

DYNEGY INC /IL/  
Form 10-Q/A  
May 01, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q/A**  
**Amendment No. 1**

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x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2005

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 1-15659

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**DYNEGY INC.**

(Exact name of registrant as specified in its charter)

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**Illinois**  
(State or other jurisdiction of  
incorporation or organization)

**74-2928353**  
(I.R.S. Employer  
Identification No.)

**1000 Louisiana, Suite 5800**

**Houston, Texas 77002**

(Address of principal executive offices)

(Zip Code)

**(713) 507-6400**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Class A common stock, no par value per share, 285,039,770 shares outstanding as of August 4, 2005; Class B common stock, no par value per share, 96,891,014 shares outstanding as of August 4, 2005.

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**DYNEGY INC.**

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**DYNEGY INC. FORM 10-Q/A**

**INTRODUCTORY NOTE**

Dynegy Inc. is filing this Amendment No. 1 on Form 10-Q/A ( Amendment No. 1 ) to reflect the effect of a \$13 million decrease to our income from discontinued operations for the six months ended June 30, 2005 and a \$13 million increase to our net deferred tax liability at June 30, 2005 on our historical consolidated financial statements and related information, as reported in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005, which was originally filed on August 9, 2005 (the Original Filing ).

The aforementioned item includes items previously announced by us in our Current Report on Form 8-K dated May 1, 2006 and is discussed in more detail in the Explanatory Note to the accompanying unaudited condensed consolidated financial statements. This Amendment No. 1 also reflects restatements made to our unaudited condensed consolidated balance sheet as of June 30, 2005 and December 31, 2004, as further discussed in the Explanatory Note beginning on page F-10 of our Form 10-K for the year ended December 31, 2005. The following items of the Original Filing are amended by this Amendment No. 1:

- Item 1. Condensed Consolidated Financial Statements**
- Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

- Item 4. Controls and Procedures
- Item 6. Exhibits

Unaffected items have not been repeated in this Amendment No. 1.

**PLEASE NOTE THAT THE INFORMATION CONTAINED IN THIS AMENDMENT NO. 1, INCLUDING THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND THE NOTES THERETO, DOES NOT REFLECT EVENTS OCCURRING AFTER THE DATE OF THE ORIGINAL FILING, WITH THE EXCEPTION OF THE ITEM DISCUSSED ABOVE. SUCH EVENTS INCLUDE, AMONG OTHERS, THE EVENTS DESCRIBED IN OUR QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2005, OUR ANNUAL REPORT ON FORM 10-K FOR THE PERIOD ENDED DECEMBER 31, 2005 AND OUR CURRENT REPORTS ON FORM 8-K AND ANY AMENDMENTS THERETO. FOR A DESCRIPTION OF THESE EVENTS, PLEASE READ OUR EXCHANGE ACT REPORTS FILED SINCE AUGUST 9, 2005.**

**Table of Contents****DEFINITIONS**

As used in this Form 10-Q/A, the abbreviations contained herein have the meanings set forth below. Additionally, the terms Dynegy, we, us and our refer to Dynegy Inc. and its subsidiaries, unless the context clearly indicates otherwise.

ARB	Accounting Research Bulletin
ARO	Asset retirement obligation
Bcf/d	Billion cubic feet per day
Cal ISO	The California Independent System Operator
Cal PX	The California Power Exchange
CDWR	California Department of Water Resources
CFTC	Commodity Futures Trading Commission
CPUC	California Public Utilities Commission
CRM	Our customer risk management business segment
CUSA	Chevron U.S.A. Inc., a wholly owned subsidiary of Chevron Corporation
DGC	Dynegy Global Communications
DHI	Dynegy Holdings Inc., our primary financing subsidiary
DMG	Dynegy Midwest Generation, Inc.
DMS	Dynegy Midstream Services
DMSLP	Dynegy Midstream Services, Limited Partnership
DNE	Dynegy Northeast Generation
DPM	Dynegy Power Marketing Inc.
EITF	Emerging Issues Task Force
EPA	Environmental Protection Agency
ERCOT	Electric Reliability Council of Texas, Inc.
ERISA	The Employee Retirement Income Security Act of 1974, as amended
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FIN	FASB Interpretation
GAAP	Generally Accepted Accounting Principles of the United States of America
GCF	Gulf Coast Fractionators
GEN	Our power generation business segment
ICC	Illinois Commerce Commission
ISO	Independent System Operator
KW <sub>yr</sub>	Kilowatt year
KWh	Kilowatt hour
LNG	Liquefied natural gas
LPG	Liquefied petroleum gas
MBbls/d	Thousands of barrels per day
Mcf	Thousand cubic feet
MISO	Midwest Independent Transmission System Operator, Inc.
MMBtu	Millions of British thermal units
MMCFD	Million cubic feet per day
MW	Megawatts
MWh	Megawatt hour
NGL	Our natural gas liquids business segment
NNG	Northern Natural Gas Company
NOL	Net operating loss
NOV	Notice of Violation issued by the EPA
NYISO	New York Independent System Operator
NYSDEC	New York State Department of Environmental Conservation

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Original Filing	Our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, filed on August 9, 2005
POL	Percentage of liquids
POP	Percentage of proceeds
PRB	Powder River Basin coal
REG	Our regulated energy delivery business segment
RMR	Reliability Must Run
RTO	Regional Transmission Organization
SEC	U.S. Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SPDES	State Pollutant Discharge Elimination System
SPE	Special Purpose Entity
SPN	Second Priority Notes
VaR	Value at Risk
VEBA	Voluntary Employees Benefit Association
VIE	Variable Interest Entity

**Table of Contents****DYNEGY INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

See Explanatory Note

(unaudited) (in millions, except share data)

	<b>June 30, 2005</b>	<b>December 31, 2004</b>
		(Restated)
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 342	\$ 628
Restricted cash	38	
Accounts receivable, net of allowance for doubtful accounts of \$158 and \$159, respectively	595	810
Accounts receivable, affiliates	11	14
Inventory	197	233
Assets from risk-management activities	640	565
Deferred income taxes	484	62
Prepayments and other current assets	298	428
Assets held for sale (Note 3)	369	
<b>Total Current Assets</b>	<b>2,974</b>	<b>2,740</b>
<b>Property, Plant and Equipment</b>	<b>6,459</b>	<b>7,822</b>
Accumulated depreciation	(1,082)	(1,692)
<b>Property, Plant and Equipment, Net</b>	<b>5,377</b>	<b>6,130</b>
<b>Other Assets</b>		
Unconsolidated investments	290	421
Restricted investments	84	
Intangible assets	416	
Assets from risk-management activities	272	313
Goodwill		15
Deferred income taxes	16	15
Other long-term assets	172	209
Assets held for sale (Note 3)	1,159	
<b>Total Assets</b>	<b>\$ 10,760</b>	<b>\$ 9,843</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 503	\$ 561
Accounts payable, affiliates	17	23
Accrued interest	146	118
Accrued liabilities and other current liabilities	384	450
Liabilities from risk-management activities	684	616
Notes payable and current portion of long-term debt	55	34
Liabilities held for sale (Note 3)	139	
<b>Total Current Liabilities</b>	<b>1,928</b>	<b>1,802</b>
Long-term debt	4,864	4,132

