

**DEAR FELLOW SHAREHOLDERS,**

2004 was a strong turnaround year for TXU. We implemented a restructuring program that brought immediate rewards as we sold underperforming businesses and refocused on the core companies, rebuilt the balance sheet, settled billions of dollars of costly and risky litigation and improved the company's financial strength. But 2004 wasn't just quick fixes. We also began the ambitious work to drive excellence deep into TXU Energy, TXU Power and TXU Electric Delivery, our three core electric businesses. All of our efforts must be directed at improving the value of what we provide the customer.

Our businesses are good at what they do – mining lignite coal and manufacturing electricity, serving more than 2.5 million retail electricity customers and delivering electric energy to three million consumers. But to compete in today's commodity markets, each business must get better. We want our customers to be delighted by their interactions with TXU, not just satisfied. We want our production plants to be world-class manufacturing facilities, not just excellent power plants. We want our transmission and distribution business to rival top transportation companies, not just the best utilities. Our aspiration is to transform TXU – its mindset, culture, processes and performance ethic – into a high-performance industrial company within five years. We face a hard climb to achieve the performance levels we desire, but coming out of 2004, I believe TXU is ahead of pace on its transformation.

**Market Value**

Measured against the assessment criteria of returns, earning power and financial flexibility, our restructuring program achieved

good results in 2004. Shareholder returns improved, as the restructuring program generated \$10 billion in market value for TXU's owners. TXU's stock outperformed the S&P electric index by almost eight times and was the third-best performer in the S&P 500, bettering that index by over 19 times. Earning power also improved. While the reported loss reflected the cost of the major restructuring, operational earnings per share rose almost 80%. They are projected to more than double this year, boosting TXU into the top of the industry. Reported cash from operations of \$1.8 billion was lower compared with 2003, primarily because of a 2003 tax refund, but normalized operating cash flow increased almost 50% to \$2.2 billion. Return on invested capital, up 50% in 2004, is projected to increase by almost 150% by 2005 from 2003 levels and would rank No. 2 in the industry.

In light of the company's improved financial strength, TXU's board of directors increased the annual dividend 350%, with an expectation of 5% annual growth. We expect

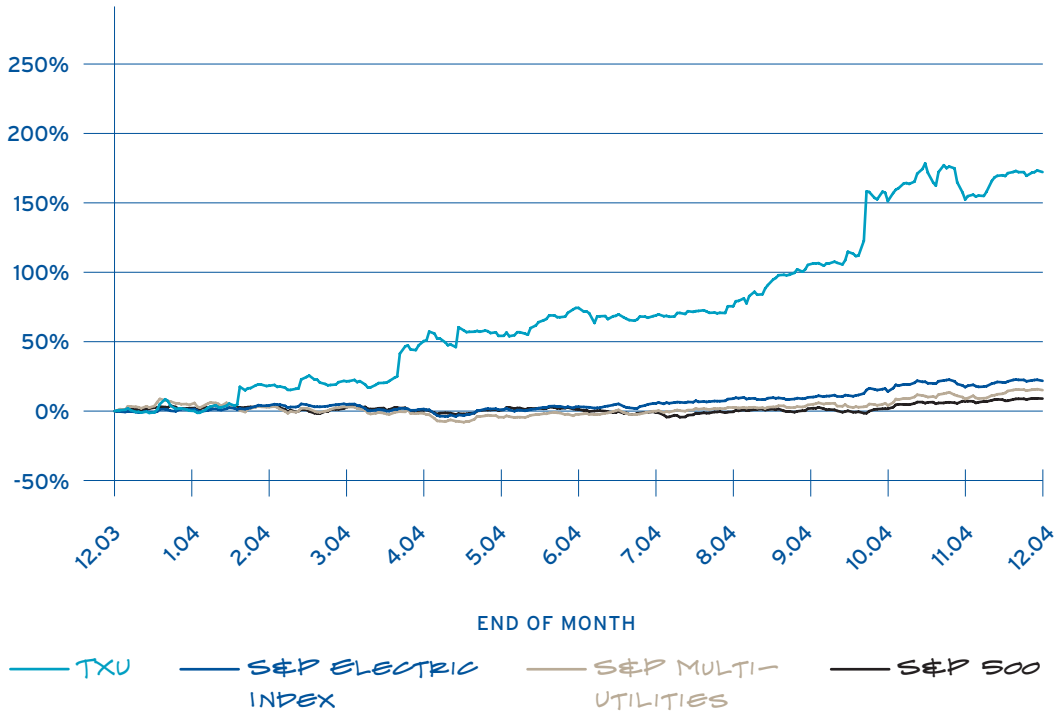
to return over \$5.5 billion of value to shareholders through dividends and share repurchases over the 2004 to 2005 period. With generation of significant incremental free cash flow after capital expenditures, TXU's cash-producing power is at or near the top of the industry.

