

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **BUSINESS**

TXU Corp. is a holding company conducting its operations principally through its TXU Energy Holdings and TXU Electric Delivery subsidiaries. TXU Energy Holdings is engaged in electricity generation and retail and wholesale energy sales largely in Texas. TXU Electric Delivery engages in regulated electricity transmission and distribution operations in Texas.

### **BUSINESS RESTRUCTURING AND OTHER ACTIONS**

Mr. C. John Wilder, who was named president and chief executive of TXU Corp. in February 2004, and senior management reviewed TXU Corp.'s operations during 2004 and implemented a three-phase restructuring and operational improvement program to restore financial strength, drive performance improvement with a competitive industrial company perspective and allocate capital in a disciplined and efficient manner.

- Phase one of the restructuring and operational improvement program involved divesting of value-disadvantaged businesses and using the sales proceeds, operating cash flows and cash on hand to simplify the debt portfolio and capital structure. This phase also included identifying contracts and business processes requiring immediate action to improve profitability. Phase one was completed during 2004.
- Phase two includes implementation of initiatives to achieve operational excellence in the core businesses and market leadership in providing service and value to customers, as well as implementing programs to drive and reward high performance from employees. TXU Corp. began implementation of Phase two during 2004.
- Phase three includes refining the capital allocation philosophy, rebasing the dividend and establishing a framework for future growth investments. Refining growth strategies, pursuing value-creating opportunities and returning capital to investors are priorities in 2005.

Management believes that its actions in 2004 have resulted in sustainable profitability improvements, principally through streamlining of the organization, optimization of energy supply costs and improved customer retention. In addition, increased focus on income tax, litigation and other contingencies has resulted in significant progress in resolving these matters. These activities have resulted in unusual charges and credits impacting 2004 income from continuing operations, summarized as follows and discussed below in more detail:

	Income Statement Classification	Charge/(Credit) to Earnings	
		Pretax	After-tax
TXU Energy Holdings segment:			
Charges related to leased equipment.....	Other deductions	\$ 180	\$ 117
Software write-off .....	Other deductions	107	70
Employee severance costs .....	Other deductions	107	69
Power purchase contract termination .....	Other deductions	101	66
Spare parts inventory write-down .....	Other deductions	79	51
Outsourcing transition costs .....	Other deductions	10	6
Other asset impairments .....	Other deductions	6	4
Other charges .....	Operating costs/SG&A	8	6
Recognition of deferred gain on plant sales.....	Other income	(58)	(38)
Gain on sale of undeveloped properties .....	Other income	(19)	(12)
TXU Electric Delivery segment:			
Employee severance costs .....	Other deductions	20	13
Rate case settlement reserve.....	Other deductions	21	14
Outsourcing transition costs .....	Other deductions	4	3
Software write-off and asset impairment .....	Other deductions	4	2
Other charges .....	Operating costs/SG&A	2	1
Corporate and other:			
Debt extinguishment losses .....	Other deductions	416	382
Litigation accrual.....	Other deductions	86	56
Executive compensation .....	SG&A	52	52
Consulting and professional fees.....	SG&A	54	35
Employee severance costs .....	Other deductions	5	3
Other charges .....	Other deductions	5	3
Recognition of TXU Europe income tax benefit ...	Income taxes	—	(75)
Total .....		<u>\$ 1,190</u>	<u>\$ 828</u>

In addition, income from discontinued operations totaled \$378 million in 2004, reflecting the recognition of additional tax benefits related to the write-off of the investment in TXU Europe, the dispositions of TXU Australia and TXU Gas and a charge related to the settlement of potential claims related to TXU Europe. (See Note 4 to Financial Statements.)

The review of TXU Corp.'s operations and formulation of strategic initiatives is ongoing, though the phases of the plan expected to result in restructuring charges are largely completed. Certain of the strategic initiatives described below could result in additional charges that TXU Corp. is currently unable to predict. In addition, other new strategic initiatives that could also materially affect TXU Corp.'s financial results are likely to be undertaken.

Following is a discussion of the major activities associated with the restructuring plan:

#### Sale of TXU Australia

In July 2004, TXU Corp. completed the sale of TXU Australia to Singapore Power Ltd. for \$1.9 billion in cash and \$1.7 billion in assumed debt, and recorded a gain on sale of \$371 million (\$241 million after-tax). TXU Australia's operations consisted of a portfolio of competitive and regulated energy businesses, principally in Victoria and South Australia, with 2003 revenues of approximately \$1.1 billion. The results of TXU Australia and the gain on sale are reported as discontinued operations as discussed in Note 4 to Financial Statements.

#### Sale of TXU Fuel

In June 2004, TXU Corp. completed the sale of the assets of TXU Fuel, the former intrastate gas transportation subsidiary of TXU Energy Holdings, to Energy Transfer Partners, L.P. for \$500 million in cash.

TXU Fuel had 2003 revenues of approximately \$65 million, the majority of which represented gas transportation fees from TXU Energy Holdings. As part of the transaction, TXU Energy Holdings entered into a transportation agreement, intended to be market-price based, with the new owner to transport gas to TXU Energy Holdings' generation plants. Because of the continuing involvement in the business through the transportation agreement, the pretax gain related to the sale of \$375 million will be recognized over the eight-year life of the transportation agreement, and the business has not been accounted for as a discontinued operation. The pretax gain is net of \$16 million of TXU Energy Holdings goodwill allocated to TXU Fuel.

#### TXU Gas Transaction

In October 2004, Atmos Energy Corporation and TXU Gas completed a merger by division, which resulted in TXU Corp.'s disposition of the operations of TXU Gas for \$1.9 billion in cash. TXU Gas was largely a regulated business engaged in the purchase, transmission, distribution and retail sale of natural gas with 2003 revenues of approximately \$1.3 billion. The results of TXU Gas, as well as charges related to the sale of \$108 million (\$193 million after-tax), are reported as discontinued operations as discussed in Note 4 to Financial Statements.

In October 2004, TXU Corp. redeemed or legally defeased \$429 million principal amount of TXU Gas debt. In addition, all of the outstanding shares of TXU Gas' preferred stock with a liquidation value of \$75 million were redeemed in November 2004.

#### Capgemini Outsourcing Agreement

In May 2004, TXU Corp. entered into a services agreement with Capgemini Energy LP (Capgemini), a new company initially providing business process support services to TXU Corp. only, but immediately implementing a plan to offer similar services to other utility companies. Under the ten-year agreement, over 2,500 employees transferred from subsidiaries of TXU Corp. to Capgemini effective July 1, 2004. Outsourced base support services performed by Capgemini for a fixed fee, subject to adjustment for volumes or other factors, include information technology, customer call center, billing, human resources, supply chain and certain accounting activities. TXU Corp. expects that the Capgemini arrangement will result in lower costs and improved service levels.

As part of the agreement, Capgemini was provided a royalty-free right, under an asset license arrangement, to use TXU Corp.'s information technology assets, consisting primarily of capitalized software. A portion of the software was in development and had not yet been placed in service. As a result of outsourcing its information technology activities, TXU Corp. no longer intends to develop the majority of these projects and from TXU Corp.'s perspective the software is abandoned. The agreements with Capgemini do not require that any software in development be completed and placed in service. Consequently, the carrying value of these software projects was written off, resulting in a charge of \$109 million (\$71 million after-tax). TXU Corp. expects to rely on Capgemini for future enhancements and modifications to the software in use at the time of the transaction.

TXU Corp. obtained a 2.9% limited partnership interest in Capgemini in exchange for the asset license described above. TXU Corp. has the right to sell (the "put option") its interest and the licensed software to Cap Gemini North America Inc. for \$200 million, plus its share of Capgemini's undistributed earnings, upon expiration of the services agreement or earlier upon the occurrence of certain unexpected events. Cap Gemini North America Inc. has the right to purchase these interests under the same terms and conditions. The partnership interest has been recorded at an initial value of \$2.9 million and is being accounted for on the cost method.

TXU Corp. has recorded the fair value of the put option, estimated at \$177 million, as a noncurrent asset. Of this amount, \$169 million was recorded as a reduction to the carrying value of the licensed software. This accounting is in accordance with guidance related to sales and licensing of internally developed software described in AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The difference of \$8 million, which represented the fair value of the assumed cash distributions and gains while holding the partnership interest for the period prior to exercise of the put, was

recorded as a noncurrent deferred credit. The remaining balance of the software is being amortized over the estimated remaining useful lives.

Also as part of the agreement, TXU Corp. agreed to indemnify Capgemini for severance costs incurred by Capgemini for former TXU Corp. employees terminated within 18 months of their transfer to Capgemini. Accordingly, TXU Corp. recorded a \$40 million (\$26 million after-tax) charge for severance expense in the second quarter of 2004. In addition, TXU Corp. committed to pay up to \$25 million for costs associated with transitioning the outsourced activities to Capgemini. Transition expenses of \$14 million (\$9 million after-tax) were recorded by TXU Corp. during 2004, and the remainder are expected to be expensed as incurred in 2005.

Subject to certain terms and conditions, Cap Gemini North America, Inc. and its parent, Cap Gemini S.A., have guaranteed the performance and payment obligations of Capgemini under the services agreement, as well as the payment of \$200 million in connection with the put option.

In July 2004, TXU Corp. loaned Capgemini \$25 million for working capital purposes pursuant to a promissory note that bears interest at a then market-based annual rate of 4% and matures in July 2019.

#### Generation Facility Closures and Sales

In December 2004, TXU Corp. committed to immediately cease operating for its own benefit nine leased gas-fired combustion turbines, and recorded a charge of \$157 million (\$102 million after-tax). The charge represents the present value of the future lease payments related to the turbines, net of estimated sublease proceeds. The leases expire in 2017 and 2018. TXU Corp. is currently evaluating opportunities with respect to the turbines, including subleasing the turbines to third parties or decommissioning the turbines. During this evaluation period, the turbines will be available to ERCOT only for system reliability purposes.

In November 2004, TXU Corp. announced plans to deactivate, or mothball, eight gas-fired operating units due to electric industry market conditions in Texas. The units were more than 30 years old and had operated only sparingly during the last two years. The facility closures resulted in employee severance costs of \$7 million (\$5 million after-tax).

In the second quarter of 2004, TXU Corp. initiated a plan to sell the Pedricktown, New Jersey 122 MW power production facility and exit the related power supply and gas transportation agreements. Accordingly, TXU Corp. recorded an impairment charge of \$26 million (\$17 million after-tax) to write down the facility to estimated fair market value. The results of the business and the impairment charge are reported in discontinued operations, as discussed in Note 4 to Financial Statements.

In March 2004, TXU Corp. announced the planned permanent retirement, completed in the second quarter of 2004, of eight gas-fired operating units. TXU Corp. also temporarily closed four other gas-fired units and placed them under evaluation for retirement. A majority of the 12 units were designated as "peaking units" and operated only during the summer for many years and had operated only sparingly during the last two years. TXU Corp. also closed its Winfield North Monticello lignite mine in Texas, as it was no longer economical to operate when compared to the cost of purchasing coal to fuel the adjacent generation facility. A total charge of \$8 million (\$5 million after-tax) was recorded for employee severance costs and impairments related to the various facility closures.

As a result of the various actions in 2004, TXU Corp. will permanently or temporarily deactivate over 40% of its gas-fired generating capacity in Texas, representing 4,572 MW of capacity.

#### Other Actions Related to Generation Operations

In December 2004, TXU Corp. executed an agreement to terminate, for a payment of \$172 million, an existing power purchase and tolling agreement that would have expired in 2006. The agreement was entered into in connection with the sale of two generation plants to the counterparty in 2001. As a result of the transaction, TXU Corp. recorded a charge of \$101 million (\$66 million after-tax). The charge represents the

payment amount less the remaining out-of-the-money liability related to the agreement originally recorded at its inception. TXU Corp. also recorded a gain of \$58 million (\$38 million after-tax), representing the remaining deferred gains from the sale of the two plants.

In October 2004, TXU Corp. entered into an agreement to terminate the operating lease for certain mining equipment for approximately \$28 million in cash, effective November 1, 2004. The lease termination resulted in a charge of \$21 million (\$14 million after-tax). TXU Corp. entered into a short-term lease with an unrelated third party for the equipment, which is expected to be taken out of service at the expiration of the lease.

As part of a review of its generation asset portfolio in the second quarter of 2004, TXU Corp. completed a review of its spare parts and equipment inventory to determine the appropriate level of such inventory. The review included nuclear, coal and gas-fired generation-related facilities. As a result of this review, TXU Corp. recorded a charge of \$79 million (\$51 million after-tax), to reflect excess inventory on hand and to write down carrying values to scrap values.

#### Organizational Realignment and Headcount Reductions

During 2004, management completed a comprehensive organizational review, including an analysis of staffing requirements. As a result, TXU Corp. completed a self-nomination severance program and other involuntary severance actions, and recorded severance charges totaling \$77 million (\$49 million after-tax).

#### Liability and Capital Management

TXU Corp. utilized cash proceeds from the sale of TXU Australia, TXU Gas and TXU Fuel and other assets sales as well as cash provided from operations and lower-cost debt issuances to increase value and reduce risks through an ongoing liability management initiative. Largely under this initiative, in 2004 TXU Corp. repurchased or legally defeased \$3.6 billion of debt securities (including equity-linked debt securities and debt held by subsidiary trusts). In addition, TXU Corp. repurchased \$6.7 billion of common equity and other securities.

The following debt securities were repurchased or legally defeased in 2004:

	<b>Principal Amount Repurchased</b>	<b>Debt Extinguishment Losses (pretax)</b>
<u>TXU Corp.</u>		
Floating Convertible Senior Notes due July 15, 2033 .....	\$ 500	\$ 315
4.446% Fixed Senior Notes Series K (equity-linked) due November 16, 2006 .....	450	23
5.450% Fixed Senior Notes Series L (equity-linked) due November 16, 2007 .....	399	22
5.800% Fixed Senior Notes Series M (equity-linked) due May 16, 2008.....	256	23
7.250% Long-term debt held by subsidiary trust (Capital I Trust).....	237	7
8.700% Long-term debt held by subsidiary trust (Capital II Trust) .....	155	4
6.375% Fixed Senior Notes Series J due June 15, 2006 .....	117	7
Other, including unamortized debt expenses and retirement fees .....	—	14
<u>TXU Gas</u>		
Floating Rate long-term debt held by subsidiary trust (Capital I Trust).....	154	—
7.125% Fixed Notes due June 15, 2005 .....	150	—
6.564% Fixed Remarketed Reset Notes due January 1, 2008 .....	125	—
<u>TXU Electric Delivery</u>		
7.625% Fixed First Mortgage Bonds due July 1, 2025(a) .....	215	—
7.375% Fixed First Mortgage Bonds due October 1, 2025(a) .....	178	—
<u>TXU Energy Holdings</u>		
2.838% Floating Rate Senior Notes due January 17, 2006.....	400	—
Brazos River Authority Pollution Control Revenue Bonds – 4.950% Fixed Series 2001A due October 1, 2030, remarketing date April 1, 2004(b).....	121	
Brazos River Authority Pollution Control Revenue Bonds – portions of Series 2003C, 2002A, 2001C, 2001D, and 1995B.....	100	1
Total .....	<u>\$ 3,557</u>	<u>\$ 416</u>

- (a) Repurchased with the proceeds from the securitization (transition) bonds issuance in June 2004.  
(b) Purchased upon mandatory tender.

TXU Corp. also repurchased the following securities during 2004:

	<b>Purchase Price</b>	<b>Common Shares Repurchased (in millions)</b>
Common equity - accelerated share repurchase programs (including fees) and open market repurchases .....	\$ 4,737	84.3
Exchangeable preferred membership interests of TXU Energy Holdings.....	1,852	—
Preferred stock of TXU Gas .....	75	—
Total .....	<u>\$ 6,664</u>	<u>84.3</u>

See Notes 8, 9, 10 and 11 to Financial Statements for further detail of debt issuances and retirements, financing arrangements, repurchase of exchangeable preferred membership interests, debt held by unconsolidated subsidiary trusts and capitalization.

#### Consolidation of Real Estate

Currently, TXU Corp. owns or leases more than 1.3 million square feet in various management and support office locations, which exceeds its anticipated needs. TXU Corp. has evaluated alternatives to reduce current office space and intends to consolidate into its existing headquarters building in Dallas, Texas, enhancing the facility to enable better employee communication and collaboration and cost effectiveness. TXU Corp. recorded \$2 million (\$1 million after-tax) in exit fees related to existing leased facilities in 2004. Implementation of this initiative is expected to result in additional charges in 2005, but the amounts are not yet estimable.

## Contingencies Update

See Note 18 to Financial Statements for more detailed discussion of contingencies. Following is a description of the progress and status of certain matters related to income taxes, litigation and other potential claims:

### Recognition of Income Tax Benefits

On its US federal income tax return for calendar year 2002, TXU Corp. claimed an ordinary loss deduction related to the worthlessness of TXU Corp.'s investment in TXU Europe, the tax benefit of which was estimated to be \$983 million (assuming the deduction is sustained on audit). Due to a number of uncertainties regarding the proper tax treatment of the worthlessness loss, no portion of the tax benefit related to TXU Corp.'s 2002 write-off of its investment in TXU Europe was recognized in income prior to 2004.

In June 2004, the IRS issued a preliminary notice of proposed adjustment proposing to disallow the 2002 worthlessness deduction and treat the worthlessness as a capital loss (deductible only against capital gains). In addition, in 2004 TXU Corp. revised the estimates of capital losses and ordinary deductions expected from the worthlessness deduction utilization. Accordingly, in 2004 TXU Corp. recorded a tax benefit of \$755 million related to the TXU Europe worthlessness deduction, which reflects expected utilization of the capital loss deduction against capital gains realized in 2004 and prior periods. The benefit recognized also included \$220 million for deductions related to the write-off of the investment in TXU Europe expected to be sustained as ordinary as a result of the preliminary notice.

Benefits arising from the resolution of uncertainty regarding utilization of deductions in the year the TXU Europe investment was written-off or in a prior year have been reported in discontinued operations. Additional such benefits arising from subsequent sales of businesses classified as discontinued operations have also been reported in discontinued operations. Accordingly, of the total \$755 million benefit recognized in 2004, \$680 million was reported in discontinued operations. The remaining \$75 million reported in continuing operations relates to the capital gain arising from the sale of the assets of TXU Fuel, the historical operations of which have been classified as continuing operations. Additional tax benefits may be recognized in the future upon final resolution with the IRS of all matters related to the TXU Europe worthlessness deduction or identification of applicable tax planning strategies.

See Note 18 to Financial Statements for discussion of income tax contingencies related to TXU Europe and other matters.

### Litigation

During the second quarter of 2004, management assessed the progress and status of matters in litigation, and in anticipation of resolution, an accrual of \$100 million (\$65 million after-tax) was recorded. In January 2005, TXU Corp. reached a comprehensive settlement regarding the consolidated amended securities class action lawsuit initially filed in October 2002. The agreement included a one-time payment to the class members of \$150 million, of which \$66 million in reimbursement from insurance carriers has been agreed upon. As a result, the previously recorded expense accrual was reduced by \$16 million (\$10 million after-tax) in the fourth quarter of 2004. The payment is expected to be made in the second quarter of 2005, and the amount ultimately paid by TXU Corp. is expected to be reduced by additional insurance reimbursements. The settlement is contingent upon final court approval.

### Potential Claims Related to TXU Europe

In January 2005, TXU Corp. executed a comprehensive agreement resolving potential claims relating to TXU Europe. Results from discontinued operations in 2004 include an accrual of \$220 million (\$143 million after-tax) for an expected payment of that amount under the terms of the agreement. The payment is expected to be made in the second quarter of 2005. A substantial portion of the payment may be recovered from insurance carriers. The agreement is contingent upon creditor approval and the receipt of formal releases.

### Rate Case Settlement

In the fourth quarter of 2004, TXU Electric Delivery recorded a \$21 million (\$14 million after-tax) charge for estimated settlement payments. The settlement, which was finalized February 22, 2005, is the result of a number of municipalities initiating an inquiry regarding distribution rates. The agreement avoids any immediate rate actions, but would require TXU Electric Delivery to file a rate case in 2006, based on a 2005 test year, unless the municipalities and TXU Electric Delivery mutually agree that such a filing is unnecessary. The final settlement amounts are being determined; however, TXU Electric Delivery believes the total will closely approximate the amount accrued.

### **KEY CHALLENGES AND INITIATIVES**

Following is a discussion of the key challenges facing management and the initiatives currently underway to manage such challenges:

#### Competitive Markets and Customer Retention

In the Texas market, 2004 was the third full year of retail competitive activity, and that activity has impacted customer counts and sales volumes. The area representing TXU Corp.'s historical service territory prior to deregulation, largely in north Texas, consisted of approximately 3 million electricity consumers (measured by meter counts) as of year-end 2004. TXU Energy Holdings currently has approximately 2.3 million customers in that territory and has acquired approximately 200,000 customers in other competitive areas in Texas. Total customer counts declined 2.3% in 2004, 4.3% in 2003 and 0.5% in 2002. Retail sales volumes declined 12% in both 2004 and 2003 and 9% in 2002, reflecting competitive activity in the business market segment and to a lesser extent in the residential market, as well as milder summer weather in 2004. While wholesale sales volumes have increased significantly, gross margins have been compressed by the loss of higher-margin retail sales volumes. In responding to the competitive landscape, TXU Corp. is focusing on the following key initiatives:

- TXU Corp.'s customer retention strategy remains focused on delivering world-class customer service and improving the overall customer experience. In line with this strategy, TXU Corp. continues to implement several call center and other major initiatives to improve customer service, including a simplified interactive voice response process, an enhanced service level program and an upgraded online presence to interact with customers over the internet.
- TXU Corp. has improved out-of-territory margins by reducing both its cost to serve and cost to acquire customers. Cost-to-serve improvements were achieved through the Capgemini arrangement, while cost-to-acquire reductions were achieved by suspending mass-media spending and prioritizing remaining marketing expenditures to focus on shorter-term return requirements. TXU Corp. is now focusing on rebalancing the customer mix towards high-value customers and reducing bad debt expenses.
- Business initiatives in the small and medium-business segment are focused largely on more targeted programs to protect the existing highest-value customers and to recapture customers who have switched. Tactical programs being put into place include improved customer service, the development of new product offerings and the establishment of a new direct-sales force for customers with demand of 200 kilowatts and above.
- While TXU Energy Holdings is evaluating strategic alternatives for the large-business segment, it remains focused on driving profitability by targeting customers with the highest economic potential and delivering with a low-cost model. Initiatives include a more disciplined contracting and pricing approach, a comprehensive hedging strategy to better protect against pricing volatility, improved economic segmentation of the large-business market to provide for more targeted sales and marketing efforts and more effective deployment of the direct-sales force.