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Long-term debt to affiliates	200	200
	<u>          </u>	<u>          </u>
<b>Long-Term Debt</b>	5,064	4,332
<b>Other Liabilities</b>		
Liabilities from risk-management activities	313	395
Deferred income taxes	800	499
Other long-term liabilities	416	353
Liabilities held for sale (Note 3)	25	
	<u>          </u>	<u>          </u>
<b>Total Liabilities</b>	8,546	7,381
	<u>          </u>	<u>          </u>
<b>Minority Interest</b>	107	106
<b>Commitments and Contingencies (Note 10)</b>		
<b>Redeemable Preferred Securities, redemption value of \$400 at June 30, 2005 and December 31, 2004, respectively</b>	400	400
<b>Stockholders Equity</b>		
Class A Common Stock, no par value, 900,000,000 shares authorized at June 30, 2005 and December 31, 2004; 286,670,174 and 285,012,203 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively	2,864	2,859
Class B Common Stock, no par value, 360,000,000 shares authorized at June 30, 2005 and December 31, 2004; 96,891,014 shares issued and outstanding at June 30, 2005 and December 31, 2004	1,006	1,006
Additional paid-in capital	45	41
Subscriptions receivable	(8)	(8)
Accumulated other comprehensive loss, net of tax	(23)	(13)
Accumulated deficit	(2,109)	(1,861)
Treasury stock, at cost, 1,686,715 shares at June 30, 2005 and 1,679,183 shares at December 31, 2004	(68)	(68)
	<u>          </u>	<u>          </u>
<b>Total Stockholders Equity</b>	1,707	1,956
	<u>          </u>	<u>          </u>
<b>Total Liabilities and Stockholders Equity</b>	\$ 10,760	\$ 9,843
	<u>          </u>	<u>          </u>

See the notes to condensed consolidated financial statements.



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## DYNEGY INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

See Explanatory Note

(unaudited) (in millions, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005 <u>(Restated)</u>	2004	2005 <u>(Restated)</u>	2004
Revenues	\$ 459	\$ 689	\$ 921	\$ 1,456
Cost of sales, exclusive of depreciation shown separately below	(380)	(423)	(910)	(989)
Depreciation and amortization expense	(54)	(57)	(109)	(125)
Impairment and other charges	(7)	(59)	(6)	(75)
Loss on sale of assets, net				(15)
General and administrative expenses	(82)	(94)	(345)	(156)
Operating income (loss)	(64)	56	(449)	96
Earnings from unconsolidated investments	4	50	7	88
Interest expense	(96)	(141)	(185)	(271)
Other income and expense, net	6	(6)	9	7
Minority interest expense		(3)		(1)
Loss from continuing operations before income taxes	(150)	(44)	(618)	(81)
Income tax benefit (Note 13)	41	29	215	82
Income (loss) from continuing operations (Note 9)	(109)	(15)	(403)	1
Income from discontinued operations, net of tax benefit (expense) of \$98, \$(48), \$80 and \$(78), respectively (Notes 3 and 13)	134	23	166	77
Net income (loss)	25	8	(237)	78
Less: preferred stock dividends	6	6	11	11
Net income (loss) applicable to common stockholders	\$ 19	\$ 2	\$ (248)	\$ 67
<b>Earnings (Loss) Per Share (Note 9):</b>				
Basic earnings (loss) per share:				
Loss from continuing operations	\$ (0.30)	\$ (0.06)	\$ (1.09)	\$ (0.03)
Income from discontinued operations	0.35	0.07	0.44	0.20
Basic earnings (loss) per share	\$ 0.05	\$ 0.01	\$ (0.65)	\$ 0.17
Diluted earnings (loss) per share:				
Loss from continuing operations	\$ (0.30)	\$ (0.06)	\$ (1.09)	\$ (0.03)
Income from discontinued operations	0.35	0.07	0.44	0.20

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Diluted earnings (loss) per share	\$ 0.05	\$ 0.01	\$ (0.65)	\$ 0.17
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Basic shares outstanding	380	378	379	377
Diluted shares outstanding	506	435	505	503

See the notes to condensed consolidated financial statements.

**Table of Contents****DYNEGY INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

See Explanatory Note

(unaudited) (in millions)

	Six Months Ended June 30,	
	2005	2004
	(Restated)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ (237)	\$ 78
Adjustments to reconcile net income (loss) to net cash flows from operating activities:		
Depreciation and amortization	151	196
Impairment and other charges	(1)	80
Earnings from unconsolidated investments, net of cash distributions	47	(19)
Risk-management activities	(1)	(44)
Gain on sale of assets, net		(38)
Deferred income taxes	(293)	(4)
Liability associated with gas transportation contracts (Note 3)		(148)
Legal and settlement charges	86	39
Independence toll settlement charge	170	
Other	2	(34)
Changes in working capital:		
Accounts receivable	(24)	84
Inventory	(9)	12
Prepayments and other assets	180	(100)
Accounts payable and accrued liabilities	(107)	(49)
Changes in non-current assets	(4)	(24)
Changes in non-current liabilities	31	32
Net cash provided by (used in) operating activities	(9)	61
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(93)	(151)
Proceeds from asset sales, net	(5)	81
Business acquisitions, net of cash acquired	(120)	
Net cash used in investing activities	(218)	(70)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net proceeds from long-term borrowings		581
Repayments of long-term borrowings	(38)	(193)
Proceeds from issuance of capital stock	2	5
Dividends and other distributions, net	(11)	(11)
Other financing, net	4	(12)

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Net cash provided by (used in) financing activities	(43)	370
	<u>          </u>	<u>          </u>
Effect of exchange rate changes on cash		(1)
Net increase (decrease) in cash and cash equivalents	(270)	360
Cash and cash equivalents, beginning of period	628	477
Less: Cash classified as held for sale at end of period (Note 3)	(16)	(42)
	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of period	\$ 342	\$ 795
	<u>          </u>	<u>          </u>

See the notes to condensed consolidated financial statements.

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## DYNEGY INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

See Explanatory Note

(unaudited) (in millions)

	Three Months Ended June 30,	
	2005	2004
	(Restated)	
Net income	\$ 25	\$ 8
Cash flow hedging activities, net:		
Unrealized mark-to-market gains arising during period, net	(3)	5
Reclassification of mark-to-market losses (gains) to earnings, net	(1)	9
Changes in cash flow hedging activities, net (net of tax benefit (expense) of \$3 and \$(8), respectively)	(4)	14
Foreign currency translation adjustments		
Other comprehensive income, net of tax	(4)	14
Comprehensive income	\$ 21	\$ 22
	Six Months Ended June 30,	
	2005	2004
	(Restated)	
Net income (loss)	\$ (237)	\$ 78
Cash flow hedging activities, net:		
Unrealized mark-to-market losses arising during period, net	(21)	(53)
Reclassification of mark-to-market losses to earnings, net	11	20
Changes in cash flow hedging activities, net (net of tax benefit of \$7 and \$20, respectively)	(10)	(33)
Foreign currency translation adjustments		(15)
Minimum pension liability (net of tax expense of zero and \$1, respectively)		2
Other comprehensive loss, net of tax	(10)	(46)
Comprehensive income (loss)	\$ (247)	\$ 32

See the notes to condensed consolidated financial statements.