**Financial Flexibility**

Another goal is to significantly strengthen TXU's financial flexibility, which means the ability to withstand downside market swings and capitalize on newly emerging opportunities. Compared with 2003, we made progress last year against three important measures of credit quality. Interest coverage, as measured by the ratio of EBITDA to interest expense, improved by one-third. Following the success of our 2004 liability and capital management program, interest coverage is expected to continue to improve in 2005. This is a significant change relative to 2003, when TXU's EBITDA-to-interest ratio ranked near the bottom of the industry. Debt to EBITDA also improved by nearly 20% in 2004, and we expect ongoing

Note: This annual report includes certain non-GAAP financial measures that management uses to measure performance. Reconciliation of these measures to the most directly comparable GAAP measures and financial definitions are included on page 11.

TXU'S 2004 COMMON STOCK PERFORMANCE VS. THE INDUSTRY



improvement in this key metric. At the end of 2004, available liquidity (cash and credit-facility capacity) stood at \$2.8 billion and is projected to remain above a \$1.5 billion threshold throughout 2005.

**TXU's Enduring Legacy**

While we had a good turnaround year, we're building TXU to last over the long haul because what we do is important. We like knowing that our service keeps a child's nightlight burning to chase away the darkness and the super store open around the clock. We're happy to cool the malls and heat the high rises. Building on TXU's 100-year history, our goal is to develop a company with the muscle and mindset to achieve strong productivity and earnings through any economic cycle, technology change or commodity price swing. High-performance

industrial companies are on relentless self-improvement programs. While the customer always rules, these companies aren't content with anything except top-quartile earning power and shareholder returns. They never cease to strive for higher efficiency, leaner production and lower costs, and they employ technology to their advantage. They earn the right to grow first; then they seize growth opportunities with high returns and prompt payback. Their work culture is disciplined, with people who have a passion for winning, an enthusiasm for surpassing aggressive targets and an intensity for constant improvement. Their financial strategies are tested against downside cases, and they operate with plenty of liquidity, properly structured debt and an abundance of capital strength. They're good stewards of the

environment, caretakers of their communities and aboveboard in their business practices. The leading companies keep it simple – simple organization, simple profit plans, clear objectives, real accountability and an understandable business model. This is the kind of company TXU aspires to be.

**Restructuring Success**

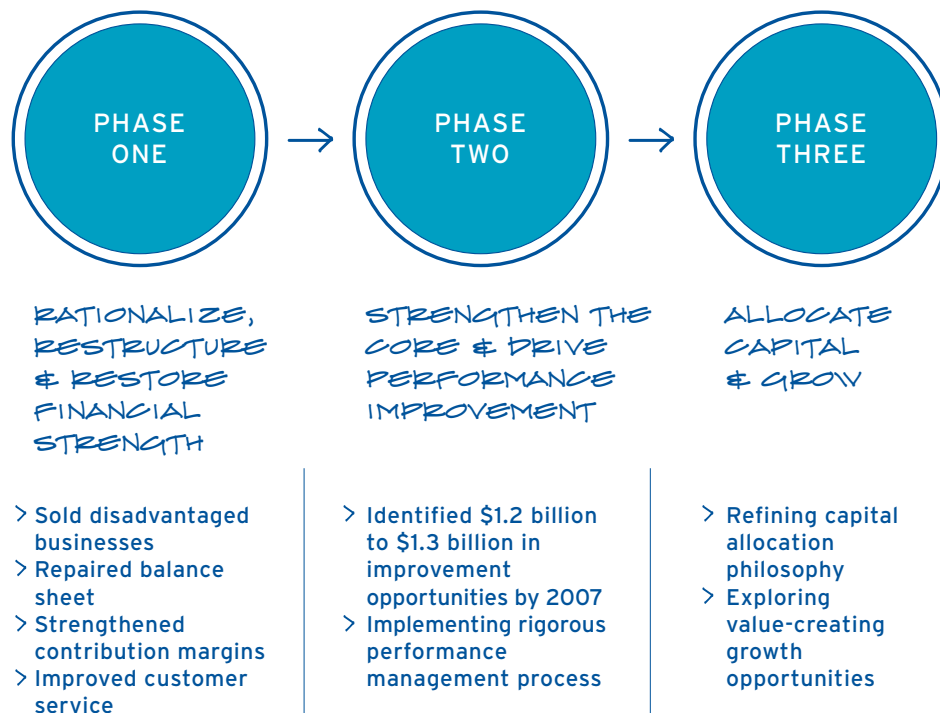
Becoming a high-performance industrial company is not as simple as it sounds, but we made real progress in 2004. Our restructuring program turned TXU around to focus our three businesses on achieving industry leadership across three critical factors. We are using these three factors – operational excellence, market leadership and human performance leadership – to drive to top-quartile financial performance and the ultimate transformation of the company.

