>		<u>Average Fair Value(1)</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
1999				
Natural gas	\$ 581	\$ 564	\$ 550	\$ 534
Electricity	122	91	96	74
Oil and other.....	193	206	183	187
	<u>\$ 896</u>	<u>\$ 861</u>	<u>\$ 829</u>	<u>\$ 795</u>
2000				
Natural gas	\$4,059	\$4,054	\$2,058	\$2,038
Electricity	1,115	1,087	601	561
Oil and other.....	39	39	63	70
	<u>\$5,213</u>	<u>\$5,180</u>	<u>\$2,722</u>	<u>\$2,669</u>

(1) Computed using the ending balance of each quarter.

In addition to the fixed-price notional volumes above, the Company also has variable-priced agreements, as discussed above, totaling 2,147,173 Bbtue and 3,004,336 Bbtue as of December 31, 1999 and 2000, respectively. Notional amounts reflect the commodity volumes underlying the transactions but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure the Company's exposure to market or credit risks.

All of the fair values shown in the table above at December 31, 1999 and 2000, have been recognized in income. The Company estimated the fair value as of December 31, 1999 and 2000, using quoted prices where available and other valuation techniques when market data was not available, for example in illiquid markets. For financial instruments for which quoted prices are not available, the Company utilizes alternative pricing methodologies, including, but not limited to, extrapolation of forward pricing curves using historically reported data from illiquid pricing points. These same pricing techniques are used to evaluate a contract prior to taking the position. The prices and fair values are subject to significant changes based on changing market conditions.

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

In addition to the risk associated with price movements, credit risk is also inherent in the Company's risk management activities. Credit risk relates to the risk of loss resulting from non-performance of contractual

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
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obligations by a counterparty. The following table shows the composition of the total price risk management assets of the Company as of December 31, 1999 and 2000.

	<u>December 31, 1999</u>		<u>December 31, 2000</u>	
	<u>Investment Grade(1)</u>	<u>Total</u>	<u>Investment Grade(1)</u>	<u>Total</u>
	(in millions)			
Energy marketers	\$202	\$230	\$2,507	\$2,709
Financial institutions	90	159	1,159	1,296
Gas and electric utilities	220	221	511	586
Oil and gas producers	31	31	500	599
Industrials	3	4	78	89
Others	<u>174</u>	<u>263</u>	<u>—</u>	<u>—</u>
Total	<u>\$720</u>	908	<u>\$4,755</u>	5,279
Credit and other reserves		<u>(12)</u>		<u>(66)</u>
Energy price risk management assets(2)		<u>\$896</u>		<u>\$5,213</u>

- (1) "Investment Grade" is primarily determined using publicly available credit ratings along with the consideration of credit support (such as parent company guarantees) and collateral, which encompass cash and standby letters of credit.
- (2) As of December 31, 2000, the Company had credit risk exposure to three investment-grade counterparties that each represented greater than 5% of price risk management assets. This information excludes some offsetting contracts that either require or permit net settlement with non-trading transactions not included in price risk management assets. The Company's resulting net credit risk exposure to these three counterparties is below 5% of price risk management assets.

(b) Non-Trading Activities.

To reduce the risk from market fluctuations in the revenues derived from the sale of electric power and natural gas and related transportation, the Company enters into futures transactions, forward contracts, swaps and options (Energy Derivatives) in order to hedge some expected purchases of electric power and natural gas and sales of electric power and natural gas (a portion of which are firm commitments at the inception of the hedge). Energy Derivatives are also utilized to fix the price of compressor fuel or other future operational gas requirements and to protect natural gas distribution earnings against unseasonably warm weather during peak gas heating months, although usage to date for this purpose has not been material. The Company applies hedge accounting for its derivative financial instruments utilized in non-trading activities. Unrealized changes in the market value of Energy Derivatives utilized as hedges are not generally recognized in the Company's Statements of Consolidated Operations until the underlying hedged transaction occurs. Once it becomes probable that an anticipated transaction will not occur, the Company recognizes deferred gains and losses. In general, the financial impact of transactions involving these Energy Derivatives is included in the Company's Statements of Consolidated Operations under the captions (a) fuel expenses, in the case of natural gas transactions, (b) purchased power, in the case of electric power purchase transactions, and (c) revenues, in the case of electric power sales transactions. Cash flows resulting from these transactions in Energy Derivatives are included in the Company's Statements of Consolidated Cash Flows in the same category as the item being hedged.

In connection with the Company's acquisition of UNA in 1999, the Company entered into call option agreements with several banks to hedge the impact of foreign exchange movements on the Dutch guilder. These call options provided the right, but not the obligation, to purchase NLG 695 million from specific banks at specific strike prices. The total premium paid, classified as other expense on the Company's Statement of

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Consolidated Operations, for all of the options that were to expire on October 26, 1999, was \$8 million. On October 12, 1999, the Company sold the remaining value in the call options for \$0.6 million. The proceeds were reflected in the Company's results of operations as a reduction of other expense.

As of December 31, 1999 and 2000, the Company had outstanding foreign currency swaps for 258 million and Euros 671 million, respectively (approximately \$228 million and \$632 million), terminating in September 2000 and January 2001, respectively. The Company also issued Euro-denominated debt, maturing in March and June 2001. The foreign currency swaps and Euro-denominated debt hedge the Company's net investment in UNA. In January 2001, the Company entered into foreign currency swaps for Euros 671 million (approximately \$633 million) to replace the foreign currency swaps that expired in January 2001. These foreign currency swaps terminate in January 2002. In January and March 2001, the Company entered into foreign currency forward contracts for Euros 159 million (approximately \$150 million) to adjust the hedge of its net investment in UNA. These forward contracts expire in January 2002. The Company records changes in the value of the hedging instruments and debt as foreign currency translation adjustments as a component of stockholders' equity and accumulated other comprehensive loss. The effectiveness of the hedging instruments can be measured by the net change in foreign currency translation adjustments attributed to the net investment in UNA. These amounts generally offset amounts recorded in stockholders' equity as adjustments resulting from translation of the hedged investment into U.S. dollars. As of December 31, 1999 and 2000, the net carrying value of the currency swaps was a \$6 million receivable and \$62 million obligation, respectively, and was recorded in other current assets and other current liabilities in the Company's Consolidated Balance Sheets.

During 2000, European Energy entered into financial instruments to purchase approximately \$120 million to hedge future fuel purchases payable in U.S. dollars. As of December 31, 2000, the fair value of these financial instruments was a \$6 million liability. Unrealized changes in the market value of these financial instruments are not recognized in the Company's Statements of Consolidated Operations until the underlying hedged transaction occurs.

For transactions involving either Energy Derivatives or foreign currency derivatives, hedge accounting is applied only if the derivative reduces the risk of the underlying hedged item and is designated as a hedge at its inception. Additionally, the derivatives must be expected to result in financial impacts that are inversely correlated to those of the item(s) to be hedged. This correlation, a measure of hedge effectiveness, is measured both at the inception of the hedge and on an ongoing basis, with an acceptable level of correlation of at least 80% for hedge designation. If and when correlation ceases to exist at an acceptable level, hedge accounting ceases and mark-to-market accounting is applied.

At December 31, 1999, the Company was a fixed-price payor and a fixed-price receiver in Energy Derivatives covering 33,108 Bbtu and 5,481 Bbtu of natural gas, respectively. At December 31, 2000, the Company was a fixed-price payor and a fixed-price receiver in Energy Derivatives covering 198,001 Bbtu and 22,874 Bbtu of natural gas, respectively, and 486 Bbtu and zero Bbtu of oil, respectively. In addition to the fixed-price notional volumes above, the Company also has variable-priced agreements totaling 44,958 Bbtu and 174,900 Bbtu of natural gas at December 31, 1999 and 2000, respectively. The weighted average maturity of these instruments is less than two years.

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

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The average maturity discussed above and the fair value discussed in Note 15 are not necessarily indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and the Company's risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

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

In addition to the risk associated with price movements, credit risk is also inherent in the Company's risk management activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. The Company has off-balance sheet risk to the extent that the counterparties to these transactions may fail to perform as required by the terms of each contract. In order to minimize this risk, the Company enters into these contracts primarily with counterparties having a minimum investment grade index rating, *i.e.* a Standard & Poor's or Moody's rating of BBB- or Baa3, respectively. For long-term arrangements, the Company periodically reviews the financial condition of these firms in addition to monitoring the effectiveness of these financial contracts in achieving the Company's objectives. If the counterparties to these arrangements fail to perform, the Company would seek to compel performance at law or otherwise obtain compensatory damages. The Company might be forced to acquire alternative hedging arrangements or be required to replace the underlying commitment at then-current market prices. In this event, the Company might incur additional losses to the extent of amounts, if any, already paid to the counterparties. For information regarding credit risk related to the California wholesale electricity market, see Note 14(h).

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

The Company has established a Risk Oversight Committee, comprised of corporate and business segment officers that oversees all commodity price and credit risk activities, including the Company's trading, marketing, power origination and risk management activities. The committee's duties are to establish the Company's commodity risk policies, allocate risk capital within limits established by the Company's Board of Directors, approve trading of new products and commodities, monitor risk positions and ensure compliance with the Company's risk management policies and procedures and trading limits established by the Company's Board of Directors.

(6) Jointly Owned Electric Utility Plant

The Company has a 30.8% interest in the South Texas Project, which consists of two 1,250 MW nuclear generating units and bears a corresponding 30.8% share of capital and operating costs associated with the project. The South Texas Project is owned as a tenancy in common among its four co-owners, with each owner retaining its undivided ownership interest in the two nuclear-fueled generating units and the electrical output from those units. The four co-owners have delegated management and operating responsibility for the South Texas Project to the South Texas Project Nuclear Operating Company (STPNOC). STPNOC is managed by a board of directors comprised of one director from each of the four owners, along with the chief executive officer of STPNOC. As of December 31, 2000, the Company's investment in the South Texas Project was \$363 million (net of \$2.1 billion accumulated depreciation which includes an impairment loss recorded in 1999 of \$745 million). For additional information regarding the impairment loss, see Note 4(a). The Company's investment in nuclear fuel was \$39 million (net of \$269 million amortization) as of December 31, 2000.

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(7) Equity Investments in Unconsolidated Subsidiaries

In April 1998, the Company formed a limited liability company to construct and operate a 490 MW electric generation plant in Boulder City, Nevada in which the Company has a 50% interest. The plant became operational in May 2000. In October 1998, the Company entered into a partnership to construct and operate a 100 MW cogeneration plant in Orange, Texas in which its ownership interest is 50%. The plant began commercial operations in December 1999. As of December 31, 1999 and 2000, the Company's net investment in these projects was \$78 million and \$109 million, respectively. The Company's equity income from these investments was \$43 million in 2000. The Company's equity loss from these investments was \$0.6 million and \$0.8 million in 1998 and 1999, respectively. During 1998 and 1999, there were no distributions from these investments. During 2000, \$18 million was distributed 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 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 and \$41 million in 1998. 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.

(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 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 TW Common, or other securities distributed with respect to TW Common (one share of TW Common and such other securities, if any, are referred to as reference shares). Each ZENS has an original principal amount of \$58.25 (the closing market price of the TW Common on September 15, 1999) 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

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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, 2000, no interest payments on the ZENS had been deferred.

On January 11, 2001, TW and America Online, Inc. combined to form AOL Time Warner Inc. (AOL TW). As a result of the combination each share of TW Common was converted into 1.5 shares of AOL TW Common Stock (AOL TW Common) and the Company now holds 25.8 million shares of AOL TW Common. As a result of the combination, the reference shares attributable to one ZENS is 1.5 shares of AOL TW Common.

The Company used \$537 million of the net proceeds from the offering of the ZENS to purchase 9.2 million shares of TW Common, which are classified as trading securities under SFAS No. 115. Unrealized gains and losses resulting from changes in the market value of the TW Common are recorded in the Company's Statements of Consolidated Operations.

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. As of December 31, 1999 and 2000, the market value of TW Common was \$72.31 and \$52.24, respectively. Therefore, during 2000, the Company recorded a pre-tax net unrealized loss on its investment in TW Common and its obligation on its indexed debt securities of \$103 million.

Prior to the purchase of additional shares of TW Common on September 21, 1999, the Company owned approximately 8 million shares of TW Common that were in excess of the 38 million shares needed to economically hedge its ACES obligation. For the period from July 6, 1999 to the ZENS issuance date, losses (due to the decline in the market value of the TW Common during such period) on these 8 million shares were \$122 million (\$79 million after-tax). The 8 million shares of TW Common combined with the additional 9.2 million shares purchased are expected to be held to facilitate the Company's ability to meet its obligation under the ZENS.