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**DYNEGY INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

**PLEASE NOTE THAT THESE FINANCIAL STATEMENTS AND THE NOTES THERETO DO NOT REFLECT EVENTS OCCURRING AFTER AUGUST 9, 2005 (THE DATE OF THE ORIGINAL FILING) WITH THE EXCEPTION OF THE ITEM DISCUSSED IN THE EXPLANATORY NOTE BELOW. FOR A DESCRIPTION OF THESE EVENTS, PLEASE READ OUR EXCHANGE ACT REPORTS FILED SINCE AUGUST 9, 2005.**

**EXPLANATORY NOTE**

This Amendment No. 1 to our Quarterly Report on Form 10-Q for the period ended June 30, 2005 includes a restatement of our unaudited condensed consolidated financial statements for the quarterly period ended June 30, 2005. The restatement relates to our deferred income tax accounts. In the second quarter 2005, we recognized a \$125 million tax benefit in anticipation of our sale of DMSLP. This benefit resulted from a reduction in the valuation allowance related to our capital loss carryforwards expected to be used against capital gains generated by the sale of DMSLP. We recently identified that a portion of the capital loss carryforwards had been previously used and therefore was not available for use against those capital gains. Because we mistakenly used these unavailable capital loss carryforwards against capital gains generated by the sale of DMSLP, income from discontinued operations during the second quarter of 2005 was overstated by \$13 million, and the net deferred tax liability was understated by \$13 million at June 30, 2005.

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## DYNEGY INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited and Restated)

For the Interim Periods Ended June 30, 2005 and 2004

The restatement effects Note 1 Accounting Policies, Note 3 Discontinued Operations, Dispositions and Contract Terminations, Note 13 Income Taxes and Note 14 Segment Information. The restatement had no effect on our previously reported loss from continuing operations or net cash provided by (used in) operating activities, investing activities or financing activities for the three and six months ended June 30, 2005. This Amendment No. 1 also reflects restatements made to our unaudited condensed consolidated balance sheet as of June 30, 2005 and December 31, 2004, as further discussed in the Explanatory Note beginning on page F-10 of our Form 10-K for the year ended December 31, 2005. A synopsis of the aggregate financial impact of these restatements on the amounts originally reported in the Original Filing is as follows:

## RESTATED SELECTED BALANCE SHEET DATA

	June 30, 2005
	(in millions)
<b>Deferred income taxes</b>	
As previously reported	\$ (885)
Adjustment (1)	98
Restatement effect	(13)
As restated	\$ (800)
<b>Total Liabilities</b>	
As previously reported	\$ (8,631)
Adjustment (1)	98
Restatement effect	(13)
As restated	\$ (8,546)
<b>Stockholders Equity</b>	
As previously reported	\$ (1,631)
Adjustment (1)	(89)
Restatement effect	13
As restated	\$ (1,707)

(1) Adjustment relates to a prior restatement of the deferred tax liability balances, as further described in the Explanatory Note beginning on page F-10 of our Form 10-K for the year ended December 31, 2005.





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## DYNEGY INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited and Restated)

For the Interim Periods Ended June 30, 2005 and 2004

## RESTATED SELECTED RESULTS OF OPERATIONS DATA

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
	(in millions)	
<b>Income from discontinued operations</b>		
As previously reported	\$ 147	\$ 179
Restatement effect	(13)	(13)
As restated	<u>\$ 134</u>	<u>\$ 166</u>
<b>Net income (loss)</b>		
As previously reported	\$ 38	\$ (224)
Restatement effect	(13)	(13)
As restated	<u>\$ 25</u>	<u>\$ (237)</u>
<b>Net income (loss) applicable to common shareholders</b>		
As previously reported	\$ 32	\$ (235)
Restatement effect	(13)	(13)
As restated	<u>\$ 19</u>	<u>\$ (248)</u>
<b>Net income (loss) per diluted share</b>		
As previously reported	\$ 0.08	\$ (0.62)
Restatement effect	(0.03)	(0.03)
As restated	<u>\$ 0.05</u>	<u>\$ (0.65)</u>

**Note 1 Accounting Policies**

Amounts in this footnote have been restated. For further information, please see the Explanatory Note.

## Edgar Filing: DYNEGY INC /IL/ - Form 10-Q/A

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to interim financial reporting as prescribed by the SEC. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. These interim financial statements should be read together with the consolidated financial statements and notes thereto included in our Form 10-K for the year ended December 31, 2004, which we refer to as our Form 10-K.

The unaudited condensed consolidated financial statements contained in this report include all material adjustments that, in the opinion of management, are necessary for a fair statement of the results for the interim periods. The results of operations for the interim periods presented in this Form 10-Q/A are not necessarily indicative of the results to be expected for the full year or any other interim period, however, due to seasonal fluctuations in demand for our energy products and services, changes in commodity prices, timing of maintenance and other expenditures and other factors. The preparation of the unaudited condensed consolidated financial statements in conformity with GAAP requires management to make estimates and judgments that affect our reported financial position and results of operations. These estimates and judgments also impact the nature and extent of disclosure, if any, of our contingent liabilities. We review significant estimates and judgments affecting our consolidated financial statements on a recurring basis and record the effect of any necessary adjustments prior to the publication of such financial statements. Estimates and judgments are based on information available at the time such estimates and judgments are made. Adjustments made with respect to the

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**DYNEGY INC.**

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

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

use of these estimates and judgments often relate to information not previously available. Uncertainties with respect to such estimates and judgments are inherent in the preparation of financial statements. Estimates and judgments are primarily used in (1) developing fair value assumptions, including estimates of future cash flows and discount rates, (2) analyzing tangible and intangible assets for possible impairment, (3) estimating the useful lives of our assets, (4) assessing future tax exposure and the realization of tax assets, (5) determining amounts to accrue for contingencies, guarantees and indemnifications and (6) estimating various factors used to value our pension assets and liabilities. Actual results could differ materially from any such estimates. Certain reclassifications have been made to prior period amounts in order to conform to current year presentation.

**Asset Retirement Obligations.** At December 31, 2004, our ARO liabilities were \$35 million for our GEN segment and \$11 million for our NGL segment. These retirement obligations related to activities such as ash pond and landfill capping, closure and post-closure costs, environmental testing, remediation, monitoring and land and equipment lease obligations. We continue to follow the provisions for disclosure and accounting for these AROs under SFAS No. 143, *Asset Retirement Obligations*. During the three and six months ended June 30, 2005 and 2004, no material additional AROs were recorded or settled, and our accretion expenses and revisions to estimated cash flows were not material. At June 30, 2005, our ARO liabilities were \$37 million for our GEN segment and \$10 million for our NGL segment. The \$10 million ARO liabilities associated with our NGL segment have been reclassified to liabilities held for sale as a result of our anticipated sale of DMSLP. Please see Note 3 *Discontinued Operations, Dispositions and Contract Terminations* *Discontinued Operations* *Natural Gas Liquids* for further discussion.