Phase 1, now fully implemented, restructured TXU and restored its profitability. We asked the hard questions to kick off the phase. Which businesses weren't creating value? Could some support functions be done more effectively by a third party? Which ones? What services do customers want and deserve? How could management be strengthened? What contracts and business processes required immediate changes? What investments and business improvements could reap quick, value-creating benefits? One answer was the sale of \$6.5 billion of assets. This step, combined with borrowings, cash flow from operations and cash on hand, funded an overall liability management program totaling more than \$14 billion. Another answer was a commitment to achieving world-class customer service.

Phase 2 launched an ongoing, broad-based performance-improvement program. Most of the initiatives are underway and yielding benefits. Overall, this program identified the potential for \$1.2 billion to \$1.3 billion of earnings improvement before taxes by 2007. The vast majority of the improvement is expected in the first two years. It falls into two broad categories: operational excellence, which accounts for about \$500 million of the improvement, and market leadership, which accounts for approximately \$750 million. The third element – human performance leadership – is a critical enabler of the success of the other two categories and the overall restructuring program. Phase 2 initiatives continue to reshape the financial profile for the company, reflecting

a commitment to high performance within each of the three core businesses. Phase 3, our growth and capital-deployment initiatives, focused in 2004 on refining the capital allocation philosophy, rebasing the dividend and establishing a framework for future growth investments. Our revamped plan stipulates that the first call on our capital is to keep customer service, delivery reliability and power production at high levels. Only after capital is allocated to assure high performance is further reinvestment in the businesses considered, and then the transactions have to be right. Refining growth strategies and pursuing attractive opportunities are important priorities in 2005, as is returning capital to investors. If financial flexibility is maintained

TXU'S THREE-PHASE RESTRUCTURING PROGRAM



at target levels for the key credit metrics discussed earlier, TXU will return up to 75% of operational earnings to shareholders.

### The Top 10

The commitment of TXU's leaders and employees to the restructuring program generated a lot of successes in 2004. These are at the top of the list:

**1** We reshaped TXU's business portfolio to focus on three core businesses. In six months, a very dedicated team sold three large noncore businesses: TXU Australia, TXU Fuel Company and TXU Gas. Overall, sales transactions generated more than \$6.5 billion in cash proceeds and assumed debt, with minimal impact on ongoing free cash flow. TXU is now focused on businesses with strategic advantages and positions in Texas, the nation's highest-growth region in electricity demand. Two of these businesses, TXU Energy and TXU Power, form the core of TXU Energy Holdings (legally TXU Energy Company LLC), which conducts business primarily in Texas' deregulated power market. TXU Energy is the nation's largest competitive electric retailer, with over 2.5 million customers. TXU Power is the second-largest unregulated power producer in the U.S. TXU Electric Delivery is the nation's sixth-largest transmission and distribution company. We think we have winning potential with these three businesses.

**2** We improved the company's financial strength and reduced risks. Along with the portfolio reshaping, we undertook a systematic program to restructure TXU's balance sheet. Over \$14 billion in cash and assumed debt, including \$6.5 billion from asset sales, was deployed to restructure

debt, reduce diluted shares of common stock outstanding by 37% and avoid issuing up to 36 million additional shares, pay dividends and invest in the core businesses. Kirk Oliver, your chief financial officer, and his team were instrumental in this effort. Overall, TXU plans to reduce total debt, excluding transition bonds, by more than 20% by the end of 2005 relative to 2003. Eric Peterson and his new legal group were responsible for removing billions of dollars of litigation exposure from your company. This was a heroic effort and will make us a much safer investment.