### Natural Gas Price & Market Heat-Rate Exposure

Wholesale electricity prices in the Texas market generally move with the price of natural gas because marginal demand is generally met with gas-fired generation plants. Wholesale electricity prices also move with market heat rates, which are a measure of the efficiency of the marginal supplier (generally gas plants) in generating electricity. Market heat rates are currently near historical lows following the substantial increase in more efficient gas-fired generation capacity in Texas in the early 2000's. In contrast, natural gas prices increased significantly in recent years, but historically the price has fluctuated due to the effects of weather, changes in industrial demand and supply availability, and other economic factors.

Consequently, sales price management and hedging activities are critical to the profitability of the business. TXU Corp. continues to have price flexibility in the large business market and in all markets outside of its historical service territory. With respect to residential and small and medium business customers in the historical service territory, TXU Corp. must offer regulated price-to-beat rates until January 1, 2007, but such rates can be adjusted up or down twice a year at TXU Corp.'s option, subject to approval by the Commission, based on changes in natural gas prices. Effective January 1, 2004 for the small and medium business market and January 1, 2005 for the residential market in the historical service territory, TXU Corp. has had flexibility to offer prices other than the regulated price-to-beat rate, so long as it continues to also offer the price-to-beat rate. The challenge in adjusting these rates is determining the appropriate timing, considering past and projected movements in natural gas prices, such that margin levels can be sustained while remaining competitive with other retailers who have price flexibility. In response to rising natural gas prices, TXU Corp. increased the price-to-beat rates twice in both 2004 and 2003.

One of TXU Corp.'s cost advantages, particularly in a time of historically high natural gas prices, is its nuclear-powered and coal/lignite-fired generation assets. Variable costs of this baseload generation, which provided approximately 50% of supply volumes in 2004, have in recent history been, and are expected to be, less than the costs of gas-fired generation. Consequently, maintaining the efficiency and reliability of the baseload assets is of critical importance in managing gross margin risk. Completing scheduled maintenance outages at the nuclear-powered facility on a timely basis, for example, is a critical management process.

TXU Corp. is both a producer and a buyer of wholesale electricity. The generation operations supply power to the wholesale market and the retail business, which also purchases power in the wholesale market. The combination of these two businesses provides a partial natural hedge against near-term price volatility in wholesale electricity and natural gas markets. With this natural hedge and TXU Corp.'s wholesale market positions, for 2005 TXU Corp.'s portfolio position is substantially balanced with respect to changes in natural gas prices, given TXU Corp.'s projections of baseload unit availability and customer churn and assuming no changes in the price-to-beat rates. The primary sensitivity to natural gas prices over the near term derives from the price-to-beat structure for residential and small business customers; higher gas prices could trigger higher price-to-beat rates and potentially increased profitability, and vice versa. In the near term, TXU Corp. has more significant exposure to changes in market heat rates than natural gas prices, in part due to TXU Corp.'s 8,825 MW of active gas-fired generation capacity in Texas that TXU Corp. currently dispatches for its own use. TXU Corp. expects that increases in heat rates would increase the profitability of its overall market position and its gas-fired generation fleet, and vice versa.

Over the longer term, TXU Corp.'s exposure to changes in natural gas prices and market heat rates is expected to increase. The magnitude of this exposure is determined by several key assumptions including, but not limited to, baseload generation capacity factors, gas plant availability, the size of the retail business (both large business and residential), and the levels and stability of margins in the retail business. In the unlikely case that TXU Corp.'s retail price changes exactly and immediately mirrored changes in wholesale electricity markets, TXU Corp. could experience an approximate \$245 million reduction in annual pretax earnings for every \$0.50 per million British thermal units reduction in natural gas prices (approximate 8% change in current price) sustained over a full year. In the same scenario of retail price linkage to wholesale markets, if natural gas prices and other nonprice conditions remained unchanged, but ERCOT electricity prices declined by \$5/MWh (approximate 10% change in current price) for a full year because of declining market heat rates, TXU Corp. could experience an approximate \$320 million reduction in annual pretax earnings.

TXU Corp.'s longer term approach to managing this risk focuses on:

- Improving customer service to increase customer retention;
- Refining retail pricing strategy to more appropriately reflect the magnitude and costs of natural gas price risk;
- Reducing fixed costs to better withstand gross margin volatility; and
- Employing disciplined hedging and risk management strategies, through physical and financial energy-related (power and natural gas) contracts to partially hedge gross margins.

See additional discussion of risk measures under "Commodity Price Risk".

#### Cost Exposure Related to Nuclear Asset Outages

TXU Corp. is currently undertaking a strategic review of its nuclear assets, comprised of two electricity generating units at Comanche Peak, each with a capacity of 1,150 MW. The objectives of this strategic review are to evaluate potential means to reduce the cost exposure associated with outages of these facilities and improve the long-term availability and certainty of electricity supply for customers. The nuclear generation facilities represent TXU Corp.'s lowest marginal cost source of electricity. Assuming both nuclear generating units experienced an outage, the negative impact to gross margin is estimated to be \$2 million per day. TXU Corp. continues to identify and evaluate various potential initiatives as part of this review. The review is expected to be completed in 2005, and no determination has been made as to the likelihood of implementing any of the initiatives. Also see discussion of nuclear insurance in Note 18 to Financial Statements.

### **CRITICAL ACCOUNTING POLICIES**

TXU Corp.'s significant accounting policies are detailed in Note 2 to Financial Statements. TXU Corp. follows accounting principles generally accepted in the US. In applying these accounting policies in the preparation of TXU Corp.'s consolidated financial statements, management is required to make estimates and assumptions about future events that affect the reporting of assets and liabilities at the balance sheet dates and revenue and expense during the periods covered. The following is a summary of certain critical accounting policies of TXU Corp. that are impacted by judgments and uncertainties and under which different amounts might be reported using different assumptions or estimation methodologies.

**Financial Instruments and Mark-to-Market Accounting** — TXU Corp. enters into financial instruments, including options, swaps, futures, forwards and other contractual commitments primarily to manage commodity price and interest rate risks. In accordance with SFAS 133, the fair values of derivatives are recognized on the balance sheet and changes in the fair values are recognized in earnings. This recognition is referred to as "mark-to-market" accounting. However, if certain criteria are met, TXU Corp. may elect the normal purchase and sale exception or may designate the derivative as a cash flow or fair value hedge. As these elections can reduce the volatility in earnings resulting from fluctuations in fair value, results of operations could be materially affected by such elections. A cash flow hedge mitigates the risk associated with variable future cash flows (e.g., a future sale at market prices), while a fair value hedge mitigates risk associated with fixed future cash flows (e.g., debt with fixed interest rate payments).

In accounting for cash flow hedges, derivative assets and liabilities are recorded on the balance sheet at fair value with an offset in other comprehensive income. Amounts remain in other comprehensive income, provided the underlying transactions remain probable of occurring, and are reclassified into earnings as the underlying transactions occur. Fair value hedges are recorded as derivative assets or liabilities with an offset to the carrying value of the related asset or liability. Any ineffectiveness associated with the hedges is recorded in earnings.

Mark-to-market accounting recognizes changes in the value of financial instruments as reflected by market price fluctuations. In the energy market, the availability of quoted market prices is dependent on the type of commodity (e.g., natural gas, electricity, etc.), time period specified and location of delivery. In computing the mark-to-market valuations, each market segment is split into liquid and illiquid periods. The liquid period varies

by region and commodity. Generally, the liquid period is supported by broker quotes and frequent trading activity. In illiquid periods, little or no market information may exist, and the fair value is estimated through market modeling techniques.

For those periods where quoted market prices are not available, forward price curves are developed based on the available information or through the use of industry accepted modeling techniques and practices based on market fundamentals (e.g., supply/demand, replacement cost, etc.). TXU Corp. does not recognize net gains in illiquid periods.

Prior to October 2002, TXU Corp. accounted for energy-related contracts, whether or not derivatives under SFAS 133, that were deemed to be entered into for trading purposes under the guidance from EITF 98-10. See Note 3 to Financial Statements for discussion of the rescission of EITF 98-10 and the cumulative effect of changes in accounting principles.

In the fourth quarter of 2004, TXU Corp. reviewed its approach to evaluating the economic performance of its large business customer sales operations. TXU Corp. decided to no longer elect the normal sale exception for fixed price sales contracts entered into after December 1, 2004, and as part of its risk management activities, will use hedging transactions to mitigate the risk of gross margin exposure. Both the sales contracts and the hedging instruments are now marked-to-market. The day-one gains on the marked sales contracts are amortized over the lives of the contracts, which average between twelve and eighteen months. The effect of marking-to-market the sales contracts in 2004 was a pretax loss of \$3 million.

The net effect of mark-to-market accounting under SFAS 133, including hedge ineffectiveness, totaled \$109 million, \$100 million and \$113 million of unrealized losses in 2004, 2003 and 2002, respectively. The 2003 amount excludes the cumulative effect of changes in accounting principles discussed in Note 3 to Financial Statements.

**Revenue Recognition** — TXU Corp. records revenue from electricity sales and delivery service under the accrual method. Revenues are recognized when power or delivery is provided to customers on the basis of periodic cycle meter readings and include an estimated accrual for the value provided from the meter reading date to the end of the period. The unbilled revenue is calculated at the end of the period based on estimated daily consumption after the meter read date to the end of the period. For retail electric sales, estimated daily consumption is derived using historical customer profiles adjusted for weather and other measurable factors affecting consumption. Calculations of unbilled revenues during certain interim periods are generally subject to more estimation variability than at year-end because of seasonal changes in demand. Accrued unbilled revenues totaled \$422 million, \$411 million and \$441 million at December 31, 2004, 2003 and 2002, respectively.

Realized and unrealized gains and losses from transacting in energy-related contracts, principally for the purpose of hedging margins on sales of energy, are reported as a component of revenues. As discussed above under “Financial Instruments and Mark-to-Market Accounting”, recognition of unrealized gains and losses involves elections, assumptions and estimates that could have a significant effect on reported revenues and earnings.

**Accounting for Contingencies** — The financial results of TXU Corp. may be affected by judgments and estimates related to loss contingencies. Accruals for loss contingencies are recorded when management determines that it is probable that an asset has been impaired or a liability has been incurred and that such economic loss can be reasonably estimated. Such determinations are subject to interpretations of current facts and circumstances, forecasts of future events and estimates of the financial impacts of such events.

A significant contingency that TXU Corp. accounts for is the loss associated with uncollectible trade accounts receivable. The determination of such bad debt expense is based on factors such as historical write-off experience, aging of accounts receivable balances, changes in operating practices, regulatory rulings, general economic conditions and customers' behaviors. With the opening of the Texas electricity market to competition, many historical measures used to estimate bad debts may be less reliable. The changing environment, including recent regulatory changes that allow REPs to disconnect nonpaying customers, and customer churn due to

competitor actions has added a level of complexity to the estimation process. Bad debt expense totaled \$90 million, \$119 million and \$160 million for the years ended December 31, 2004, 2003 and 2002, respectively.

In connection with the opening of the Texas market to competition, the Texas Legislature established a retail clawback provision intended to incent affiliated REPs of utilities to actively compete for customers outside their historical service territories. A retail clawback liability arises unless 40% of the electricity consumed by residential and small business customers in the affiliated REP's historical service territory is supplied by competing REPs after the first two years of competition. This threshold was reached for small business customers in 2003, but not for residential customers. The amount of the liability is equal to the number of such customers retained by TXU Energy Holdings as of January 1, 2004, less the number of new customers from outside the historical service territory, multiplied by \$90. The credit, which is funded by TXU Energy Holdings, is applied to delivery fees charged by TXU Electric Delivery to REPs, including TXU Energy Holdings, over a two-year period beginning January 1, 2004. In 2002, TXU Energy Holdings recorded a charge to cost of energy sold and delivery fees of \$185 million (\$120 million after-tax) to accrue an estimated retail clawback liability. In 2003, TXU Energy Holdings reduced the accrual by \$12 million (\$8 million after-tax), to reflect the calculation of the estimated liability applicable only to residential customers in accordance with the Settlement Plan. In 2004, TXU Energy Holdings further reduced the estimated liability by \$12 million (\$8 million after-tax) to reflect revised estimates of customer counts. The balance of the liability at December 31, 2004 was \$82 million.

In 2002, TXU Corp.'s former telecommunications business, then an unconsolidated joint venture, recorded impairments of long-lived assets and goodwill, which increased TXU Corp.'s equity in losses of the business by \$37 million. Consequently, TXU Corp. evaluated its potential obligations related to the partnership arrangement. TXU Corp. determined that it was probable, in light of the decline in value of the business, that an economic loss had occurred, and accordingly recorded a charge of \$150 million (without tax benefit) in 2002, reported in other deductions.

**Accounting for Income Taxes** - TXU Corp.'s income tax expense and related balance sheet amounts involve significant management estimates and judgments. Amounts of deferred income tax assets and liabilities, as well as current and noncurrent accruals, involve judgments and estimates of the timing and probability of recognition of income and deductions by taxing authorities. In assessing the likelihood of realization of deferred tax assets, management considers estimates of the amount and character of future taxable income. Actual income taxes could vary from estimated amounts due to the future impacts of various items, including changes in income tax laws, TXU Corp.'s financial condition and results of operations in future periods, as well as final review of filed tax returns by taxing authorities. TXU Corp.'s income tax returns are regularly subject to examination by applicable tax authorities. In management's opinion, an adequate provision has been made for any future taxes that may be owed as a result of any examination. See Notes 12 and 17 to Financial Statements for discussion of income tax matters.

**ERCOT Settlements** - ERCOT's responsibilities include the balancing and settlement of electricity volumes and related ancillary services among the various participants in the deregulated Texas market. ERCOT settles balancing energy with market participants through a load and resource imbalance charge or credit for any differences between actual and scheduled volumes. Ancillary services and various fees are allocated to market participants based on each participant's load.

Initial settlement information is due from ERCOT within 17 days after the operating day, final settlement is due from ERCOT within two months and true-up settlements are due from ERCOT within six months after the operating day. All periods continue to be subject to a dispute resolution process. During 2003, the ERCOT settlement process was delayed several times to address operational data management problems among ERCOT, the transmission and distribution service providers and the REPs, which arose as a result of new processes and systems associated with the opening of the market to competition. These operational data management issues were resolved during 2004.

As a result of time lags in ERCOT settlements, TXU Energy Holdings' operating revenues and costs of energy sold contain estimates for load and resource imbalance charges or credits with ERCOT and for ancillary services and related fees that are subject to change and may result in charges or credits impacting future reported

results of operations. The amounts recorded represent the best estimate of these settlements based on available information. During 2004, TXU Energy Holdings recorded a net expense of \$4 million to adjust amounts previously recorded for 2003, 2002, and 2001 ERCOT settlements. During 2003, TXU Energy Holdings recorded a net expense of \$20 million to adjust amounts previously recorded for 2002 and 2001 ERCOT settlements.

***Impairment of Long-Lived Assets*** — TXU Corp. evaluates long-lived assets for impairment whenever indications of impairment exist, in accordance with the requirement of SFAS 144. One of those indications is a current expectation that “more likely than not” a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. In this circumstance, impairment would be evaluated based on the current market price of the asset. For TXU Corp.’s baseload generation assets, another indication would be a significant drop in natural gas prices. In this circumstance, the impairment test would be based on future undiscounted cash flow associated with the asset, in accordance with SFAS 144. The determination of the existence of these and other indications of impairment involves judgments that are subjective in nature and may require the use of estimates in forecasting future results and cash flows related to an asset or group of assets. Further, the unique nature of TXU Corp.’s property, plant and equipment, which includes a fleet of generation assets using different fuels and individual plants that have varying utilization rates, requires the use of significant judgments in determining the existence of impairment indications and grouping assets for impairment testing.

TXU Corp.’s most significant long-lived asset in terms of carrying value is its Comanche Peak nuclear generation facility. The net book value of the facility was \$7.5 billion at December 31, 2004. TXU Corp. believes that the net book value of the facility significantly exceeds the estimated current market value. However, TXU Corp. estimates that future undiscounted cash flows from the facility significantly exceed net book value. Significant assumptions used in this analysis are forward price curves for natural gas and power, market heat rates (the amount of natural gas required to produce a given amount of power) and production estimates. A significant decline in forward price curves for natural gas and/or heat rates could trigger an evaluation of impairment of the facility. TXU Corp. has conservatively estimated that a sustained structural decline in natural gas prices of at least 40% would need to occur before any risk of impairment would arise, assuming market heat rates remain unchanged.

In 2002, TXU Corp. recorded an impairment charge of \$237 million (\$154 million after-tax), reported in other deductions, for the writedown of two generation plant construction projects as a result of weaker wholesale electricity market conditions and reduced planned developmental capital spending. Fair value was determined based on appraisals of property and equipment.

***Depreciation*** — The depreciable lives of plant and equipment are based on management’s estimates/determinations of the assets’ economically useful lives. To the extent that the actual lives differ from these estimates there would be an impact on the amount of depreciation charged to the financial statements. As is common in the industry, TXU Corp. records depreciation expense using composite depreciation rates that reflect blended estimates of the lives of major asset components, as compared to depreciation expense calculated on an asset-by-asset-basis.

Effective January 1, 2004, the estimates of depreciable lives of lignite-fired generation facilities were extended an average of nine years to better reflect the useful lives of the assets, and depreciation rates for the Comanche Peak nuclear generating plant were decreased as a result of an increase in the estimated lives of boiler and turbine generator components of the plant by an average of five years. The net impact of these changes was a reduction in depreciation expense of \$44 million (\$29 million after-tax) in 2004.

Effective April 1, 2003, the estimates of the depreciable lives of the Comanche Peak nuclear generating plant and several gas generation plants were extended to better reflect the useful lives of the assets. At the same time, depreciation rates were increased on lignite and gas generation facilities to reflect investments in emissions control equipment. The net impact of these changes was a reduction in depreciation expense of an additional \$12 million (\$8 million after-tax) in 2004 and \$37 million (\$24 million after-tax) in 2003.

The Comanche Peak nuclear-powered generation units were originally estimated to have a useful life of 40 years, based on the life of the operating licenses granted by the NRC. Over the last several years, the NRC has granted 20-year extensions to the initial 40-year terms for several commercial power reactors. Based on these extensions and current expectations of industry practice, the useful life of the Comanche Peak nuclear-powered generation units is now estimated to be 60 years. TXU Energy Holdings expects to file a license extension request in accordance with timing and other provisions established by the NRC.

TXU Corp. continues to review estimates of depreciable lives and in 2005 expects to adjust composite depreciation rates related to the lignite-fired facilities, resulting in lower future depreciation expense.

**Regulatory Assets and Liabilities** — The financial statements of TXU Electric Delivery reflect regulatory assets and liabilities under cost-based rate regulation in accordance with SFAS 71. The assumptions and judgments used by regulatory authorities continue to have an impact on the recovery of costs, the rate earned on invested capital and the timing and amount of assets to be recovered by rates. (See discussion in Note 20 to Financial Statements under “Regulatory Assets and Liabilities.”)

Approximately \$1.8 billion in regulatory asset stranded costs arising prior to the 1999 Restructuring Legislation became subject to recovery through issuance of transition (securitization) bonds in accordance with the Settlement Plan with the Commission as described in Note 17 to Financial Statements. As a result of the final approval of the Settlement Plan in January 2003, TXU Corp. recorded an extraordinary loss of \$134 million (net of income tax benefit of \$72 million) in the fourth quarter of 2002 principally to write down this regulatory asset. The carrying value of the regulatory asset after the write down represented the projected future cash flows to be recovered from REPs through revenues as a transition charge to service the principal and estimated interest of the bonds. An extraordinary gain of \$16 million (net of tax of \$9 million) was recorded in 2004, representing an increase in the carrying value of TXU Electric Delivery’s regulatory asset subject to securitization, due to the issuance of the second and final tranche of the securitization bonds in June 2004. The increase in the related regulatory asset was due to the effect of higher than estimated interest rates on the bonds and therefore increased amounts to be recovered from REPs through revenues as a transition charge to service the bonds. The balance of the regulatory asset was \$1.6 billion at December 31, 2004.

**Retirement Plans and Other Postretirement Benefit Plans** — TXU Corp. offers pension benefits through either a defined benefit pension plan or a cash balance plan and also offers certain health care and life insurance benefits to eligible employees and their eligible dependents upon the retirement of such employees from TXU Corp. Reported costs of providing noncontributory defined pension benefits and other postretirement benefits are dependent upon numerous factors, assumptions and estimates.

These costs are impacted by actual employee demographics (including age, compensation levels and employment periods), the level of contributions made to retiree plans and earnings on plan assets. TXU Corp.’s retiree plan assets are primarily made up of equity and fixed income investments. Changes made to the provisions of the plans may also impact current and future benefit costs. Fluctuations in actual equity market returns as well as changes in general interest rates may result in increased or decreased benefit costs in future periods. Benefit costs may also be significantly affected by changes in key actuarial assumptions, including anticipated rates of return on plan assets and the discount rates used in determining the projected benefit obligation.