**Employee Stock Options.** In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation*, and provides alternative methods of transition (prospective, modified prospective or retroactive) for entities that voluntarily change to the fair value-based method of accounting for stock-based employee compensation in a fiscal year beginning before December 16, 2003. SFAS No. 148 requires prominent

disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. We transitioned to a fair value-based method of accounting for stock-based compensation January 1, 2003 and are using the prospective method of transition as described under SFAS No. 148.

Under the prospective method of transition, all stock options granted after January 1, 2003 are accounted for on a fair value basis. Options granted prior to January 1, 2003 continue to be accounted for using the intrinsic value method. Accordingly, for options granted prior to January 1, 2003, compensation expense is not reflected for employee stock options unless they were granted at an exercise price lower than market value on the grant date. We have granted in-the-money options in the past and have recognized compensation expense over the applicable vesting periods. No in-the-money stock options have been granted since 1999.

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## DYNEGY INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited and Restated)

For the Interim Periods Ended June 30, 2005 and 2004

Had compensation cost for all stock options granted prior to January 1, 2003 been determined on a fair value basis consistent with SFAS No. 123, our net income (loss) and basic and diluted earnings (loss) per share amounts would have approximated the following pro forma amounts for the three- and six-month periods ended June 30, 2005 and 2004, respectively.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(in millions, except per share data)			
Net income (loss) as reported	\$ 25	\$ 8	\$ (237)	\$ 78
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	1	1	2	2
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1)	(7)	(2)	(16)
Pro forma net income (loss)	\$ 25	\$ 2	\$ (237)	\$ 64
Earnings (loss) per share:				
Basic as reported	\$ 0.05	\$ 0.01	\$ (0.65)	\$ 0.17
Basic pro forma	\$ 0.05	\$ (0.01)	\$ (0.65)	\$ 0.14
Diluted as reported	\$ 0.05	\$ 0.01	\$ (0.65)	\$ 0.17
Diluted pro forma	\$ 0.05	\$ (0.01)	\$ (0.65)	\$ 0.14

*Accounting Principle Adopted*

**FIN No. 46R.** In the fourth quarter 2003, we adopted the initial provisions of FIN No. 46R, Consolidation of Variable Interest Entities An Interpretation of ARB No. 51. FIN No. 46R was effective on December 31, 2003 for entities considered SPEs. We adopted the remaining provisions of FIN No. 46R on March 31, 2004. These provisions require that we review the structure of non-SPE legal entities in which we have an investment and other legal entities with whom we transact to determine whether such entities are VIEs, as defined by FIN No. 46R. With respect to each of the VIEs we identified, we assessed whether we are the primary beneficiary, as defined by FIN No. 46R. We concluded that we were not the primary beneficiary of any of these entities and, therefore, the adoption did not have an impact on our unaudited condensed consolidated financial statements.

FIN No. 46R requires additional disclosures for entities that meet the definition of a VIE in which we hold a significant variable interest but are not the primary beneficiary. We own 50% equity interests in various generation facilities in Illinois and California, which are accounted for using equity method accounting and are included in unconsolidated investments in our unaudited condensed consolidated balance sheets. We acquired or began involvement with these equity interests in 1997 and 1999. Total net generating capacity for these facilities ranges from 165

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MW to 902 MW. As a result of various contractual arrangements into which these entities have entered, we have concluded that they are VIEs. As we do not absorb a majority of the expected losses or receive a majority of the expected residual returns, we are not considered the primary beneficiary of these entities. Our equity investment balance in the facilities totaled \$273 million at June 30, 2005, and one of our affiliates has a loan outstanding to one of these entities, which totaled \$20 million at June 30, 2005.

On January 31, 2005, we completed the acquisition of ExRes SHC, Inc., the parent company of Sithe Energies, Inc., which we refer to as Sithe Energies, and Sithe/Independence Power Partners, L.P., which we refer to as Independence. ExRes SHC, Inc., which we refer to as ExRes, owns through its subsidiaries four

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**DYNEGY INC.**

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

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

natural gas-fired merchant facilities in New York and four hydroelectric generation facilities in Pennsylvania. The entities owning these facilities meet the definition of VIEs. In accordance with the purchase agreement, Exelon Corporation, which we refer to as Exelon, has the sole and exclusive right to direct our efforts to decommission, sell, bankrupt, or otherwise dispose of the hydroelectric facilities owned through the VIE entities. Exelon is obligated to reimburse ExRes for all costs, liabilities, and obligations of the entities owning these hydroelectric generation facilities, and to indemnify ExRes with respect to the past and present assets and operations of the entities. As a result, we are not the primary beneficiary of the entities, and have not consolidated them in accordance with the provisions of FIN No. 46R.

With regard to the four natural gas-fired merchant facilities located in New York, we had the option to elect to decommission any or all of these facilities within a 180-day period after the January 31, 2005 closing date. Prior to expiration of the option period which ended on July 30, 2005, we elected to decommission all four of the natural gas-fired merchant facilities owned by ExRes. Under the terms of the purchase agreement, Exelon will direct the decommissioning, sale, or other disposal of the facilities. Further, Exelon is obligated to indemnify us with respect to all operations prior to February 1, 2005, and subsequent to our election to decommission or sell the facilities and must provide written consent for any payments or actions outside the ordinary course of operations. On June 8, 2005 and August 4, 2005, we entered into agreements, as directed by Exelon, to sell our ownership and operating interests in the four natural gas-fired power generation peaking facilities to Alliance Energy Group LLC. The sale, subject to approval by the FERC and review by the New York Public Service Commission, is expected to close by end of year 2005 and is expected to have no impact on our unaudited condensed consolidated financial statements, as Exelon will receive any proceeds from the sale. As a result of the rights retained by Exelon with respect to these facilities, we are not the primary beneficiary of these VIEs, and have not consolidated them in accordance with the provisions of FIN No. 46R. Please see Note 2 Acquisition Site Energies for further discussion regarding this acquisition.

The hydroelectric generation facilities have commitments and obligations that are off-balance sheet with respect to Dynegy arising under operating leases for equipment and long-term power purchase agreements with local utilities. As of June 30, 2005, the equipment leases have remaining terms from two to sixteen years and involve a maximum aggregate obligation of \$131 million over the terms of the leases. Additionally, each of these facilities is party to a long-term power purchase agreement with a local utility. Under the terms of each of these agreements, a project tracking account, which we refer to as the Tracking Account, was established to quantify the difference between (i) the facility's fixed price revenues under the power purchase agreement and (ii) the respective utility's Public Utility Commission approved avoided costs associated with those power purchases plus accumulated interest on the balance. Each power purchase agreement calls for the hydroelectric facility to return to the utility the balance in the Tracking Account before the end of the facility's life through decreased pricing under the respective power purchase agreement. Two of the four hydroelectric facilities are currently in the Tracking Account repayment period of the contract, whereby balances are repaid through decreased pricing. This pricing cannot be decreased below a level sufficient to allow the facilities to recover their operating costs, exclusive of lease or interest costs. The remaining two facilities are anticipated to begin reducing the Tracking Accounts in 2006. The aggregate balance of the Tracking Accounts as of June 30, 2005, was approximately \$287 million, and the obligations with respect to each Tracking Account are secured by the assets of the respective facility. The decreased pricing necessary to reduce the Tracking Accounts may cause the facilities to operate at a net cash deficit. As discussed above, the obligations of the four hydroelectric facilities are non-recourse to us. Under the terms of the stock purchase agreement with Exelon, we are indemnified for any net cash outflow arising from ownership of these facilities.