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

	<u>TW Investment</u>	<u>ACES</u>	<u>ZENS</u>
	(in millions)		
Balance at December 31, 1997	\$ 990	\$ 1,174	
Loss on indexed debt securities	—	1,176	
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	2,452	—	—
Balance at December 31, 1999	<u>3,979</u>	<u>2,738</u>	<u>1,241</u>
Loss (Gain) on indexed debt securities	—	139	(241)
Loss on TW Common	(205)	—	—
Settlement of ACES	<u>(2,877)</u>	<u>(2,877)</u>	—
Balance at December 31, 2000	<u>\$ 897</u>	<u>\$ —</u>	<u>\$1,000</u>

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Upon adoption of SFAS No. 133 effective January 1, 2001, the ZENS obligation is 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 is valued at fair value and determines 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 is 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. The transition adjustment gain will be 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 Operations. Changes in the fair value of the AOL TW Common held by the Company should substantially offset changes in the fair values of the derivative component of the ZENS.

(9) Preferred Stock and Preference Stock

(a) Preferred Stock.

At December 31, 1999 and 2000, Reliant Energy had 10,000,000 authorized shares of cumulative preferred stock, of which 97,397 shares were outstanding. As of these dates, Reliant Energy's only outstanding series of preferred stock was its \$4.00 Preferred Stock. The \$4.00 Preferred Stock pays an annual dividend of \$4.00 per share, is redeemable at \$105 per share and has a liquidation price of \$100 per share to third-parties.

(b) Preference Stock.

At December 31, 1999 and 2000, Reliant Energy had 10,000,000 authorized shares of preference stock, none of which was outstanding for financial reporting purposes.

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. 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.

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
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(10) Long-term Debt and Short-term Borrowings

	December 31, 1999		December 31, 2000	
	Long-term	Current(1)	Long-term	Current(1)
	(in millions)			
Short-term borrowings:				
Commercial paper		\$1,793		\$3,675
Lines of credit(2)		563		853
Receivables facilities		350		350
Other(2)		170		126
Total short-term borrowings		2,876		5,004
Long-term debt:				
Reliant Energy				
ACES(3)	\$ —	2,738	\$ —	—
ZENS(3)	—	1,241	—	1,000
Debentures 7.88% to 9.38% due 2001 to 2002	350	—	100	250
First mortgage bonds 4.90% to 9.15% due 2002 to 2027	1,261	150	1,261	—
Pollution control bonds 4.70% to 5.95% due 2011 to 2030	1,046	—	1,046	—
Other	13	2	12	1
Financing Subsidiaries (directly or indirectly held by Reliant Energy)				
Notes payable 7.12% to 7.40% due 2001 to 2002	525	—	300	225
Reliant Energy Power Generation, Inc.				
Notes payable various market rates due 2002	70	—	260	—
N.V. UNA (2)				
Debentures 6.00% to 8.93% due 2001 to 2010	391	—	66	1
Reliant Energy Capital Europe (2)				
Notes Payable due 2003	—	—	565	—
RERC Corp.				
Convertible debentures 6.0% due 2012	93	—	93	—
Debentures 6.38% to 8.90% due 2003 to 2008	962	—	1,285	—
Notes payable 8.77% to 9.23% due 2001	150	223	—	146
Unamortized discount and premium(4)	8	—	8	—
Total long-term debt	4,869	4,354	4,996	1,623
Total borrowings	\$4,869	\$7,230	\$4,996	\$6,627

- (1) Includes amounts due or exchangeable within one year of the date noted.
- (2) Includes borrowings at December 31, 1999 and 2000 which are denominated in Dutch Guilders (NLG) and Euros. As of December 31, 1999 and 2000, the assumed exchange rate was 2.19 NLG and 2.34 NLG per U.S. dollar, respectively, and 0.9938 Euro and 1.0616 Euros per U.S. dollar, respectively.
- (3) For additional information regarding ACES and ZENS, see Note 8(b) and (c). 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.

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- (4) Debt acquired in business acquisitions is adjusted to fair market value as of the acquisition date. Included in unamortized premium and discount is unamortized premium related to fair value adjustments of long-term debt of \$33 million and \$12 million at December 31, 1999 and 2000, respectively, and is being amortized over the respective remaining term of the related long-term debt.

(a) Short-term Borrowings.

As of December 31, 2000, the Company had credit facilities in effect, which included facilities of various financing subsidiaries and operating subsidiaries, with financial institutions which provide for an aggregate of \$8.4 billion in committed credit. The facilities expire as follows: \$5.0 billion in 2001, \$2.1 billion in 2002 and \$1.3 billion in 2003. 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. As of December 31, 2000, unused credit facilities totaled \$1.7 billion. As of December 31, 2000, letters of credit outstanding under these facilities aggregated \$899 million. As of December 31, 2000, borrowings of \$825 million were outstanding under these facilities that were classified as long-term debt, based on availability of committed credit facilities with expiration dates exceeding one year and management's intention to borrow these amounts in excess of one year. Credit facilities aggregating \$2.0 billion are unsecured.

Of the \$8.4 billion of committed credit facilities described above, \$5.0 billion will expire in 2001. To the extent that the Company continues to need access to this amount of committed credit, the Company expects to extend or replace these facilities on normal commercial terms on a timely basis.

The credit facilities under which Reliant Energy borrows or provides credit support contain various business and financial covenants requiring the Company to, among other things, maintain leverage (as defined in the credit facilities) below specified ratios. Certain credit facilities at the subsidiary level also contain various financial covenants limiting leverage and requiring the subsidiary to maintain its interest coverage ratio (as defined in the credit facilities) above a specified ratio during stated periods. The Company is in compliance with the covenants under all of these credit agreements. The Company does not expect any of these covenants to materially limit the Company's ability to borrow or obtain letters of credit under these facilities.

The Company sells commercial paper to provide financing for general corporate purposes. As of December 31, 2000, \$3.7 billion of commercial paper was outstanding. The commercial paper borrowings are supported by various credit facilities discussed above including credit facilities aggregating \$3.0 billion expiring in 2001, a \$1.6 billion credit facility expiring in 2002 and a \$350 million revolving credit facility expiring in 2003.

The weighted average interest rate on short-term borrowings as of December 31, 1998, 1999 and 2000 was 5.77%, 5.84% and 7.43%, respectively.

(b) Long-term Debt.

Maturities of long-term debt and sinking fund requirements for the Company are \$630 million in 2001, \$789 million in 2002, \$1.2 billion in 2003, \$48 million in 2004 and \$332 million in 2005.

Substantially all physical assets used in the conduct of the business and operations of Electric Operations are 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 1998, 1999 and 2000 have been satisfied by certification of property additions. The replacement fund requirement to be satisfied in 2001 is \$340 million.

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

At December 31, 1999 and 2000, RERC Corp. had issued and outstanding \$98 million aggregate principal amount (\$93 million 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. During 1999, RERC Corp. purchased \$12 million aggregate principal amount of its Subordinated Debentures.

In November 1998, RERC Corp. issued \$500 million aggregate principal amount of its 6³/₈% Term Enhanced ReMarketable Securities (TERM Notes). The TERM Notes provide to the investment bank 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 6³/₈% through November 1, 2003. On November 1, 2003, the holders of the TERM Notes are required to tender their notes at 100% of their principal amount. The portion of the proceeds attributable to the 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.

During the second quarter of 2000, UNA 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 banking facility and proceeds from the sale of trading securities by UNA were used to finance the debt repurchase.

During 1998 and 1999, the Company's regulated operations recorded losses from the extinguishment of debt of \$20 million and \$22 million, respectively. There were no losses recorded from the early extinguishment of debt in 2000. 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).

(11) Trust Preferred Securities

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. In February 1997, two Delaware statutory business trusts created by Reliant Energy (HL&P Capital Trust I and HL&P Capital Trust II) publicly issued (a) \$250 million aggregate amount of preferred securities and (b) \$100 million aggregate amount of capital securities, respectively. 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 guaranty by Reliant Energy of each trust's obligations with respect to the respective series of preferred securities or capital securities.

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES

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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, 2000, no interest payments on the junior subordinated debentures had been deferred.

In June 1996, a Delaware statutory business trust created by RERC Corp. (Resources Trust) issued \$173 million aggregate amount of convertible preferred securities to the public. RERC Corp. accounts for Resources Trust as a wholly owned consolidated subsidiary. Resources 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 Resources 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 guaranty 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 1998, 1999 and 2000, convertible preferred securities aggregating \$16 million, \$0.2 million and \$0.3 million, respectively, were converted, leaving \$0.7 million and \$0.4 million liquidation amount of convertible preferred securities outstanding at December 31, 1999 and 2000, respectively. 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, 2000, no interest payments on the 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, 1999 and 2000 (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 2048	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
Resources Trust	\$ 1	6.25 %	June 2026	6.25% Convertible Junior Subordinated Debentures due 2026

RELIANT ENERGY, INCORPORATED AND SUBSIDIARIES
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(12) Stock-Based Incentive Compensation Plans and Retirement Plans

(a) Incentive Compensation Plans.

The Company has a long-term incentive compensation plan (LICP) and other incentive compensation plans that provide for the issuance of stock-based incentives, including performance-based stock compensation, restricted shares, stock options and stock appreciation rights, to key employees of the Company, including officers. No stock appreciation rights have ever been issued under the LICP. As of December 31, 2000, 604 current and 39 former employees of the Company participate in the plans. A maximum of approximately 24 million shares of Reliant Energy common stock may be issued under these plans.

Performance-based shares and restricted shares are granted to employees without cost to the participants. The performance shares 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 three-year period. Upon vesting, the shares are released to the plans' participants. During 1998, 1999 and 2000, the Company recorded compensation expense of \$17 million, \$8 million and \$22 million, respectively, related to performance-based shares and restricted share grants. The following table summarizes performance-based shares and restricted share grant activity for the years 1998 through 2000:

	Number of Performance-based Shares	Number of Restricted Shares
Outstanding at December 31, 1997	555,847	150,000
Granted	537,448	11,685
Canceled	(40,223)	(300)
Released to participants	(148,075)	—
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
Weighted average fair value of performance shares and restricted shares granted for 1998	\$ 23.75	\$ 26.69
Weighted average fair value of performance shares and restricted shares granted for 1999	\$ 29.23	\$ 26.88
Weighted average fair value of performance shares and restricted shares granted for 2000	\$ 25.19	\$ 28.03

Outstanding performance shares under the LICP will vest for the performance cycle ending December 31, 2000 according to the terms and conditions of the plan. Assuming the Distribution occurs during the calendar year 2001, Reliant Energy's compensation committee will determine as of the Distribution Date the level at which the performance objectives are expected to have been achieved through the end of the performance cycle ending December 31, 2001 and will vest the outstanding performance shares as of the Distribution Date as though the performance objectives were achieved at that level. In addition, as of the

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Distribution Date, Reliant Energy's compensation committee will convert outstanding performance 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 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 Distribution Date, holders of these time-based restricted shares will receive shares of Reliant Resources common stock in the same manner as other holders 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 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.

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 Reliant Energy common stock on the New York Stock Exchange on the grant date. The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 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 for the years 1998 through 2000:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 1997.....	1,074,567	\$19.07
Options granted	2,243,535	26.31
Options exercised	(294,445)	15.66
Options canceled	(78,003)	
Outstanding at December 31, 1998.....	<u>2,945,654</u>	24.87
Options granted	3,806,051	26.74
Options exercised	(83,610)	19.38
Options canceled	(205,124)	
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)	
Outstanding at December 31, 2000.....	<u>10,042,435</u>	24.13
Options exercisable at December 31, 1998	531,855	20.31
Options exercisable at December 31, 1999	1,350,374	23.87
Options exercisable at December 31, 2000	2,258,397	25.76

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Exercise prices for Reliant Energy stock options outstanding ranged from \$7.00 to \$47.22. The following table provides information with respect to stock options outstanding at December 31, 2000:

	<u>Options Outstanding</u>	<u>Average Exercise Price</u>	<u>Remaining Average Contractual Life (Years)</u>
Ranges of Exercise Prices Exercisable at:			
\$7.00-\$21.00	4,790,791	20.42	9.0
\$21.01-\$26.00	1,700,730	25.31	7.0
\$26.01-\$47.22	<u>3,550,914</u>	28.57	8.4
Total	<u>10,042,435</u>	24.13	8.5

The following table provides information with respect to Reliant Energy stock options exercisable at December 31, 2000:

	<u>Options Exercisable</u>	<u>Average Exercise Price</u>
Ranges of Exercise Prices Exercisable at:		
\$7.00-\$21.00	150,310	\$17.89
\$21.01-\$26.00	1,107,248	25.18
\$26.01-\$33.56	<u>1,000,839</u>	27.57
Total	<u>2,258,397</u>	25.76

In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company applies the guidance contained in APB 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 options granted during 1998, 1999 and 2000 were \$4.27, \$3.13 and \$5.07, respectively, and were estimated using the Black-Scholes option valuation model with the following weighted-average assumptions:

	<u>1998</u>	<u>1999</u>	<u>2000</u>
Expected life in years	10	5	5
Interest rate	5.65%	5.10%	6.57%
Volatility	24.01%	21.23%	24.00%
Expected common stock dividend	\$ 1.50	\$ 1.50	\$ 1.50

Pro forma information for 1998, 1999 and 2000 is provided below, 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 net loss would have been increased by \$6 million in 1998. The Company's net income would have been reduced by \$5 million and \$10 million in 1999 and 2000, respectively. Loss per share would have been increased by \$0.02 per share in 1998. Earnings per share would have been reduced by \$0.02 per share and \$0.03 per share in 1999 and 2000, respectively.