**3** We dramatically improved customer service, thanks to the hard work of Paul O'Malley and his TXU Energy team. In 2003, the quality of customer service dropped to unacceptable levels, as average call answer times in call centers hit almost 270 seconds. In March 2004, we launched a major new initiative to offer the best customer service of any electric provider in the nation by the summer. Additional people were hired to reduce answer times to the best in the industry. By the summer of 2004, the call centers were answering calls in 15 seconds or less, a world-class achievement. They got even better. By December, the average speed to answer calls was just 10 seconds. Customer time in the integrated voice recognition system, which automates the handling of customer calls, also dropped 32% by the end of 2004. A more thorough and broad-based program to achieve world-class customer service across all key interaction points is a crucial goal of Phase 2. Our objective is to build a reputation for market leadership in customer service and satisfaction, which is expected

to translate directly into keeping and attracting customers.

**4** We achieved power production records in an environmentally responsible way. TXU Power, headed by Mike Greene and a very capable team of employees, achieved all-time records in lignite and nuclear generation in 2004, reflecting the progress of Phase 2 initiatives. The lignite mines kept pace with production that exceeded 23 million tons. As part of Phase 2, TXU Power also began implementing the TXU Operating System in its lignite operations in 2004. The TXU Operating System is a systematic program to apply manufacturing principles focused on cost containment and operational improvement. It is a first in the coal generation industry. The TXU Operating System can enable more than \$140 million in earnings improvement before taxes by 2007 as waste is eliminated and work processes improved. A critical part of operational excellence is environmental responsibility. According to the U.S. Environmental Protection Agency, America's air is the cleanest it has been in over 30 years. TXU is playing an important part in this progress by reducing air emissions and complying with all applicable environmental regulations. Since 1990, we have reduced emission rates of nitrogen oxides (NOx) by 64%, carbon dioxide by 11% and sulfur dioxide by 13%. In the Dallas-Fort Worth area, we've reduced NOx emission rates by almost 90% since 1997.

**5** We achieved top-quartile performance in two key delivery reliability benchmarks last year and progressed toward that level in the third metric. Tom Baker and the TXU Electric Delivery team

made that happen. Building on this momentum, TXU Electric Delivery has committed to the objective of reaching top quartile in all reliability metrics by 2006, reducing transmission congestion and maintaining cost-performance leadership.

**6** We increased investment in the core businesses. Along with the investment to improve TXU Energy's customer service, Phase 1 also

center, human resources and accounts payable functions.

**8** We reduced TXU's fixed-cost structure. Debt and overhead reductions are significantly lowering fixed costs, improving the flexibility and resiliency of the company. Fixed costs fell in 2004 at the same time that contribution margin increased, and more progress is expected in 2005. One element driving the savings

giving back, our contributions clearly set the standard within Texas in 2004. Representing a fivefold increase, TXU Energy is committing \$15 million over three years to Energy Aid, our program to help customers in need pay their energy bills. TXU Electric Delivery is investing \$30 million in weatherization assistance over three years to help lower-income customers manage their energy use. For

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included significant additional investment in TXU Electric Delivery and TXU Power. TXU Electric Delivery has increased planned spending for vegetation management by more than a third over the next three years to achieve top-quartile reliability performance. The business is also committed to a sixfold increase in transmission improvements compared with investment in the mid-1990s. TXU Power plans to increase its investment over the next three years by more than 40% to improve plant availability.

**7** We improved back-office effectiveness and reduced costs. An innovative outsourcing partnership with Capgemini that began in July 2004 is reducing overhead costs an estimated \$175 million by 2005 and improving service to TXU customers and employees. Around 3,000 TXU employees and contractors transferred to the new joint venture, Capgemini Energy, including billing, call

is the reduction of retail bad debt, which tripled following deregulation in 2002. Stricter disconnect policies, upfront billing of deposits and aggressive large-business collections reduced bad-debt expense by a fifth in 2004, with a 37% decrease targeted in 2005 from 2003 levels. With this new fixed-cost structure, TXU is much better positioned to withstand potential business shocks and take advantage of unexpected opportunities.

**9** We returned value to shareholders. Our revamped capital-deployment and growth program is expected to return more than \$5.5 billion through dividends and share repurchases in 2004 and 2005. In late October, we raised the annual dividend from 50 cents to \$2.25 per share.

**10** We increased investment in the communities we serve. In keeping with our heritage of

its weatherization outreach, TXU Electric Delivery received the prestigious Platts Global Energy Award for Community Development Program of the Year in 2004. TXU's employees also reached into their own pockets, as the company exceeded its goal of \$1.2 million in contributions to the United Way.