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**DYNEGY INC.**

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

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

***Accounting Principles Not Yet Adopted***

**SFAS No. 123(R).** In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which revises SFAS No. 123. SFAS No. 123(R) is effective for January 1, 2006 for all calendar year-end companies. SFAS No. 123(R) requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. We expect to adopt the provisions of SFAS No. 123(R) on January 1, 2006. SFAS No. 123(R) describes several transition methods, and we expect to apply the modified prospective method of adoption. Under this method, compensation expense will be recognized for the remaining portion of outstanding, unvested awards at the date of adoption.

As noted in *Employee Stock Options* above, we adopted the prospective method for expensing the fair value of stock options and restricted stock awards granted after January 1, 2003, and, as such we do not expect the guidance under SFAS No. 123(R) to have a material impact on our consolidated statement of operations.

**FIN No. 47.** In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, which is an interpretation of SFAS No. 143. FIN No. 47 clarifies the term conditional asset retirement obligation, which refers to legal obligations for which companies must perform asset retirement activity for which the timing and/or method of settlement are conditional upon future events that may or may not be within the control of the entity. However, the obligation to perform the asset retirement is unconditional, despite the uncertainty that exists surrounding the timing and method of settlement. Uncertainty about the timing and method of settlement for a conditional ARO should be considered in estimating the ARO when sufficient information exists. FIN No. 47 clarifies when sufficient information exists to reasonably estimate the fair value of an ARO. FIN No. 47 is effective no later than the end of the first fiscal year ending after December 15, 2005, and early adoption is encouraged.

As noted in *Asset Retirement Obligations* above, we currently record AROs for our GEN and NGL segments. These AROs involve significant judgment regarding future cash flows and the ultimate timing of these cash flows, some of which include the probability of future events occurring such as the timing and method of settlement. As such, we are in the process of evaluating the impact of FIN No. 47 and expect to adopt FIN No. 47 in the first quarter of 2006.

**Note 2 Acquisition**

**Sithe Energies.** On January 31, 2005, we acquired 100% of the outstanding common shares of ExRes, the parent company of Sithe Energies and Independence. The results of the operations of ExRes have been included in our consolidated financial statements since that date. Through this acquisition, we acquired the 1,021 MW Independence power generation facility located near Scriba, New York, as well as four natural gas-fired merchant facilities in New York and four hydroelectric generation facilities in Pennsylvania. We have not consolidated the entities that own these four natural gas-fired facilities and four hydroelectric generation facilities, in accordance with the provisions of FIN No. 46R. See Note



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1 Accounting Policies Accounting Principle Adopted FIN No. 46R for additional discussion of these facilities. In addition to these power plants, we acquired the 750 MW firm capacity sales agreement between Independence and Con Edison, a subsidiary of Consolidated Edison, Inc. This agreement, which runs through 2014, will provide us with annual cash receipts of approximately \$100 million, subject to the restrictions on distribution under Independence's indebtedness. Independence holds power tolling, financial swap and other contracts with other Dynegy subsidiaries. As a result of the acquisition, these contracts have become intercompany agreements, and their financial statement impact has been substantially eliminated. This transaction enabled us to address one of our outstanding power tolling arrangements and to expand our generation capacity in a market where we have an existing presence.

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The aggregate purchase price was comprised of (i) \$135 million cash, which was reduced by a purchase price adjustment of approximately \$2 million; (ii) transaction costs of approximately \$16 million, approximately \$3 million of which were paid in 2004 and (iii) the assumption of \$919 million of face value project debt, which was recorded at its fair value of \$797 million as of January 31, 2005. Please read Note 7 Debt Independence Debt for additional information regarding the debt assumed.

The allocation of purchase price to specific assets and liabilities is based, in part, upon outside appraisals using customary valuation procedures and techniques. The allocation is substantially complete at this time and we do not anticipate any material changes. We expect to finalize our allocation of the purchase price in 2005, once the final tax basis of the assets and liabilities acquired has been determined. The acquisition resulted in an excess of the fair value of assets acquired over cost of the acquisition. This excess was then allocated to property plant and equipment and intangible assets acquired, including intangibles arising from contracts with us, on a pro-rata basis. The following table summarizes the fair values of the assets and liabilities acquired at the date of acquisition, January 31, 2005 (in millions):

Other current assets	\$ 87
Restricted cash and investments	132
Property, plant and equipment	352
Assets from risk-management activities	62
Intangible assets	657
	<hr/>
Total assets acquired	\$ 1,290
	<hr/>
Current liabilities	\$ (96)
Deferred income taxes	(189)
Other long-term liabilities	(59)
Long-term debt	(797)
	<hr/>
Total liabilities assumed	\$ (1,141)
	<hr/>
Net assets acquired	\$ 149
	<hr/>

Included in the assets acquired are restricted cash and investments of approximately \$132 million. The restricted investments include Federal Home Loan Bank Bonds, U.S. Treasury Bonds, and high-grade short-term commercial paper. The restricted cash and investments are related to a sinking fund required by Independence's debt instruments, including a major overhaul reserve, a debt service reserve, a principal payment reserve, an interest reserve and a project restoration reserve. Restrictions on the cash and investments are scheduled to be lifted at the end of the project financing term in 2014. For further discussion, please see Note 7 Debt Independence Debt.

Of the \$657 million of acquired intangible assets, \$487 million was allocated to the firm capacity sales agreement with Con Edison. This asset will be amortized on a straight-line basis over the ten-year remaining life of the contract as a reduction to revenue in our unaudited condensed

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consolidated statements of operations, through October 2014. In addition, Independence holds a power tolling contract, valued at \$154 million, and a gas supply agreement, valued at \$16 million, with another of our subsidiaries. Upon completion of our purchase of Independence, the power tolling agreement and the gas supply agreement were effectively settled, which resulted in a 2005 charge equal to their fair values, in accordance with EITF Issue 04-01, Accounting for Pre-existing Contractual Relationships Between the Parties to a Purchase Business Combination. As a result, we recorded a first quarter 2005 pre-tax charge of \$183 million, which is included in cost of sales on our unaudited

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**DYNEGY INC.**

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

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

condensed consolidated statements of operations. In the second quarter 2005, we substantially completed the determination of the tax basis of the assets and liabilities acquired, and revised our purchase price allocation, resulting in additional excess of the fair value of the assets acquired over the cost of the acquisition. Accordingly, we reversed \$13 million of the pre-tax charge recorded in the first quarter, resulting in a net pre-tax charge of \$170 million in accordance with EITF Issue 04-01, as well as made additional revisions to our deferred income taxes (\$80 million decrease to liability), intangible assets (\$52 million decrease to asset), and property, plant and equipment balances (\$28 million decrease to asset). Upon settlement of the power tolling and gas supply agreements, the firm capacity sales agreement with Con Edison is the only remaining intangible asset associated with the acquisition of ExRes, which is included in intangibles and prepaids and other current assets on our unaudited condensed consolidated balance sheets.