In accordance with accounting rules, changes in benefit obligations associated with these factors may not be immediately recognized as costs on the income statement, but are recognized in future years over the remaining average service period of plan participants. As such, significant portions of benefit costs recorded in any period may not reflect the actual level of cash benefits provided to plan participants. TXU Corp. recorded pension costs and other postretirement benefit costs as summarized in the following table:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Pension costs under SFAS 87 (a).....	\$ 58	\$ 45	\$ 6
Other postretirement benefit costs under SFAS 106 (a).....	80	100	84
Total.....	<u>\$138</u>	<u>\$ 145</u>	<u>\$ 90</u>

(a) Includes amounts capitalized as part of construction projects.

Additional data regarding pension and other postretirement benefit plans:

- During 2004, the discount rate assumption for the pension and other postretirement benefit plans was revised as a result of remeasurements required by the Capgemini and TXU Gas transactions and changing interest rates. For the first half of 2004, the discount rate was 6.25%. The rate used for the third quarter was 6.5%, and the rate used in the fourth quarter was 6.0%. The discount rate for 2005 is expected to be 6.0%.
- During 2004, the expected rate of return remained at 8.5% for the pension plan assets and 8.01% for the other postretirement benefit plan. The rate of return for 2005 is expected to be 8.75% for the pension plan and 8.66% for the other postretirement benefit plan.
- The decline in other postretirement benefit costs of \$20 million to \$80 million in 2004 was due primarily to the effect of the Medicare Prescription Drug Improvement and Modernization Act of 2003 enacted in December 2003.
- Pension and other postretirement benefit costs are expected to decrease \$23 million to \$115 million in 2005 due primarily to fewer active employees following the 2004 Capgemini and divestiture transactions.
- Funding of pension and other postretirement benefit plans is expected to decrease by \$28 million to \$75 million in 2005.
- A total curtailment charge of \$5 million is included in pension and other postretirement benefit costs in 2004 due to the effects of the Capgemini outsourcing and TXU Gas transactions.

Sensitivity of total pension and other postretirement benefit costs to changes in key assumptions:

<u>Assumption</u>	<u>Increase/(Decrease) in Costs</u>
Discount rate – 1% increase.....	\$(24)
Discount rate – 1% decrease.....	\$ 36
Expected return on assets – 1% increase.....	\$(14)
Expected return on assets – 1% decrease.....	\$ 14

See Note 14 to Financial Statements for additional information on pension and other postretirement benefit plans.

**Stock-based compensation** – TXU Corp. grants awards of restricted stock and performance units paid in stock under its Long Term Incentive Compensation Plan (LTIP). The awards ultimately distributed are based on the performance of TXU Corp. stock versus peer company stock performance over a future period (generally three years) and the number of shares ultimately awarded varies depending upon that relative performance. TXU Corp. early adopted SFAS 123R in the fourth quarter of 2004, which provides for the recognition of expense related to LTIP awards based on the grant-date fair value of those awards. Under the previous accounting rule (APB 25), expense recognition was based on the current estimate of shares expected to be awarded and the current market value of shares; consequently, recorded LTIP expense was subject to significant volatility. LTIP expense recorded in 2004 under SFAS 123R and reported in SG&A expenses totaled \$56 million. See Note 12 to Financial Statements for additional information.

The determination of fair value of LTIP awards at grant date is based on valuation techniques involving a number of assumptions. The more significant assumptions and the related sensitivities are as follows:

<u>Assumption</u>	<u>Range</u>			<u>Increase/(Decrease) in LTIP expense</u>	
	<u>Low</u>	<u>Base</u>	<u>High</u>	<u>Low</u>	<u>High</u>
Expected number of shares distributable per award	.7 shares	.8 shares	.9 shares	\$2	\$(3)
Discount for risk during vesting period	13%	15%	17%	\$1	\$(1)
Discount for liquidation restrictions	24%	30%	36%	\$5	\$(5)

## RESULTS OF OPERATIONS

The results of operations and the related management's discussion of those results for all periods presented reflect the discontinuance of certain operations (see Note 4 to Financial Statements regarding discontinued operations).

**Accounting Changes** — TXU Corp. grants awards of restricted stock and performance units payable in stock to management employees. During 2004, TXU Corp. reviewed a number of alternatives with respect to its management incentive compensation programs, including potential changes to levels and criteria of awards under the stock-based program. The review is ongoing and changes are likely for the 2005 awards. In December 2004, the FASB issued SFAS 123R, which addresses accounting for stock-based compensation. TXU Corp. elected to early adopt this new standard because its application better reflects the underlying economic cost of the awards. TXU Corp. adopted the standard effective with results for the fourth quarter of 2004 in accordance with the "modified retrospective" transition rules of the standard. The adoption resulted in the recognition of a cumulative effect of change in accounting principle of a \$10 million after-tax credit. See Note 12 to Financial Statements for additional discussion. Assuming TXU Corp. had taken no other actions to reduce the expense for the 2004 year, TXU Corp. would have recorded an additional \$102 million (\$66 million after-tax) of expense under the previous accounting rules (APB 25) as compared to the expense under SFAS 123R.

In October 2002, the EITF, through EITF 02-3, rescinded EITF 98-10, which required mark-to-market accounting for all trading activities. Pursuant to this rescission, only financial instruments that are derivatives under SFAS 133 are subject to mark-to-market accounting. Effective January 1, 2003, non-derivative energy contracts were required to be accounted for on a settlement basis. SFAS 143, regarding asset retirement obligations, became effective on January 1, 2003. As a result of the implementation of these two accounting standards, in 2003 TXU Corp. recorded a cumulative effect of changes in accounting principles of a net \$58 million after-tax charge. See Note 3 to Financial Statements for additional discussion.

Also see Note 2 to Financial Statements for discussion of other changes in accounting standards.

### **TXU Corp. Consolidated**

#### **2004 compared to 2003**

Reference is made to comparisons of results by business segment following the discussion of consolidated results. The business segment comparisons provide additional detail and quantification of items affecting financial results.

TXU Corp.'s operating revenues increased \$708 million, or 8%, to \$9.3 billion in 2004. Operating revenues in the TXU Energy Holdings segment rose \$509 million, or 6%, to \$8.5 billion reflecting higher retail and wholesale pricing, partially offset by the effect of a mix shift to lower-price wholesale sales. Retail volumes declined 12% due to competitive activity and milder weather primarily in the summer. Operating revenues in the TXU Electric Delivery segment increased \$139 million, or 7%, to \$2.2 billion reflecting \$87 million in transition charges associated with securitization bonds issued in August 2003 and June 2004 as well as higher transmission and distribution fees (tariffs). Consolidated revenue growth also reflected a \$60 million reduction in the intercompany sales elimination, primarily reflecting lower sales by TXU Electric Delivery to TXU Energy Holdings as sales to nonaffiliated REPs increased.

*Gross Margin*

	<b>Year Ended December 31,</b>			
	<b>2004</b>	<b>% of Revenue</b>	<b>2003</b>	<b>% of Revenue</b>
Operating revenues .....	\$ 9,308	100%	\$ 8,600	100%
Costs and expenses:				
Cost of energy sold, including delivery fees .....	3,847	41%	3,640	42%
Operating costs.....	1,429	15%	1,389	16%
Depreciation and amortization.....	709	8%	654	8%
Gross margin.....	<u>\$ 3,323</u>	<u>36%</u>	<u>\$ 2,917</u>	<u>34%</u>

Gross margin is considered a key operating metric as it measures the effect of changes in sales volumes and pricing versus the variable and fixed costs of energy sold, whether generated or purchased, as well as the variable and fixed costs to deliver energy.

Gross margin increased \$406 million, or 14%, to \$3.3 billion in 2004. The TXU Energy Holdings segment's gross margin increased \$383 million, or 21%, to \$2.2 billion. Higher gross margin reflected initiatives taken to respond to higher natural gas prices, including retail pricing actions and more cost effective sourcing of power. The gross margin increase reflected higher retail and wholesale prices partially offset by the effect of lower retail volumes and lower results from hedging and risk management activities. The average cost per MWh of power produced and purchased was about even with 2003 as higher purchased power costs due to rising natural gas prices were largely offset by lower cost of power produced due to reduced utilization of high heat rate gas-fired generation and higher lignite and nuclear facility output. The TXU Electric Delivery segment's gross margin increased \$17 million, or 2%, to \$1.1 billion reflecting an increase in transmission-related tariffs, partially offset by the effect of milder weather primarily in the summer and an increase in operating costs.

Operating costs increased \$40 million, or 3%, to \$1.4 billion in 2004, driven by \$25 million in incremental costs primarily associated with a planned outage for refueling at the nuclear generation facility and a \$12 million increase in third-party transmission costs.

Depreciation and amortization (including amounts shown in the gross margin table above) rose \$36 million, or 5%, to \$760 million in 2004. This increase reflected \$87 million in higher regulatory asset amortization arising from issuances of TXU Electric Delivery securitization bonds in August 2003 and June 2004, normal additions and replacements of equipment and the effect of higher asset retirement obligations due to new mining activity. These increases were partially offset by a \$56 million impact of lower depreciation related to TXU Energy Holdings' generation fleet, due primarily to extensions of estimated depreciable lives to better reflect useful lives (see Note 2 to Financial Statements) and a decrease in amortization due to a reduction in the carrying values of software assets in connection with the Capgemini outsourcing transaction.

SG&A expense increased \$184 million, or 20%, to \$1.1 billion in 2004. The increase reflected \$112 million in higher incentive compensation expense due to the improved performance of the business and achievement of certain targets related to trading activities, \$54 million in consulting and professional fees incurred in the formulation and execution of strategic initiatives and \$52 million in compensation expense under Mr. Wilder's employment agreement, due largely to the increase in TXU Corp.'s stock price, partially offset by \$29 million in lower bad debt expense and \$4 million in reduced marketing expenses.

Other income increased \$90 million to \$148 million in 2004. Other income in 2004 included the remaining \$58 million of previously deferred gain on the 2002 sale of two generation plants recognized as the result of the termination late in the fourth quarter of 2004 of an existing power purchase and tolling agreement discussed above under "Business Restructuring and Other Actions", a \$19 million gain on sale of undeveloped land and \$16 million of amortization of a gain on the June 2004 sale of TXU Fuel. Other income in both 2004 and 2003 included \$30 million in amortization of the gain on the 2002 sale of two generation plants. The 2003 period also included a \$9 million gain on the sale of contracts related to retail gas activities outside of Texas.

Other deductions totaled \$1.172 billion in 2004 and \$42 million in 2003. The 2004 amount reflected the initiatives discussed above under “Business Restructuring and Other Actions” and included \$416 million in debt extinguishment losses, \$180 million in lease-related charges primarily related to generation and mining assets taken, or to be taken, out of service, \$132 million in employee severance charges, \$109 million in software write-offs, \$101 million in termination costs for an existing power purchase and tolling agreement, \$84 million in accruals for the resolution of outstanding litigation, and \$79 million in spare parts inventory writedowns. The 2003 period includes \$17 million of equity losses of Pinnacle prior to its consolidation in March 2003 and several individually insignificant items.

Interest expense and related charges decreased \$89 million, or 11%, to \$695 million in 2004, primarily reflecting an \$82 million decrease due to lower average interest rates and a \$7 million decrease due to lower average borrowings.

The effective income tax rate on income from continuing operations before extraordinary gain and cumulative effect of changes in accounting principles was 34.1% in 2004 and 30.8% in 2003. The increase was driven by several factors, including the non-deductibility of certain executive compensation and the limited deductibility of expenses recorded in connection with the repurchase of convertible and equity-linked debt securities, partially offset by the \$75 million tax benefit arising from the recognition of tax benefits related to the 2002 write-off of the investment in TXU Europe and the ongoing benefits of lignite depletion and investment tax credit amortization on a lower income base.

Income from continuing operations before extraordinary gain and cumulative effect of changes in accounting principles (an after-tax measure) decreased \$485 million to \$81 million in 2004. This performance reflected a decrease of \$89 million in the TXU Energy Holdings segment. Results in the TXU Energy Holdings segment reflected several unusual charges reported in other deductions and discussed above, partially offset by higher gross margin. Earnings in the TXU Electric Delivery segment declined \$3 million reflecting \$13 million after-tax of severance costs and \$14 million after-tax for a rate case settlement, partially offset by higher transmission-related revenues. Corporate and other expenses increased \$393 million, primarily reflecting (all amounts after-tax):

- debt extinguishment losses of \$382 million
- litigation accrual of \$56 million
- nonrecurring executive compensation expenses of \$52 million
- consulting fees of \$35 million
- other items totaling \$25 million (primarily stock-based compensation and severance costs)

partially offset by:

- recognition of a \$75 million tax benefit associated with TXU Europe as a result of a capital gain generated by the sale of TXU Fuel
- the effect of \$11 million in equity losses in 2003 related to the telecommunications business, then a joint venture, and
- lower net external and affiliate interest expense (net of interest income) of \$64 million due to financing-related activity, including interest income of \$29 million on TXU Energy Holdings’ exchangeable preferred membership interests acquired by TXU Corp.

Net pension and postretirement benefit costs reduced income from continuing operations by \$67 million after-tax in 2004 and \$69 million after-tax in 2003.

Income from discontinued operations (an after-tax measure) totaled \$378 million in 2004 and \$74 million in 2003 and included the following:

- Income from the TXU Australia business, which was sold in July 2004, totaled \$177 million in 2004 and \$121 million in 2003. TXU Australia's results in 2004 included an after-tax gain on sale of \$241 million and a deferred tax charge of \$112 million to recognize a deferred tax liability for the excess of TXU Corp.'s carrying value of the TXU Australia investment over the related tax basis.
- Results of the TXU Gas business totaled a loss of \$282 million in 2004 and income of \$54 million in 2003. TXU Gas' results in 2004 included charges related to the sale of the business of \$193 million after-tax. Results in 2004 included a loss of \$99 million after-tax related to regulatory disallowances arising from a system-wide distribution rate case ruling, an income tax charge of \$17 million due to an IRS ruling related to a prior year disputed deduction.
- In January of 2005, TXU Corp. executed a comprehensive agreement resolving potential claims relating to TXU Europe. Results from discontinued operations in 2004 include an after-tax charge of \$143 million for an expected payment of that amount under the terms of the agreement. A substantial portion of the payment may be recovered from insurance carriers. The agreement is contingent upon creditor approval and the receipt of formal releases.
- Discontinued operations results in 2004 also reflected the recognition of \$680 million in tax benefits associated with the 2002 write-off of the investment in TXU Europe. The tax benefit was based on a preliminary notice received from the IRS in June 2004 and primarily reflected the utilization of the worthlessness deduction against capital gains arising from the TXU Gas transaction and the sales of TXU Australia and TXU Communications as well as transactions completed in prior years.
- Finally, discontinued operations results in 2004 included a \$17 million after-tax impairment charge arising from a June 2004 decision to sell the Pedricktown, New Jersey generation facility and discontinue related operations, and a \$6 million after-tax charge to settle a contract dispute related to the strategic retail services business discontinued in 2003.

Additional discussion of the above items and a detailed analysis of discontinued operations results are presented in Note 4 to Financial Statements.

An extraordinary gain of \$16 million (net of tax of \$9 million) in 2004 represents an increase in the carrying value of TXU Electric Delivery's regulatory asset subject to securitization. The second and final tranche of the securitization bonds was issued in June 2004. The increase in the related regulatory asset is due to the effect of higher interest rates than previously estimated on the bonds and therefore increased amounts to be recovered from REPs through revenues as a transition charge to service the bonds.

Cumulative effect of changes in accounting principles, representing after-tax income of \$10 million in 2004 and an after-tax charge of \$58 million in 2003, reflect the adoption of SFAS 123R in 2004 and the impact on commodity contract mark-to-market accounting from rescission of EITF 98-10 and the recording of asset retirement obligations under SFAS 143 in 2003. (See Note 3 to Financial Statements.)

Diluted results per share of common stock were a net loss of \$1.29 in 2004 compared to net income of \$1.62 in 2003. Basic average common shares outstanding decreased by 7% to 300 million shares reflecting the repurchase of 20 million shares in an accelerated repurchase plan in June 2004 and the repurchase of 52.5 million shares in an accelerated repurchase plan in November 2004. Diluted average common shares decreased by 21% to 300 million shares reflecting the accelerated repurchase plan transactions mentioned above and the exclusion of the dilutive impacts of 57 million shares issuable under the exchangeable preferred membership interests. For 2004, results per diluted share of common stock equaled results per basic share because of antidilution accounting rules. Results in 2004 were unfavorably impacted by a \$2.83 per share effect from TXU Corp.'s repurchase of TXU Energy Holdings' exchangeable preferred membership interests in April 2004. The amounts paid in excess of the carrying value of these instruments, net of an associated income tax benefit, totaled \$849 million. This premium was charged to additional paid-in capital and treated in a manner similar to preference share dividends in computing earnings per share.

## **TXU Corp. Consolidated**

### **2003 compared to 2002**

TXU Corp.'s operating revenues increased \$506 million, or 6%, to \$8.6 billion in 2003. Revenues in the TXU Electric Delivery segment rose by \$93 million, or 5%, to \$2.1 billion driven by increased electricity transmission and distribution tariffs and higher transition charges related to the issuance of securitization bonds. Operating revenues rose \$308 million, or 4%, to \$8.0 billion in the TXU Energy Holdings segment reflecting higher retail and wholesale pricing, partially offset by the effect of a mix shift to lower-price wholesale sales and lower sales volumes. Consolidated revenue growth also reflected a \$105 million reduction in the intercompany sales elimination, primarily reflecting lower sales by TXU Electric Delivery to TXU Energy Holdings as sales to nonaffiliated REPs increased.

#### *Gross Margin*

	<b>Year Ended December 31,</b>			
	<b><u>2003</u></b>	<b><u>% of Revenue</u></b>	<b><u>2002</u></b>	<b><u>% of Revenue</u></b>
Operating revenues .....	\$ 8,600	100%	\$ 8,094	100%
Costs and expenses:				
Cost of energy sold and delivery fees .....	3,640	42%	3,199	39%
Operating costs .....	1,389	16%	1,354	17%
Depreciation and amortization .....	<u>654</u>	<u>8%</u>	<u>663</u>	<u>8%</u>
Gross margin .....	<u>\$ 2,917</u>	<u>34%</u>	<u>\$ 2,878</u>	<u>36%</u>

The depreciation and amortization expense included in gross margin excludes \$70 million of such expense for each of the years ended December 31, 2003 and 2002 related to assets that are not directly used in the generation and delivery of energy.

Gross margin increased \$39 million, or 1%, to \$2.9 billion in 2003. The TXU Electric Delivery segment's gross margin increased \$29 million, or 3%, to \$1.1 billion reflecting higher electricity delivery rates. The TXU Energy Holdings segment's gross margin increased \$15 million, or 1%, to \$1.8 billion. The gross margin comparison was favorably impacted by \$197 million due to regulatory-related retail clawback accrual adjustments (a \$185 million charge in 2002 and a \$12 million credit in 2003). The balance of the TXU Energy Holdings segment's gross margin change reflected a 12% decline in retail sales volumes, partially offset by lower depreciation expense as described immediately below.

Depreciation and amortization (including amounts shown in the gross margin table above) decreased \$9 million, or 1%, to \$724 million in 2003, reflecting a \$37 million impact of lower depreciation related to TXU Energy Holdings' generation fleet due primarily to an extension of the estimated depreciable life of the nuclear generation facility to better reflect its useful life, largely off set by investments in delivery facilities to support growth and normal replacements of equipment and the start of amortization of regulatory assets associated with securitization bonds issued in 2003.

SG&A expense decreased \$139 million, or 13%, to \$907 million in 2003. This decrease was driven by the TXU Energy Holdings segment and reflected lower staffing and related administrative expenses arising from cost reduction and productivity enhancing initiatives and a focus on activities in the Texas market.

Franchise and revenue-based taxes decreased \$38 million, or 9%, to \$390 million in 2003, due primarily to lower retail revenues on which gross receipts taxes are based.

Other income increased \$17 million to \$58 million in 2003. Net gains on sales of businesses and properties totaled \$46 million in 2003 and \$32 million in 2002. See Note 20 to Financial Statements under *Other Income and Deductions* for additional detail.

Other deductions decreased \$491 million to \$42 million in 2003. The 2002 period includes a \$237 million (\$154 million after-tax) writedown of an investment in generation plant construction projects and \$187 million (\$174 million after-tax) in charges related to the telecommunications business, then an unconsolidated joint venture (Pinnacle). The charges related to Pinnacle include \$37 million (\$24 million after-tax) for TXU Corp.'s share of the joint venture's impairments of long-lived assets and goodwill and a \$150 million charge (without tax benefit) to record TXU Corp.'s obligations under the partnership agreement arising from the decline in value of the business. Ongoing equity losses (excluding impairment charges in 2002) related to Pinnacle, also reported in other deductions, were \$17 million in 2003 and \$67 million in 2002. The decline primarily reflected the consolidation of the business effective March 2003. (See Notes 4 and 20 to Financial Statements.) Other deductions in 2002 included \$27 million (\$18 million after-tax) in losses on retirement of debt. See Note 20 to Financial Statements under *Other Income and Deductions* for additional detail.

Interest income rose \$3 million, or 9%, to \$36 million in 2003. The increase primarily reflected interest income on higher cash balances due to actions taken in late 2002 to ensure ample liquidity, as well as interest received on restricted cash balances held as collateral for a credit facility.

Interest expense and related charges increased \$91 million, or 13%, to \$784 million in 2003, reflecting an \$81 million increase due to higher average interest rates resulting in part from the replacement of short-term borrowings with higher rate long-term debt, a \$4 million increase due to higher average borrowings and a \$8 million increase due to the full-year effect of the amortization of the discount on the TXU Energy Holdings exchangeable subordinated notes issued in 2002. (The notes were subsequently exchanged by TXU Energy Holdings for exchangeable preferred membership interests.)

The effective income tax rate on income from continuing operations before extraordinary loss and cumulative effect of changes in accounting principles was 30.8% in 2003 and 42.3% in 2002. The decrease reflected the absence of tax benefit on a portion of the 2002 charge related to the Pinnacle joint venture, partially offset by the effect of comparable tax benefit amounts of depletion allowances and amortization of investment tax credits on a higher income base in 2003. (See Note 13 to Financial Statements for an analysis of the effective tax rate.)