**Ahead of Pace**

While we still have a lot to do and face challenges ahead, I think the work we accomplished in 2004 puts us on a clear path to make the transformation from the utility TXU was for over a century to a high-performance industrial company that sets the standard for the power industry. After a full year as CEO, I'm more confident than ever that TXU is a compelling value proposition. Few Texas businesses have devoted more time, money and effort to the industrial, commercial and agricultural development of the state than TXU. The importance

*continued on page 8*

of what we do, our three strong businesses and their significant improvement potential are what continue to make me so enthusiastic about my role here. I'm excited to work with a team that's providing an essential service to society.

Going into 2005, TXU can build on these advantages:

**A strong business profile.** TXU has three core businesses that are well positioned and situated in a high-growth regional market.

**A rejuvenated financial profile.** Compared with 2003, TXU expects to have three times the earning power, double the normalized free cash flow and an approximate 145% improvement in return on invested capital in 2005.

**A more resilient business model.** Our integrated business model should exhibit adequate to good performance under a wide range of commodity price scenarios.

identified initiatives that can and should drive \$1.2 billion to \$1.3 billion of improvement before taxes over the next three years relative to 2004.

**Disciplined capital allocation.** TXU's capital allocation philosophy focuses on maximizing returns to shareholders while maintaining strong credit metrics. With the increased dividend and potential share repurchases or other distributions to shareholders, TXU should be able to maintain high-performance total payout ratios.

**The Fun Part**

At the end of the year, an employee asked me if I was bored now that we'd reshaped the businesses and regained some financial flexibility. I told him I appreciated his concern about my motivation but went on to say that I'm more inspired today than I was when I arrived

I'm the kind of person who takes the bandage off with one hard pull and swallows the medicine with one big gulp. Although we'll always be challenged by hard choices, we tried to get as many of the tough decisions as possible out of the way last year.

Now we're in a motivational position with exciting challenges. How will we grow? How can we keep improving our businesses to be the undisputed leaders in their markets? How can we create new products or technologies? How can we develop our leaders in a way that inspires employees more? How can we liberate employees to make more decisions on their own? This is the phase of business I truly love. It's the fun part of my job.

**Plain and Simple**

We have six clear priorities in 2005:

**High performance.** We must continue to drive high perfor-

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Individually, TXU Energy and TXU Power are highly exposed to wholesale electricity prices, but the combination of the two businesses reduces price volatility, providing a natural hedge within TXU Energy Holdings. And TXU Electric Delivery, with its industry cost leadership, is in a good position to leverage the high underlying long-term annual growth rate of 2.5% in its service area.

**Performance-improvement potential.** TXU's businesses have

in February 2004. I knew when I came to TXU that we had painful decisions to make. We knew the core businesses weren't performing at the levels we needed and that others had to be shut down or sold. We knew we had too little cash, too much debt, too many leaders who didn't fit the new TXU and some financial arrangements that were killing the company. Turnarounds are brutal, so my theory was simple – get it over with as fast as you can. You can probably tell

mance in the core businesses as we focus on operational excellence, market leadership and human performance leadership. David Campbell will lead this effort and has already made tremendous progress. And while our business portfolio is in a much better position than when we began 2004, we're still challenged to make our businesses more resilient to the uncertainties of laws and regulations, the volatility of the commodity markets and the natural exposure of a

concentrated position in a single regulatory jurisdiction.

**Customer excellence.** Although TXU made remarkable progress in 2004 in repairing poor customer service, the company has yet to be challenged by the inevitable entry of a competitor with an established consumer brand. That test will come, and TXU must be ready. We must spur ourselves to keep ahead of the competition at our heels. Improving customer service and attracting and retaining customers are the most important priorities of TXU Energy's retail business and will remain constant challenges. 2004 proves that customer service is key: as customer service improved, customer retention in the North Texas residential market also went up and customer churn rates dropped. Building a profitable out-of-territory residential business in regions of the state outside of North Texas is also a