We have exercised our right to require Exelon to decommission, sell, or otherwise dispose of all four natural gas-fired merchant facilities owned by ExRes. Under the terms of the purchase agreement, Exelon will direct the disposition of these facilities, and will indemnify us with respect to all past and present operations. On June 8, 2005 and August 4, 2005, we entered into agreements, as directed by Exelon, to sell our ownership and operating interests in the four natural gas-fired power generation peaking facilities in upstate New York to Alliance Energy Group LLC, which includes our 80% interest in an 84 megawatt plant in Massena and our 85% interest in an 83 megawatt plant in Ogdensburg. The sale, subject to approval by the FERC and review by the New York Public Service Commission, is expected to close by end of year 2005 and is expected to have no impact on our unaudited condensed consolidated financial statements, as Exelon will receive any proceeds from the sale. Further, Exelon is entitled to cause us to decommission, sell, or bankrupt any or all of the four hydroelectric facilities owned by ExRes, for which we have been indemnified for any losses.

**Note 3 Discontinued Operations, Dispositions and Contract Terminations**

Amounts in this footnote have been restated. For further information, please see the Explanatory Note.

***Discontinued Operations***

***Natural Gas Liquids.*** On August 2, 2005, we entered into an agreement to sell our ownership interests in DMSLP, which comprises substantially all of the operations of our NGL segment, to Targa Resources, Inc. and two of its subsidiaries. We expect to receive \$2.475 billion in cash proceeds from the sale, subject to purchase price adjustments, of which \$2.35 billion will be paid by Targa at closing, and, based on current expectations, approximately \$125 million, representing cash collateral, will be paid by Targa within 60 days of closing. In addition, we expect our responsibility for approximately \$75 million in letters of credit to be eliminated at closing. The parties have made customary representations, warranties and covenants in the purchase agreement. The completion of the transaction is conditioned upon the expiration or termination of the Hart-Scott-Rodino waiting period and the fulfillment of other closing conditions as set forth in the purchase agreement, including the lack of a material adverse effect and other conditions that are customary in transactions of this type. The purchase agreement also contains customary termination rights, including termination rights by either party in the event the transaction has not been consummated by December 31, 2005. In certain circumstances (including the failure by Targa to close the transaction when all conditions precedent to Targa's obligation to close have been satisfied), the purchase agreement provides for Targa to pay to Dynegy liquidated damages of \$65 million upon

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termination of the purchase agreement. Pending satisfaction of the conditions in the purchase agreement, the sale is expected to close in the fourth quarter 2005. Please see Note 7 Debt Natural Gas Liquids for a discussion of our anticipated use of proceeds.

At June 1, 2005, NGL met the held for sale classification requirements of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , and is classified as such on our unaudited condensed

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consolidated balance sheet. The major classes of current and long-term assets and liabilities classified as assets held for sale or liabilities held for sale at June 30, 2005 are as follows (in millions):

<b>Current Assets:</b>	
Cash	\$ 16
Accounts receivable, net of allowance for doubtful accounts of \$2	266
Inventory	67
Other	20
	<hr/>
<b>Total Current Assets</b>	<b>\$ 369</b>
	<hr/>
<b>Long-Term Assets:</b>	
Property, plant and equipment, net	\$ 1,063
Unconsolidated investments	78
Goodwill	15
Other	3
	<hr/>
<b>Total Long-Term Assets</b>	<b>\$ 1,159</b>
	<hr/>
<b>Current Liabilities:</b>	
Accounts payable	\$ 65
Other	74
	<hr/>
<b>Total Current Liabilities</b>	<b>\$ 139</b>
	<hr/>
<b>Long-Term Liabilities:</b>	
Other	25
	<hr/>
<b>Total Long-Term Liabilities</b>	<b>\$ 25</b>
	<hr/>

Additionally, the \$107 million in minority interest and \$1 million of accumulated other comprehensive loss at June 30, 2005 relate to NGL and will not be included in our unaudited condensed consolidated balance sheets subsequent to the sale. As a result of the anticipated sale of DMSLP, our expected realization of certain deferred tax assets has been accelerated. For further discussion, please read Note 13 Income Taxes Balance Sheet Classification.

SFAS No. 144 also requires that long-lived assets not be depreciated or amortized while they are classified as held for sale. As such, we discontinued depreciation and amortization of NGL's property, plant and equipment, effective June 1, 2005. Depreciation and amortization expense related to NGL totaled \$15 million and \$35 million in the three- and six-month periods ended June 30, 2005, compared to \$25 million

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and \$45 million in the three- and six-month periods ended June 30, 2004.

In addition, SFAS No. 144 requires a loss to be recognized if assets held for sale less liabilities held for sale are in excess of fair value less costs to sell. Because the fair value less costs to sell is greater than assets held for sale less liabilities held for sale, we did not recognize a loss in the second quarter 2005. However, as a result of the anticipated sale of DMSLP, we reduced our deferred tax valuation allowance. For further discussion, please read Note 13 Income Taxes Capital Loss Valuation Allowance. We expect to record a pre-tax gain of approximately \$1.1 billion (\$700 million after-tax) upon closing of the transaction.

Pursuant to SFAS No. 144, we are reporting the results of NGL's operations as a discontinued operation. Accordingly, the results of operations of our NGL segment have been included in discontinued operations for all

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periods presented. EITF Issue 87-24, Allocation of Interest to Discontinued Operations, requires that interest expense on debt that is required to be repaid upon the sale of DMSLP should be reclassified to discontinued operations. Therefore, interest expense on our \$594 million term loan scheduled to mature in 2010 and our \$189 million generation facility debt scheduled to mature in 2007 has been allocated to discontinued operations, as the respective debt instruments are required to be paid upon the sale of DMSLP. Such interest expense totaled \$14 million and \$4 million for the three months ended June 30, 2005 and 2004, respectively, and \$25 million and \$6 million for the six months ended June 30, 2005 and 2004, respectively. For further information, please see Note 7 Debt Natural Gas Liquids.

Additionally, results from NGL's operations include revenues and cost of sales arising from intersegment transactions, which will cease after the sale of DMSLP. NGL processes natural gas and sells this natural gas to CRM for resale to third parties. NGL also purchases natural gas from CRM and electricity from GEN. As the intersegment revenues and cost of sales included in NGL's results were reclassified to discontinued operations, the effects of these intersegment transactions eliminated in consolidation, including the ultimate third party settlement, previously recorded in other segments, have also been reclassified to discontinued operations.

*Other.* We sold or liquidated some of our operations during 2003, including our communications business and our U.K. CRM business, which have been accounted for as discontinued operations under SFAS No. 144.