Income from continuing operations before extraordinary loss and cumulative effect of changes in accounting principles (an after-tax measure) increased \$461 million to \$566 million in 2003. This performance reflected an increase of \$175 million, or 54%, to \$497 million in the TXU Energy Holdings segment, reflecting impairment charges in 2002 related to generation plant construction projects (\$154 million) and accrual of the retail clawback credit (\$120 million). Lower gross margin and higher interest expense was partially offset by reduced SG&A expenses. Earnings in the TXU Electric Delivery segment increased \$13 million, or 5%, to \$258 million driven by higher revenues, partially offset by higher operating expenses and interest expense. Corporate and other expenses declined \$282 million, reflecting a charge in 2002 of \$174 million related to the Pinnacle joint venture and \$50 million in lower ongoing equity losses related to Pinnacle; the balance of the decrease reflected lower interest expense on lower debt levels and the effect of an \$18 million loss on retirement of debt in 2002. Net pension and postretirement benefit costs reduced income from continuing operations by \$69 million in 2003 and \$42 million in 2002.

Results from discontinued operations totaled income of \$74 million in 2003, primarily reflecting operating results of the TXU Australia, TXU Gas, telecommunications and strategic retail services businesses, and a loss of \$4.2 billion in 2002, primarily reflecting the write-off of the investment in the TXU Europe business. (See Note 4 to Financial Statements.)

An extraordinary loss of \$134 million (net of income tax benefit of \$72 million) in 2002 principally represents the writedown of the regulatory assets subject to recovery through the issuance of securitization bonds. (See Note 5 to Financial Statements.)

A cumulative effect of changes in accounting principles, representing an after-tax charge of \$58 million in 2003, reflects the impact on commodity contract mark-to-market accounting from rescission of EITF 98-10 and the recording of asset retirement obligations under SFAS 143. (See Note 3 to Financial Statements.)

Diluted earnings per share available to common shareholders from continuing operations before extraordinary loss and cumulative effect of changes in accounting principles increased \$1.26 to \$1.63 per share in 2003. Basic average common shares outstanding increased 16% to 322 million reflecting new issuances of 35 million shares in December 2002 and 11.8 million shares in June 2002. An additional 8.4 million shares were issued in August 2002 related to equity-linked debt securities originally issued in 1998. A total of 57 million dilutive shares relate to the \$750 million exchangeable preferred membership interests originally issued as subordinated notes in November 2002. For the diluted earnings per share calculation, \$53 million in after-tax distributions and discount amortization related to these securities is added back to net income.

### **Energy-Related Commodity Contracts and Mark-to-Market Activities**

The table below summarizes the changes in commodity contract assets and liabilities for the years ended December 31, 2004, 2003 and 2002. The net changes in these assets and liabilities, excluding “cumulative effect of change in accounting principle” and “other activity” as described below, represent the net effect of recording unrealized gains/(losses) under mark-to-market accounting for positions in the commodity contract portfolio. These positions consist largely of economic hedge transactions, with speculative trading representing a small fraction of the activity.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Balance of net commodity contract assets at beginning of year .....	\$ 108	\$ 316	\$ 371
Cumulative effect of change in accounting principle (1) .....	—	(75)	—
Settlements of positions included in the opening balance (2) .....	(59)	(145)	(225)
Unrealized mark-to-market valuations of positions held at end of period (3) .....	(31)	9	153
Other activity (4) .....	<u>5</u>	<u>3</u>	<u>17</u>
Balance of net commodity contract assets at end of year .....	<u>\$ 23</u>	<u>\$ 108</u>	<u>\$ 316</u>

- (1) Represents a portion of the pre-tax cumulative effect of the rescission of EITF 98-10 (see Note 3 to Financial Statements).
- (2) Represents unrealized mark-to-market valuations of these positions recognized in earnings as of the beginning of the period.
- (3) There were no significant changes in fair value attributable to changes in valuation techniques. Includes \$14 million in origination gains recognized in 2002 related to nonderivative wholesale contracts.
- (4) Includes initial values of positions involving the receipt or payment of cash or other consideration, such as option premiums, the amortization of such values and reflects the exit of certain retail gas activities in 2003. Also reflects \$71 million of contract-related liabilities to Enron Corporation reclassified to other current liabilities in 2002. These activities have no effect on unrealized mark-to-market valuations.

The decline in net commodity contract assets over the last three years reflects an accounting rule change issued in 2003 that limited mark-to-market accounting to agreements that met the definition of a derivative. Certain energy contracts previously marked-to-market were not derivatives (see Note 3 to Financial Statements). The decline also reflected reduced trading activities following the sale of retail gas operations outside of Texas in 2003 and the appropriate use of normal and cash flow hedge designations in the remaining contract portfolio.

In addition to the net effect of recording unrealized mark-to-market gains and losses that are reflected in changes in commodity contract assets and liabilities, similar effects arise in the recording of unrealized ineffectiveness mark-to-market gains and losses associated with commodity-related cash flow hedges. These effects are reflected in the balance sheet as changes in cash flow hedge and other derivative assets and liabilities. The total net effect of recording unrealized gains and losses under mark-to-market accounting is summarized as follows (excludes cumulative effect of change in accounting principle):

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Unrealized gains/(losses) in mark-to-market commodity contract portfolio.....	\$ (90)	\$ (136)	\$ (72)
Ineffectiveness gains/(losses) related to cash flow hedges .....	<u>(19)</u>	<u>36</u>	<u>(41)</u>
Total unrealized gains/(losses) associated with energy-related commodity contracts .....	<u>\$ (109)</u>	<u>\$ (100)</u>	<u>\$ (113)</u>

These amounts are included in the “hedging and risk management activities” component of revenues as presented in the TXU Energy Holdings segment data.

As a result of guidance provided in EITF 02-3, TXU Corp. has not recognized origination gains on energy contracts in 2003 or 2004. TXU Corp. recognized origination gains on retail sales contracts of \$40 million in 2002. Because of the short-term nature of these contracts, a portion of these gains would have been recognized on a settlement basis in the year the origination gain was recorded.

**Maturity Table** — Of the net commodity contract asset balance above at December 31, 2004, the amount representing unrealized mark-to-market net gains that have been recognized in current and prior years’ earnings is \$31 million. The offsetting net liability of \$8 million included in the December 31, 2004 balance sheet is comprised principally of amounts representing current and prior years’ net receipts of cash or other consideration, including option premiums, associated with contract positions, net of any amortization. The following table presents the unrealized mark-to-market balance at December 31, 2004, scheduled by contractual settlement dates of the underlying positions.

<u>Source of fair value</u>	<u>Maturity dates of unrealized net mark-to-market balances at December 31, 2004</u>				<u>Total</u>
	<u>Maturity less than 1 year</u>	<u>Maturity of 1-3 years</u>	<u>Maturity of 4-5 years</u>	<u>Maturity in Excess of 5 years</u>	
Prices actively quoted.....	\$ 59	\$ —	\$ —	\$ —	\$ 59
Prices provided by other external sources .....	—	(38)	8	(3)	(33)
Prices based on models.....	<u>5</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>5</u>
Total .....	<u>\$ 64</u>	<u>\$(38)</u>	<u>\$ 8</u>	<u>\$(3)</u>	<u>\$ 31</u>
Percentage of total fair value.....	207%	(123)%	26%	(10)%	100%

As the above table indicates, 84% of the unrealized mark-to-market valuations at December 31, 2004 mature within three years. This is reflective of the terms of the positions and the methodologies employed in valuing positions for periods where there is less market liquidity and visibility. The “prices actively quoted” category reflects only exchange traded contracts with active quotes available. The “prices provided by other external sources” category represents forward commodity positions at locations for which over-the-counter broker quotes are available. Over-the-counter quotes for power and natural gas generally extend through 2005 and 2010, respectively. The “prices based on models” category contains the value of all non-exchange traded options, valued using industry accepted option pricing models. In addition, this category contains other contractual arrangements which may have both forward and option components. In many instances, these contracts can be broken down into their component parts and modeled as simple forwards and options based on prices actively quoted. As the modeled value is ultimately the result of a combination of prices from two or more different instruments, it has been included in this category.

**TXU Energy Holdings****Financial Results**

	Year Ended December 31,		
	2004	2003	2002
Operating revenues .....	<u>\$ 8,495</u>	<u>\$ 7,986</u>	<u>\$ 7,678</u>
Costs and expenses:			
Cost of energy sold and delivery fees.....	5,265	5,117	4,771
Operating costs.....	704	685	698
Depreciation and amortization.....	350	407	450
Selling, general and administrative expenses.....	667	636	774
Franchise and revenue-based taxes .....	117	124	120
Other income .....	(110)	(48)	(33)
Other deductions.....	610	22	254
Interest income.....	(31)	(8)	(10)
Interest expense and other charges.....	<u>353</u>	<u>323</u>	<u>215</u>
Total costs and expenses.....	<u>7,925</u>	<u>7,258</u>	<u>7,239</u>
Income from continuing operations before income taxes and cumulative effect of changes in accounting principles .....	570	728	439
Income tax expense.....	<u>162</u>	<u>231</u>	<u>117</u>
Income from continuing operations before cumulative effect of changes in accounting principles.....	<u>\$ 408</u>	<u>\$ 497</u>	<u>\$ 322</u>

**TXU Energy Holdings**

**Sales Volume and Customer Count Data**

	Year Ended December 31,		
	2004	2003	2002
<b>Sales volumes:</b>			
Retail electricity sales volumes (GWh):			
Historical service territory (a):			
Residential .....	30,897	34,082	36,967
Small business (b) .....	<u>10,476</u>	<u>12,673</u>	<u>15,480</u>
Total historical service territory.....	41,373	46,755	52,447
Other territories (a):			
Residential .....	3,089	1,899	725
Small business (b) .....	<u>363</u>	<u>313</u>	<u>427</u>
Total other territories .....	3,452	2,212	1,152
Large business and other customers.....	<u>25,466</u>	<u>30,955</u>	<u>36,982</u>
Total retail electricity.....	70,291	79,922	90,581
Wholesale electricity sales volumes .....	<u>48,309</u>	<u>36,809</u>	<u>29,353</u>
Total retail and wholesale electricity sales volumes .....	<u>118,600</u>	<u>116,731</u>	<u>119,934</u>
<b>Average volume (kWh) per retail customer (c):</b>			
Residential .....	15,619	15,959	16,272
Small business .....	34,095	39,728	47,235
Large business and other customers.....	351,542	421,203	450,674
<b>Weather (service territory average) – percent of normal (d):</b>			
Percent of normal:			
Cooling degree days.....	89.9%	95.7%	99.8%
Heating degree days.....	89.2%	98.1%	102.0%
<b>Customer counts:</b>			
Retail electricity customers (end of period and in thousands) (e):			
Historical service territory (a):			
Residential .....	1,951	2,059	2,204
Small business (b) .....	<u>309</u>	<u>316</u>	<u>328</u>
Total historical service territory.....	2,260	2,375	2,532
Other territories (a):			
Residential .....	194	148	98
Small business (b) .....	<u>6</u>	<u>5</u>	<u>5</u>
Total other territories .....	200	153	103
Large business and other customers.....	<u>76</u>	<u>69</u>	<u>78</u>
Total retail electricity customers .....	<u>2,536</u>	<u>2,597</u>	<u>2,713</u>

- (a) Historical service and other territory data for 2003 and 2002 are best estimates.
- (b) Customers with demand of less than 1 MW annually.
- (c) Calculated using average number of customers for period.
- (d) Weather data is obtained from Weatherbank, Inc., an independent company that collects and archives weather data from reporting stations of the National Oceanic and Atmospheric Administration (a federal agency under the US Department of Commerce).
- (e) Based on number of meters.

**TXU Energy Holdings**

**Revenue and Market Share Data**

	Year Ended December 31,		
	2004	2003	2002
<b>Operating revenues (millions of dollars):</b>			
Retail electricity revenues:			
Historical service territory (a):			
Residential .....	\$ 3,164	\$ 3,152	\$ 3,044
Small business (b) .....	<u>1,103</u>	<u>1,213</u>	<u>1,312</u>
Total historical service territory.....	4,267	4,365	4,356
Other territories (a):			
Residential .....	298	159	64
Small business (b) .....	<u>34</u>	<u>25</u>	<u>18</u>
Total other territories .....	332	184	82
Large business and other customers.....	<u>1,771</u>	<u>1,935</u>	<u>2,085</u>
Total retail electricity revenues.....	6,370	6,484	6,523
Wholesale electricity revenues .....	1,886	1,258	841
Hedging and risk management activities.....	(103)	30	147
Other revenues .....	<u>342</u>	<u>214</u>	<u>167</u>
Total operating revenues.....	<u>\$ 8,495</u>	<u>\$ 7,986</u>	<u>\$ 7,678</u>
<b>Hedging and risk management activities:</b>			
Net unrealized mark-to-market losses.....	\$ (109)	\$ (100)	\$ (113)
Realized gains.....	<u>6</u>	<u>130</u>	<u>260</u>
Total .....	<u>\$ (103)</u>	<u>\$ 30</u>	<u>\$ 147</u>
<b>Average revenues per MWh:</b>			
Residential .....	\$ 101.88	\$ 92.02	\$ 82.44
Small business .....	\$ 104.87	\$ 95.38	\$ 81.75
Large business and other customers.....	\$ 69.54	\$ 62.51	\$ 56.93
<b>Estimated share of ERCOT retail markets (c):</b>			
Historical service territory (a):			
Residential (d) .....	81%	86%	95%
Small business (d) .....	78%	82%	89%
Total ERCOT:			
Residential .....	44%	46%	49%
Small business .....	31%	32%	35%
Large business and other customers.....	33%	37%	43%

(a) Historical service and other territory data for 2003 and 2002 are best estimates.

(b) Customers with demand of less than 1 MW annually.

(c) Based on number of meters, except large business which is based upon annualized consumption.

(d) Estimated market share is based on the number of customers that have choice.

**TXU Energy Holdings**

**Cost of Energy Sold Data**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Fuel and purchased power costs (cost of energy sold) per MWh:</b>			
Nuclear generation .....	\$ 4.31	\$ 4.49	\$ 4.61
Lignite/coal generation .....	\$ 12.96	\$ 12.53	\$ 12.65
Gas/oil generation and purchased power .....	\$ 47.95	\$ 46.12	\$ 34.06
Average total electricity supply .....	\$ 29.02	\$ 28.73	\$ 23.61
<b>Delivery fees per MWh .....</b>	<b>\$ 21.75</b>	<b>\$ 18.93</b>	<b>\$ 19.45</b>
<b>Production and purchased power volumes (GWh):</b>			
Nuclear (baseload) .....	18,979	17,717	16,557
Lignite/coal (baseload) .....	42,339	41,311	38,181
Gas/oil .....	4,726	13,250	19,572
Purchased power .....	<u>56,007</u>	<u>49,915</u>	<u>50,546</u>
Total energy supply .....	122,051	122,193	124,856
Less line loss and other .....	<u>3,451</u>	<u>5,462</u>	<u>4,922</u>
Net energy supply volumes .....	<u>118,600</u>	<u>116,731</u>	<u>119,934</u>
<b>Baseload capacity factors (%):</b>			
Nuclear .....	94.3%	88.1%	82.2%
Lignite/coal .....	86.2%	84.7%	78.0%

**TXU Energy Holdings**

**2004 compared to 2003**

Operating revenues increased \$509 million, or 6%, to \$8.5 billion in 2004. Retail electricity revenues decreased \$114 million, or 2%, to \$6.4 billion. This decline reflected a \$781 million decrease attributable to a 12% drop in sales volumes, driven by the effect of competitive activity and milder weather primarily in the summer, partially offset by a \$667 million increase due to higher average pricing. Lower business market volumes also reflected a strategy to target higher margin customer segments. Higher pricing reflected increased price-to-beat rates, reflecting regulatory-approved fuel factor increases and higher pricing in the competitive business market, both resulting from higher natural gas prices. Retail electricity customer counts at December 31, 2004 declined 2.3% from December 31, 2003. Wholesale electricity revenues grew \$628 million, or 50%, to \$1.9 billion reflecting a \$393 million increase attributable to a 31% rise in sales volumes and a \$235 million increase due to the effect of increased natural gas prices on wholesale prices. Higher wholesale electricity sales volumes reflected, principally during the first half of the year, the establishment of the new northeast zone in ERCOT. Because TXU Energy Holdings has a generation plant and a relatively small retail customer base in the new zone, wholesale sales volumes increased, and wholesale power purchases also increased to meet retail sales demand in other zones and minimize congestion costs. Completion of transmission projects later in the year reduced congestion costs, resulting in normalized sales and purchase volumes. The increase in wholesale sales volumes also reflected a partial shift in TXU Energy Holdings' customer base from retail to wholesale services, particularly in the business market.

Net results from hedging and risk management activities, which are reported in revenues and include both realized and unrealized gains and losses, declined \$133 million from a net gain of \$30 million in 2003 to a net loss of \$103 million in 2004. Results from these activities included the net effect of recording unrealized gains and losses under mark-to-market accounting, versus settlement accounting, of \$109 million in net losses in 2004 and \$100 million in net losses in 2003. Because the hedging activities are intended to mitigate the risk of commodity price movements on revenues and cost of energy sold, the changes in such results should not be viewed in isolation, but rather taken together with the effects of pricing and cost changes on gross margin. The decline included \$22 million in mark-to-market losses associated with required 2004 capacity auctions, \$19 million in increased reserves, primarily reflecting the release in 2003 of liquidity reserves related to retail contracts settled and \$26 million of increased cash flow accounting hedge ineffectiveness. The comparison also reflected \$34 million of gas storage and retail gas business margin in 2003, primarily related to businesses sold in late 2003, and \$18 million due to a favorable settlement with a counterparty in 2003. The majority of TXU Energy Holdings' natural gas physical sales and purchases are in the wholesale markets and essentially represent hedging activities. These activities are accounted for on a net basis with the exception of retail sales to business customers, which effective October 1, 2003 are reported gross in accordance with new accounting rules and totaled \$126 million in revenues for the first nine months of 2004. The increase in other revenues of \$128 million to \$342 million in 2004 was primarily driven by this change.

*Gross Margin*

	<b>Year Ended December 31,</b>			
	<b>2004</b>	<b>% of Revenue</b>	<b>2003</b>	<b>% of Revenue</b>
Operating revenues .....	\$ 8,495	100%	\$ 7,986	100%
Costs and expenses:				
Cost of energy sold and delivery fees .....	5,265	62%	5,117	64%
Operating costs .....	704	8%	685	8%
Depreciation and amortization .....	327	4%	368	5%
Gross margin .....	<u>\$ 2,199</u>	<u>26%</u>	<u>\$ 1,816</u>	<u>23%</u>

Gross margin increased \$383 million, or 21%, to \$2.2 billion in 2004. Higher gross margin reflected initiatives taken to respond to higher natural gas prices, including retail pricing actions and more cost effective sourcing of power. The gross margin increase reflected higher retail and wholesale prices partially offset by the

effect of lower retail volumes, lower results from hedging and risk management activities and increased delivery fees. The average cost per MWh of power produced and purchased was about even with 2003, as higher purchased power costs due to rising natural gas prices were largely offset by lower cost of power produced due to reduced utilization of high heat rate gas-fired generation and higher lignite and nuclear facility output. Delivery fees increased on a per MWh basis due to a lower retail clawback credit applied to delivery fees in 2004 compared to the excess mitigation credit applied in 2003, as well as increased transition charges related to the issuance of regulatory asset securitization bonds by TXU Electric Delivery.

Operating costs increased \$19 million, or 3%, to \$704 million in 2004. The increase reflected \$30 million in incremental testing, inspection and component repair costs associated with the planned outage for refueling at the nuclear facility and planned lignite/coal plant outages, \$11 million in higher incentive compensation expense, an increase of \$4 million in ad valorem taxes due to higher gas prices and a \$4 million increase in property insurance premiums. Operating costs reflected a decline of \$16 million related to customer care support services previously provided to TXU Gas (largely offset by lower related revenues), and \$14 million due to the absence of the gas transportation subsidiary sold in June 2004 (largely offset by higher costs of energy sold related to gas-fired production).

Depreciation and amortization (including amounts shown in the gross margin table above) decreased \$57 million, or 14%, to \$350 million. The decrease was driven by extensions of estimated average depreciable lives of lignite and nuclear generation facilities' assets to better reflect their useful lives, partially offset by the effect of mining activity and the related asset retirement obligation and the effect of the transfer of information technology assets, principally capitalized software, to a TXU Corp. affiliate in connection with the Capgemini transaction. Depreciation and amortization included in gross margin represents depreciation of assets directly used in the generation of electricity.

SG&A expenses increased by \$31 million, or 5%, to \$667 million reflecting \$72 million in higher incentive compensation expense due to improved performance of the business and achievement of certain targets related to trading activities, partially offset by \$24 million in lower bad debt expense reflecting stricter disconnect policies, more focused collection activities, targeted customer marketing and lower accounts receivable balances, \$8 million from various cost reduction initiatives and \$4 million in reduced marketing costs outside the historical service territory.

Other income increased by \$62 million to \$110 million in 2004. Other income in 2004 included \$58 million of the remaining unamortized gain on the 2002 sale of two generation plants recognized as a result of the termination of an existing power purchase and tolling agreement discussed above under "Business Restructuring and Other Actions" and a \$19 million gain on the sale of undeveloped land. Other income in both 2004 and 2003 reflected \$30 million in amortization of the gain on the 2002 sale of two generation plants. The 2003 period also included a \$9 million gain on the sale of contracts related to retail gas activities outside of Texas.

Other deductions increased \$588 million to \$610 million in 2004. Other deductions in 2004 consist largely of \$180 million in lease-related charges primarily related to generation and mining assets taken, or to be taken, out of service, \$107 million in software write-offs, \$107 million for employee severance, \$101 million in termination costs for an existing power purchase and tolling agreement and \$79 million for spare parts inventory writedowns, all discussed above under "Business Restructuring and Other Actions."