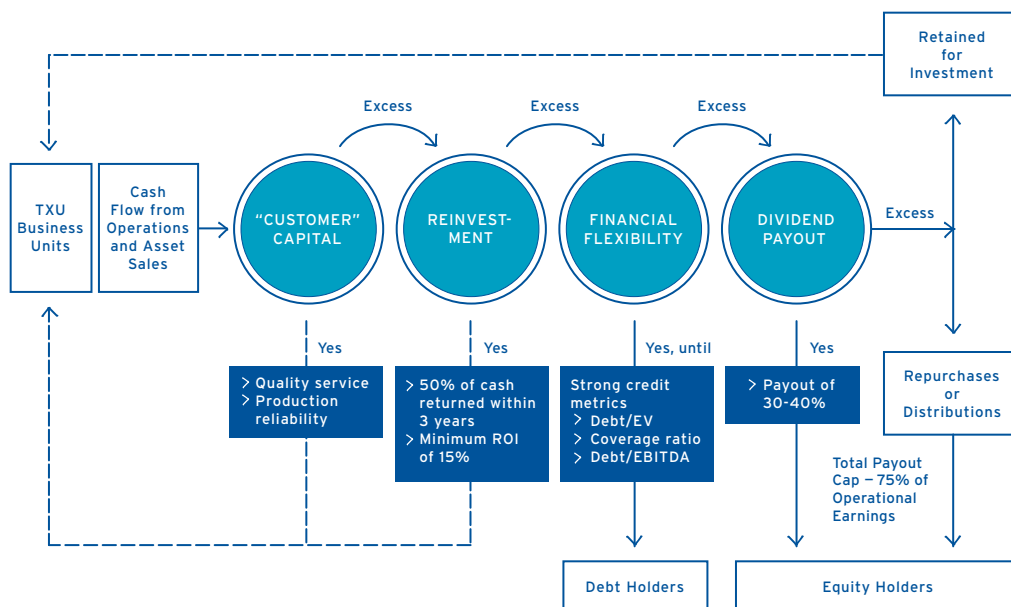
priority and one of TXU Energy's growth paths. The small- and medium-business segment continues to be a competitive battleground in which TXU Energy lost a significant share in its home territory in 2004. Stabilizing market share and margins in this segment are important priorities. The large commercial and industrial business, which improved in the second half of 2004, faces a make-or-break year in 2005. We will focus on and win profitable customers or exit the business.

**Cost leadership.** While we expect to reduce fixed costs by \$1.3 billion, or 32%, from 2003 to 2005, they must be cut another \$500 million within five years. The next level of reductions will be tougher to achieve than the 2004 and 2005 cuts and will require more ingenuity and fundamental change in work processes and human performance.

**Human performance.** The success of the restructuring program and TXU's aspiration to become a high-performance industrial company are dependent on the quality of TXU's people. The company made progress last year in improving human performance by restructuring the management team and increasing the number of employees embedded in the businesses, but we have more to do. This year, we must upgrade management talent, develop the right incentive plan that motivates and rewards high performance, inspire a high-performance culture within each business and develop people. And while the workforce was restructured and its capability strengthened in 2004, TXU has areas that require more attention this year.

**Continued restructuring for value.** The restructuring program, which is about 75% complete, has already unlocked considerable value. In 2005, we'll

TXU'S DISCIPLINED CAPITAL ALLOCATION PROCESS





**C. JOHN WILDER, Chief Executive (center)**  
with (from left) **Dung Tran, Kim Rucker and Jonathan Siegler**

continue mining the hidden value embedded in TXU by freeing trapped cash. Assets such as lignite reserves and underused real estate, including thousands of acre-feet of water rights and considerable office space, offer potential for creating value. Millions of dollars in poor-performing legacy contracts that continue to burden the income statement could also be restructured. Assets that are not a natural fit for the company, such as the gas fleet, are another way we may be able to monetize selected assets and provide value to shareholders.

**Profitable growth.** TXU must deliberately examine its growth options. Although the bar is high for deploying growth capital – 50% of cash returned in three years with a 15% return on investment – there are exciting opportunities to explore.

**A Team Effort**

In 2005, we'll continue to judge our success by assessing whether we achieve top-quartile financial results, measured in terms of returns on capital, shareholder returns, and earnings and cash-flow growth, while maintaining strong financial flexibility. At the same time, we'll continue building a culture that is obsessively focused on deeply understanding what customers need and want (which may or may not be the same thing) and operating our plants, mines and delivery infrastructure at the highest production levels, lowest costs and safest performance.

I'm grateful to TXU's employees for their hard work, commitment and resiliency during 2004. Employees dealt with the upheaval of restructuring and the inevitable uncertainty of competitive markets and did a truly remarkable job.

They set generation records, delivered electricity with improved reliability and took big steps toward a distinctive reputation for customer service. In some cases, employees were simply heroic, especially in June as thousands worked around the clock to restore service and care for customers following the worst storm outages in the company's history.

I'm proud to work with the great team at TXU as we build this enterprise into a high-performance industrial company. I am also grateful for your support as the owners of the company, and I look forward to the completion of TXU's exciting and rewarding transformation.

X 

**C. JOHN WILDER**

Chief Executive