The following table summarizes information related to all of our discontinued operations, including the NGL operations discussed above:

	<b>U.K. CRM</b>	<b>DGC</b>	<b>NGL</b>	<b>Total</b>
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
	(in millions)			
<b>Three Months Ended June 30, 2005</b>				
Revenue	\$	\$	\$ 933	\$ 933
Income from operations before taxes	1		35	36
Income from operations after taxes		2	132	134
<b>Three Months Ended June 30, 2004</b>				
Revenue	\$	\$	\$ 766	\$ 766
Income from operations before taxes	1		70	71
Income (loss) from operations after taxes	(19)		42	23
<b>Six Months Ended June 30, 2005</b>				
Revenue	\$	\$	\$ 1,979	\$ 1,979
Income from operations before taxes	5		81	86
Income from operations after taxes	5		161	166
<b>Six Months Ended June 30, 2004</b>				
Revenue	\$	\$	\$ 1,667	\$ 1,667



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Income from operations before taxes	18	3	134	155
Income (loss) from operations after taxes	(7)	2	82	77

In the six months ending June 30, 2005, we recognized \$5 million of pre-tax income primarily associated with U.K. CRM s receipt from a third party bankruptcy settlement.

In the first quarter 2004, we recognized \$17 million of pre-tax income related to translation gains on foreign currency in the U.K. Please see Note 5 Risk Management Activities and Accumulated Other Comprehensive

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

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**For the Interim Periods Ended June 30, 2005 and 2004**

Loss Net Investment Hedges in Foreign Operations for further discussion. Also in the first quarter 2004, we recognized \$3 million of pre-tax income associated with DGC's receipt of \$3 million from a third party in settlement of a prior contractual claim. In the second quarter 2004, we recognized a tax expense of \$20 million in U.K. CRM related to charges resulting from the conclusion of prior year tax audits. Please see Note 13 Income Taxes Prior Year Tax Audits for further discussion.

***Dispositions and Contract Terminations***

***Sale of Illinois Power.*** On September 30, 2004, we sold all of our outstanding common and preferred shares of Illinois Power Company, which formerly comprised our REG segment, as well as our 20% interest in the Joppa power generation facility, to Ameren Corporation for \$2.3 billion. The \$2.3 billion sale price consisted of Ameren's assumption of \$1.8 billion of Illinois Power's debt and preferred stock obligations, cash proceeds of approximately \$375 million and an additional \$100 million of cash placed in escrow. At June 30, 2005 and December 31, 2004, we reflected the balance held in escrow in prepayments and other current assets on our unaudited condensed consolidated balance sheets. Under the escrow agreement, which we filed as an exhibit to our third quarter 2004 Form 10-Q, the \$100 million deposited by Ameren was to be released to us upon the occurrence of specified events relating to contingent environmental liabilities associated with Illinois Power's former generating facilities (currently owned by DMG). The Baldwin consent decree, which was approved and entered by the Illinois federal district court on May 27, 2005, satisfied the condition for the release of the \$100 million in escrowed funds. We received the funds on July 27, 2005. Please read Note 10 Commitments and Contingencies Baldwin Station Litigation for further discussion of this consent decree. During the time that these funds remained in escrow, the escrow fund earned interest on a quarterly basis.

During the first quarter 2005, we paid approximately \$5 million to Ameren for a final working capital purchase price adjustment. As a result of an adjustment to the contingent liabilities identified as part of the Illinois Power sale, we recorded a \$12 million charge in the second quarter of 2005. On July 27, 2005, we paid \$8 million in partial satisfaction of such contingent liabilities. For further discussion, please see Note 10 Commitments and Contingencies Guarantees and Indemnification. The adjustment to the contingent liabilities resulted in an increase to our capital loss carryforward, and a corresponding increase to the deferred tax valuation allowance of \$4 million.

Further, on September 30, 2004, we entered into a two-year power purchase agreement with Illinois Power, now known as AmerenIP. Under the terms of this agreement, which became effective January 1, 2005, we have agreed to provide Illinois Power with up to 2,800 MWs of capacity at \$48 per KW-yr and up to 11.5 million MWh of energy each year at a fixed price of \$30 per MWh. We also agreed to sell 300 MW of capacity in 2005 and 150 MW of capacity in 2006 to Illinois Power at a fixed price of \$16 per KW-yr with an option to purchase energy at market-based prices.

During the first quarter 2004, Illinois Power met the held for sale classification requirements of SFAS No. 144, and continued to meet the requirements through the closing of the sale on September 30, 2004. SFAS No. 144 requires that long-lived assets not be depreciated or amortized while they are classified as held for sale. As such, we discontinued depreciation and amortization of Illinois Power's property, plant and equipment and regulatory assets, effective February 1, 2004. Depreciation and amortization expense related to Illinois Power totaled \$10 million in the six-month period ended June 30, 2004. In addition, SFAS No. 144 requires a loss to be recognized in the amount by which assets

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held for sale less liabilities held for sale are in excess of fair value less costs to sell. Accordingly, for the three- and six-month periods ended June 30, 2004, we recorded pre-tax losses on the sale of \$48 million and \$69 million, respectively. The first quarter charge, which was primarily associated

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## DYNEGY INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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## For the Interim Periods Ended June 30, 2005 and 2004

with the expected transaction costs and an impairment of assets, is reflected in loss on sale of assets, net, and impairment and other charges on the unaudited condensed consolidated statements of operations. The second quarter charge, an impairment of assets, is reflected in impairments and other charges on our unaudited condensed consolidated statements of operations.

Further, pursuant to SFAS No. 144, we are not reporting the results of Illinois Power's operations as a discontinued operation. If we were to account for Illinois Power as a discontinued operation, its results of operations would be condensed into income from discontinued operations, net of taxes, on our unaudited condensed consolidated statements of operations, and prior periods would be required to be restated to conform to this presentation. To qualify for discontinued operations classification, SFAS No. 144 and subsequent interpretations, specifically EITF Issue 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in Determining Whether to Report Discontinued Operations, require that the seller have no significant continuing involvement with the business being sold. As noted above, we have contracted to sell capacity and energy to Illinois Power for two years beginning in January 2005. Consequently, because we still have significant continuing involvement with Illinois Power, we will continue to include the historical results of Illinois Power's operations as part of our continuing operations. Additionally, power sales to Illinois Power occurring subsequent to the disposition will be reported in our consolidated statements of operations as third party sales. Approximately \$108 million and \$183 million of revenues, derived from power sales to Illinois Power occurring subsequent to the disposition, are reflected in our continuing operations for the three- and six-month periods ending June 30, 2005.