In connection with the Distribution, Reliant Energy expects to convert all outstanding Reliant Energy stock options granted in 2000 and in prior years to a combination of adjusted Reliant Energy stock options and new Reliant Resources stock options. For the converted Reliant Energy stock options, the sum of the intrinsic value of Reliant Energy stock options immediately prior to the Distribution will equal the sum of the intrinsic values of the adjusted Reliant Energy stock options and new Reliant Resources stock options granted immediately after the Distribution. Following the Distribution Date, Reliant Resources employees who no longer work for the Company due to the Distribution will hold Reliant Energy stock options.

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(b) Pension.

The Company has noncontributory pension plans, that cover the employees of the Company, except for the employees of its foreign subsidiaries. Effective January 1, 1999, Reliant Energy amended and restated its plan and converted the present value of the accrued benefits under the existing pension plan into a cash balance pension plan. In connection with this conversion, Reliant Energy grandfathered the existing benefit formulas for all employees participating in the plan on December 31, 1998 for a period of ten years so that eligible individuals will receive the greater of the prior pension plan benefit or the new cash balance benefit upon retirement. Under the cash balance formula, each participant has an account, for recordkeeping purposes only, to which credits are allocated annually based on a percentage of the participant's pay. The applicable percentage for 1999 and 2000 was 4% in each period.

Reliant Energy'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 high-quality, interest-bearing obligations.

UNA 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 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 and \$6 million for the three months ended December 31, 1999 and during 2000, respectively.

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

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
Service cost — benefits earned during the period	\$ 33	\$ 34	\$ 33
Interest cost on projected benefit obligation	85	88	88
Expected return on plans assets	(121)	(141)	(146)
Net amortization	—	(5)	(12)
Net pension benefit	<u>\$ (3)</u>	<u>\$ (24)</u>	<u>\$ (37)</u>

Following are reconciliations of the Company's beginning and ending balances of its retirement plan benefit obligation, plans assets and funded status for 1999 and 2000 (excluding UNA):

	Year Ended December 31,	
	1999	2000
	(in millions)	
Change in Benefit Obligation		
Benefit obligation, beginning of year	\$1,390	\$1,232
Service cost	34	33
Interest cost	88	88
Benefits paid	(98)	(85)
Plan amendments	—	3
Acquisitions	—	1
Transfer of obligation to non-qualified pension plan	—	(11)
Actuarial (gain) loss	(182)	58
Benefit obligation, end of year	<u>\$1,232</u>	<u>\$1,319</u>

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	Year Ended December 31,	
	1999	2000
	(in millions)	
Change in Plans Assets		
Plans assets, beginning of year	\$1,430	\$1,513
Benefits paid	(98)	(85)
Actual investment return	181	(11)
Acquisitions	—	1
Plans assets, end of year	<u>\$1,513</u>	<u>\$1,418</u>
Reconciliation of Funded Status		
Funded status	\$ 281	\$ 99
Unrecognized transition asset	(5)	(4)
Unrecognized prior service cost	(138)	(125)
Unrecognized actuarial loss	11	227
Net amount recognized at end of year	<u>\$ 149</u>	<u>\$ 197</u>
Actuarial Assumptions		
Discount rate	7.5%	7.5%
Rate of increase in compensation levels	3.5-5.5%	3.5-5.5%
Expected long-term rate of return on assets	10.0%	10.0%

The transitional asset at January 1, 1986, is being recognized over 17 years, and the prior service cost is being recognized over 15 years. The actuarial gains and losses are due to changes in actuarial assumptions.

Effective March 1, 2001, the Company will no longer accrue benefits under a noncontributory pension plan for its domestic non-union employees of Reliant Resources and Reliant Energy Tegco, Inc. (Resources Participants). Effective March 1, 2001, each non-union Resources Participant's unvested pension account balance will be fully vested and a one-time benefit enhancement will be provided to some qualifying participants. At the Distribution Date, each Resources Participant will be able to elect to have his pension account balance (a) left in the Reliant Energy 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 \$85 million (pre-tax) for the one-time benefit enhancement discussed above and a gain of \$23 million (pre-tax) related to the curtailment of Reliant Energy's pension plan.

In addition to the noncontributory pension plans discussed above, Reliant Energy maintains non-qualified pension plans which allow participants to retain the benefits to which they would have been entitled under Reliant Energy'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 in 1998 and 1999, respectively, and \$25 million in 2000. The related accrued benefit liability at December 31, 1999 and 2000, was \$28 million and \$92 million, respectively. During 2000, the Company recognized an additional minimum benefit liability related to these non-qualified plans as a component of accumulated other comprehensive loss of \$30 million. Effective March 1, 2001, the Company will not provide non-qualified pension benefits to Reliant Resources and its participating subsidiaries' employees, or Reliant Energy Tegco, Inc.'s employees.

(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

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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 a portion of each employee's compensation contributed, with most matching contributions subject to a vesting schedule. A substantial portion of Reliant Energy's match is invested in Reliant Energy common stock.

Reliant Energy's savings plan has a leveraged Employee Stock Ownership Plan (ESOP) component. Reliant Energy may use ESOP shares to satisfy its obligation to make matching contributions under Reliant Energy'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 Reliant Energy. 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, 1999 and 2000 were as follows:

	December 31,	
	1999	2000
Allocated shares transferred/distributed from the savings plan . . .	2,115,536	2,397,523
Allocated shares	5,967,159	7,725,772
Unearned shares	10,679,489	8,638,889
Total original ESOP shares	<u>18,762,184</u>	<u>18,762,184</u>
Fair value of unearned ESOP shares	\$244,293,311	\$374,171,880

The Company's savings plan benefit expense was \$25 million, \$35 million and \$53 million in 1998, 1999 and 2000, respectively.

(d) Postretirement Benefits.

The Company provides some postretirement benefits (primarily medical care and life insurance benefits) for its retired employees, substantially all of whom may become eligible for these benefits when they retire. Effective January 1, 1999, Reliant Energy amended its retiree medical plan to create an account balance for each participant based on credited service at December 31, 1998. Under the new plan, each participant has an account, for recordkeeping purposes only, to which a \$750 credit is allocated annually. Employees become eligible for this postretirement benefit after completing five years of service after age 50. At retirement the account balance is converted into one of several annuity options, the proceeds of which can be used solely to offset the cost of purchasing medical benefits under Reliant Energy's medical plans. The accounts may not be taken as a cash distribution.

Under SFAS No. 106, "Employer's Accounting for Postretirement Benefits Other Than Pensions" (SFAS No. 106), postretirement benefits are accounted for on an accrual basis using a specified actuarial method based on benefits and years of service. The Company is amortizing \$213 million over a 20-year period to cover the "transition cost" of adopting SFAS No. 106.

Reliant Energy HL&P is required to fund during each year in an irrevocable external trust \$22 million of postretirement benefit costs, which are included in its rates. Reliant Energy Minnegasco is required to fund postretirement benefit costs for the amount included in its rates. The Company, excluding Reliant Energy

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HL&P and Reliant Energy Minnegasco, will continue funding its postretirement benefits on a pay-as-you-go basis.

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

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
Service cost — benefits earned during the period	\$ 8	\$ 5	\$ 6
Interest cost on projected benefit obligation	17	26	29
Expected return on plan assets	(6)	(9)	(11)
Net amortization	4	15	12
Net postretirement benefit cost	<u>\$23</u>	<u>\$37</u>	<u>\$ 36</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 1999 and 2000:

	Year Ended December 31,	
	1999	2000
	(in millions)	
Change in Benefit Obligation		
Benefit obligation, beginning of year	\$ 410	\$ 395
Service cost	5	6
Interest cost	26	29
Benefits paid	(22)	(27)
Participant contributions	4	3
Acquisitions	12	12
Plan amendments	—	3
Foreign exchange impact	—	(1)
Actuarial (gain) loss	(40)	35
Benefit obligation, end of year	<u>\$ 395</u>	<u>\$ 455</u>
Change in Plan Assets		
Plan assets, beginning of year	\$ 84	\$ 105
Benefits paid	(22)	(27)
Employer contributions	33	37
Participant contributions	4	3
Actual investment return	6	4
Plan assets, end of year	<u>\$ 105</u>	<u>\$ 122</u>
Reconciliation of Funded Status		
Funded status	\$ (290)	\$ (333)
Unrecognized transition obligation	135	126
Unrecognized prior service cost	92	88
Unrecognized actuarial gain	(98)	(52)
Net amount recognized at end of year	<u>\$ (161)</u>	<u>\$ (171)</u>

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	Year Ended December 31,	
	1999	2000
	(in millions)	
Actuarial Assumptions		
Discount rate	6.6-7.5%	6.6-7.5%
Expected long-term rate of return on assets	10.0%	10.0%
Health care cost trend rates — Under 65	5.8%	8.0%
Health care cost trend rates — 65 and over	6.2%	9.0%

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, 2000 would increase by approximately 3.82%. The annual effect of the 1% increase on the total of the service and interest costs would be an increase of approximately 3.13%. If the health care cost trend rate assumptions were decreased by 1%, the accumulated postretirement benefit obligation as of December 31, 2000 would decrease by approximately 3.76%. The annual effect of the 1% decrease on the total of the service and interest costs would be a decrease of 3.08%.

Effective March 1, 2001, the Company discontinued providing subsidized postretirement benefits to its domestic non-union employees of Reliant Resources and its participating subsidiaries and Reliant Energy Tegco, Inc. 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.

(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 not material in 1998 and were \$11 million in 1999 and \$2 million in 2000.

(f) Other Non-qualified Plans.

Since 1985, Reliant Energy 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 Reliant Energy'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 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 1998, 1999 and 2000, the Company recorded interest expense related to its deferred compensation obligation of \$32 million, \$22 million and \$14 million, respectively. The discounted deferred compensation obligation recorded by the Company was \$151 million and \$159 million as of December 31, 1999 and 2000, respectively.

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(g) Other Employee Matters.

As of December 31, 2000, approximately 38% 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, 2001.

(13) Income Taxes

The components of (loss) income from continuing operations before taxes are as follows:

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
United States	\$(361)	\$2,568	\$1,137
Foreign	—	22	11
(Loss) income from continuing operations before income taxes	<u>\$(361)</u>	<u>\$2,590</u>	<u>\$1,148</u>

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

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
Current:			
Federal	\$ 341	\$287	\$391
State	11	4	25
Foreign	—	—	3
Total current	<u>352</u>	<u>291</u>	<u>419</u>
Deferred:			
Federal	(448)	591	(47)
State	13	34	1
Foreign	—	—	4
Total deferred	<u>(435)</u>	<u>625</u>	<u>(42)</u>
Income tax (benefit) expense	<u>\$ (83)</u>	<u>\$916</u>	<u>\$377</u>

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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>1998</u>	<u>1999</u>	<u>2000</u>
	(in millions)		
(Loss) income from continuing operations before income taxes	\$(361)	\$2,590	\$1,148
Federal statutory rate	<u>35%</u>	<u>35%</u>	<u>35%</u>
Income taxes at statutory rate	<u>(126)</u>	<u>907</u>	<u>402</u>
Net addition (reduction) in taxes resulting from:			
State income taxes, net of valuation allowances and federal income tax benefit	16	25	17
Amortization of investment tax credit	(20)	(21)	(18)
Excess deferred taxes	(4)	(5)	(4)
Difference between book and tax depreciation for which deferred taxes have not been normalized	37	—	—
UNA tax holiday	—	(5)	(44)
Federal and foreign valuation allowance	—	1	13
Goodwill amortization	18	18	19
Other, net	<u>(4)</u>	<u>(4)</u>	<u>(8)</u>
Total	<u>43</u>	<u>9</u>	<u>(25)</u>
Income tax (benefit) expense	<u>\$ (83)</u>	<u>\$ 916</u>	<u>\$ 377</u>
Effective rate	22.9%	35.4%	32.8%

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>1999</u>	<u>2000</u>
	(in millions)	
Deferred tax assets:		
Current:		
Unrealized loss on indexed debt securities	<u>\$ 675</u>	<u>\$ 555</u>
Non-current:		
Alternative minimum tax and other credit carryforwards	35	25
Employee benefits	95	143
Disallowed plant cost, net	58	56
Operating loss carryforwards	39	84
Contingent liabilities associated with discontinuance of SFAS No. 71	74	74
Environmental reserves	10	25
Allowance for doubtful accounts	5	34
Foreign exchange gains	—	26
Other	103	88
Valuation allowance	<u>(19)</u>	<u>(68)</u>
Total non-current deferred tax assets	<u>400</u>	<u>487</u>
Total deferred tax assets, net	<u>\$1,075</u>	<u>\$1,042</u>

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	December 31,	
	1999	2000
	(in millions)	
Deferred tax liabilities:		
Current:		
Unrealized gain on AOL Time Warner investment	\$1,091	\$ 864
Non-current:		
Depreciation	2,367	2,290
Regulatory assets, net	380	380
Deferred state income taxes	69	69
Deferred gas costs	32	201
Other	93	96
Total non-current deferred tax liabilities	2,941	3,036
Total deferred tax liabilities	4,032	3,900
Accumulated deferred income taxes, net	\$2,957	\$2,858

Tax Attribute Carryforwards. At December 31, 2000, the Company had \$20 million, \$523 million and \$27 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 2020. The foreign losses available to offset future foreign taxable income will not expire under current foreign jurisdiction tax law.