Interest income increased by \$23 million to \$31 million in 2004 primarily due to higher average advances to affiliates.

Interest expense and related charges increased by \$30 million, or 9%, to \$353 million in 2004. The increase reflected \$40 million due to higher average debt levels and \$12 million representing higher interest reimbursement to TXU Electric Delivery for carrying costs related to securitized regulatory assets, partially offset by \$21 million due to lower average interest rates.

The effective income tax rate decreased to 28.4% in 2004 from 31.7% in 2003 driven by the effects of ongoing tax benefits of depletion allowances and amortization of investment tax credits on a lower income base in 2004.

Income from continuing operations before cumulative effect of changes in accounting principles decreased \$89 million to \$408 million in 2004, reflecting the net restructuring related charges reported in other deductions and other income and higher SG&A expenses, partially offset by the higher gross margin. Net pension and postretirement benefit costs reduced net income by \$36 million in both 2004 and 2003.

## **TXU Energy Holdings**

### **2003 compared to 2002**

Effective with reporting for 2003, results for the TXU Energy Holdings segment exclude expenses incurred by the US Holdings parent company in order to present the segment on the same basis as the results of the business are evaluated by management. Prior year amounts are presented on this revised basis.

Operating revenues increased \$308 million, or 4%, to \$8.0 billion in 2003. Total retail and wholesale electricity revenues rose \$378 million, or 5%, to \$7.7 billion. This growth reflected higher retail and wholesale pricing, partially offset by the effects of a mix shift to lower-price wholesale sales and a 3% decline in total sales volumes. Retail electricity revenues decreased \$39 million, or 1%, to \$6.5 billion reflecting a \$768 million decline attributable to a 12% drop in sales volumes, driven by the effect of competitive activity in the business market, largely offset by a \$730 million increase due to higher pricing. Higher prices reflected increased price-to-beat rates, due to approved fuel factor increases, and higher contract pricing in the competitive large business market, both resulting from higher natural gas prices. Retail electricity customer counts declined 4.3% from year-end 2002. Wholesale electricity revenues grew \$417 million, or 50%, to \$1.3 billion reflecting a \$223 million increase attributable to a 25% rise in sales volumes and a \$194 million increase due to the effect of increased natural gas prices on wholesale prices. Higher wholesale electricity sales volumes reflected a partial shift in the customer base from retail to wholesale services, particularly in the business market.

Net gains from hedging and risk management activities, which are reported in revenues and include both realized and unrealized gains and losses, declined \$117 million to \$30 million in 2003. Changes in these results reflect market price movements on commodity contracts entered into to hedge gross margin; the comparison to 2002 also reflects a decline in activities in markets outside of Texas. Because the hedging activities are intended to mitigate the risk of commodity price movements on revenues and cost of energy sold, the changes in such results should not be viewed in isolation, but rather taken together with the effects of pricing and cost changes on gross margin. Results from these activities include net unrealized losses arising from mark-to-market accounting of \$100 million in 2003 and \$113 million in 2002. The majority of TXU Energy Holdings' natural gas physical sales and purchases are in the wholesale markets and essentially represent hedging activities. These activities are accounted for on a net basis with the exception of retail sales to business customers, which effective October 1, 2003 are reported gross in accordance with new accounting rules and totaled \$39 million in revenues since that date. The increase in other revenues of \$47 million to \$214 million in 2003 was driven by this change.

#### *Gross Margin*

	<b>Year Ended December 31,</b>			
	<b>2003</b>	<b>% of Revenue</b>	<b>2002</b>	<b>% of Revenue</b>
Operating revenues .....	\$ 7,986	100%	\$ 7,678	100%
Costs and expenses:				
Cost of energy sold and delivery fees .....	5,117	64%	4,771	62%
Operating costs .....	685	9%	698	9%
Depreciation and amortization .....	368	4%	408	5%
Gross margin .....	<u>\$ 1,816</u>	<u>23%</u>	<u>\$ 1,801</u>	<u>24%</u>

The depreciation and amortization expense reported in the gross margin amounts above excluded \$39 million and \$42 million of such expense for the years ended December 31, 2003 and 2002, respectively, related to assets that are not directly used in the generation of electricity.

Gross margin increased \$15 million, or 1%, to \$1.8 billion in 2003. The gross margin comparison was favorably impacted by \$197 million due to regulatory-related retail clawback accrual adjustments (a \$185 million charge in 2002 and a \$12 million credit in 2003), as described in Note 17 to Financial Statements, and \$53 million in lower operating costs and depreciation and amortization. Adjusting for these effects, margin declined \$235 million, driven by the effect of lower retail sales volumes. The combined effect of higher costs of energy sold and lower results from hedging and risk management activities was essentially offset by higher sales prices. Higher costs of energy sold were driven by higher natural gas prices, but were mitigated by increased sourcing of retail and wholesale sales demand from TXU Energy Holdings' baseload (nuclear-powered and coal-fired) generation plants. Baseload supply of sales demand increased by five percentage points to 51% in 2003. The balance of sales demand in 2003 was met with gas-fired generation and purchased power.

Operating costs decreased \$13 million, or 2%, to \$685 million in 2003. The decline reflected \$20 million due to one scheduled outage for nuclear generation unit refueling and maintenance in 2003 compared to two in 2002 and \$15 million from various cost reduction initiatives, partially offset by \$27 million in higher employee benefits and insurance costs.

Depreciation and amortization (including amounts shown in the gross margin table above) decreased \$43 million, or 10%, to \$407 million largely due to the effect of adjusted depreciation rates related to the generation fleet effective April 2003. The adjusted rates reflect an extension in the estimated average depreciable life of the nuclear generation facility's assets of approximately 11 years (to 2041) to better reflect its useful life, partially offset by higher depreciation rates for lignite and gas facilities to reflect investments in emissions equipment made in recent years.

SG&A expenses declined \$138 million, or 18%, to \$636 million in 2003. Lower staffing and related administrative expenses contributed approximately \$95 million to the decrease, reflecting cost reduction and productivity enhancing initiatives and a focus on activities in the Texas market. Lower SG&A expenses also reflected a \$40 million decline in bad debt expense. In the retail electricity business, the effect of enhanced credit and collection activities was largely offset by increased write-offs arising from disconnections now allowed under new regulatory rules and increased churn of non-paying customers. The decrease in bad debt expense primarily reflected the wind down of retail gas (business customer supply) activities outside of Texas and the recording of related reserves in 2002.

Other income increased \$15 million to \$48 million in 2003. Other income in both periods included approximately \$30 million of amortization of a gain on the sale of two generation plants in 2002. The 2003 period also included a \$9 million gain on the sale of contracts related to retail gas activities outside of Texas.

Other deductions decreased \$232 million to \$22 million in 2003, reflecting a \$237 million (\$154 million after-tax) writedown in 2002 of an investment in two generation plant construction projects. In addition, both periods include several individually immaterial items.

Interest expense and related charges increased \$108 million, or 50%, to \$323 million in 2003. The increase reflected \$108 million due to higher average interest rates as short-term borrowings were replaced with higher-rate long-term financing. An \$11 million full-year effect of the amortization of the discount on the exchangeable subordinated notes issued in 2002 (subsequently exchanged by TXU Energy Holdings for exchangeable preferred membership interests), was largely offset by the effect of lower average short-term debt levels.

The effective income tax rate increased to 31.7% in 2003 from 26.7% in 2002. The increase was driven by the effect of comparable (to 2002) tax benefit amounts of depletion allowances and amortization of investment tax credits on a higher income base in 2003. (See Note 13 for analysis of the effective tax rate.)

Income from continuing operations before cumulative effect of changes in accounting principles increased \$175 million, or 54%, to \$497 million in 2003. Results in 2002 included impairment charges related to generation plant construction projects and an accrual for retail clawback of \$154 million after-tax and \$120 million after-tax, respectively. Excluding these items, earnings declined on gross margin compression due to lower retail sales volumes as well as higher interest expense, partially offset by lower SG&A expenses. Net pension and postretirement benefit costs reduced net income by \$36 million in 2003 and by \$21 million in 2002.

## **TXU Electric Delivery**

### **Financial Results**

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Operating revenues .....	\$ 2,226	\$ 2,087	\$ 1,994
Costs and expenses:			
Operating costs .....	730	709	676
Depreciation and amortization .....	389	297	264
Selling, general and administrative expenses .....	219	207	213
Franchise and revenue-based taxes .....	248	250	272
Other income .....	(7)	(8)	(9)
Other deductions .....	52	—	—
Interest income .....	(56)	(52)	(49)
Interest expense and related charges .....	<u>280</u>	<u>300</u>	<u>265</u>
Total costs and expenses .....	<u>1,855</u>	<u>1,703</u>	<u>1,632</u>
Income from continuing operations before income taxes, extraordinary items and cumulative effect of change in accounting principle .....	371	384	362
Income tax expense .....	<u>116</u>	<u>126</u>	<u>117</u>
Income from continuing operations before extraordinary items and cumulative effect of change in accounting principle .....	<u>\$ 255</u>	<u>\$ 258</u>	<u>\$ 245</u>

**TXU Electric Delivery**

**Operating Data**

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Volumes:</b>			
Electric energy delivered (GWh).....	101,928	101,810	102,481
<b>Reliability statistics:</b>			
System Average Interruption Duration Index (SAIDI) (non-storm) (a).....	75.54	74.15	90.36
System Average Interruption Frequency Index (SAIFI) (non-storm) (a).....	1.10	1.17	1.39
Customer Average Interruption Duration Index (CAIDI) (non-storm) (a).....	68.67	63.30	64.81
<b>Electricity points of delivery (end of period and in thousands):</b>			
Electricity distribution points of delivery - based on number of meters (b).....	2,971	2,932	2,909
<b>Operating revenues (millions of dollars):</b>			
Electricity distribution revenues (c):			
Affiliated (TXU Energy Holdings).....	\$ 1,418	\$ 1,485	\$ 1,581
Nonaffiliated.....	<u>590</u>	<u>410</u>	<u>239</u>
Total distribution revenues.....	2,008	1,895	1,820
Third-party transmission revenues.....	192	167	151
Other miscellaneous revenues and eliminations.....	<u>26</u>	<u>25</u>	<u>23</u>
Total operating revenues.....	<u>\$ 2,226</u>	<u>\$ 2,087</u>	<u>\$ 1,994</u>

- (a) SAIDI is the average number of total electric service outage minutes per customer in the past year. SAIFI is the average number of electric service interruptions per customer in the past year. CAIDI is the average number of electric service outage minutes per interruption in the past year.
- (b) Includes lighting sites, principally guard lights, for which TXU Energy Holdings is the REP but are not included in TXU Energy Holdings' customer count. Such sites totaled 95,252 in 2004, 100,901 in 2003 and 105,987 in 2002.
- (c) Includes disconnect/reconnect fees.

## TXU Electric Delivery

### 2004 compared to 2003

Operating revenues increased \$139 million, or 7%, to \$2.2 billion in 2004. Higher tariffs drove the growth, reflecting \$87 million in transition charges associated with the issuance of securitization bonds in August 2003 and June 2004, \$26 million in increased distribution tariffs to recover higher transmission costs, \$23 million in transmission rate increases approved in 2003 and 2004 and \$9 million from implementation of power factor billing. Power factor billing is a tariff on nonresidential end-use consumers that utilize inefficient equipment. Revenue growth also included \$7 million in increased disconnect/reconnect fees, reflecting activities initiated by REPs. Milder weather, primarily in the summer, and consumer usage efficiencies, partially offset by growth in points of delivery resulted in an estimated net \$16 million decrease in revenue. The increase in the nonaffiliated component of TXU Electric Delivery's revenues, as well as the decrease in the affiliated component, reflects competitive activity in the historical service territory. Delivered electricity volumes were about even with 2003.

#### *Gross Margin*

	Year Ended December 31,			
	2004	% of Revenue	2003	% of Revenue
Operating revenues .....	\$ 2,226	100%	\$ 2,087	100%
Costs and expenses:				
Operating costs .....	730	33%	709	34%
Depreciation and amortization .....	<u>386</u>	<u>17%</u>	<u>285</u>	<u>14%</u>
Gross margin .....	<u>\$ 1,110</u>	<u>50%</u>	<u>\$ 1,093</u>	<u>52%</u>

Gross margin increased \$17 million, or 2%, to \$1.1 billion in 2004, driven by an increase in transmission-related tariffs, partially offset by the effect of milder weather primarily in the summer and an increase in operating costs. The increase in operating costs of \$21 million, or 3%, to \$730 million, reflected a \$12 million increase in third-party transmission costs, an \$8 million increase in property taxes due to property additions and increased value, a \$6 million increase in metering-related costs associated with the increased disconnect/reconnect activity, and a \$5 million increase in vegetation management to improve system reliability, partially offset by \$4 million decrease in benefits and labor as a result of 2004 storm activity (recorded to a regulatory asset or billed to companies affected by the hurricane season) and \$6 million of various other costs that were individually insignificant. Depreciation and amortization included in gross margin represents depreciation of assets directly used in the transmission and distribution of electricity and amortization of regulatory assets. The increase in depreciation and amortization of \$101 million, or 35%, to \$386 million reflected \$87 million in higher amortization of regulatory assets associated with the issuance of securitization bonds (offsetting the same amount of revenue increase) and \$13 million in higher depreciation due to normal additions and replacements of property, plant and equipment.

Depreciation and amortization not included in gross margin totaled \$3 million and \$12 million for 2004 and 2003, respectively. This decline reflected a transfer of information technology assets, principally capitalized software, to a TXU Corp. affiliate in connection with the Capgemini outsourcing transaction (see Note 1 to Financial Statements).

SG&A expenses increased \$12 million, or 6%, to \$219 million in 2004. The increase primarily reflected an \$8 million increase in incentive compensation expense due to the improved performance of the business. Increases in various costs that were individually insignificant were largely offset by lower bad debt expense reflecting a \$4 million write-off in 2003.

Other deductions totaled \$52 million in 2004. This line item includes a charge of \$21 for estimated settlement payments arising from the resolution of a distribution rate inquiry initiated by a number of Texas cities. Other deductions also includes \$20 million of severance-related charges in connection with the Capgemini outsourcing transaction and other cost reduction initiatives, \$4 million for costs associated with

transitioning the outsourced activities to Capgemini, \$2 million related to TXU Electric Delivery's portion of the equity losses (representing depreciation expense) in the TXU Corp. entity holding the capitalized software licensed to Capgemini, and \$4 million in asset write-downs and other unusual charges. See the discussion above under "Business Restructuring and Other Actions" for additional information.

Interest income increased by \$4 million, or 8%, to \$56 million in 2004 driven by an \$11 million increase in interest income from TXU Energy Holdings related to securitized regulatory assets, partially offset by a \$6 million decrease in interest income from TXU Energy Holdings related to the excess mitigation credit that ceased at the end of 2003.

Interest expense and related charges decreased \$20 million, or 7%, to \$280 million in 2004. The decrease reflected a \$23 million impact of lower average interest rates and \$6 million in interest paid to REPs in 2003 related to the excess mitigation credit that ceased at the end of 2003, partially offset by a \$9 million impact of higher average borrowings.

The effective income tax rate decreased to 31.3% in 2004 from 32.8% in 2003. The decrease was due primarily to the effects of the Medicare Prescription and Drug, Improvement and Modernization Act of 2003, the nontaxable prescription drug subsidy.

Income before extraordinary gain and cumulative effect of change in accounting principle (an after-tax measure) decreased \$3 million, or 1%, to \$255 million in 2004, as unusual charges reported in other deductions were partially offset by lower interest expense and higher gross margin. Net pension and postretirement benefit costs reduced net income by \$19 million for both 2004 and 2003.

## **TXU Electric Delivery**

### **2003 compared to 2002**

TXU Electric Delivery's operating revenues increased \$93 million, or 5%, to \$2.1 billion in 2003. Higher tariffs drove the growth, reflecting \$19 million in transition charges associated with the issuance of securitization bonds in August 2003, \$19 million in increased distribution tariffs to recover higher transmission costs and \$18 million in transmission rate increases approved. Revenue growth also included \$26 million in increased disconnect/reconnect fees, reflecting disconnections initiated by REPs under new regulatory rules, and \$10 million from increased pricing to certain business consumers due to higher peak demands in 2003. The increase in the nonaffiliated component of TXU Electric Delivery's revenues, as well as the decrease in the affiliated component, reflected competitive activity in the historical service territory. Delivered electricity volumes were about even with 2002.

#### *Gross Margin*

	Year Ended December 31,			
	2003	% of Revenue	2002	% of Revenue
Operating revenues .....	\$ 2,087	100%	\$ 1,994	100%
Costs and expenses:				
Operating costs .....	709	34%	676	34%
Depreciation and amortization .....	285	14%	254	13%
Gross margin .....	<u>\$ 1,093</u>	<u>52%</u>	<u>\$ 1,064</u>	<u>53%</u>

Gross margin increased \$29 million, or 3%, to \$1.1 billion in 2003, driven by the benefit of higher transmission-related tariffs, partially offset by increased operating costs. The increase in operating costs of \$33 million, or 5%, to \$709 million reflects \$22 million in third-party transmission costs and \$8 million in higher pension and other postretirement benefit costs. The increase in depreciation and amortization of \$31 million, or 12%, to \$285 million reflects \$11 million in higher depreciation due to investments in delivery facilities to support growth and normal replacements of equipment and \$19 million in amortization of regulatory assets

associated with the issuance of securitization bonds in August 2003 (offsetting the same amount of revenue increase).

Depreciation and amortization not included in gross margin rose \$2 million to \$12 million in 2003.

SG&A expenses decreased \$6 million, or 3%, to \$207 million in 2003 due primarily to lower outside services and consulting expenses arising from cost reduction initiatives implemented in late 2002.

Franchise and revenue-based taxes declined \$22 million, or 8%, to \$250 million in 2003 due to the full implementation of a regulatory change in the basis for the calculation of local gross receipts taxes from revenue dollars to kWh.

Interest income increased \$3 million, or 6%, to \$52 million in 2003 reflecting a \$15 million increase in the reimbursement from TXU Energy Holdings for higher carrying costs on regulatory assets (see discussion of higher average interest rates below) and a \$3 million increase in investment income, partially offset by \$15 million less interest on the excess mitigation credit note receivable from TXU Energy Holdings due to principal payments.

Interest expense and related charges rose by \$35 million, or 13%, to \$300 million in 2003. The increase reflected a \$48 million impact of higher average interest rates and a \$2 million impact of higher average borrowings, partially offset by \$15 million less interest credited to REPs related to the excess mitigation credit. The change in average interest rates reflected the refinancing of affiliate borrowings with higher rate long-term debt issuances.

The effective income tax rate was 32.8% in 2003 compared to 32.3% in 2002. There were no significant unusual items impacting the effective rates.

Income from continuing operations before extraordinary loss increased \$13 million, or 5%, to \$258 million in 2003, reflecting higher transmission-related revenues, partially offset by higher operating expenses and higher interest expense. Net pension and postretirement benefit costs reduced net income by \$19 million in 2003 and \$11 million in 2002.

## COMPREHENSIVE INCOME – Continuing Operations

Cash flow hedge activity reported in other comprehensive income from continuing operations included:

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Cash flow hedge activity (net of tax):			
Net change in fair value of hedges – gains/(losses):			
Commodities .....	\$ (86)	\$ (138)	\$ (96)
Financing – interest rate swaps .....	<u>12</u>	<u>(63)</u>	<u>(124)</u>
	(74)	(201)	(220)
Losses realized in earnings (net of tax):			
Commodities .....	32	162	15
Financing – interest rate swaps .....	<u>11</u>	<u>76</u>	<u>41</u>
	43	238	56
Effect of cash flow hedges reported in comprehensive results related to continuing operations.....	<u>\$ (31)</u>	<u>\$ 37</u>	<u>\$ (164)</u>

TXU Corp. has historically used, and expects to continue to use, derivative financial instruments that are highly effective in offsetting future cash flow volatility in interest rates and energy commodity prices. The amounts included in accumulated other comprehensive income are expected to offset the impact of rate or price changes on forecasted transactions. Amounts in accumulated other comprehensive income include (i) the value of the cash flow hedges (for the effective portion), based on current market conditions, and (ii) the value of

dedesignated and terminated cash flow hedges at the time of such dedesignation, less amortization, providing the transaction that was hedged is still probable. The effects of the hedge will be recorded in the statement of income as the hedged transactions are actually settled.

Other comprehensive income also included adjustments related to minimum pension liabilities.

Minimum pension liability adjustments were a gain of \$21 million (\$14 million after-tax) in 2004, a gain of \$71 million (\$46 million after-tax) in 2003 and a loss of \$100 million (\$65 million after-tax) in 2002. The minimum pension liability represents the excess of the accumulated benefit obligation over the plans' assets and the liability recorded under SFAS 87. The recording of the minimum pension liability did not affect TXU Corp.'s financial covenants in any of its credit agreements. Changes in minimum pension liability adjustments reflect fluctuating returns on the plans' investment assets.

See also Note 14 to Financial Statements.

## FINANCIAL CONDITION

### *LIQUIDITY AND CAPITAL RESOURCES*

Cash flows provided by operating activities decreased \$655 million, or 27%, to \$1.8 billion in 2004. The decline was driven by the effect of an income tax refund received in 2003 of approximately \$600 million. An unfavorable change in working capital (accounts receivable, accounts payable and inventory) of \$322 million, which reflected improvements in 2003 due to higher collections following billing delays experienced during the transition to competition, was largely offset by improved operating results after adjusting for noncash unusual charges.

Cash flows from operating activities in 2003 increased \$1.4 billion over 2002. The principal drivers of the increase were improved working capital changes of \$790 million, which primarily reflects the effect of billing and collection delays in 2002 associated with the transition to competition and includes \$115 million in increased funding under the accounts receivable sale program, as well as the receipt of an income tax refund of approximately \$600 million.