Had the results of Illinois Power been excluded from our comparative results as though the sale had occurred on January 1, 2004, our revenues, net income applicable to common stockholders and associated basic and diluted earnings per share would have approximated the following pro forma amounts for the three- and six-month periods ended June 30, 2004:

	Three Months Ended	Six Months Ended
	June 30, 2004	
	(in millions, except per share data)	
Revenues:		
As reported	\$ 689	\$ 1,456
Pro forma	480	925
Net income applicable to common stockholders:		
As reported	2	67
Pro forma	15	72
Earnings per share Net income applicable to common stockholders:		
Basic as reported	\$ 0.01	\$ 0.17
Basic pro forma	\$ 0.04	\$ 0.19
Diluted as reported	\$ 0.01	\$ 0.17
Diluted pro forma	\$ 0.04	\$ 0.19

**Hackberry LNG Project.** During the first quarter 2003, we entered into an agreement to sell our ownership interest in Hackberry LNG Terminal LLC, the entity we formed in connection with our proposed LNG terminal/ gasification project in Hackberry, Louisiana, to Sempra LNG Corp., a subsidiary of San Diego-based Sempra Energy. The transaction closed in April 2003, after which we received contingent payments in 2003 based upon

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project development milestones. In March 2004, we sold our remaining financial interest in this project, which included rights to future contingent payments under the 2003 agreement, for \$17 million and recognized a pre-tax gain of \$17 million on the sale. This gain is included in income from discontinued operations on our unaudited condensed consolidated statements of operations.

*Indian Basin.* In April 2004, we sold our 16% interest in the Indian Basin Gas Processing Plant for approximately \$48 million. In the second quarter 2004, we recognized a pre-tax gain on the sale of approximately \$36 million. This gain is included in income from discontinued operations on our unaudited condensed consolidated statements of operations.

*PESA.* In April 2004, we sold our interest in the Plantas Eolicas, S.A. de R.L. 20 MW wind-powered electric generation facility located in Costa Rica for approximately \$11 million. We recognized a pre-tax loss of approximately \$1 million on the sale. This loss is included in loss on sale of assets, net, on our unaudited condensed consolidated statements of operations.

*Gas Transportation Contracts.* In June 2004, we agreed to exit four long-term natural gas transportation contracts whose purpose was to secure firm pipeline capacity through 2014 in support of our former third-party marketing and trading business. In exchange for exiting these obligations, we paid \$20 million in June 2004, \$16 million in December 2004 and \$26 million in March 2005. This payment obligation was recorded at its fair value of \$40 million and was accreted to \$42 million over the period July 1, 2004 through March 31, 2005. Additionally, we reversed an aggregate liability of \$148 million associated with the transportation contracts that was originally established in 2001 and recognized a pre-tax gain of \$88 million related to these transactions. This gain is included in revenues on our unaudited condensed consolidated statements of operations and is included in the results of our CRM segment. This agreement eliminated our obligation to make approximately \$295 million in aggregate fixed capacity payments from April 2005 through 2014.

**Note 4 Restructuring Charges**

In the three and six months ended June 30, 2004, we recorded pre-tax charges relating to our interest in Illinois Power totaling \$48 million and \$69 million, respectively. For further discussion, please read Note 3 Discontinued Operations, Dispositions and Contract Terminations Dispositions and Contract Terminations Sale of Illinois Power. In addition, in the three months ended June 30, 2004, we recorded a \$5 million pre-tax charge related to the impairment of our midstream assets.

In October 2002, we announced a restructuring plan designed to improve operational efficiencies and performance across our lines of business. The following is a schedule of 2005 activity for the liabilities recorded in connection with this restructuring:

	Severance	Cancellation Fees and Operating Leases	Total
	—	—	—
	(in millions)		
Balance at December 31, 2004	\$ 3	\$ 25	\$ 28
2005 adjustments to liability		(1)	(1)
Cash payments		(5)	(5)
	—	—	—
Balance at June 30, 2005	\$ 3	\$ 19	\$ 22
	—	—	—

We expect the \$19 million accrual as of June 30, 2005 associated with cancellation fees and operating leases to be paid by the end of 2007 when the leases expire.

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**DYNEGY INC.**

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

**(Unaudited and Restated)**

**For the Interim Periods Ended June 30, 2005 and 2004**

**Note 5 Risk Management Activities and Accumulated Other Comprehensive Loss**

The nature of our business necessarily involves market and financial risks. We enter into financial instrument contracts in an attempt to mitigate or eliminate these various risks. These risks and our strategy for mitigating them are more fully described in Note 5 Risk Management Activities and Financial Instruments beginning on page F-33 of our Form 10-K.

**Cash Flow Hedges.** We enter into financial derivative instruments that qualify as cash flow hedges. Instruments related to our GEN and NGL businesses are entered into for purposes of hedging future fuel requirements and sales commitments and locking in future margin.

During the three and six months ended June 30, 2005, we recorded a \$2 million and \$6 million charge, respectively, related to ineffectiveness from changes in fair value of hedge positions and no amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and six months ended June 30, 2004, there was no material ineffectiveness from changes in fair value of hedge positions and no amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and six months ended June 30, 2005 and 2004, no amounts were reclassified to earnings in connection with forecasted transactions that were no longer considered probable of occurring.

The balance in cash flow hedging activities, net at June 30, 2005 is expected to be reclassified to future earnings, contemporaneously with the related purchases of fuel, sales of electricity or natural gas liquids and payments of interest, as applicable to each type of hedge. Of this amount, after-tax losses of approximately \$22 million are currently estimated to be reclassified into earnings over the 12-month period ending June 30, 2006. The actual amounts that will be reclassified to earnings over this period and beyond could vary materially from this estimated amount as a result of changes in market conditions and other factors.

**Fair Value Hedges.** We also enter into derivative instruments that qualify as fair value hedges. We use interest rate swaps to convert a portion of our non-prepayable fixed-rate debt into floating-rate debt. During the three and six months ended June 30, 2005 and 2004, there was no ineffectiveness from changes in the fair value of hedge positions and no amounts were excluded from the assessment of hedge effectiveness. During the three and six months ended June 30, 2005 and 2004, no amounts were recognized in relation to firm commitments that no longer qualified as fair value hedges.

**Net Investment Hedges in Foreign Operations.** Although we have exited a substantial amount of our foreign operations, we continue to have investments in foreign subsidiaries, the net assets of which are exposed to currency exchange-rate volatility. In the past, we used derivative financial instruments, including foreign exchange forward contracts and cross-currency interest rate swaps, to hedge this exposure. As of June 30, 2005, we had no net investment hedges in place.



**Accumulated Other Comprehensive Loss.** Accumulated other comprehensive loss, net of tax, is included in stockholders' equity on our unaudited condensed consolidated balance sheets as follows:

	June 30, 2005	December 31, 2004
	<u>          </u>	<u>          </u>
	(in millions)	
Cash flow hedging activities, net	\$ (26)	\$ (16)
Foreign currency translation adjustment	16	16
Minimum pension liability	(13)	(13)
	<u>          </u>	<u>          </u>
Accumulated other comprehensive loss, net of tax	\$ (23)	\$ (13)
	<u>          </u>	<u>          </u>

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During the first quarter 2004, we repatriated a majority of our cash from the U.K., resulting in the substantial liquidation of our investment in the U.K. As such, we recognized approximately \$17 million of pre-tax translation gains in income that had accumulated in stockholders' equity.

**Note 6 Unconsolidated Investments**

A summary of our unconsolidated investments is as follows:

	<b>June 30, 2005</b>	<b>December 31, 2004</b>
	<u>          </u>	<u>          </u>
	<b>(in millions)</b>	
Equity affiliates:		
GEN investments	\$ 290	\$ 337
NGL investments	78	78
	<u>          </u>	<u>          </u>
Total equity affiliates	368	415
Othe		