At December 31, 2000, the Company had \$9 million of federal alternative minimum tax credits which are available to reduce future federal income taxes payable over an indefinite period and \$1 million of state alternative minimum tax credits that are available to reduce future state income taxes payable through the year 2002.

The valuation allowance reflects a net increase of \$11 million and \$49 million in 1999 and 2000, respectively. This net increase resulted from a reassessment of the Company's future ability to use federal, state and foreign tax net operating loss carryforwards, offset by changes in valuation allowances provided for expiring state net operating loss carryforwards.

UNA Tax Holiday. Under 1998 Dutch tax law relating to the Dutch electricity industry, UNA qualifies for a zero percent tax rate through December 31, 2001. The tax holiday applies only to the Dutch income earned by UNA. Beginning January 1, 2002, UNA will be subject to Dutch corporate income tax at standard statutory rates, which is currently 35%.

Undistributed Earnings of Foreign Subsidiaries. The undistributed earnings of foreign subsidiaries aggregated \$120 million as of December 31, 2000, 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.

Tax Refunds. In February 1998, the Company received a refund from the Internal Revenue Service (IRS) of \$141 million in taxes and interest following an audit of the Company's 1983 and 1984 federal income tax returns. The income statement effect of this refund was recorded in 1997 earnings.

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 Consolidated Statement of Operations. Of

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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 have been audited and settled.

(14) Commitments and Contingencies

(a) Capital and Environmental Commitments.

The Company has various commitments for capital and environmental expenditures. The Wholesale Energy segment has entered into commitments associated with various non-rate regulated electric generating projects, including commitments for the purchase of combustion turbines aggregating \$436 million. In addition, the Wholesale Energy segment has options to purchase additional generating equipment for a total estimated cost of \$544 million for future generating projects.

The Company anticipates investing up to \$711 million in capital and other special project expenditures between 2001 and 2005 for environmental compliance. The Company anticipates expenditures to be as follows (in millions):

2001	\$217
2002	259
2003	80
2004	76
2005	<u>79</u>
Total	<u>\$711</u>

(b) Fuel and Purchased Power.

Reliant Energy HL&P is a party to several long-term coal, lignite and natural gas contracts, which have various quantity requirements and durations. Minimum payment obligations for coal and transportation agreements that extend through 2011 are approximately \$280 million in 2001, \$281 million in 2002 and \$274 million in 2003. Purchase commitments related to lignite mining and lease agreements, natural gas purchases and storage contracts, and purchased power are not material to the operations of the Company. Currently, Reliant Energy HL&P is allowed recovery of these costs through base rates for electric service. As of December 31, 2000, some of these contracts are above market. The Company anticipates that stranded costs associated with these obligations will be recoverable through the stranded costs recovery mechanisms contained in the Legislation. For information regarding the Legislation, see Note 4(a).

REMA is a party to several long-term fuel supply contracts which have various quantity requirements and durations. Minimum payment obligations under these agreements that extend through 2004 are as follows as of December 31, 2000 (in millions):

2001	\$ 85
2002	66
2003	29
2004	<u>14</u>
Total	<u>\$194</u>

The Company'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 the Company's results of operations or cash flows.

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(c) Lease Commitments.

In August 2000, the Company entered into separate sale/leaseback transactions with each of three owner-lessors for the Company's 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 some 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, guarantees the lease obligations. The Company will make lease payments through 2029. The lease terms expire in 2034.

The following table sets forth information concerning the Company's obligations under non-cancelable long-term operating leases at December 31, 2000, which primarily relate to the REMA leases mentioned above. Other non-cancelable long-term operating leases principally consist of rental agreements for building space, data processing equipment and vehicles, including major work equipment.

	REMA Sale-Lease Obligation	Other	Total
	(in millions)		
2001	\$ 259	\$ 16	\$ 275
2002	137	10	147
2003	77	8	85
2004	84	6	90
2005	75	6	81
2006 and beyond	<u>1,188</u>	<u>36</u>	<u>1,224</u>
Total	<u>\$1,820</u>	<u>\$ 82</u>	<u>\$1,902</u>

Total lease expense for all operating leases was \$10 million, \$13 million and \$46 million during 1998, 1999 and 2000, respectively.

(d) Cross Border Leases.

During the period from 1994 through 1997, under cross border lease transactions, UNA 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, 2000, of 1 to 24 years. UNA 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 \$1.7 billion remained outstanding as of December 31, 2000. These transactions involve UNA 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 UNA of the transactions were recorded as a deferred gain and are currently being amortized to income over the lease terms. At December 31, 1999 and 2000, the unamortized deferred gain on these transactions totaled \$87 million and \$77 million, respectively. The power plants, related equipment and turbines remain on the financial statements of UNA and continue to be depreciated.

UNA is required to maintain minimum insurance coverages, perform minimum annual maintenance and, in specified situations, post letters of credit. UNA's shareholder is subject to some restrictions with respect to the liquidation of UNA's shares. In the case of early termination of these contracts, UNA would be contingently liable for some payments to the sublessors, which at December 31, 2000, are estimated to be

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\$274 million. Starting in March 2000, UNA 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 \$274 million as of December 31, 2000. Commitments for these letters of credit have been obtained as of December 31, 2000.

(e) Naming Rights to Houston Sports Complex.

In October 2000, the Company 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 the Company with significant sponsorship rights. The aggregate cost of the naming rights will be approximately \$300 million. During the fourth quarter of 2000, the Company 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 Company's Statement of Consolidated Operations in 2000. Starting in 2002, when the new stadium is operational, the Company will pay \$10 million each year through 2032 for annual advertising under this agreement.

(f) 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, 1999 and 2000, 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 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.

(g) 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

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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 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 opinions over the past decade. The Company estimates the range of possible outcomes for the plaintiffs to be between zero and \$17 million inclusive of interest and attorneys' fees.

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.

California Wholesale Market. Reliant Energy and Reliant Energy Services, Inc. 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. RERC Corp. has also been named as a defendant on one of the lawsuits. Pursuant to the terms of the master separation agreement between Reliant Energy and Reliant Resources (see Note 4(b)), Reliant Resources will agree to indemnify RERC Corp. for any damages arising under this lawsuit, and will agree to indemnify Reliant Energy for damages arising under any of these lawsuits, and may elect to defend these lawsuits at Reliant Resources' 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. 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 during all or portions of 2000, costs of suit and attorneys' fees. In one of the cases the plaintiffs allege aggregate damages of over \$4 billion. Defendants have filed petitions to remove the cases to federal court. Furthermore, defendants have filed a motion with the Panel on Multidistrict Litigation seeking transfer and consolidation of all the cases. These lawsuits have only recently been filed. Therefore, the ultimate outcome of the lawsuits cannot be predicted with any degree of certainty at this time. However, the Company does not believe, based on its analysis to date of the claims asserted in these lawsuits and the underlying facts, that resolution of these lawsuits will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

Environmental Matters.

Manufactured Gas Plant Sites. RERC Corp. and its subsidiaries (RERC) and its predecessors operated a manufactured gas plant (MGP) adjacent to the Mississippi River in Minnesota, formerly known as Minneapolis Gas Works (MGW) until 1960. 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, 1999 and 2000, RERC had accrued \$19 million and \$17 million, respectively, for remediation of the Minnesota sites. At December 31, 2000, the estimated range of possible remediation costs was \$8 million to \$36 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.

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The actual remediation costs will be dependent upon the number of sites remediated, the participation of other potentially responsible parties, if any, and the remediation methods used.

Other Minnesota Matters. At December 31, 1999 and 2000, RERC had recorded accruals of \$1 million and \$2 million, respectively (with a maximum estimated exposure of approximately \$13 million and \$17 million at December 31, 1999 and 2000, respectively), for other environmental matters in Minnesota for which remediation may be required.

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 potentially responsible party (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.

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 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, REMA has liabilities associated with six ash disposal site closures and six 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. The Company expects approximately \$13 million will be paid over the next five years.

UNA Asbestos Abatement and Soil Remediation. Prior to the Company's acquisition of UNA (see Note 3(b)), UNA 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 UNA's properties. UNA 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, the estimated undiscounted liability for this asbestos abatement and soil remediation was \$24 million.

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. In addition, the Company has been named as a defendant in litigation related to such sites and in recent years has been named, along with numerous others, as a defendant in several lawsuits filed by a large number of individuals who claim injury due to exposure to asbestos while working at sites along the Texas Gulf Coast. Most of these claimants have been workers who participated in construction of various industrial facilities, including power plants, and some of the claimants have worked at locations owned by the

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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.

(h) California Wholesale Market Uncertainty.

During the summer and fall of 2000, 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, decreases in net electric imports, structural market flaws including over-reliance on the electric spot market, and limitations on supply as a result of maintenance and other outages. Although wholesale prices increased, California's deregulation legislation kept retail rates frozen below 1996 levels. This caused two of California's public utilities, which are the Company's customers based on its deliveries to the Cal PX and the Cal ISO, to amass billions of dollars of uncollected wholesale power costs and to ultimately default in January and February 2001 on payments owed for wholesale power purchased through the Cal PX and from the Cal ISO.

As of December 31, 2000, the Company was owed \$101 million by the Cal PX and \$181 million by the Cal ISO. In the fourth quarter of 2000, the Company recorded a pre-tax provision of \$39 million against receivable balances related to energy sales in the California market. From January 1, 2001 through February 28, 2001, the Company has collected \$105 million of these receivable balances. As of March 1, 2001, the Company was owed a total of \$358 million by the Cal ISO, the Cal PX, the California Department of Water Resources (CDWR) and California Energy Resource Scheduling, for energy sales in the California wholesale market from the fourth quarter of 2000 through February 28, 2001. Management will continue to assess the collectibility of these receivables based on further developments affecting the California electricity market and the market participants described herein. Additional provisions to the allowance may be warranted in the future.

In response to the filing of a number of complaints challenging the level of wholesale prices, the FERC initiated a staff investigation and issued an order on December 15, 2000 implementing a series of wholesale market reforms, including an interim price review procedure for prices above a \$150/MWh "breakpoint" on sales to the Cal ISO and through the Cal PX. The order does not prohibit sales above the "breakpoint," but the seller is subject to weekly reporting and monitoring requirements. For each reported transaction, potential refund liability extends for a period of 60 days following the date any such transaction is reported to the FERC. On March 9, 2001, the FERC issued a further order establishing a proxy market clearing price of \$273/MWh for January 2001, and on March 16, 2001 the FERC issued a further order adjusting the proxy market clearing price to \$430/MWh for February 2001. New market monitoring and mitigation measures to replace the \$150/MWh breakpoint and reporting obligation are being developed by the FERC to take effect on May 1, 2001.

In the FERC's March 9 and March 16 orders, the FERC outlined criteria for determining amounts subject to possible refund based on the proxy market clearing price for January and February 2001 and indicated that approximately \$12 million of the \$125 million charged by the Company in January 2001 in

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California to the Cal ISO and the Cal PX and approximately \$7 million of the \$47 million charged by the Company in February 2001 in California to the Cal ISO and the Cal PX were subject to possible refunds. In the March 9 and March 16 orders, the FERC set forth procedures for challenging possible refund obligations. Because the Company believes that there is cost or other justification for prices charged above the proxy market clearing prices established in the March 9 and March 16 orders, the Company intends to pursue such a challenge with respect to the Company's potential refund amounts identified in such orders. Any refunds the Company may ultimately be obligated to pay are to be credited against unpaid amounts owed to the Company for its sales in the Cal PX or to the Cal ISO. The December 15 order established that a refund condition would be in place for the period beginning October 2, 2000 through December 31, 2002. The December 15 order also eliminated the requirement that California's public utilities sell all of their generation into and purchase all of their power from the Cal PX and directed that the Cal PX wholesale tariffs be terminated effective April 2001. The Cal PX has since suspended its day-ahead and day-of markets and filed for bankruptcy protection on March 9, 2001. Motions for rehearing have been filed on a number of issues related to the December 15 order and such motions are still pending before the FERC.

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 Public Utilities Commission, the California Electricity Oversight Board, the California Bureau of State Audits and the California Office of the Attorney General all have separate ongoing investigations into the high prices and their causes. None of these investigations have been completed and no findings have been made in connection with any of them.

Despite the market restructuring ordered under the December 15 order, the California public utilities have continued to accrue unrecovered wholesale costs. As a result, the credit ratings of two of these public utilities were severely downgraded to below investment grade in January 2001. As their credit lines became unavailable, the two utilities defaulted on payments due to the Cal PX and the Cal ISO, which operate financially as pass-through entities, coordinating payments from buyers and sellers of electricity. As a result, the Cal PX and Cal ISO were not able to pay final invoices to market participants totaling over \$1 billion.