Cash flows used in financing activities were \$6.5 billion in 2004 compared to \$1.7 billion in 2003. Financing activities provided cash flows of \$1.8 billion in 2002. The drivers of the \$4.8 billion increase in cash used in financing activities from 2003 to 2004 and the \$3.5 billion change from 2002 to 2003 are summarized in the table below:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Cash provided by (used in) financing activities:			
Net issuances and (repayments) of borrowings, including premiums and discounts .....	\$ 155	\$ (1,474)	\$ 1,182
Net issuances and (repurchases) of common stock .....	(4,575)	23	1,274
Repurchase of exchangeable preferred membership interests.....	(1,852)	—	—
Payment of common stock dividends .....	(150)	(160)	(652)
Other .....	(97)	(120)	(22)
Total.....	<u>\$ (6,519)</u>	<u>\$ (1,731)</u>	<u>\$ 1,782</u>

Net issuances and repayments of borrowings in 2004 included the repayment of \$576 million of debt of the telecommunications holding company (classified separately in the balance sheet).

Cash flows provided by investing activities totaled \$4.3 billion in 2004. Cash flows used in investing activities totaled \$1.4 billion and \$603 million in 2003 and 2002, respectively. The drivers of the \$5.7 billion

change in cash flows related to investing activities from 2003 to 2004 and the \$797 million increase in cash used in investing activities from 2002 to 2003 are summarized in the table below:

	Year Ended December 31,		
	2004	2003	2002
Cash provided by (used in) investing activities:			
Capital expenditures, including nuclear fuel .....	\$ (999)	\$ (765)	\$ (864)
Sale of TXU Australia.....	1,885	—	—
Merger by division of TXU Gas .....	1,905	—	—
Sale of TXU Fuel .....	500	—	—
Sale of telecommunications business .....	524	—	—
Sale of retail gas business .....	—	14	—
Acquisition of partners' interest in telecommunications joint venture .....	—	(150)	—
Sale of two generation plants.....	—	—	443
Proceeds from sale of other assets .....	27	10	4
Return of investment (investment) in trust to support a credit facility .....	525	(525)	—
Termination of out-of-the-money cash flow hedges .....	—	—	(147)
Capgemini working capital loan (see Note 1) .....	(25)	—	—
Other, including transaction costs.....	(62)	16	(39)
Total.....	<u>\$ 4,280</u>	<u>\$ (1,400)</u>	<u>\$ (603)</u>

The \$234 million increase in capital expenditures, including nuclear fuel, in 2004 was driven by a \$161 million increase at TXU Energy Holdings. This increase primarily reflected increased spending on generation projects, including costs to replace the four steam generators at the Comanche Peak nuclear plant and improve security. The balance of the growth reflected increased spending in the TXU Electric Delivery operations to improve system reliability and performance and support growth.

Capital expenditures are expected to total \$1.1 billion for 2005, substantially all of which is for maintenance and organic growth of existing operations, and is expected to be funded by cash flows from operations. Of this amount, approximately 63% is planned for the TXU Electric Delivery segment and 37% for the TXU Energy Holdings segment.

Depreciation and amortization expense reported in the statement of cash flows exceeds the amount reported in the statement of income by \$66 million for 2004. This difference represents amortization of nuclear fuel, which is reported as cost of energy sold in the statement of income consistent with industry practice.

**Capital Resources** — Over the next twelve months, TXU Corp. and its subsidiaries will need to fund ongoing working capital requirements and maturities of debt. TXU Corp. and its subsidiaries have funded or intend to fund these requirements through cash on hand, cash flows from operations, short-term credit facilities and the issuance of long-term debt or other securities.

**Long-term Debt Activity** — During the year ended December 31, 2004, TXU Corp. and its subsidiaries issued, reacquired, or made scheduled principal payments on long-term debt as follows (all amounts presented are principal):

	<u>Issuances</u>	<u>Retirements</u>
TXU Corp.:		
Convertible senior notes.....	\$ —	\$ 500
Equity-linked.....	—	1,105
Senior notes.....	3,500	295
Notes payable included in liabilities of telecommunications holding company.....	—	576
Long-term debt held by unconsolidated subsidiary trusts.....	—	392
Other long-term debt.....	—	12
TXU Energy Holdings:		
Pollution control revenue bonds.....	—	222
Senior notes.....	800	400
Other long-term debt.....	—	8
TXU Electric Delivery:		
Transition bonds.....	790	32
First mortgage bonds.....	—	613
TXU Gas:		
Senior notes.....	—	425
Long-term debt held by unconsolidated subsidiary trusts.....	—	154
US Holdings:		
Long-term debt.....	—	5
Total.....	<u>\$ 5,090</u>	<u>\$ 4,739</u>

See Notes 7, 8, 9 and 10 to Financial Statements for further detail of debt issuances and retirements, repurchase of exchangeable preferred membership interests, financing arrangements and debt held by unconsolidated subsidiary trusts.

**Regulatory Asset Securitization**— The Settlement Plan approved by the Commission provided TXU Electric Delivery with a financing order authorizing the issuance of securitization bonds in the aggregate principal amount of up to \$1.3 billion to recover regulatory asset stranded costs. TXU Electric Delivery's bankruptcy remote subsidiary issued \$790 million of the bonds in June of 2004 and \$500 million of the bonds in August of 2003. The proceeds were used to retire debt. Because the bond principal and interest payments are secured by the collection of transition charges by TXU Electric Delivery, the \$1.3 billion in debt is excluded from TXU Corp.'s and TXU Electric Delivery's capitalization by credit rating agencies. There is no further issuance authority under the financing order.

In March 2005, as part of its ongoing liability management initiative, TXU Corp. repurchased \$25 million principal amount of its outstanding Series L equity-linked debt securities for \$36 million. The \$11 premium primarily reflects the in-the-money value (to holders) of the associated equity purchase contracts, which was charged to additional paid-in-capital. See Note 8 to Financial Statements for a detailed discussion of equity-linked debt securities.

**Credit Facilities** — At March 7, 2005, TXU Corp. had access to credit facilities totaling \$3.0 billion of which \$2.2 billion was unused. These credit facilities are used for working capital and general corporate purposes and to support issuances of letters of credit. In January 2005, TXU Corp.'s \$425 million credit facility was terminated and \$419 of related outstanding letters of credit were effectively transferred to other facilities of TXU Energy Holdings. See Note 7 to Financial Statements for details of the arrangements.

**Registered Financing Arrangements** — Additional debt and equity securities may be issued and sold as needed, including: (i) issuances by TXU Corp. of up to approximately \$2.0 billion of equity securities, equity-linked debt securities, debt securities and/or preferred securities of subsidiary trusts and (ii) issuances by US Holdings of up to \$25 million of cumulative preferred stock and up to an aggregate of \$924 million of additional

cumulative preferred stock, debt securities and/or preferred securities of subsidiary trusts, all of which are currently registered with the SEC for offering pursuant to Rule 415 under the Securities Act.

**Share Repurchases** — See Note 11 to Financial Statements for detail of common stock repurchases during 2004.

**Dividends** - TXU Corp. or its predecessor TEI, has declared common stock dividends payable in cash in each year since TEI's incorporation in 1945. In October 2004, TXU Corp.'s Board of Directors adopted a revised dividend and cash distribution policy. The new policy set the annual dividend at \$2.25, with an expectation of 5% annual dividend growth. Consistent with the new policy, TXU Corp.'s Board of Directors, at its February 2005 meeting, declared a quarterly dividend of 56.25 cents a share, payable April 1, 2005 to shareholders of record on March 4, 2005. The dividend rate will be subject to the regular review of TXU Corp.'s Board of Directors and may be changed based upon a number of factors including earnings and cash flow levels and capital requirements as well as financial and other business conditions existing at the time. In addition, under Texas law, TXU Corp. may only declare dividends out of its surplus, which is statutorily defined as a company's net assets (i.e. total assets minus total debts) less its stated capital. The write-off of TXU Corp.'s investment in TXU Europe in 2002 resulted in negative surplus. In February 2003, TXU Corp. received shareholder approval as permitted under Texas law to reclassify approximately \$8 billion of its stated capital to its surplus. In addition, the policy provides that, in any year, the Board of Directors may authorize cash distributions to TXU Corp.'s shareholders in the form of share repurchases or special dividends, subject to a cap of 75% of TXU Corp.'s income from continuing operations excluding unusual charges or credits, and net of preference share dividends, in that year.

**Other Capital Transactions** — See Note 11 to Financial Statements for share activity related to certain savings and investment plans.

**Capitalization** — The capitalization ratios of TXU Corp. at December 31, 2004, consisted of 2.2% equity-linked debt securities, 92.6% other long-term debt, less amounts due currently, 2.3% preference stock, 0.3% preferred stock of subsidiaries and 2.6% common stock equity. Total debt to capitalization, including short-term debt, was 95% and 64% at December 31, 2004 and 2003, respectively.

**Short-term borrowings** — At December 31, 2004, TXU Corp. had outstanding short-term borrowings consisting of bank borrowings of \$210 million at a weighted average interest rate of 5.25%. At December 31, 2003, TXU Corp. had no outstanding short-term borrowings.

**Sale of Receivables** — TXU Corp. has established an accounts receivable securitization program. The activity under this program is accounted for as a sale of accounts receivable in accordance with SFAS 140. Under the program, subsidiaries of TXU Corp. (originators) sell trade accounts receivable to TXU Receivables Company, a consolidated wholly-owned bankruptcy remote direct subsidiary of TXU Corp., which sells undivided interests in the purchased accounts receivable for cash to special purpose entities established by financial institutions. All new trade receivables under the program generated by the originators are continuously purchased by TXU Receivables Company with the proceeds from collections of receivables previously purchased. Funding under the program at December 31, 2004 and 2003 totaled \$474 million and \$600 million, respectively. Funding under the program at December 31, 2003 included \$53 million related to TXU Gas, which is reflected in cash flows from discontinued operations. See Note 7 to Financial Statements for a more complete description of the program including the financial impact on earnings and cash flows for the periods presented and the contingencies that could result in termination of the program.

**Cash and Cash Equivalents** — Cash on hand totaled \$106 million and \$829 million at December 31, 2004 and 2003, respectively. The decline reflects net repayments of borrowings and the repurchase of common stock.

**Credit Ratings** — Current credit ratings for TXU Corp. and certain of its subsidiaries are presented below:

	TXU Corp.	US Holdings	TXU Electric Delivery	TXU Electric Delivery	TXU Energy Holdings
	(Senior Unsecured)	(Senior Unsecured)	(Secured)	(Senior Unsecured)	(Senior Unsecured)
S&P .....	BBB-	BBB-	BBB	BBB-	BBB
Moody's .....	Ba1	Baa3	Baa1	Baa2	Baa2
Fitch.....	BBB-	BBB-	A-/BBB+	BBB+	BBB

TXU Electric Delivery's first mortgage bonds are rated A- and its senior secured notes are rated BBB+ by Fitch. Moody's and Fitch currently maintain a stable outlook for TXU Corp., US Holdings, TXU Energy Holdings and TXU Electric Delivery. S&P currently maintains a negative outlook for each such entity.

These ratings are investment grade, except for Moody's rating of TXU Corp.'s senior unsecured debt, which is one notch below investment grade.

A rating reflects only the view of a rating agency, and is not a recommendation to buy, sell or hold securities. Any rating can be revised upward or downward at any time by a rating agency if such rating agency decides that circumstances warrant such a change.

**Financial Covenants, Credit Rating Provisions and Cross Default Provisions** — The terms of certain financing arrangements of subsidiaries of TXU Corp. contain financial covenants that require maintenance of specified fixed charge coverage ratios and leverage ratios and/or contain minimum net worth covenants. As of December 31, 2004, all such applicable covenants were complied with.

**Material Credit Rating Covenants**

TXU Energy Holdings has provided a guarantee of the obligations under TXU Corp.'s lease of its headquarters building (approximately \$120 million at December 31, 2004). In the event of a downgrade of TXU Energy Holdings' credit rating to below investment grade, a letter of credit would need to be provided within 30 days of any such rating decline.

TXU Energy Holdings has entered into certain commodity contracts and lease arrangements that in some instances give the other party the right, but not the obligation, to request TXU Energy Holdings to post collateral in the event that its credit rating falls below investment grade. Based on its current commodity contract positions, if TXU Energy Holdings were downgraded to below investment grade by specified rating agencies, counterparties would have the option to request TXU Energy Holdings to post additional collateral of up to approximately \$181 million at December 31, 2004. The amount TXU Energy Holdings could be required to post under these transactions depends in part on the value of the contracts at that time.

Under the terms of leases aggregating \$154 million in remaining lease payments, if TXU Energy Holdings' credit rating were downgraded to below investment grade by any specified rating agency, TXU Energy Holdings could be required to sell the assets, assign the leases to a new obligor that is investment grade, post a letter of credit or defease the leases.

ERCOT also has rules in place to assure adequate credit worthiness for parties that schedule power on the ERCOT System. Under those rules, if TXU Energy Holdings' credit rating were downgraded to below investment grade by any specified rating agency, TXU Energy Holdings could be required to post collateral of approximately \$46 million.

Other arrangements of TXU Corp., including credit facilities, contain terms pursuant to which the interest rates charged under the agreements may be adjusted depending on the credit ratings of TXU Corp. or its subsidiaries.

Material Cross Default Provisions

Certain financing arrangements contain provisions that would result in an event of default if there were a failure under other financing arrangements to meet payment terms or to observe other covenants that would result in an acceleration of payments due. Such provisions are referred to as “cross default” provisions.

A default by TXU Energy Holdings or TXU Electric Delivery or any subsidiary thereof in respect of indebtedness in a principal amount in excess of \$50 million would result in a cross default under the \$2.5 billion joint credit facilities expiring in June 2005, 2007 and 2009. Under these credit facilities, a default by TXU Energy Holdings or any subsidiary thereof would cause the maturity of outstanding balances under such facility to be accelerated as to TXU Energy Holdings but not as to TXU Electric Delivery. Also, under this credit facility, a default by TXU Electric Delivery or any subsidiary thereof would cause the maturity of outstanding balances under such facility to be accelerated as to TXU Electric Delivery but not as to TXU Energy Holdings.

A default by US Holdings or any subsidiary thereof on financing arrangements of \$50 million or more would result in a cross default under the TXU Mining (a subsidiary of TXU Energy Holdings) \$30 million senior notes agreement, which has a \$1 million cross default threshold.

TXU Energy Holdings has entered into certain mining and related equipment leasing arrangements aggregating \$68 million that would terminate upon the default of any other obligations of TXU Energy Holdings owed to the lessor.

The accounts receivable securitization program also contains a cross default provision with a threshold of \$50 million applicable to each of the originators under the program. TXU Receivables Company and TXU Business Services Company each have a cross default threshold of \$50 thousand. If either an originator, TXU Business Services or TXU Receivables Company defaults on indebtedness of the applicable threshold, the facility could terminate.

TXU Corp. and TXU Energy Holdings enter into energy-related and financial contracts, the master forms of which contain provisions whereby an event of default or acceleration of settlement would occur if TXU Energy Holdings were to default under an obligation in respect of borrowings in excess of thresholds, which vary, stated in the contracts. The accelerated share repurchase program may also be required to settle early in the event of a similar default.

Other arrangements, including leases, have cross default provisions, the triggering of which would not result in a significant effect on liquidity.

**Long-term Contractual Obligations and Commitments** — The following table summarizes TXU Corp.’s contractual cash obligations as of December 31, 2004 (see Notes 8 and 17 to Financial Statements for additional disclosures regarding these obligations).

<u>Contractual Cash Obligations</u>	<u>Less Than One Year</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>More Than Five Years</u>
Long-term debt – principal .....	\$ 229	\$ 1,667	\$ 1,866	\$ 8,885
Long-term debt – interest(a) .....	717	1,315	1,167	6,546
Operating and capital leases (b).....	80	170	160	429
Obligations under commodity purchase and services agreements (c) ...	<u>2,722</u>	<u>2,428</u>	<u>1,204</u>	<u>1,667</u>
Total contractual cash obligations .....	<u>\$ 3,748</u>	<u>\$ 5,580</u>	<u>\$ 4,397</u>	<u>\$ 17,527</u>

- (a) Includes net amounts payable under interest rate swaps. Variable interest payments and net amounts payable under interest rate swaps are calculated based on interest rates in effect at December 31, 2004.
- (b) Includes short-term noncancelable leases.
- (c) Includes capacity payments, gas take-or-pay contracts, coal contracts, business services outsourcing and other purchase commitments. Amounts presented for variable priced contracts assumed the year-end 2004 price remained in effect for all periods except where contractual price adjustment or index-based prices were specified.

The following contractual obligations were excluded from the table above:

- contracts between affiliated entities and intercompany debt;
- individual contracts that have an annual cash requirement of less than \$1 million (however, multiple contracts with one counterparty that are more than \$1 million on an aggregated basis have been included);
- contracts that are cancelable without payment of a substantial cancellation penalty;
- employment contracts with management; and
- projected funding for TXU Corp.'s pension plan and other postretirement benefit plans.

*Guarantees* — See Note 18 to Financial Statements for details of guarantees.

## **OFF BALANCE SHEET ARRANGEMENTS**

TXU Corp. has established an accounts receivable securitization program. See discussion above under “Sale of Receivables” and in Note 7 to Financial Statements.

TXU Corp. has an ownership interest in the Capgemini outsourcing business as described in Note 1 to Financial Statements.

Also see Note 11 to Financial Statements regarding the Accelerated Share Repurchase agreement and Note 18 to Financial Statements regarding guarantees.

## **COMMITMENTS AND CONTINGENCIES**

Consistent with industry practices, TXU Energy Holdings has decided to replace the four steam generators in one of the two generation units of the Comanche Peak nuclear plant in order to maintain the operating efficiency of the unit. An agreement for the manufacture and delivery of the equipment was completed in October 2003 and delivery is scheduled for late 2006. Estimated project capital requirements, including purchase and installation, are \$175 million to \$225 million, of which \$9 million was paid in 2004. Cash outflows of approximately \$80 million are expected to occur in 2005 and the remaining spending is expected to occur in 2006 and 2007.

See Note 18 to Financial Statements for additional discussion of commitments and contingencies.

## **REGULATION AND RATES**

*Price-to-Beat Rates* — Under the 1999 Restructuring Legislation, TXU Energy Holdings was required to charge a price-to-beat rate established by the Commission to residential customers in the historical service territory through December 31, 2004. As of January 1, 2005, TXU Energy Holdings can offer rates other than the price-to-beat to residential customers, but must make service at the price-to-beat price available until January 1, 2007. TXU Energy Holdings must continue to make price-to-beat rates available to small business customers; however, it may continue to offer rates other than price-to-beat, since it met the requirements of the 40% threshold target calculation in December 2003. The fuel factor component of the price-to-beat rate can be adjusted upward or downward twice a year, subject to approval by the Commission, for changes in the market price of natural gas.

TXU Energy Holdings implemented two price-to-beat increases in 2003. The first, requested in January and approved by the Commission and implemented in March, raised the average monthly residential bill of a customer using 1,000 kilowatt hours by 12%. The second increase, requested in July and approved and implemented in August, raised the average monthly residential bill by 4%.

TXU Energy Holdings also implemented two price-to-beat increases in 2004. The first, requested in March and approved and implemented in May, raised the average monthly residential bill of a customer by 3%. The second increase, requested in June and approved in July and implemented in August, raised the average monthly residential bill by 6%.

**Transmission Rates** — Provisions of the 1999 Restructuring Legislation allow TXU Electric Delivery to annually update its wholesale transmission rates to reflect changes in invested capital. These provisions encourage investment in the transmission system to help ensure reliability and efficiency by allowing for timely recovery of and return on new transmission investments. In April 2004, the Commission approved an increase in TXU Electric Delivery's wholesale transmission rate, resulting in an annualized revenue increase of \$14 million. Approximately \$8.5 million of this increase is recoverable through transmission rates charged to wholesale customers, and the remaining \$5.5 million is recoverable from REPs through the retail transmission cost recovery factor (TCRF) component of TXU Electric Delivery's distribution rates charged to REPs.

In order to recover increased affiliate and third-party transmission rates, TXU Electric Delivery is also allowed to request an update to the TCRF component of its distribution rates twice a year. In March 2004, the Commission approved an estimated annualized increase of \$9 million in the TCRF component of TXU Electric Delivery's distribution rates. In September 2004, TXU Electric Delivery implemented a second increase in the TCRF component of its distribution rates. The new rate will increase annual revenues by an estimated \$29.5 million. The effect of the wholesale transmission rate increase described in the preceding paragraph is included in the September 2004 TCRF update. Consolidated results are not benefited by higher distribution rates to the extent that such higher rates are absorbed by TXU Energy Holdings (as a REP).

**Other Commission Matters** — On May 27, 2004, the Commission opened an investigation to gather information regarding TXU Electric Delivery's and its affiliates' compliance with the Commission's affiliate code of conduct rules. Conversations with the Commission indicate that this investigation was prompted in large part by TXU Electric Delivery's change in its legal corporate name from Oncor Electric Delivery Company back to TXU Electric Delivery Company. Those discussions indicate a reasonable expectation that the Commission would focus its investigation on TXU Energy Holdings' implementation of a disclaimer rule that requires TXU Energy Holdings to place a disclaimer in certain advertisements and on business cards to explain the distinction between TXU Energy Holdings and TXU Electric Delivery. TXU Energy Holdings has received no formal or informal request for information in this investigation.

TXU Electric Delivery filed formal notice of its name change at the Commission on June 1, 2004, by filing for approval of reissued tariffs that display the new company name, but are in all other respects identical to the preexisting tariffs. On August 9, 2004, the Commission Policy Development Division approved the reissued tariffs and ordered TXU Electric Delivery to implement use of a disclaimer regarding the difference between TXU Electric Delivery and its competitive affiliates.