The default of two of California's public utilities on amounts owed the Cal PX and the Cal ISO for purchased power has further exacerbated the current crisis in the California wholesale markets and resulted in substantial uncollected receivables owed to the Company by the Cal ISO and the Cal PX. The Cal PX's efforts to recover the available collateral of the utilities, in the form of block forward contracts, have been frustrated by the emergency acts of California's Governor, who seized control of the contracts upon the expiration of temporary restraining orders prohibiting such action. Although obligated to pay reasonable value for the contracts, the state of California has not yet made any payment for the contracts. Various actions have been filed challenging the Governor's ability to seize these contracts.

Upon the default of the two utilities of amounts due to the Cal PX, the Cal PX issued "charge-backs" allocating the utilities' defaults to the other market participants. Proceedings were brought both in federal court and at the FERC seeking a suspension of the charge-backs and challenging the reasonableness of the Cal PX's actions. The Cal PX has since agreed to a preliminary injunction suspending any of its charge-back activities in order to allow the FERC to address the charge-back issues. Amounts owed to the Company were debited in invoices by the Cal PX for charge-backs in the amount of \$29 million and, on February 14, 2001, the Company filed its own lawsuit against the Cal PX in the United States District Court for the Central District of California, seeking a recovery of those amounts and a stay of any further charge-backs by the Cal PX. The filing of bankruptcy by the Cal PX will automatically stay for some period the various court and administrative cases against the Cal PX.

The two defaulting utilities have both filed lawsuits challenging the refusal of state regulators to allow wholesale power costs to be passed through to retail customers under the "filed rate doctrine". The filed rate

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doctrine provides that wholesale power costs approved by the FERC are entitled to be recovered through rates. Additionally, to address the failing financial condition of the two defaulting utilities and the utilities' potential bankruptcy, the California Legislature passed emergency legislation, effective January 18, 2001 and February 2, 2001, appropriating funds to be used by the CDWR for the purchase of wholesale electricity on behalf of the utilities and authorizing the sale of bonds to fund future purchases under long-term power contracts with wholesale generators. The CDWR began the process of soliciting bids from generators for long-term contracts and continued the purchasing of short-term power contracts. No bonds have yet been issued by the CDWR to support long-term power purchases or to provide credit support for short-term purchases.

As noted above two of California's public utilities have defaulted in their payment obligations to the Cal PX and the Cal ISO as a result of the refusal of state regulators to allow them to recover their wholesale power costs. This refusal by state regulators has also caused the utilities to default on numerous other financial obligations, which could result in either the voluntary or involuntary bankruptcy of the utilities. While a bankruptcy filing would result in further post-petition purchases of wholesale electricity being considered administrative expenses of the debtor, a substantial delay could be experienced in the payment of pre-petition receivables pending the confirmation of a reorganization plan. The California Legislature is currently considering legislation under which a state entity would be formed to purchase and operate a substantial share of the transmission lines in California in an effort to provide cash to the utilities and thereby avoid potential bankruptcy filings by the utilities. A number of the creditors for the two California public utilities have indicated, however, that unless California moves quickly with such a plan, an involuntary bankruptcy filing may be made by one or more of such creditors.

Because California's power reserves remain at low levels, in part as a result of the lack of creditworthy buyers of power given the defaults of the California utilities, the Cal ISO has relied on emergency dispatch orders requiring generators to provide at the Cal ISO's direction all power not already under contract. The power supplied to the Cal ISO has been used to meet the needs of the customers of the utilities, even though two of those utilities do not have the credit required to receive such power and may be unable to pay for it. The Company has contested the obligation to provide power under these circumstances. The Cal ISO sought a temporary restraining order compelling the Company to continue to comply with the emergency dispatch orders despite the utilities' defaults. Although the payment issue is still disputed, on February 21, 2001, the Company and the CDWR entered into a contract expiring March 23, 2001 for the purchase of all of the Company's available capacity not already under contract and the litigation has been temporarily stayed. The CDWR is current in its payments under this contract, but the Company is still owed \$108 million for power provided in compliance with the emergency dispatch orders for the six weeks prior to the agreement. Depending on the outcome of the court proceedings initiated by the Cal ISO seeking to enjoin us from ceasing power deliveries to the Cal ISO, the Company may be forced to continue selling power without the guarantee of payment.

Additionally, the Company is seeking a prompt FERC determination that the Cal ISO is not complying with the credit provisions of its tariff and a related order of the FERC issued on February 14, 2001, requiring the Cal ISO not to make purchases in the real time market unless a creditworthy purchaser is responsible for such purchases.

(i) Indemnification of Stranded Costs.

The stranded costs in the Dutch electricity market are considered to be the liabilities, uneconomical contractual commitments, and other costs associated with obligations entered into by the coordinating body for the Dutch electricity generating sector, N.V. Samenwerkende elektriciteits-productiebedrijven (SEP), plus some district heating contracts with some municipalities in Holland. As of December 29, 2000, SEP changed its name to BV Nederlands Elektriciteit Administratiekantoor.

SEP was incorporated as the coordinating body for four of the large-scale Dutch electricity generation companies, including UNA, which currently has an equity interest in SEP of 25%. Among other things, SEP

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prior to 2001 owned and managed the dispatch for the national transmission grid, coordinated the fuel supply, managed the import and the export of electricity, and settled production costs for the electricity generation companies.

Under the Cooperation Agreement (OvS Agreement), UNA and the other Dutch generators agreed to sell their generating output through SEP. Over the years, SEP incurred stranded costs as a result of a perceived need to cover anticipated shortages in energy production supply. SEP stranded costs consist primarily of investments in alternative energy sources and fuel and power purchase contracts currently estimated to be uneconomical.

In December 2000, the Dutch parliament adopted legislation, The Electricity Production Sector Transitional Arrangements Act (Transition Act), allocating to the Dutch generation sector, including UNA, financial responsibility for various stranded costs contracts and other liabilities of SEP. The Transition Act also authorizes the government to purchase from SEP at least a majority of the shares in the Dutch national transmission grid company. The legislation became effective in all material respects on January 1, 2001.

The Transition Act allocates financial responsibility to the individual Dutch generators based on their average share in the costs and revenues under the OvS Agreement during the past ten years. UNA's allocated share of these costs has been set at 22.5%. In particular, the Transition Act allocates to the four Dutch generation companies, including UNA, financial responsibility for SEP's obligations to purchase electricity and gas under an import gas supply contract and three electricity import contracts. The gas import contract expires in 2015 and provides for gas imports aggregating 2.283 billion cubic meters per year. The three electricity contracts have the following capacities and terms: (a) 300 MW through 2005, (b) 600 MW through 2005 and (c) 600 MW through 2002 and 750 MW through 2009. The generators have the option of assuming their pro rata interests in the contracts or, subject to the assignment terms of the contracts, selling their interests to third parties.

The Transition Act provides that, subject to the approval of the European Commission, the Dutch government will make financial compensations to the Dutch generation sector for the out of market costs associated with two stranded cost items: an experimental coal facility and district heating contracts.

The four Dutch generation companies and SEP are in discussions with the Dutch Ministry of Economic Affairs regarding the implementation of the Transition Act. The parties have reached an agreement in principle with the Dutch Ministry of Economic Affairs regarding the compensation to be paid to SEP for the national transmission grid company. The proposed compensation amount is NLG 2.55 billion (approximately \$1.1 billion based on an exchange rate of 2.34 NLG per U.S. dollar as of December 31, 2000). Although the Transition Act clarifies many issues regarding the anticipated resolution of the stranded costs debate in the Netherlands, there remain considerable uncertainties regarding the exact manner in which the Transition Act will be implemented and the potential for third parties to challenge the Transition Act on legal and constitutional grounds.

In connection with the acquisition of UNA, the selling shareholders of UNA agreed to indemnify UNA for some stranded costs in an amount not to exceed NLG 1.4 billion (approximately \$599 million based on an exchange rate of 2.34 NLG per U.S. dollar as of December 31, 2000), which may be increased in some circumstances at the option of the Company up to NLG 1.9 billion (approximately \$812 million). Of the total consideration paid by the Company for the shares of UNA, NLG 900 million (approximately \$385 million) has been placed by the selling shareholders in an escrow account under the direction of the Dutch Ministry of Economic Affairs to secure the indemnity obligations. Although the Company's management believes that the indemnity provision will be sufficient to fully satisfy UNA's ultimate share of any stranded costs obligation, this judgment is based on numerous assumptions regarding the ultimate outcome and timing of the resolution of the stranded cost issue, the former shareholders' timely performance of their obligations under the indemnity arrangement, and the amount of stranded costs which at present is not determinable.

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(j) Operations Agreement with City of San Antonio.

As part of the 1996 settlement of certain litigation claims asserted by the City of San Antonio with respect to the South Texas Project, the Company entered into a 10-year joint operations agreement under which the Company and the City of San Antonio, acting through the City Public Service Board of San Antonio (CPS), share savings resulting from the joint dispatching of their respective generating assets in order to take advantage of each system's lower cost resources. 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. It is anticipated that the cumulative obligation will be met in the first quarter of 2001. In 1998, 1999 and 2000, savings generated for CPS' account were \$14 million, \$14 million and \$60 million, respectively. Through December 31, 2000, cumulative savings generated for CPS' account were \$124 million.

(k) 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, 2000. 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.

(l) Nuclear Decommissioning.

The Company contributes \$14.8 million per year to a trust established to fund its share of the decommissioning costs for the South Texas Project. For a discussion of the accounting treatment for the securities held in the Company's nuclear decommissioning trust, see Note 2(l). In July 1999, an outside consultant estimated the Company's portion of decommissioning costs to be approximately \$363 million. While the current and projected 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 Legislation, 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 non-bypassable 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).

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(15) Estimated Fair Value of Financial Instruments

	December 31,			
	1999		2000	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in millions)			
Financial assets:				
Energy derivatives — non-trading	\$ —	\$ 3	\$ —	\$ 520
Foreign currency swaps	6	6	—	—
Financial liabilities:				
Long-term debt (excluding capital leases)	9,210	9,092	6,607	6,512
Trust preferred securities	705	599	705	665
Energy derivatives — non-trading	—	1	—	69
Foreign currency swaps	—	—	62	68

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 equivalent to carrying amounts and have been excluded from the above table. The fair value of financial instruments included in the trading operations are marked-to-market at December 31, 1999 and 2000 (see Note 5). Therefore, they are stated at fair value and are excluded from the above table. The remaining fair values have been determined using quoted market prices for the same or similar securities when available or other estimation techniques.

(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,		
	1998	1999	2000
	(in millions, except per share and share amounts)		
Basic EPS calculation:			
(Loss) income from continuing operations before extraordinary item	\$ (278)	1,674	771
Discontinued operations	137	(9)	(331)
Extraordinary (loss) gain	—	(183)	7
Net (loss) income	<u>\$ (141)</u>	<u>\$ 1,482</u>	<u>\$ 447</u>
Weighted average shares outstanding	284,095,000	285,040,000	284,652,000
Basic EPS:			
(Loss) income from continuing operations before extraordinary item	\$ (0.98)	\$ 5.87	\$ 2.71
Discontinued operations	0.48	(0.03)	(1.17)
Extraordinary (loss) gain	—	(0.64)	0.03
Net (loss) income	<u>\$ (0.50)</u>	<u>\$ 5.20</u>	<u>\$ 1.57</u>

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	For the Year Ended December 31,		
	1998	1999	2000
	(in millions, except per share and share amounts)		
Diluted EPS calculation:			
Net (loss) income	\$ (141)	\$ 1,482	\$ 447
Plus: Income impact of assumed conversions			
Interest on 6¼% convertible trust preferred securities ..	—	—	—
Total earnings effect assuming dilution	<u>\$ (141)</u>	<u>\$ 1,482</u>	<u>\$ 447</u>
Weighted average shares outstanding	284,095,000	285,040,000	284,652,000
Plus: Incremental shares from assumed conversions (1)			
Stock options	—	260,000	1,652,000
Restricted stock	—	698,000	955,000
6¼% convertible trust preferred securities	—	23,000	14,000
Weighted average shares assuming dilution	<u>284,095,000</u>	<u>286,021,000</u>	<u>287,273,000</u>
Diluted EPS:			
(Loss) income from continuing operations before extraordinary item	\$ (0.98)	\$ 5.85	\$ 2.68
Discontinued operations	0.48	(0.03)	(1.15)
Extraordinary (loss) gain	—	(0.64)	0.03
Net (loss) income	<u>\$ (0.50)</u>	<u>\$ 5.18</u>	<u>\$ 1.56</u>

(1) No assumed conversions were included in the computation of diluted earnings per share for 1998 because additional shares outstanding would result in an anti-dilutive per share amount. The computation of diluted EPS for 1998 excludes 492,000 shares of restricted stock and purchase options for 434,000 shares of common stock, which would be anti-dilutive if exercised.

Options to purchase 433,915 and 442,385 shares were outstanding for the years ended December 31, 1999 and 2000, 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.

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(17) Unaudited Quarterly Information

Summarized quarterly financial data is as follows:

	Year Ended December 31, 1999			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in millions, except per share amounts)			
Revenues	\$2,695	\$3,614	\$4,913	\$4,001
Operating income	266	275	479	238
(Loss) income from continuing operations before extraordinary item	(137)	62	1,676	73
(Loss) income from discontinued operations, net of tax	(73)	13	14	37
Extraordinary item, net of tax	—	—	—	(183)
Net (loss) income attributable to common stockholders	(210)	75	1,690	(73)
Basic (loss) earnings per share: (1)				
(Loss) income from continuing operations before extraordinary item	(0.48)	0.21	5.87	0.26
(Loss) income from discontinued operations, net of tax	(0.26)	0.05	0.05	0.13
Extraordinary item, net of tax	—	—	—	(0.65)
Net (loss) income attributable to common stockholders	(0.74)	0.26	5.92	(0.26)
Diluted (loss) earnings per share: (1)				
(Loss) income from continuing operations before extraordinary item	(0.48)	0.21	5.85	0.26
(Loss) income from discontinued operations, net of tax	(0.26)	0.05	0.05	0.13
Extraordinary item, net of tax	—	—	—	(0.65)
Net (loss) income attributable to common stockholders	(0.74)	0.26	5.90	(0.26)

	Year Ended December 31, 2000			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in millions, except per share amounts)			
Revenues	\$4,213	\$5,755	\$9,502	\$9,869
Operating income	342	513	776	248
Income from continuing operations before extraordinary item	134	236	395	6
Loss from discontinued operations, net of tax	(1)	(19)	(6)	(146)
Loss on disposal of discontinued operations, net of tax	—	—	—	(159)
Extraordinary item, net of tax	—	7	—	—
Net income (loss) attributable to common stockholders	133	224	389	(299)
Basic earnings (loss) per share: (1)				
Income from continuing operations before extraordinary item	0.47	0.83	1.38	0.02
Loss from discontinued operations, net of tax	—	(0.07)	(0.02)	(0.51)
Loss on disposal of discontinued operations, net of tax	—	—	—	(0.55)
Extraordinary item, net of tax	—	0.03	—	—
Net income (loss) attributable to common stockholders	0.47	0.79	1.36	(1.04)
Diluted earnings (loss) per share: (1)				
Income from continuing operations before extraordinary item	0.47	0.82	1.36	0.02
Loss from discontinued operations, net of tax	—	(0.07)	(0.02)	(0.51)
Loss on disposal of discontinued operations, net of tax	—	—	—	(0.55)
Extraordinary item, net of tax	—	0.03	—	—
Net income (loss) attributable to common stockholders	0.47	0.78	1.34	(1.04)

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- (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 and UNA from their respective acquisition dates as discussed in Note 3. The variances in revenues from quarter to quarter were primarily due to these acquisitions, the seasonal fluctuations in demand for energy and energy services and changes in energy commodity prices. Changes in operating (loss) income and net (loss) income from quarter to quarter were primarily due to these acquisitions, the seasonal fluctuations in demand for energy and energy services, changes in energy commodity prices and the timing of maintenance expenses on electric generation plants.

(18) Reportable Segments

The Company's determination of reportable 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 UNA are included in the segment disclosures only for periods beginning on their respective acquisition dates. The accounting policies of the 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 segments. The Company evaluates performance based on operating income excluding some corporate costs not allocated to the segments. The Company accounts for intersegment sales as if the sales were to third parties, that is, at current market prices. In the fourth quarter of 2000, the Company transferred its non-rate regulated retail gas marketing operations from Other Operations to Natural Gas Distribution and its natural gas gathering business from Wholesale Energy to Pipelines and Gathering. Reportable segments from previous years have been restated to conform to the 2000 presentation.

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The Company has identified the following reportable segments: Electric Operations, Natural Gas Distribution, Pipelines and Gathering, Wholesale Energy, European Energy and Other Operations. For a description of the financial reporting 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	Other Operations	Discontinued Operations	Reconciling Eliminations	Consolidated
	(in millions)								
As of and for the year ended December 31, 1998:									
Revenues from external customers	\$ 4,350	\$2,363	\$ 168	\$4,248	\$ —	\$ 101	\$ —	\$ —	\$11,230
Intersegment revenues	—	63	178	168	—	1	—	(410)	—
Depreciation and amortization	663	131	48	14	—	10	—	—	866
Operating income (loss) ...	1,002	167	146	42	—	(77)	—	—	1,280
Total assets	10,025	3,061	2,217	1,458	—	1,523	1,041	(358)	18,967
Equity investments in unconsolidated subsidiaries	—	—	—	42	—	—	—	—	42
Expenditures for long-lived assets	433	162	76	347	—	28	—	—	1,046
As of and for the year ended December 31, 1999:									
Revenues from external customers	4,483	2,742	163	7,648	153	34	—	—	15,223
Intersegment revenues	—	46	168	264	—	1	—	(479)	—
Depreciation and amortization	667	137	53	21	21	6	—	—	905
Operating income (loss) ...	981	158	131	27	32	(71)	—	—	1,258
Total assets	9,941	3,700	2,486	2,821	3,247	4,308	1,078	(1,125)	26,456
Equity investments in unconsolidated subsidiaries	—	—	—	78	—	—	—	—	78
Expenditures for long-lived assets	573	206	79	481	834	89	—	—	2,262
As of and for the year ended December 31, 2000:									
Revenues from external customers	5,494	4,379	177	18,655	579	55	—	—	29,339
Intersegment revenues	—	33	207	579	—	—	—	(819)	—
Depreciation and amortization	507	145	56	109	75	14	—	—	906
Operating income (loss) ...	1,230	113	137	482	89	(172)	—	—	1,879
Total assets	10,691	4,462	2,357	11,312	2,473	1,648	195	(1,061)	32,077
Equity investments in unconsolidated subsidiaries	—	—	—	109	—	—	—	—	109
Expenditures for long-lived assets	643	195	61	1,966	995	91	—	—	3,951

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

	<u>Year Ended December 31,</u>		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
	(in millions)		
Reconciliation of Operating Income to Net Income (Loss) Attributable to Common Stockholders:			
Operating income	\$ 1,280	\$ 1,258	\$ 1,879
(Loss) income of equity investments	(1)	(1)	43
Other income	68	60	83
Gain (loss) on AOL Time Warner investment	—	2,452	(205)
(Loss) gain on indexed debt securities	(1,176)	(629)	102
Interest expense and other charges	(532)	(550)	(754)
Income tax benefit (expense)	83	(916)	(377)
Income (loss) from discontinued operations	137	(9)	(172)
Loss on disposal of discontinued operations	—	—	(159)
Extraordinary (loss) gain, net of tax	—	(183)	7
Net (loss) income attributable to common stockholders	<u>\$ (141)</u>	<u>\$ 1,482</u>	<u>\$ 447</u>
Revenues by Products and Services:			
Retail power sales	\$ 4,350	\$ 4,483	\$ 5,494
Retail gas sales	2,372	2,669	4,291
Wholesale energy and energy related sales	4,248	7,808	19,290
Gas transport	168	158	122
Energy products and services	92	105	142
Total	<u>\$11,230</u>	<u>\$15,223</u>	<u>\$29,339</u>
Revenues and Long-Lived Assets by Geographic Areas:			
Revenues:			
US	\$11,230	\$14,954	\$27,710
Netherlands	—	153	579
Other	—	116	1,050
Total	<u>\$11,230</u>	<u>\$15,223</u>	<u>\$29,339</u>
Long-lived assets:			
US	\$16,287	\$16,862	\$19,734
Netherlands	—	3,058	2,335
Total	<u>\$16,287</u>	<u>\$19,920</u>	<u>\$22,069</u>

(19) Discontinued Operations

Effective December 1, 2000 (the Measurement Date), the Company's Board of Directors approved a plan to dispose of its Latin America business segment, through sales of its Latin American assets. Accordingly, the Company is reporting the results of its Latin America business segment as discontinued operations for all periods presented in the Consolidated Financial Statements in accordance with Accounting Principles Board Opinion No. 30.

In the fourth quarter of 2000, prior to the Measurement Date, the Latin America business segment sold its investments in El Salvador and a portion of its investments in Colombia for an aggregate \$303 million in after-tax proceeds. The Company recorded a \$127 million after-tax loss in connection with the sale of these investments which is included in the after-tax loss from discontinued operations of \$172 million (net of an income tax benefit of \$46 million) in 2000.

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

Subsequent to the Measurement Date, the Latin America business segment sold its investments in Brazil and its remaining investments in Colombia for an aggregate \$487 million in after-tax proceeds. The Company recorded a \$114 million after-tax loss in connection with the sale of these investments which is included in the after-tax loss on disposal of discontinued operations of \$159 million (net of income taxes of \$13 million) in 2000. The total provision for the disposal of discontinued operations includes a \$5 million reserve for anticipated operating losses through the completion of the sales, which includes \$4 million in operating losses from Measurement Date through December 31, 2000. There was no interest allocated to the discontinued operations. The Latin America business segment's remaining investments include a wholly owned cogeneration facility and a distribution company both located in Argentina and a minority interest in a coke calcining plant in India. The Company anticipates that the sale of the remainder of these assets will be completed by December 2001. The amounts that the Company will ultimately realize from this disposal could be materially different from the amounts assumed in arriving at the estimated loss on disposal of the discontinued operations. Components of amounts reflected in the Company's Consolidated Statements of Operations through the Measurement Date and the Company's Consolidated Balance Sheets are presented in the following table.

	Year Ended December 31,		
	1998	1999	2000
	(in millions)		
Income Statement Data:			
Revenues	\$ 50	\$ 93	\$ 80
Operating expenses	73	98	81
Operating loss	(23)	(5)	(1)
Income (loss) of equity investments	71	(14)	(29)
Gain (loss) on sales of assets	138	—	(176)
Other income (expense)	3	(7)	(12)
Income tax benefit (expense)	(52)	17	46
Income (loss) from discontinued operations	<u>\$137</u>	<u>\$ (9)</u>	<u>\$ (172)</u>
Balance Sheet Data:			
Current assets	\$ 38	\$ 36	
Equity investment and other	990		46
Property, plant and equipment, net	126		130
Current liabilities	(63)		(14)
Other liabilities	(13)		(3)
Net assets of discontinued operations	<u>\$1,078</u>	<u>\$195</u>	

(20) Subsequent Events

(a) Credit Facilities.

Between December 2000 and March 2001, Reliant Resources entered into eleven bilateral credit facilities with financial institutions, which provide for an aggregate of \$1.6 billion in committed credit. The facilities became effective subsequent to December 31, 2000 and expire on October 2, 2001. Concurrent with the effectiveness of these facilities, \$500 million of the facilities of a financing subsidiary were canceled. Interest rates on the borrowings are based on LIBOR plus a margin, a base rate or a rate determined through a bidding

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

process. These facilities contain various business and financial covenants requiring Reliant Resources to, among other things, maintain a ratio of net debt to the sum of net debt, subordinated affiliate debt and shareholders' equity not to exceed 0.60 to 1.00. These covenants are not anticipated to materially restrict Reliant Resources from borrowing funds or obtaining letters of credit under these facilities. The credit facilities are subject to commitment and usage fees that are calculated based on the amount of the facility and/or the amounts outstanding under the facilities, respectively.

(b) 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.

(c) Florida Tolling Arrangement.

In the first quarter 2001, the Company entered into tolling arrangements with a third party to purchase the right to utilize and dispatch electric generating capacity of approximately 1,100 MW. This electricity is expected to be generated by two gas-fired, simple-cycle peaking plants, with fuel oil backup, to be constructed by the tolling partner in Florida, which are anticipated to be completed by the summer of 2002, at which time the Company will commence tolling payments.

INDEPENDENT AUDITORS' REPORT

Reliant Energy, Incorporated:

We have audited the accompanying consolidated balance sheets of Reliant Energy, Incorporated and its subsidiaries (the Company) as of December 31, 1999 and 2000, and the related statements of consolidated operations, consolidated comprehensive income, consolidated cash flows and consolidated stockholders' equity for each of the three years in the period ended December 31, 2000. Our audits also included the Company's financial statement schedule listed in 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, 1999 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2000 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.

DELOITTE & TOUCHE LLP

Houston, Texas
March 16, 2001

South Texas Project Electric Generating Station

Project Statements
December 31, 2000 and 1999

**South Texas Project Electric Generating Station
Project Statements
Index**

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Report of Independent Accountants

To the City of San Antonio (acting through
the City Public Service Board), AEP-CPL,
Reliant Energy Inc.
and the City of Austin (collectively, the Participants)

In our opinion, the special-purpose project statements listed in the accompanying index present fairly, in all material respects, the South Texas Project Electric Generating Station (STPEGS) Statements of Owners' Assets and Related Liabilities as of December 31, 2000 and 1999, the STP Nuclear Operating Company (STPNOC) Balance Sheets at December 31, 2000 and 1999, the STPEGS Statements of Expenses and Miscellaneous Income (Deductions) and the STPEGS and STPNOC Statements of Selected Cash Flows for the years ended December 31, 2000 and 1999 and the STPEGS and STPNOC Statements of Owners' Liabilities as of December 31, 2000 and 1999, under the requirements of Paragraph 9.3.4 of the Amended and Restated South Texas Project Participation Agreement (Participation Agreement) dated November 17, 1997 as more fully described in Note 1. The accompanying special-purpose project statements were prepared for the purpose of complying with the above-noted section of the Participation Agreement and are not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America. These project statements are the responsibility of STPNOC management; our responsibility is to express an opinion on these project statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the project statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the project statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall project statement presentation. We believe that our audits provide a reasonable basis for our opinion.