Certain cities within TXU Corp.'s historical service territory, acting in their role as a regulatory authority (with original jurisdiction), have initiated inquiries to determine if the rates of TXU Electric Delivery, which have been established by the Commission, are just and reasonable. Twenty-three cities have passed such resolutions (and eleven have passed resolutions supporting the other cities). TXU Electric Delivery has the right to appeal any city action to the Commission. In the fourth quarter of 2004, TXU Electric Delivery recorded a \$21 million charge, reported in other deductions, for estimated settlement payments arising from the resolution of these inquiries. The settlement agreement, which was finalized February 22, 2005, avoids any immediate rate actions, but requires TXU Electric Delivery to file a rate case in 2006, based on a 2005 test year, unless the cities and TXU Electric Delivery mutually agree that such a filing is unnecessary. The final settlement amount is undetermined; however, TXU Electric Delivery believes it will approximate the amount accrued.

TXU Energy Holdings, along with several ERCOT wholesale market participants, has filed an appeal at the Court of Appeals for the Third District of Texas (Austin) contesting certain aspects of a recently adopted Commission rule regarding enforcement standards applicable to the wholesale power market. TXU Energy Holdings believes that certain portions of the rule as adopted are unconstitutionally vague and other portions may exact an unconstitutional taking of private property without just compensation. The Court of Appeals heard oral arguments in the case on December 15, 2004. There is no statutory deadline by which the court must act on the appeal.

In August 2004, TXU Energy Holdings proposed a tiered pricing program for out-of-territory customers (i.e., those customers outside of the historical service territory) that would provide the lowest prices to customers that TXU Energy Holdings has determined will pose the lowest risk of poor payment behavior, and higher prices to customers who will pose a higher risk of poor payment behavior. TXU Energy Holdings' proposed tiered pricing program would have made use of credit information obtained from a credit reporting agency to make the payment risk determination. On September 8, 2004, the Texas Office of Public Utility Counsel (OPC) filed a complaint at the Commission alleging generally that the use of credit information is unlawfully discriminatory. Subsequently, on September 14, 2004, TXU Energy Holdings filed its response to the OPC complaint and in that response, in addition to asserting that the proposed pricing plan is lawful, notified the Commission that, pursuant to the Commission Staff's request, TXU Energy Holdings would suspend implementation of the proposed tiered pricing program for at least 45 days, so that TXU Energy Holdings could engage in discussions with Commission Staff, OPC, and others regarding other tools to address the pressing issue of bad debt write-offs. OPC requested, and the Commission granted, the dismissal of the complaint without prejudice to refiling. Discussions began shortly thereafter and are continuing. TXU Energy Holdings has not yet implemented the proposed tiered pricing program.

**ERCOT Market Issues** - The Texas Public Utility Regulatory Act (PURA) and the Commission are subject to "sunset review" by the Texas Legislature in the 2005 legislative session. Sunset review entails, generally, a comprehensive review of the need for and efficacy of an administrative agency (e.g., the Commission), along with an evaluation of the advisability of any changes to that agency's authorizing legislation (e.g., PURA). As part of the sunset review process, the legislative Sunset Advisory Commission has recommended that the Legislature reauthorize the Commission for at least six years, and has recommended other changes to PURA that are not expected to have a material impact upon TXU Corp.'s operations. The Legislature could consider and enact other changes to PURA, but TXU Corp. cannot predict whether any such changes might have a material impact on its operations.

In addition to sunset review, the Texas Legislature and other Texas governmental entities have initiated investigations into alleged improprieties regarding some contracting practices of ERCOT, the nongovernmental entity that has operational control of the electric grid for much of Texas. To date, these activities have not resulted in actions that are expected to have a material impact on TXU Corp.'s operations, but TXU Corp. cannot predict whether the culmination of these or other governmental activities that may affect the ERCOT market may result in any such material adverse effect.

**Wholesale market design** – In August 2003, the Commission adopted a rule that, if fully implemented, would alter the wholesale market design in ERCOT. The rule requires ERCOT:

- to use a stakeholder process to develop a new wholesale market model;
- to operate a voluntary day-ahead energy market;
- to directly assign all congestion rents to the resources that caused the congestion;
- to use nodal energy prices for resources;
- to provide information for energy trading hubs by aggregating nodes;
- to use zonal prices for loads; and
- to provide congestion revenue rights (but not physical rights).

Under the rule, the proposed market design and associated cost-benefit analysis was to be filed with the Commission by November 1, 2004 and is to be implemented by October 1, 2006. On October 28, 2004 the Commission adopted a rule change that would delay the filing date for the proposed market design from November 1, 2004 to March 18, 2005. Additionally, the Commission approved an extension until December 31, 2004 for the filing of the cost-benefit analysis. The third-party consultant produced its cost-benefit analysis at the end of November 2004 and it was filed by ERCOT with the Commission in December. TXU Energy Holdings is currently unable to predict the cost or impact of implementing any proposed change to the current wholesale market design.

On December 8, 2004 the Commission Staff opened a project (PUC Project No. 30513) to facilitate an ongoing informal fact-finding review of the electric wholesale market activities of TXU Energy Holdings and its affiliates. Commission Staff indicated that it "created this project because of substantial concerns publicly

expressed by the Commission and market participants about TXU's recent activities." TXU Corp.'s discussions with Commission staff and the requests for information indicate that the informal review is focused on TXU Corp.'s offers to sell balancing energy services in ERCOT. Balancing energy constitutes only about five to ten percent of the energy sold at wholesale in ERCOT. TXU Corp. has been fully cooperating with the Commission Staff in its investigation and has fully responded to Commission Staff's requests for information. As indicated in those responses, TXU Corp. believes that its activities in the electric wholesale market are both reasonable and lawful.

**Summary** — Although TXU Corp. cannot predict future regulatory or legislative actions or any changes in economic and securities market conditions, no changes are expected in trends or commitments, other than those discussed in this report, which might significantly alter its basic financial position, results of operations or cash flows.

## **QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Market risk is the risk that TXU Corp. may experience a loss in value as a result of changes in market conditions affecting commodity prices and interest rates, which TXU Corp. is exposed to in the ordinary course of business. TXU Corp.'s exposure to market risk is affected by a number of factors, including the size, duration and composition of its energy and financial portfolio, as well as volatility and liquidity of markets. TXU Corp. enters into financial instruments such as interest rate swaps to manage interest rate risks related to its indebtedness, as well as exchange traded, over-the-counter contracts and other contractual commitments to manage commodity price risk as part of its wholesale markets management activities.

### ***RISK OVERSIGHT***

TXU Corp.'s wholesale markets management operation manages the market, credit and operational risk related to commodity prices of the unregulated energy business within limitations established by senior management and in accordance with TXU Corp.'s overall risk management policies. Interest rate risks are managed centrally by the corporate treasury function. Market risks are monitored daily by risk management groups that operate and report independently of the wholesale markets management operations, utilizing industry accepted practices and analytical methodologies. These techniques measure the risk of change in value of the portfolio of contracts and the hypothetical effect on this value from changes in market conditions and include, but are not limited to, Value at Risk (VaR) methodologies.

TXU Corp. has a corporate risk management organization that is headed by a Chief Risk Officer. The Chief Risk Officer, through his designees, enforces all applicable risk limits, including the respective policies and procedures to ensure compliance with such limits and evaluates the risks inherent in the various businesses of TXU Corp. and their associated transactions. Key risk control activities include, but are not limited to, credit review and approval, operational and market risk measurement, validation of transaction capture, portfolio valuation and daily portfolio reporting, including mark-to-market valuation, VaR and other risk measurement metrics.

### ***COMMODITY PRICE RISK***

TXU Corp. is subject to the inherent risks of market fluctuations in the price of electricity, natural gas and other energy-related products marketed and purchased. TXU Corp. actively manages its portfolio of owned generation assets, fuel supply and retail sales load to mitigate the near-term impacts of these risks on its results of operations. TXU Corp., as well as any participant in the market, cannot fully manage the long-term value impact of structural declines or increases in natural gas, power and oil prices and spark spreads (differences between the market price of electricity and its cost of production).

Also see discussion of *Natural Gas Price & Market Heat-Rate Exposure* under "Key Challenges and Initiatives" above.

In managing energy price risk, TXU Corp. enters into short- and long-term physical contracts, exchange traded and over-the-counter financial contracts as well as bilateral contracts with customers. TXU Corp.'s risk management activities also incorporate some speculative trading activity. The operation continuously monitors the valuation of identified risks and adjusts the portfolio based on current market conditions. Valuation adjustments or reserves are established in recognition that certain risks exist until full delivery of energy has occurred, counterparties have fulfilled their financial commitments and related financial instruments have either matured or are closed out.

TXU Corp. strives to use consistent assumptions regarding forward market price curves in evaluating and recording the effects of commodity price risk.

TXU Corp. continuously reviews its disclosed risk analysis metrics. In the course of this review, it was determined that the Portfolio VaR metric would no longer be disclosed as it is not a meaningful measure of actionable commodity price risk. Portfolio VaR represented the estimated potential loss in value, due to changes in market conditions, of the entire energy portfolio, including owned generation assets, estimates of retail sales load and all contractual positions. Other metrics that measure the effect of such risk on earnings, cash flows and the value of its mark-to-market contract portfolio continue to be disclosed. TXU Corp. may in the future add or eliminate other metrics in its disclosures of risks.

**VaR Methodology** — A VaR methodology is used to measure the amount of market risk that exists within the portfolio under a variety of market conditions. The resultant VaR produces an estimate of a portfolio's potential for loss given a specified confidence level and considers among other things, market movements utilizing standard statistical techniques given historical and projected market prices and volatilities. Stress testing of market variables is also conducted to simulate and address abnormal market conditions.

The use of this method requires a number of key assumptions, such as use of (i) an assumed confidence level; (ii) an assumed holding period (i.e. the time necessary for management action, such as to liquidate positions); and (iii) historical estimates of volatility and correlation data.

**VaR for Energy Contracts Subject to Mark-to-Market Accounting** — This measurement estimates the potential loss in value, due to changes in market conditions, of all energy-related contracts subject to mark-to-market accounting, based on a specific confidence level and an assumed holding period. Assumptions in determining this VaR include using a 95% confidence level and a five-day holding period. A probabilistic simulation methodology is used to calculate VaR, and is considered by management to be the most effective way to estimate changes in a portfolio's value based on assumed market conditions for liquid markets.

	<u>December 31, 2004</u>	<u>December 31, 2003</u>
Period-end MtM VaR: .....	\$ 20	\$ 15
Average Month-end MtM VaR: .....	\$ 20	\$ 25

**Earnings at Risk (EaR)** — EaR measures the estimated potential loss of expected pretax earnings for the year presented due to changes in market conditions. EaR metrics include the owned generation assets, estimates of retail load and all contractual positions except for accrual positions expected to be settled beyond the fiscal year. Assumptions include using a 95% confidence level over a five-day holding period under normal market conditions.

**Cash Flow at Risk (CFaR)** — CFaR measures the estimated potential loss of expected cash flow over the next six months, due to changes in market conditions. CFaR metrics include all owned generation assets, estimates of retail load and all contractual positions that impact cash flow during the next six months. Assumptions include using a 99% confidence level over a six-month holding period under normal market conditions.

	December 31, 2004	December 31, 2003
<b>EaR</b> .....	\$ 24	\$ 15
<b>CFaR</b> .....	\$ 116	\$ 67

### INTEREST RATE RISK

The table below provides information concerning TXU Corp.'s financial instruments as of December 31, 2004 and 2003, that are sensitive to changes in interest rates, which include debt obligations and interest rate swaps. TXU Corp. has entered into interest rate swaps under which it has agreed to exchange the difference between fixed-rate and variable-rate interest amounts calculated with reference to specified notional principal amounts at dates that generally coincide with interest payments. The weighted average rate is based on the rate in effect at the reporting date. Capital leases and the effects of unamortized premiums and discounts and fair value hedges are excluded from the table. See Notes 8 and 10 to Financial Statements for a discussion of changes in debt obligations.

	Expected Maturity Date					There- After	2004 Total	2004 Fair Value	2003 Total	2003 Fair Value
	2005	2006	2007	2008	2009					
Equity-linked debt:										
Fixed rate	—	—	\$ 101	\$ 184	—	—	\$ 285	\$ 339	\$ 1,440	\$ 990
Average interest rate	—	—	5.45%	5.80%	—	—	5.68%	—	5.31%	—
Long-term debt held by subsidiary trusts:										
Fixed rate	—	—	—	—	—	—	—	—	\$ 391	\$ 399
Average interest rate	—	—	—	—	—	—	—	—	7.82%	—
Variable rate	—	—	—	—	—	—	—	—	\$ 155	\$ 155
Average interest rate	—	—	—	—	—	—	—	—	2.51%	—
All other long-term debt:										
Fixed rate (a)	\$ 229	\$ 842	\$ 324	\$ 565	\$ 1,117	\$ 8,483	\$ 11,560	\$ 12,227	\$ 8,901	\$ 9,626
Average interest rate	5.43%	5.94%	4.20%	5.87%	4.68%	6.24%	5.98%	—	6.41%	—
Variable rate	—	\$ 400	—	—	—	\$ 402	\$ 802	\$ 764	\$ 922	\$ 955
Average interest rate	—	2.84%	—	—	—	1.90%	2.37%	—	2.04%	—
Exchangeable preferred membership interest:										
Fixed rate	—	—	—	—	—	—	—	—	\$ 750	\$ 1,580
Average interest rate	—	—	—	—	—	—	—	—	9.00%	—
Fixed to variable swaps:										
Average pay rate	—	7.11%	4.33%	5.74%	3.57%	4.12%	5.18%	—	3.31%	—
Average receive rate	—	6.38%	5.00%	6.24%	4.80%	6.42%	6.07%	—	7.00%	—

(a) Reflects the maturity date and not the remarketing date for certain debt which is subject to mandatory tender for remarketing prior to maturity. See Note 8 to Financial Statements for details concerning long-term debt subject to mandatory tender for remarketing.

## **CREDIT RISK**

**Credit Risk** — Credit risk relates to the risk of loss associated with non-performance by counterparties. TXU Corp. maintains credit risk policies with regard to its counterparties to minimize overall credit risk. These policies require an evaluation of a potential counterparty's financial condition, credit rating, and other quantitative and qualitative credit criteria and specify authorized risk mitigation tools, including but not limited to use of standardized agreements that allow for netting of positive and negative exposures associated with a single counterparty. TXU Corp. has standardized documented processes for monitoring and managing its credit exposure, including methodologies to analyze counterparties' financial strength, measurement of current and potential future credit exposures and standardized contract language that provides rights for netting and set-off. Credit enhancements such as parental guarantees, letters of credit, surety bonds and margin deposits are also utilized. Additionally, individual counterparties and credit portfolios are managed to preset limits and stress tested to assess potential credit exposure. This evaluation results in establishing credit limits or collateral requirements prior to entering into an agreement with a counterparty that creates credit exposure to TXU Corp. Additionally, TXU Corp. has established controls to determine and monitor the appropriateness of these limits on an ongoing basis. Any prospective material adverse change in the payment history or financial condition of a counterparty or downgrade of its credit quality will result in the reassessment of the credit limit with that counterparty. This process can result in the subsequent reduction of the credit limit or a request for additional financial assurances.

**Credit Exposure** — TXU Corp.'s gross exposure to credit risk related to trade accounts receivable as well as commodity contract assets and other derivative assets that arise primarily from hedging activities totaled \$2.141 billion at December 31, 2004.

A large share of gross assets subject to credit risk represents accounts receivable from the retail sale of electricity to residential and small business customers. The risk of material loss (after consideration of allowances) from nonperformance by these customers is unlikely based upon historical experience. Allowances for uncollectible accounts receivable are established for the potential loss from nonpayment by these customers based on historical experience and market or operational conditions. In addition, TXU Electric Delivery has exposure to credit risk as a result of nonperformance by nonaffiliated REPs.

Most of the remaining trade accounts receivable are with large business customers and hedging counterparties. These counterparties include major energy companies, financial institutions, electric utilities, independent power producers, oil and gas producers and energy trading companies. The exposure to credit risk from these customers and counterparties, excluding credit collateral, as of December 31, 2004, is \$983 million net of standardized master netting contracts and agreements that provide the right of offset of positive and negative credit exposures with individual customers and counterparties. When considering collateral currently held by TXU Corp. (cash, letters of credit and other security interests), the net credit exposure is \$784 million. Of this amount, approximately 80% of the associated exposure is with investment grade customers and counterparties, as determined using publicly available information including major rating agencies' published ratings and TXU Corp.'s internal credit evaluation process. Those customers and counterparties without an S&P rating of at least BBB- or similar rating from another major rating agency are rated using internal credit methodologies and credit scoring models to estimate an S&P equivalent rating. TXU Corp. routinely monitors and manages its credit exposure to these customers and counterparties on this basis.

TXU Corp. is also exposed to credit risk related to the Capgemini put option with a carrying value of \$177 million as discussed in Note 1 to Financial Statements.

The following table presents the distribution of credit exposure as of December 31, 2004, for trade accounts receivable from large business customers, commodity contract assets and other derivative assets that arise primarily from hedging activities, by investment grade and noninvestment grade, credit quality and maturity.

	<u>Exposure by Maturity</u>						<u>Total</u>
	<u>Exposure before Credit Collateral</u>	<u>Credit Collateral</u>	<u>Net Exposure</u>	<u>2 years or less</u>	<u>Between 2-5 years</u>	<u>Greater than 5 years</u>	
Investment grade	\$ 780	\$ 149	\$ 631	\$ 465	\$ 89	\$ 77	\$ 631
Noninvestment grade	<u>203</u>	<u>50</u>	<u>153</u>	<u>112</u>	<u>22</u>	<u>19</u>	<u>153</u>
Totals	<u>\$ 983</u>	<u>\$ 199</u>	<u>\$ 784</u>	<u>\$ 577</u>	<u>\$ 111</u>	<u>\$ 96</u>	<u>\$ 784</u>
Investment grade	79%	75%	80%				
Noninvestment grade	21%	25%	20%				

TXU Corp. had no exposure to any customer or counterparty greater than 10% of the net exposure of \$784 million at December 31, 2004. Additionally, approximately 74% of the credit exposure, net of collateral held, has a maturity date of two years or less. TXU Corp. does not anticipate any material adverse effect on its financial position or results of operations as a result of nonperformance by any customer or counterparty.

#### **RISK FACTORS THAT MAY AFFECT FUTURE RESULTS**

Some important factors, in addition to others specifically addressed in this Management's Discussion and Analysis of Financial Condition and Results of Operations, that could have a material impact on TXU Corp.'s operations, financial results and financial condition, and could cause TXU Corp.'s actual results or outcomes to differ materially from any projected outcome contained in any forward-looking statement in this report, include:

The implementation of performance improvement initiatives identified by management may not produce the desired results and may result in disruptions arising from employee displacements and the rapid pace of changes to organizational structure and operating practices and processes. Most notably, TXU Corp. is subject to the risk that the joint venture outsourcing arrangement with Capgemini may not produce the desired cost savings as well as potential transition costs, which would likely be significant, in the event TXU Corp. needed to switch to another vendor if Capgemini failed to perform its obligations to TXU Corp.

ERCOT is the independent system operator that is responsible for maintaining reliable operation of the bulk electric power supply system in the ERCOT region. Its responsibilities include the clearing and settlement of electricity volumes and related ancillary services among the various participants in the deregulated Texas market. Because of new processes and systems associated with the opening of the market to competition, which continue to be improved, there have been delays in finalizing these settlements. As a result, TXU Corp. is subject to settlement adjustments from ERCOT related to prior periods, which may result in charges or credits impacting future reported results of operations.

TXU Corp.'s businesses operate in changing market environments influenced by various legislative and regulatory initiatives regarding deregulation, regulation or restructuring of the energy industry, including deregulation of the production and sale of electricity. TXU Corp. will need to adapt to these changes and may face increasing competitive pressure.

TXU Corp.'s businesses are subject to changes in laws (including PURA, the Federal Power Act, as amended, the Atomic Energy Act, as amended, the Public Utility Regulatory Policies Act of 1978, as amended, the Clean Air Act, as amended, and the Public Utility Holding Company Act of 1935, as amended) and changing governmental policy and regulatory actions (including those of the Commission, the FERC, the EPA and the NRC) with respect to matters including, but not limited to, market structure and design, operation of nuclear

power facilities, construction and operation of other power generation facilities, construction and operation of transmission facilities, acquisition, disposal, depreciation, and amortization of regulated assets and facilities, recovery of purchased gas costs, decommissioning costs, and return on invested capital for TXU Corp.'s regulated businesses, and present or prospective wholesale and retail competition. In particular, PURA and the Commission will be subject to sunset review by the Texas Legislature during this 2005 legislative session. See "ERCOT Market Issues" and "Wholesale Market Design" above.

TXU Energy Holdings, along with other market participants, is subject to oversight by the Commission. In that connection, TXU Energy Holdings and other market participants may be subject to various competition-related rules and regulations, including but not limited to possible price-mitigation rules, as well as rules related to market behavior.

TXU Corp. is not guaranteed any rate of return on its capital investments in unregulated businesses. TXU Corp. markets and trades power, including power from its own production facilities, as part of its wholesale markets management operation. TXU Corp.'s results of operations are likely to depend, in large part, upon prevailing retail rates, which are set, in part, by regulatory authorities, and market prices for electricity, gas and coal in its regional market and other competitive markets. Market prices may fluctuate substantially over relatively short periods of time. Demand for electricity can fluctuate dramatically, creating periods of substantial under- or over-supply. During periods of over-supply, prices might be depressed. Also, at times there may be political pressure, or pressure from regulatory authorities with jurisdiction over wholesale and retail energy commodity and transportation rates, to impose price limitations, bidding rules and other mechanisms to address volatility and other issues in these markets.