This report is intended solely for the information and use of the Participants and should not be used for any other purpose.

PricewaterhouseCoopers LLP

March 21, 2001

South Texas Project Electric Generating Station
Statements of Owners' Assets and Related Liabilities
December 31, 2000 and 1999

Account number	Assets	2000	1999
101.0	Electric plant in-service	\$ 5,882,746,129	\$ 5,792,002,405
107	Construction work in progress	72,417,179	205,817,677
108	Accumulated provision for depreciation of electric plant in-service	(30,130,119)	(102,150,643)
120.1	Nuclear fuel in process	43,475,286	51,415,054
120.2	Nuclear fuel in stock	1,229,475	
120.3	Nuclear fuel assemblies	221,712,197	223,660,201
120.4	Spent nuclear fuel	629,890,871	581,818,230
120.5	Accumulated provision for amortization of nuclear fuel	(770,112,769)	(714,946,030)
131	Cash	60,803	60,539
135	Working funds	12,347	7,569
143	Other accounts receivable	198,453	67,050
154	Materials and supplies	86,213,712	85,838,774
163	Stores expense undistributed	1,219,056	1,391,010
165	Prepayments	3,744,198	3,019,566
184	Clearing accounts	190,188	281,385
186.1	Retirement work in progress	77,104	76,880
186.2	Other work in progress	1,764,483	61,736
186.4	Enrichment decommissioning and decontamination receivable from owners	20,961,608	20,469,857
186.5	Accumulated provision for amortization of enrichment decommissioning and decontamination	(6,587,083)	(4,510,211)
		<u>\$ 6,159,083,118</u>	<u>\$ 6,144,381,049</u>
Liabilities			
232	Accounts payable	\$ 36,260,690	\$ 51,543,454
242	Accrued spent fuel disposal fee	5,103,617	4,278,999
242	Other miscellaneous accrued liabilities	375,496	348,000
228.2	Injuries and damages reserve	1,344,619	1,459,597
242	Enrichment decommissioning and decontamination liability - current	2,129,559	2,059,309
228.4	Enrichment decommissioning and decontamination liability - noncurrent	10,647,797	12,355,855
		<u>\$ 55,861,778</u>	<u>\$ 72,045,214</u>

The accompanying notes are an integral part of these financial statements.

STP Nuclear Operating Company
Balance Sheets
December 31, 2000 and 1999

Account number	Assets	2000	1999
146	Total receivables from owners	<u>\$ 47,043,668</u>	<u>\$ 33,080,014</u>
	Total assets	<u>\$ 47,043,668</u>	<u>\$ 33,080,014</u>
Liabilities			
232	Accrued payroll and related expenses	\$ 1,473,588	\$ 1,371,367
236	Accrued payroll taxes	66,100	51,105
242	Incentive compensation and benefit accruals - current	9,904,240	13,073,013
253	Incentive compensation and benefit accruals - noncurrent	3,781,856	1,985,816
228.3	Pension liability	15,762,048	9,648,292
228.3	Other postretirement benefit liability	15,677,836	6,572,421
228.3	Postemployment benefit liability	<u>378,000</u>	<u>378,000</u>
	Total liabilities	<u>\$ 47,043,668</u>	<u>\$ 33,080,014</u>

The accompanying notes are an integral part of these financial statements.

South Texas Project Electric Generating Station
Statements of Expenses and Miscellaneous Income (Deductions)
Years Ended December 31, 2000 and 1999

Account number	Miscellaneous Income (Deductions)	2000	1999
421	Miscellaneous nonoperating income	\$ 9,364	\$ 6,986
426	Other income (deductions)	(128,019)	(136,440)
	Total miscellaneous income (deductions)	<u>(118,655)</u>	<u>(129,454)</u>
Production Expenses			
Operation			
517	Supervision and engineering	32,614,373	32,074,082
519	Coolants and water	4,003,279	4,108,852
520	Steam expenses	4,323,858	9,840,652
523	Electric expenses	16,274,008	15,972,563
524	Miscellaneous nuclear power expenses	29,346,887	28,870,094
525	Rents	10,991	24,215
	Total operation expenses	<u>86,573,396</u>	<u>90,890,458</u>
Maintenance			
528	Supervision and engineering	17,551,597	22,483,843
529	Structures	4,858,668	4,758,920
530	Reactor plant equipment	15,476,328	37,312,614
531	Electric plant	17,874,120	21,496,745
532	Miscellaneous nuclear plant	5,676,530	7,064,480
	Total maintenance expenses	<u>61,437,243</u>	<u>93,116,602</u>
Fuel			
518.101/ 201	Nuclear fuel amortization	56,388,326	66,035,649
518.103/ 203	Nuclear fuel disposal fees	17,915,787	18,273,451
518.104/ 204	Department of Energy assessments	2,076,872	2,192,924
518.105/ 205	Nuclear fuel credits	(89,000)	(695,549)
	Total fuel expenses	<u>76,291,985</u>	<u>85,806,475</u>
	Total production expenses	<u>224,302,624</u>	<u>269,813,535</u>

The accompanying notes are an integral part of these financial statements.

South Texas Project Electric Generating Station
Statements of Expenses and Miscellaneous Income (Deductions) (continued)
Years Ended December 31, 2000 and 1999

Account number	Transmission Expenses	2000	1999
Maintenance			
569	Structures		\$ 131,360
570	Station equipment	\$ (66,035)	670,986
	Total maintenance expenses	(66,035)	802,346
	Total transmission expenses	(66,035)	802,346
Administrative and General Expenses			
920	Administrative and general salaries	13,997,027	17,869,629
921	Office supplies and expenses	3,708,500	4,073,095
923	Outside services employed	4,105,977	4,815,546
924	Nuclear property insurance	458,803	1,659,839
925	Injuries and damages	1,057,237	4,151,654
926	Employee pensions and other benefits	36,869,535	20,706,803
930	Miscellaneous general expenses	2,996,690	3,336,452
935	Maintenance of general plant	2,328,968	5,305,663
408	Taxes other than income taxes	7,102,101	7,057,063
	Total administrative and general expenses	72,624,838	68,975,744
	Total operating expenses	296,861,427	339,591,625
	Net expenses and miscellaneous income (deductions)	\$ 296,980,082	\$ 339,721,079

The accompanying notes are an integral part of these financial statements.

**South Texas Project Electric Generating Station and
STP Nuclear Operating Company**
Statements of Selected Cash Flows
Years Ended December 31, 2000 and 1999

	2000	1999
Cash flows used in operating activities:-		
Net expenses and miscellaneous income (deductions)	\$ (296,980,082)	\$ (339,721,079)
Adjustments to reconcile net expenses and miscellaneous income (deductions) to net cash used in operating activities:		
Amortization of enrichment decommissioning and decontamination assessment	2,076,872	2,192,924
Amortization of nuclear fuel	56,388,326	66,035,649
Change in accumulated provision for depreciation of electric plant in service	85,236	331,956
Change in inventory - nuclear fuel	(39,414,344)	(79,312,304)
Change in inventory - stores	(374,939)	44,877
Change in other accounts receivable	(131,402)	148,453
Change in prepaid expense	(724,631)	194,398
Change in undistributed stores expense	171,955	323,644
Change in enrichment decommissioning and decontamination assessment	(491,751)	(364,742)
Change in clearing accounts	91,198	40,282
Change in other assets	(28,223,628)	(79,971)
Change in accounts payable	(15,282,764)	3,734,478
Change in accrued payroll and related expenses	117,214	(547,859)
Change in enrichment decommissioning and decontamination - current	70,250	45,593
Change in enrichment decommissioning and decontamination - noncurrent	(1,708,059)	(1,740,160)
Change in incentive compensation accrued	(1,372,734)	1,540,605
Change in injuries and damages reserve	(114,979)	(1,460,500)
Change in accrued spent fuel disposal fee	824,618	(68,397)
Change in other miscellaneous accrued liabilities	27,496	10,060
Change in postemployment benefits liability		268,000
Change in pension liability	6,113,756	3,313,123
Change in other postretirement benefits liability	9,105,415	2,542,896
Total adjustments	<u>(12,766,895)</u>	<u>(2,806,995)</u>
Net cash used in operating activities	<u>(309,746,977)</u>	<u>(342,528,074)</u>
Cash flows from investing activities:		
Capital expenditures	(2,933,288)	(30,807,499)
Net cash used in investing activities	<u>(2,933,288)</u>	<u>(30,807,499)</u>
Cash flows from financing activities:		
Cash funding from owners	312,680,529	373,311,343
Net cash provided by financing activities	<u>312,680,529</u>	<u>373,311,343</u>
Net increase (decrease) in cash and cash equivalents	264	(24,230)
Cash and cash equivalents at beginning of period	60,539	84,769
Cash and cash equivalents at end of period	<u>\$ 60,803</u>	<u>\$ 60,539</u>

The accompanying notes are an integral part of these financial statements.

**South Texas Project Electric Generating Station and
STP Nuclear Operating Company**
Statements of Selected Cash Flows (continued)
Years Ended December 31, 2000 and 1999

	Reliant Energy	City Public Service Board	AEP- Central Power and Light	City of Austin	Total
Year ended					
December 31, 2000:					
Cash funding from owners:					
Operations	\$ 91,029,164	\$ 82,753,785	\$ 74,518,534	\$ 47,287,877	\$ 295,589,360
Spent fuel	<u>5,324,745</u>	<u>4,786,924</u>	<u>4,212,846</u>	<u>2,766,654</u>	<u>17,091,169</u>
	<u>\$ 96,353,909</u>	<u>\$ 87,540,709</u>	<u>\$ 78,731,380</u>	<u>\$ 50,054,531</u>	<u>\$ 312,680,529</u>
Year ended					
December 31, 1999:					
Cash funding from owners:					
Operations	\$ 109,323,213	\$ 99,448,865	\$ 89,406,138	\$ 56,791,279	\$ 354,969,495
Spent fuel	<u>5,711,961</u>	<u>5,163,123</u>	<u>4,547,874</u>	<u>2,918,890</u>	<u>18,341,848</u>
	<u>\$ 115,035,174</u>	<u>\$ 104,611,988</u>	<u>\$ 93,954,012</u>	<u>\$ 59,710,169</u>	<u>\$ 373,311,343</u>

The accompanying notes are an integral part of these financial statements.

South Texas Project Electric Generating Station and STP Nuclear Operating Company
Statements of Owners' Liabilities
December 31, 2000 and 1999

	Reliant Energy	City Public Service Board	AEP- Central Power and Light	City of Austin	Total
December 31, 2000:					
South Texas Project Electric Generating Station:					
Accrued spent fuel disposal fee	\$ 1,586,256	\$ 1,422,309	\$ 1,255,781	\$ 839,271	\$ 5,103,617
Enrichment decommissioning and decontamination liability	3,935,426	3,577,660	3,219,894	2,044,376	12,777,356
Accounts payable	11,168,293	10,152,993	9,137,694	5,801,710	36,260,690
Other liabilities	529,796	481,632	433,469	275,218	1,720,115
STP Nuclear Operating Company:					
Incentive compensation and benefit accruals	4,215,318	3,832,107	3,448,896	2,189,775	13,686,096
Other liabilities	10,274,132	9,340,120	8,406,108	5,337,212	33,357,572
Total owners' liabilities	\$ 31,709,221	\$ 28,806,821	\$ 25,901,842	\$ 16,487,562	\$ 102,905,446
December 31, 1999:					
South Texas Project Electric Generating Station:					
Accrued spent fuel disposal fee	\$ 1,336,334	\$ 1,204,974	\$ 1,056,796	\$ 680,895	\$ 4,278,999
Enrichment decommissioning and decontamination liability	4,439,871	4,036,246	3,632,621	2,306,426	14,415,164
Accounts payable	15,875,384	14,432,167	12,988,950	8,246,953	51,543,454
Other liabilities	556,740	506,127	455,514	289,216	1,807,597
STP Nuclear Operating Company:					
Incentive compensation and benefit accruals	4,638,119	4,216,472	3,794,825	2,409,413	15,058,829
Other liabilities	5,550,525	5,045,932	4,541,339	2,883,389	18,021,185
Total owners' liabilities	\$ 32,396,973	\$ 29,441,918	\$ 26,470,045	\$ 16,816,292	\$ 105,125,228

The accompanying notes are an integral part of these financial statements.

South Texas Project Electric Generating Station and STP Nuclear Operating Company

Notes to Project Statements
December 31, 2000 and 1999

1. The Project and Its Significant Accounting Policies

The South Texas Project Electric Generating Station (STPEGS) consists of two 1,250-megawatt nuclear steam electric generating units and all interests in property, facilities and structures used therewith or related thereto on or adjacent to the South Texas Project (STP) site, a parcel of land in Matagorda County, Texas, consisting of approximately 12,200 acres.

The Amended and Restated South Texas Project Participation, Operating and Transition Agreements (the Agreements), dated November 17, 1997, provide for the licensing, construction, operation and maintenance of the jointly owned and operated electric generation facilities of STPEGS. The Participants are: Reliant Energy Inc. (Reliant Energy), the City of San Antonio, acting through the City Public Service Board of San Antonio (San Antonio), AEP-Central Power and Light (AEP-CPL) and the City of Austin, acting through Austin Energy (Austin) (collectively, the Participants). Ownership percentages are 30.8%, 28.0%, 25.2% and 16.0% for Reliant Energy, San Antonio, AEP-CPL and Austin, respectively.

Effective October 1, 1997, the Participants formed an operating company, STP Nuclear Operating Company (STPNOC), which performs all responsibilities previously performed by Reliant Energy, as project manager. As of December 31, 2000 and 1999, and for the years then ended, STPNOC was the project manager for all aspects of STPEGS except for the construction, operation and maintenance of power and transmission lines, for which AEP-CPL is responsible, and switchyard maintenance, for which Reliant Energy is responsible. Procurement of nuclear fuel (other than fabrication) is the responsibility of the Owners' committee.

Basis of Accounting and Account Classifications

The accounting records of STPEGS and STPNOC, collectively "the Project", are maintained on the accrual basis of accounting, as required by the Agreements. Certain items including, but not limited to, project financing, ad valorem and sales taxes, depreciation and decommissioning expenses are not considered in the accounting records of the Project.

The accounting records are also maintained and the accompanying amounts are classified in accordance with the Agreements and with the Federal Energy Regulatory Commission's (FERC) "Uniform System of Accounts Prescribed for Public Utilities and Licensees," as adopted by the Public Utility Commission of Texas.

The prior period information includes cash flow reclassifications which were made to conform to the current presentation. These reclassifications have no effect on reported net expenses and miscellaneous income, or on the net change in cash and cash equivalents.

Use of Estimates

Preparation of these project statements in conformity with the Agreements requires management to make estimates and assumptions that affect the reported amounts of assets

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and liabilities and reported amounts of expenses during the period. Actual results could differ from those estimates.

Electric Plant in-Service

Electric plant in-service is stated at the original cost of construction which includes the cost of contracted services, direct labor, materials and overhead items. Additions to electric plant in-service, betterments to existing property and replacements of units of property are capitalized at cost. Maintenance repairs and minor replacement costs are charged to operating expense when incurred.

Construction Work in Progress

Construction work in progress includes capital modifications or additions to electric plant in-service. Expenditures are accumulated and classified through work orders. As work orders are completed and the asset is placed in-service, the related costs are transferred to electric plant in-service.

Accumulated Provision for Depreciation of Electric Plant in-Service

Upon retirement, the historical cost of the asset removed from service, net of salvage value plus the cost to retire, is accumulated through work orders and transferred from electric plant in-service to accumulated provision for depreciation of electric plant in-service on the Statements of Owners' Assets and Related Liabilities. The historical cost of the asset is the unitized value which is based on allocated construction costs determined principally from engineering estimates. At December 31, 2000 and 1999, this account includes warranty credits received from equipment vendors. STPEGS accounts for these credits as salvage value received prior to the retirement of warranty equipment.

Nuclear Fuel

Nuclear fuel includes nuclear fuel materials as well as refinement, conversion, enrichment and fabrication costs incurred to produce nuclear fuel assemblies. Nuclear fuel assemblies are amortized using a units-of-production method whereby an amortization rate is derived by dividing the unamortized value of an assembly by the calculated remaining million British thermal units (MMBTUs) for such assembly. Amortization expense is then computed from measurements of MMBTUs produced by each fuel assembly, multiplied by the previously determined amortization rate.

Materials and Supplies

Materials and supplies are carried at the lower of average cost or net realizable value. During the years ended December 31, 2000 and 1999, STPEGS wrote off \$1.26 million and \$1.98 million, respectively, of excess and obsolete materials and supplies as a result of the Project's ongoing assessment of its inventory.

Enrichment Decommissioning and Decontamination Assessment and Liability

As of December 31, 2000, STPEGS has six years remaining for payment of a Department of Energy (DOE) Enrichment Decommissioning and Decontamination Assessment. STPEGS accounts for the remaining amount as a liability and a receivable from the

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Participants. Included in the receivable amount is an asset for the prepayment of nine months of Enrichment Decommissioning and Decontamination assessment.

Operating Costs

Under the provisions of the Agreements, costs incurred to operate STPEGS are shared by the Participants in the same proportion as their respective ownership percentages in the generating units and common facilities, except for the spent fuel disposal fee which is shared in the proportion of net generation received by each Participant.

Federal Income Tax Status

No provision for federal income taxes has been recorded in the accompanying project statements as each participant is responsible for the reporting and payment of such taxes. STNPOC has filed a corporate tax return for 1999 which indicates that it has no taxable income. A similar tax filing requirement exists for 2000.

2. Pension Plans and Other Postretirement Benefits

STPNOC has a noncontributory defined benefit pension plan covering most employees. This plan provides benefits that are based on years of service and the employee's highest paid consecutive 36 months during the last 120 months before termination of employment. The assets in the plan at December 31, 2000 and 1999 were invested in various equity and fixed income securities. A contribution of approximately \$3.4 million will be required no later than September 15, 2001 for the 2000 plan year. A contribution of approximately \$3.6 million was made to the plan for the 1999 plan year.

Employees whose pension benefits exceed ERISA limitations are covered by a supplementary nonqualified, unfunded pension plan which is being provided for by charges to STPEGS' expense sufficient to meet the projected benefit obligations. The accruals for the cost of this plan are based on substantially the same actuarial methods and economics as the noncontributory defined benefit pension plan.

STPNOC has a defined benefit postretirement plan that provides medical, dental and life insurance benefits for substantially all retirees and eligible dependents. STPNOC retains the right to change or terminate these benefits. The cost of these benefits is recognized in the financial statements during an employee's active working career with STPNOC. In June 1999, Reliant Energy transferred approximately \$7.8 million into a trust that STP used to partially meet the obligations of the plan. In October 2000, a final transfer of approximately \$2.1 million was made to the trust by Reliant Energy.

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	Pension Benefits		Other Benefits	
	2000	1999	2000	1999
Change in benefit obligation:				
Benefit obligation at beginning of period	\$ 47,244,746	\$ 48,850,659	\$ 13,232,826	\$ 14,023,968
Service cost	3,357,028	4,350,720	1,840,296	2,320,960
Interest cost	4,160,499	3,188,986	1,592,335	779,732
Special termination benefits	9,079,674		3,578,204	
Net curtailment (gain) loss	(1,464,344)		4,744,840	
Actuarial (gain) loss	2,862,459	(9,094,297)	2,106,480	(3,789,534)
Benefits paid	(1,251,501)	(51,322)	(561,145)	(102,300)
Benefit obligation at end of period	<u>63,988,561</u>	<u>47,244,746</u>	<u>26,533,836</u>	<u>13,232,826</u>
Change in plan assets:				
Fair value of plan assets at beginning of period	51,262,558	44,614,580	8,000,000	6,570,000
Actual return on plan assets	2,576,829	6,699,300	500,728	200,000
Additional transfer			2,117,310	1,230,000
Employer contributions	3,589,780		491,507	102,300
Benefits paid	(1,251,501)	(51,322)	(561,145)	(102,300)
Fair value of plan assets at end of period	<u>56,177,666</u>	<u>51,262,558</u>	<u>10,548,400</u>	<u>8,000,000</u>
Funded status at end of period	(7,810,895)	4,017,812	(15,985,436)	(5,232,826)
Unrecognized net actuarial gain	(8,350,746)	(14,065,961)	(4,844,972)	(10,017,738)
Unrecognized prior service cost	612,987	738,163		
Unrecognized transition (asset) obligation	(213,394)	(338,306)	5,152,572	8,678,143
Accrued benefit cost	<u>\$ (15,762,048)</u>	<u>\$ (9,648,292)</u>	<u>\$ (15,677,836)</u>	<u>\$ (6,572,421)</u>
Weighted-average assumptions:				
Discount rate	7.50%	7.50%	7.50%	7.50%
Expected return on plan assets	9.50%	9.50%	9.50%	9.50%
Rate of compensation increase	3.50%	3.50%	3.50%	3.50%

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Components of net periodic benefit cost:				
Service cost	\$ 3,357,028	\$ 4,350,720	\$ 1,840,296	\$ 2,320,960
Interest cost	4,160,499	3,188,986	1,592,335	779,732
Expected return on plan assets	(4,899,743)	(4,226,847)	(760,000)	(624,150)
Amortization of prior service cost	125,176	125,176		
Amortization of transition (asset) obligation	(124,912)	(124,912)	426,621	586,361
Recognized net actuarial gain	(529,842)		(179,484)	(417,707)
Special termination benefits	9,079,674		3,578,204	
Net curtailment (gain) loss	(1,464,344)		3,098,950	
Net periodic benefit cost	\$ 9,703,536	\$ 3,313,123	\$ 9,596,922	\$ 2,645,196

Actuarial estimates for STPNOC's postretirement benefit plan assumed a weighted average annual rate of increase in the per capita costs of covered health care benefits of 4.90 percent through 2001 and beyond. Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	2000	1999
One-percentage-point increase:		
Effect on total of service and interest cost components	\$ 530,000	\$ 363,725
Effect on postretirement benefit obligation	3,467,000	1,627,261
One-percentage-point decrease:		
Effect on total of service and interest cost components	\$ (432,000)	\$ (295,150)
Effect on postretirement benefit obligation	(2,887,000)	(1,334,296)

STPNOC has a contributory savings plan for substantially all employees. STPNOC contributes 70% of an employee's contribution up to 6% of an employee's salary. Expenses recognized for contributions during 2000 and 1999 were \$3,609,394 and \$4,005,397, respectively.

3. Severance Program

On November 17, 1999, the Board of Directors approved the offering of a Voluntary Severance Program and an Early Retirement Program to be offered simultaneously to eligible employees of STPNOC. A total of approximately 230 employees accepted the

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Voluntary Severance Program or the Early Retirement Program. Those employees accepting the Early Retirement Program were also eligible for the Voluntary Severance Program. The accrued termination benefit cost and the amount charged to employee pension and benefits expense for these employees as of December 31, 2000 and 1999 was approximately \$18.4 million and \$2.7 million, respectively. Actual termination benefits paid and charged against the liability were \$2.7 million for the year ended December 31, 2000. No amounts were paid and charged against the liability for the year ended December 31, 1999. The Project does not expect to incur any additional expense for the Severance Program or Early Retirement Program as of December 31, 2000.

4. Commitments, Contingencies and Other

The Project is a party to various claims and lawsuits resulting from normal construction and operating activities. While the ultimate outcome is not currently determinable, project management believes that any future costs associated with these actions will be immaterial to these statements.

Employers National Insurance Company (ENIC), the Project's Insurance Carrier for Workers' Compensation and General Liability for the policy periods October 1983 through December 1990, is currently in "receivership" status. STPEGS and the Special Deputy Receiver are currently in settlement negotiations related to these policy periods. Although management cannot predict the Project's ultimate liability for these policy periods, management believes such amount will not exceed \$575,000. Such amount has been recorded as a component of the injuries and damages reserve in the accompanying STPEGS Statements of Owners' Assets and Related Liabilities.

The Participants maintain nuclear property and nuclear liability insurance coverage as required by law and periodically review available limits and coverage for additional protection. 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 losses not covered by insurance would be borne by the Participants.

5. Supplemental Disclosures to the Statement of Cash Flows

Noncash investing activities excluded from the statement of cash flows were approximately \$72.1 million and \$(57.2) million for the years ended December 31, 2000 and 1999, respectively. These items represent capital retirements (net of salvage and removal costs) and other noncash items related to plant.

6. New Accounting Pronouncements Not Yet Adopted

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. In June of 1999, the FASB extended the adoption date of SFAS No. 133 through the issuance of SFAS No. 137, "Deferral of the Effective Date of SFAS 133." In June 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and

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Certain Hedging Activities," which also amended SFAS No. 133. SFAS No. 133, and its amendments and interpretations, establishes accounting and reporting standards for derivative instruments, including derivative instruments embedded in other contracts, and derivative instruments used for hedging activities. It will require the Project to measure all derivative instruments at their fair values and classify them as either assets or liabilities on the balance sheet, with a corresponding offset to income depending on their designation, their intended use, or their ability to qualify as hedges under the standard.

The Project adopted SFAS No. 133 beginning January 1, 2001. There was no impact on the project statements as a result of adopting SFAS No. 133 because the Project did not have any derivative instruments at the date of adoption. However, if the Project enters into any future derivative transactions, these transactions may have an impact on the project statements.