TXU Corp.'s regulated businesses are subject to cost-of-service regulation and annual earnings oversight. This regulatory treatment does not provide any assurance as to achievement of earnings levels. TXU Electric Delivery's rates are regulated by the Commission based on an analysis of TXU Electric Delivery's costs, as reviewed and approved in a regulatory proceeding. While rate regulation is premised on the full recovery of prudently incurred costs and a reasonable rate of return on invested capital, there can be no assurance that the Commission will judge all of TXU Electric Delivery's costs to have been prudently incurred or that the regulatory process in which rates are determined will always result in rates that will produce full recovery of TXU Electric Delivery's costs and the return on invested capital allowed by the Commission.

Some of the fuel for TXU Corp.'s power production facilities is purchased under short-term contracts or on the spot market. Prices of fuel, including natural gas, may also be volatile, and the price TXU Corp. can obtain for power sales may not change at the same rate as changes in fuel costs. In addition, TXU Corp. purchases and sells natural gas and other energy related commodities, and volatility in these markets may affect TXU Corp.'s costs incurred in meeting its obligations.

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

- severe or unexpected weather conditions,
- seasonality,
- changes in electricity usage,
- illiquidity in the wholesale power or other markets,
- transmission or transportation constraints, inoperability or inefficiencies,
- availability of competitively priced alternative energy sources,
- changes in supply and demand for energy commodities,
- changes in power production capacity,
- outages at TXU Corp.'s power production facilities or those of its competitors,
- changes in production and storage levels of natural gas, lignite, coal and crude oil and refined products,
- natural disasters, wars, sabotage, terrorist acts, embargoes and other catastrophic events, and
- federal, state, local and foreign energy, environmental and other regulation and legislation.

All but one of TXU Corp.'s facilities for power production are located in the ERCOT region, a market with limited interconnections to other markets. Electricity prices in the ERCOT region are correlated to gas prices

because gas-fired plant is the marginal cost unit during the majority of the year in the ERCOT region. Accordingly, the contribution to earnings and the value of TXU Corp.'s baseload power production is dependent in significant part upon the price of gas. TXU Corp. cannot fully hedge the risk associated with dependency on gas because of the expected useful life of TXU Corp.'s power production assets and the size of its position relative to market liquidity.

To manage its near-term financial exposure related to commodity price fluctuations, TXU Corp. routinely enters into contracts to hedge portions of its purchase and sale commitments, weather positions, fuel requirements and inventories of natural gas, lignite, coal, refined products, and other commodities, within established risk management guidelines. As part of this strategy, TXU Corp. routinely utilizes fixed-price forward physical purchase and sales contracts, futures, financial swaps and option contracts traded in the over-the-counter markets or on exchanges. However, TXU Corp. can normally cover only a small portion of the exposure of its assets and positions to market price volatility, and the coverage will vary over time. To the extent TXU Corp. has unhedged positions, fluctuating commodity prices can materially impact TXU Corp.'s results of operations and financial position, either favorably or unfavorably.

Although TXU Corp. devotes a considerable amount of management time and effort to the establishment of risk management procedures as well as the ongoing review of the implementation of these procedures, the procedures it has in place may not always be followed or may not always function as planned and cannot eliminate all the risks associated with these activities. As a result of these and other factors, TXU Corp. cannot predict with precision the impact that risk management decisions may have on its business, results of operations or financial position.

TXU Corp. or one of its subsidiaries has guaranteed or indemnified the performance of a portion of the obligations of certain subsidiaries, including those involved in hedging and risk management activities. TXU Corp. or its subsidiary, as the case may be, might not be able to satisfy all of these guarantees and indemnification obligations if they were to come due at the same time.

TXU Corp.'s hedging and risk management activities are exposed to the risk that counterparties that owe TXU Corp. money, energy or other commodities as a result of market transactions will not perform their obligations. The likelihood that certain counterparties may fail to perform their obligations has increased due to financial difficulties, brought on by various factors including improper or illegal accounting and business practices, affecting some participants in the industry. Some of these financial difficulties have been so severe that certain industry participants have filed for bankruptcy protection or are facing the possibility of doing so. Should the counterparties to these arrangements fail to perform, TXU Corp. might be forced to acquire alternative hedging arrangements or honor the underlying commitment at then-current market prices. In such event, TXU Corp. might incur losses in addition to amounts, if any, already paid to the counterparties. ERCOT market participants are also exposed to risks that another ERCOT market participant may default in its obligations to pay ERCOT for power taken in the ancillary services market, in which case such costs, to the extent not offset by posted security and other protections available to ERCOT, may be allocated to various nondefaulting ERCOT market participants.

The current credit ratings for TXU Corp.'s and its subsidiaries' long-term debt are investment grade, except for Moody's credit rating for long-term debt of TXU Corp. (the holding company), which is one notch below investment grade. A rating reflects only the view of a rating agency, and it is not a recommendation to buy, sell or hold securities. Any rating can be revised upward or downward at any time by a rating agency if such rating agency decides that circumstances warrant such a change. If S&P, Moody's or Fitch were to downgrade TXU Corp.'s and/or its subsidiaries' long-term ratings, particularly below investment grade, borrowing costs would increase and the potential pool of investors and funding sources would likely decrease. If the downgrade were below investment grade, liquidity demands would be triggered by the terms of a number of commodity contracts, leases and other agreements.

Most of TXU Corp.'s large customers, suppliers and counterparties require sufficient creditworthiness in order to enter into transactions. If TXU Corp. subsidiaries' ratings were to decline to below investment grade, costs to operate the power business would increase because counterparties may require the posting of collateral

in the form of cash-related instruments, or counterparties may decline to do business with TXU Corp.'s subsidiaries.

In addition, as discussed in this Annual Report on Form 10-K, the terms of certain of TXU Corp.'s financing and other arrangements contain provisions that are specifically affected by changes in credit ratings and could require the posting of collateral, the repayment of indebtedness or the payment of other amounts.

The operation of power production and energy transportation facilities involves many risks, including start up risks, breakdown or failure of facilities, lack of sufficient capital to maintain the facilities, the dependence on a specific fuel source or the impact of unusual or adverse weather conditions or other natural events, as well as the risk of performance below expected levels of output or efficiency, the occurrence of any of which could result in lost revenues and/or increased expenses. A significant portion of TXU Corp.'s facilities was constructed many years ago. In particular, older generating equipment, even if maintained in accordance with good engineering practices, may require significant capital expenditures to keep it operating at peak efficiency. The risk of increased maintenance and capital expenditures arises from (a) increased starting and stopping of generation equipment due to the volatility of the competitive market, (b) any unexpected failure to produce power, including failure caused by breakdown or forced outage, and (c) repairing damage to facilities due to storms, natural disasters, wars, terrorist acts and other catastrophic events. Further, TXU Corp.'s ability to successfully and timely complete capital improvements to existing facilities or other capital projects is contingent upon many variables and subject to substantial risks. Should any such efforts be unsuccessful, TXU Corp. could be subject to additional costs and/or the write-off of its investment in the project or improvement.

Insurance, warranties or performance guarantees may not cover all or any of the lost revenues or increased expenses, including the cost of replacement power. Likewise, TXU Corp.'s ability to obtain insurance, and the cost of and coverage provided by such insurance, could be affected by events outside its control.

The ownership and operation of nuclear facilities, including TXU Corp.'s ownership and operation of the Comanche Peak generation plant, involve certain risks. These risks include: mechanical or structural problems; inadequacy or lapses in maintenance protocols; the impairment of reactor operation and safety systems due to human error; the costs of storage, handling and disposal of nuclear materials; limitations on the amounts and types of insurance coverage commercially available; and uncertainties with respect to the technological and financial aspects of decommissioning nuclear facilities at the end of their useful lives. The following are among the more significant of these risks:

- *Operational Risk* – Operations at any nuclear power production plant could degrade to the point where the plant would have to be shut down. Over the next three years, certain equipment at Comanche Peak is expected to be replaced. The cost of these actions is currently expected to be material and could result in extended outages. If this were to happen, the process of identifying and correcting the causes of the operational downgrade to return the plant to operation could require significant time and expense, resulting in both lost revenue and increased fuel and purchased power expense to meet supply commitments. Rather than incurring substantial costs to restart the plant, the plant may be shut down. Furthermore, a shut-down or failure at any other nuclear plant could cause regulators to require a shut-down or reduced availability at Comanche Peak.
- *Regulatory Risk* – The NRC may modify, suspend or revoke licenses and impose civil penalties for failure to comply with the Atomic Energy Act, the regulations under it or the terms of the licenses of nuclear facilities. Unless extended, the NRC operating licenses for Comanche Peak Unit 1 and Unit 2 will expire in 2030 and 2033, respectively. Changes in regulations by the NRC could require a substantial increase in capital expenditures or result in increased operating or decommissioning costs.
- *Nuclear Accident Risk* – Although the safety record of Comanche Peak and other nuclear reactors generally has been very good, accidents and other unforeseen problems have occurred both in the US and elsewhere. The consequences of an accident can be severe and include loss of life and property damage. Any resulting liability from a nuclear accident could exceed TXU Corp.'s resources, including insurance coverage.

TXU Corp. is subject to extensive environmental regulation by governmental authorities. In operating its facilities, TXU Corp. is required to comply with numerous environmental laws and regulations, and to obtain numerous governmental permits. TXU Corp. may incur significant additional costs to comply with these requirements. If TXU Corp. fails to comply with these requirements, it could be subject to civil or criminal liability and fines. Existing environmental regulations could be revised or reinterpreted, new laws and regulations could be adopted or become applicable to TXU Corp. or its facilities, and future changes in environmental laws and regulations could occur, including potential regulatory and enforcement developments related to air emissions.

TXU Corp. may not be able to obtain or maintain all required environmental regulatory approvals. If there is a delay in obtaining any required environmental regulatory approvals or if TXU Corp. fails to obtain, maintain or comply with any such approval, the operation of its facilities could be stopped or become subject to additional costs. Further, at some of TXU Corp.'s older facilities, including baseload lignite and coal plants, it may be uneconomical for TXU Corp. to install the necessary equipment, which may cause TXU Corp. to shut down those facilities.

In addition, TXU Corp. may be responsible for any on-site liabilities associated with the environmental condition of facilities that it has acquired or developed, regardless of when the liabilities arose and whether they are known or unknown. In connection with certain acquisitions and sales of assets, TXU Corp. may obtain, or be required to provide, indemnification against certain environmental liabilities. Another party could fail to meet its indemnification obligations to TXU Corp.

The Texas electricity market was deregulated as of January 1, 2002. Competition has resulted, and may continue to result in, declines in customer counts and sales volumes.

While TXU Corp. may now offer prices other than the price-to-beat, it is obligated to offer the price to beat to its residential and small business customers in the historical service territory through January 1, 2007. The results of TXU Corp.'s retail electric operations in its historical service territory are largely dependent upon the amount of headroom available to TXU Corp. in its price-to-beat rate. The margin or "headroom" available in the price-to-beat rate for any REP equals the difference between the price-to-beat rate and the sum of delivery charges and the price that REP pays for power. Headroom may be a positive or a negative number. Since headroom is dependent, in part, on power production and purchase costs, TXU Corp. does not know nor can it estimate the amount of headroom that it will have in its price-to-beat rate. There is no assurance that future adjustments to TXU Corp.'s price-to-beat rate will be adequate to cover future increases in its costs of electricity to serve its price-to-beat rate customers or that TXU Corp.'s price-to-beat rate will not result in negative headroom in the future.

In most retail electric markets outside the historical service territory, TXU Corp.'s principal competitor may be the retail affiliate of the local incumbent utility company. The incumbent retail affiliates have the advantage of long-standing relationships with their customers. In addition to competition from the incumbent utilities and their affiliates, TXU Corp. may face competition from a number of other energy service providers, or other energy industry participants, who may develop businesses that will compete with TXU Corp. and nationally branded providers of consumer products and services. Some of these competitors or potential competitors may be larger and better capitalized than TXU Corp. If there is inadequate margin in these retail electric markets, it may not be profitable for TXU Corp. to enter these markets.

TXU Corp. depends on transmission and distribution facilities owned and operated by other utilities, as well as its own such facilities, to deliver the electricity it produces and sells to consumers, as well as to other REPs. If transmission capacity is inadequate, TXU Corp.'s ability to sell and deliver electricity may be hindered, it may have to forgo sales or it may have to buy more expensive wholesale electricity that is available in the capacity-constrained area. In particular, during some periods transmission access is constrained to some areas of the Dallas-Fort Worth metroplex. TXU Corp. expects to have a significant number of customers inside these constrained areas. The cost to provide service to these customers may exceed the cost to provide service to other customers, resulting in lower headroom. In addition, any infrastructure failure that interrupts or impairs

delivery of electricity to TXU Corp.'s customers could negatively impact the satisfaction of its customers with its service.

TXU Corp. offers its customers a bundle of services that include, at a minimum, the electric commodity itself plus transmission, distribution and related services. The prices TXU Corp. charges for this bundle of services or for the various components of the bundle, either of which may be fixed by contract with the customer for a period of time, could fall below TXU Corp.'s underlying cost to obtain the commodities or services.

Research and development activities are ongoing to improve existing and alternative technologies to produce electricity, including gas turbines, fuel cells, microturbines and photovoltaic (solar) cells. It is possible that advances in these or other alternative technologies will reduce the costs of electricity production from these technologies to a level that will enable these technologies to compete effectively with electricity production from traditional power plants like TXU Corp.'s. While demand for electric energy services is generally increasing throughout the US, the rate of construction and development of new, more efficient power production facilities may exceed increases in demand in some regional electric markets. Consequently, where TXU Corp. has facilities, the market value of TXU Corp.'s power production and/or energy transportation facilities could be significantly reduced. Also, electricity demand could be reduced by increased conservation efforts and advances in technology, which could likewise significantly reduce the value of TXU Corp.'s facilities. Changes in technology could also alter the channels through which retail electric customers buy electricity.

TXU Corp. is a holding company and conducts its operations primarily through wholly-owned subsidiaries. Substantially all of TXU Corp.'s consolidated assets are held by these subsidiaries. Accordingly, TXU Corp.'s cash flows and ability to meet its obligations and to pay dividends are largely dependent upon the earnings of its subsidiaries and the distribution or other payment of such earnings to TXU Corp. in the form of distributions, loans or advances, and repayment of loans or advances from TXU Corp. The subsidiaries are separate and distinct legal entities and have no obligation to provide TXU Corp. with funds for its payment obligations, whether by dividends, distributions, loans or otherwise.

Because TXU Corp. is a holding company, its obligations to its creditors are structurally subordinated to all existing and future liabilities and existing and future preferred stock of its subsidiaries. Therefore, TXU Corp.'s rights and the rights of its creditors to participate in the assets of any subsidiary in the event that such a subsidiary is liquidated or reorganized are subject to the prior claims of such subsidiary's creditors and holders of its preferred stock. To the extent that TXU Corp. may be a creditor with recognized claims against any such subsidiary, its claims would still be subject to the prior claims of such subsidiary's creditors to the extent that they are secured or senior to those held by TXU Corp. Subject to restrictions contained in TXU Corp.'s other financing arrangements, TXU Corp.'s subsidiaries may incur additional indebtedness and other liabilities.

The inability to raise capital on favorable terms, particularly during times of uncertainty in the financial markets, could impact TXU Corp.'s ability to sustain and grow its businesses, which are capital intensive, and would increase its capital costs. TXU Corp. relies on access to financial markets as a significant source of liquidity for capital requirements not satisfied by cash on hand or operating cash flows. TXU Corp.'s access to the financial markets could be adversely impacted by various factors, such as:

- changes in credit markets that reduce available credit or the ability to renew existing liquidity facilities on acceptable terms;
- inability to access commercial paper markets;
- a deterioration of TXU Corp.'s credit or the credit of its subsidiaries or a reduction in TXU Corp.'s credit ratings or the credit ratings of its subsidiaries;
- extreme volatility in TXU Corp.'s markets that increases margin or credit requirements;
- a material breakdown in TXU Corp.'s risk management procedures;
- prolonged delays in billing and payment resulting from delays in switching customers from one REP to another; and
- the occurrence of material adverse changes in TXU Corp.'s businesses that restrict TXU Corp.'s ability to access its liquidity facilities.

A lack of necessary capital and cash reserves could adversely impact the evaluation of TXU Corp.'s credit worthiness by counterparties and rating agencies, and would likely increase its capital costs. Further, concerns on the part of counterparties regarding TXU Corp.'s liquidity and credit could limit its wholesale markets management activities.

As a result of the energy crisis in California during 2001, the recent volatility of natural gas prices in North America, the bankruptcy filing by Enron Corporation, accounting irregularities of public companies, and investigations by governmental authorities into energy trading activities, companies in the regulated and nonregulated utility businesses have been under a generally increased amount of public and regulatory scrutiny. Accounting irregularities at certain companies in the industry have caused regulators and legislators to review current accounting practices and financial disclosures. The capital markets and ratings agencies also have increased their level of scrutiny. Additionally, allegations against various energy trading companies of "round trip" or "wash" transactions, which involve the simultaneous buying and selling of the same amount of power at the same price and delivery location and provide no true economic benefit, power market manipulation and inaccurate power and commodity price reporting have had a negative effect on the industry. TXU Corp. believes that it is complying with all applicable laws, but it is difficult or impossible to predict or control what effect events and investigations in the energy industry may have on TXU Corp.'s financial condition or access to the capital markets. Additionally, it is unclear what laws and regulations may develop, and TXU Corp. cannot predict the ultimate impact of any future changes in accounting regulations or practices in general with respect to public companies, the energy industry or its operations specifically. Any such new accounting standards could negatively impact reported financial results.

TXU Corp. is subject to costs and other effects of legal and administrative proceedings, settlements, investigations and claims. Since October 2002, a number of lawsuits have been filed in federal and state courts in Texas against TXU Corp. and various of its officers, directors and underwriters. Such current and potential legal proceedings could result in payments of judgment or settlement amounts. If the settlement agreement between TXU Corp. and the creditors of TXU Europe does not become final and binding, potential claims by such creditors could be material.

The market price of TXU Corp.'s common stock has been volatile in the past, and a variety of factors could cause the price to fluctuate in the future. In addition to the matters discussed above and in TXU Corp.'s other filings under the Securities Exchange Act of 1934, as amended, the following could impact the market price for TXU Corp.'s common stock:

- developments related to TXU Corp.'s businesses;
- fluctuations in TXU Corp.'s results of operations;
- the level of dividends and share repurchases;
- TXU Corp.'s debt to equity ratios and other credit metrics;
- effect of significant events relating to the energy sector in general;
- sales of TXU Corp. securities into the marketplace;
- general conditions in the industry and the energy markets in which TXU Corp. is a participant;
- the worldwide economy;
- an outbreak of war or hostilities;
- a shortfall in revenues or earnings compared to securities analysts' expectations;
- changes in analysts' recommendations or projections; and
- actions by credit rating agencies.

Fluctuations in the market price of TXU Corp.'s common stock may be unrelated to TXU Corp.'s performance. General market declines or market volatility could adversely affect the price of TXU Corp.'s common stock and the current market price may not be indicative of future market prices.

The issues and associated risks and uncertainties described above are not the only ones TXU Corp. may face. Additional issues may arise or become material as the energy industry evolves.

## FORWARD-LOOKING STATEMENTS

This report and other presentations made by TXU Corp. contain “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical facts, that are included in this report, or made in presentations, in response to questions or otherwise, that address activities, events or developments that TXU Corp. expects or anticipates to occur in the future, including such matters as projections, capital allocation and cash distribution policy, future capital expenditures, business strategy, competitive strengths, goals, future acquisitions or dispositions, development or operation of power production assets, market and industry developments and the growth of TXU Corp.’s business and operations (often, but not always, through the use of words or phrases such as “will likely result,” “are expected to,” “will continue,” “is anticipated,” “estimated,” “projection,” “target,” “outlook”), are forward-looking statements. Although TXU Corp. believes that in making any such forward-looking statement its expectations are based on reasonable assumptions, any such forward-looking statement involves uncertainties and is qualified in its entirety by reference to the discussion of risk factors discussed above under “RISK FACTORS THAT MAY AFFECT FUTURE RESULTS” and the following important factors, among others, that could cause the actual results of TXU Corp. to differ materially from those projected in such forward-looking statements:

- prevailing governmental policies and regulatory actions, including those of the FERC, the Commission, the RRC and the NRC, with respect to:
  - allowed rates of return;
  - industry, market and rate structure;
  - purchased power and recovery of investments;
  - operations of nuclear generating facilities;
  - acquisitions and disposal of assets and facilities;
  - operation and construction of plant facilities;
  - decommissioning costs;
  - present or prospective wholesale and retail competition;
  - changes in tax laws and policies; and
  - changes in and compliance with environmental and safety laws and policies;
- continued implementation of, and “sunset” provisions regarding, the 1999 Restructuring Legislation;
- legal and administrative proceedings and settlements;
- general industry trends;
- power generation costs (including repair costs) and availability;
- weather conditions and other natural phenomena, and acts of sabotage, wars or terrorist activities;
- unanticipated population growth or decline, and changes in market demand and demographic patterns;
- changes in business strategy, development plans or vendor relationships;
- TXU Corp.’s ability to implement the initiatives that are part of its restructuring, operational improvement and cost reduction program, and the terms upon which those initiatives are executed;
- competition for retail and wholesale customers;
- access to adequate transmission facilities to meet changing demands;
- pricing and transportation of crude oil, natural gas and other commodities;
- unanticipated changes in interest rates, commodity prices, rates of inflation or foreign exchange rates;
- unanticipated changes in operating expenses, liquidity needs and capital expenditures;
- commercial bank market and capital market conditions;
- competition for new energy development and other business opportunities;
- inability of various counterparties to meet their obligations with respect to TXU Corp.’s financial instruments;
- changes in technology used by and services offered by TXU Corp.;

- significant changes in TXU Corp.'s relationship with its employees, including the availability of qualified personnel, and the potential adverse effects if labor disputes or grievances were to occur;
- significant changes in critical accounting policies material to TXU Corp.; and
- actions by credit rating agencies.

Any forward-looking statement speaks only as of the date on which it is made, and TXU Corp. undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for TXU Corp. to predict all of them; nor can TXU Corp. assess the impact of each such factor or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement.