DYNEGY INC.
Form 10-Q
November 06, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

DYNEGY INC.
DYNEGY HOLDINGS INC.

(Exact name of registrant as specified in its charter)

Entity	Commission File Number	State of Incorporation	I.R.S. Employer Identification No.
Dynegy Inc.	001-33443	Delaware	20-5653152
Dynegy Holdings Inc.	000-29311	Delaware	94-3248415

1000 Louisiana, Suite 5800
Houston, Texas **77002**
(Address of principal executive offices) **(Zip Code)**

(713) 507-6400
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Dynegy Inc.	Yes x No ¨
Dynegy Holdings Inc.	Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

	Large accelerated filer	Accelerated filer	Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
Dynegy Inc.	x	¨	¨	¨
Dynegy Holdings Inc.	¨	¨	x	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Dynegy Inc.	Yes ¨ No x
Dynegy Holdings Inc.	Yes ¨ No x

Indicate the number of shares outstanding of Dynegy Inc.'s classes of common stock, as of the latest practicable date: Class A common stock, $0.01 par value per share, 502,905,922 shares outstanding as of November 3, 2008; Class B common stock, $0.01 par value per share, 340,000,000 shares outstanding as of November 3, 2008. All of Dynegy Holdings Inc.'s outstanding common stock is owned indirectly by Dynegy Inc.

This combined Form 10-Q is separately filed by Dynegy Inc. and Dynegy Holdings Inc. Information contained herein relating to any individual registrant is filed by such registrant on its own behalf. Each registrant makes no representation as to information relating to a registrant other than itself.

DYNEGY INC. and DYNEGY HOLDINGS INC.

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EXPLANATORY NOTE

This report includes the combined filing of Dynegy Inc. ("Dynegy") and Dynegy Holdings Inc. ("DHI"). DHI is the principal subsidiary of Dynegy, providing approximately 100 percent of Dynegy's total consolidated revenue for the nine month period ended September 30, 2008 and constituting approximately 100 percent of Dynegy's total consolidated asset base as of September 30, 2008 except for Dynegy's 50 percent interests in DLS Power Holdings, LLC and DLS Power Development Company, LLC. Unless the context indicates otherwise, throughout this report, the terms "the Company," "we," "us," "our" and "ours" are used to refer to both Dynegy and DHI and their direct and indirect subsidiaries, including Dynegy Illinois Inc. ("Dynegy Illinois") before it became a wholly owned subsidiary of Dynegy by way of the merger of Merger Sub Co., then Dynegy's wholly owned subsidiary, with and into Dynegy Illinois. Discussions or areas of this report that apply only to Dynegy or DHI will clearly be noted in such section.

DEFINITIONS

As used in this Form 10-Q, the abbreviations contained herein have the meanings set forth below.

APB	Accounting Principles Board
ASM	Ancillary Services Market
BTA	Best technology available
CAIR	Clean Air Interstate Rule
CFTC	Commodity Futures Trading Commission
CO2	Carbon Dioxide
CRM	Our former customer risk management business segment
CUSA	Chevron U.S.A. Inc., a wholly owned subsidiary of Chevron Corporation
DHI	Dynegy Holdings Inc., Dynegy's primary financing subsidiary
DMG	Dynegy Midwest Generation, Inc.
DMSLP	Dynegy Midstream Services L.P.
EITF	Emerging Issues Task Force
EPA	Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FIN	FASB Interpretation
GAAP	Generally Accepted Accounting Principles of the United States of America
GEN	Our power generation business
GEN-MW	Our power generation business - Midwest segment
GEN-NE	Our power generation business - Northeast segment
GEN-WE	Our power generation business - West segment
GHG	Greenhouse gasses
ICC	Illinois Commerce Commission
IMA	In-market asset availability
ISO	Independent System Operator
ISO-NE	Independent System Operator – New England
MAAC-APS	Mid–Atlantic Area Council – Allegheny Power System delivery area
MISO	Midwest Independent Transmission Operator, Inc.
MMBtu	One million British thermal units
MW	Megawatts
MWh	Megawatt hour
NOx	Nitrogen Oxide
NPDES	National Pollutant Discharge Elimination System
NRG	NRG Energy, Inc.
NYSDEC	New York State Department of Environmental Conservation
OTC	Over the Counter
PJM	PJM Interconnection, LLC
PPEA	PPEA Holding Company LLC
RGGI	Regional Greenhouse Gas Initiative
RTO	Regional transmission organization
SCEA	Sandy Creek Energy Associates, LP
SCH	Sandy Creek Holdings LLC
SEC	U.S. Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards

SO2	Sulfur Dioxide
SPDES	State Pollutant Discharge Elimination System
VaR	Value at Risk
VIE	Variable Interest Entity

PART I. FINANCIAL INFORMATION

Item 1—FINANCIAL STATEMENTS—DYNEGY INC. AND DYNEGY HOLDINGS INC.

DYNEGY INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited) (in millions, except share data)

	September 30, 2008	December 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 750	$ 328
Restricted cash	141	104
Short-term investments	125	—
Accounts receivable, net of allowance for doubtful accounts of $24 and $20, respectively	351	426
Accounts receivable, affiliates	—	1
Inventory	164	199
Assets from risk-management activities	947	358
Deferred income taxes	12	45
Prepayments and other current assets	232	145
Assets held for sale (Note 3)	—	57
Total Current Assets	2,722	1,663
Property, Plant and Equipment	10,684	10,689
Accumulated depreciation	(1,798)	(1,672)
Property, Plant and Equipment, Net	8,886	9,017
Other Assets		
Unconsolidated investments	62	79
Restricted cash and investments	1,167	1,221
Assets from risk-management activities	174	55
Goodwill	433	438
Intangible assets	451	497
Deferred income taxes	5	6
Accounts receivable, affiliates	3	—
Other long-term assets	299	245
Total Assets	$ 14,202	$ 13,221
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 323	$ 292
Accrued interest	126	56
Accrued liabilities and other current liabilities	160	201

Liabilities from risk-management activities	917	397
Notes payable and current portion of long-term debt	57	51
Liabilities held for sale	—	2
Total Current Liabilities	1,583	999
Long-term debt	5,864	5,739
Long-term debt, affiliates	200	200
Long-Term Debt	6,064	5,939
Other Liabilities		
Liabilities from risk-management activities	190	116
Deferred income taxes	1,319	1,250
Other long-term liabilities	360	388
Total Liabilities	9,516	8,692
Minority Interest	7	23
Commitments and Contingencies (Note 10)		
Stockholders' Equity		
Class A Common Stock, $0.01 par value, 2,100,000,000 shares authorized at September 30, 2008 and December 31, 2007; 505,336,540 and 502,819,794 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	5	5
Class B Common Stock, $0.01 par value, 850,000,000 shares authorized at September 30, 2008 and December 31, 2007; 340,000,000 shares issued and outstanding at September 30, 2008 and December 31, 2007	3	3
Additional paid-in capital	6,480	6,463
Subscriptions receivable	(3)	(5)
Accumulated other comprehensive loss, net of tax	(52)	(25)
Accumulated deficit	(1,683)	(1,864)
Treasury stock, at cost, 2,561,828 and 2,449,259 shares at September 30, 2008 and December 31, 2007, respectively	(71)	(71)
Total Stockholders' Equity	4,679	4,506
Total Liabilities and Stockholders' Equity	$ 14,202	$ 13,221

See the notes to condensed consolidated financial statements.

DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited) (in millions, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenues	$ 1,886	$ 1,046	$ 2,754	$ 2,379
Cost of sales	(558)	(535)	(1,465)	(1,144)
Operating and maintenance expense, exclusive of depreciation shown separately below	(130)	(114)	(367)	(334)
Depreciation and amortization expense	(91)	(92)	(277)	(232)
Gain on sale of assets	57	4	83	4
General and administrative expenses	(48)	(62)	(126)	(163)
Operating income	1,116	247	602	510
Earnings (losses) from unconsolidated investments	(5)	8	(17)	6
Interest expense	(105)	(117)	(322)	(268)
Minority interest income (expense)	1	1	3	(8)
Other income and expense, net	11	16	46	34
Income from continuing operations before income taxes	1,018	155	312	274
Income tax expense (Note 12)	(413)	(59)	(131)	(95)
Income from continuing operations	605	96	181	179
Income from discontinued operations, net of tax expense of $1, $93, zero and $97, respectively (Notes 3 and 12)	—	124	—	131
Net income	$ 605	$ 220	$ 181	$ 310
Earnings Per Share (Note 9):				
Basic earnings per share:				
Income from continuing operations	$ 0.72	$ 0.11	$ 0.22	$ 0.25
Income from discontinued operations	—	0.15	—	0.18
Basic earnings per share	$ 0.72	$ 0.26	$ 0.22	$ 0.43
Diluted earnings per share:				
Income from continuing operations	$ 0.72	$ 0.11	$ 0.22	$ 0.25
Income from discontinued operations	—	0.15	—	0.18
Diluted earnings per share	$ 0.72	$ 0.26	$ 0.22	$ 0.43

Basic shares outstanding	837	836	837	721
Diluted shares outstanding	839	838	839	723

See the notes to condensed consolidated financial statements.

DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited) (in millions)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 181	$ 310
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	281	239
Earnings (losses) from unconsolidated investments, net of cash distributions	17	(6)
Risk-management activities	(127)	(137)
Gain on sale of assets	(83)	(214)
Deferred income taxes	116	172
Legal and settlement charges	7	29
Other	34	22
Changes in working capital:		
Accounts receivable	43	(64)
Inventory	27	(5)
Prepayments and other assets	(75)	(43)
Accounts payable and accrued liabilities	75	109
Changes in non-current assets	(84)	(45)
Changes in non-current liabilities	(15)	(1)
Net cash provided by operating activities	397	366
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(460)	(236)
Unconsolidated investments	(1)	(7)
Proceeds from asset sales, net	452	466
Business acquisitions, net of cash acquired	—	(128)
Increase in short-term investments	(127)	—
Decrease (increase) in restricted cash and restricted investments	17	(598)
Other investing	11	—
Net cash used in investing activities	(108)	(503)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term borrowings, net	153	2,705
Repayments of long-term borrowings	(21)	(2,300)
Proceeds from issuance of capital stock	2	4
Other financing, net	(1)	(5)
Net cash provided by financing activities	133	404

Net increase in cash and cash equivalents	422	267
Cash and cash equivalents, beginning of period	328	371
Cash and cash equivalents, end of period	$ 750	$ 638
Other non-cash investing activity:		
Noncash construction expenditures	$ 3	$ 13

See the notes to condensed consolidated financial statements.

DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited) (in millions)

	Three Months Ended September 30,	
	2008	**2007**
Net income	$ 605	$ 220
Cash flow hedging activities, net:		
Unrealized mark-to-market losses arising during period, net	(21)	(15)
Reclassification of mark-to-market losses to earnings, net	3	12
Deferred gains on cash flow hedges, net	2	—
Changes in cash flow hedging activities, net (net of tax benefit of $4 and $3, respectively)	(16)	(3)
Allocation to minority interest	10	—
Total cash flow hedging activities	(6)	(3)
Recognized prior service cost and actuarial loss	—–	1
Foreign currency translation adjustment	—	2
Unrealized gain on securities, net:		
Unrealized gain on securities	—	6
Less: Reclassification adjustments for gains realized in net income	—	(4)
Net unrealized gains, (net of tax expense of zero and $1, respectively)	—	2
Unconsolidated investment other comprehensive loss, net (net of tax benefit of $3)	(4)	—
Other comprehensive income (loss), net of tax	(10)	2
Comprehensive income	$ 595	$ 222

	Nine Months Ended September 30,	
	2008	**2007**
Net income	$ 181	$ 310
Cash flow hedging activities, net:		
Unrealized mark-to-market losses arising during period, net	(27)	(74)
Reclassification of mark-to-market gains (losses) to earnings, net	10	(16)
Changes in cash flow hedging activities, net (net of tax benefit of $4 and $54, respectively)	(17)	(90)
Allocation to minority interest	12	—

Total cash flow hedging activities	(5)	(90)
Recognized prior service cost and actuarial loss	1	3
Foreign currency translation adjustment	—	4
Unrealized loss on securities, net:		
Unrealized gain (loss) on securities	(3)	4
Less: Reclassification adjustments for gains realized in net income	(9)	(4)
Net unrealized losses, (net of tax benefit of $8 and zero, respectively)	(12)	—
Unconsolidated investment other comprehensive loss, net (net of tax benefit of $7)	(11)	—
Other comprehensive loss, net of tax	(27)	(83)
Comprehensive income	$ 154	$ 227

See the notes to condensed consolidated financial statements.

DYNEGY HOLDINGS INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited) (in millions)

	September 30, 2008	December 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 724	$ 292
Restricted cash	141	104
Short-term investments	118	—
Accounts receivable, net of allowance for doubtful accounts of $21 and $15 respectively	352	428
Accounts receivable, affiliates	—	1
Inventory	164	199
Assets from risk-management activities	947	358
Deferred income taxes	3	30
Prepayments and other current assets	232	145
Assets held for sale	—	57
Total Current Assets	2,681	1,614
Property, Plant and Equipment	10,684	10,689
Accumulated depreciation	(1,798)	(1,672)
Property, Plant and Equipment, Net	8,886	9,017
Other Assets		
Unconsolidated investments	—	18
Restricted cash and investments	1,167	1,221
Assets from risk-management activities	174	55
Goodwill	433	438
Intangible assets	451	497
Deferred income taxes	5	6
Accounts receivable, affiliates	3	—
Other long-term assets	300	241
Total Assets	$ 14,100	$ 13,107
LIABILITIES AND STOCKHOLDER'S EQUITY		
Current Liabilities		
Accounts payable	$ 322	$ 291
Accrued interest	126	56
Accrued liabilities and other current liabilities	161	202
Deferred income taxes	—	—
Liabilities from risk-management activities	917	397
Notes payable and current portion of long-term debt	57	51

Liabilities held for sale	—	2
Total Current Liabilities	1,583	999
Long-term debt	5,864	5,739
Long-term debt to affiliates	200	200
Long-Term Debt	6,064	5,939
Other Liabilities		
Liabilities from risk-management activities	190	116
Deferred income taxes	1,132	1,052
Other long-term liabilities	356	381
Total Liabilities	9,325	8,487
Minority Interest	7	23
Commitments and Contingencies (Note 10)		
Stockholder's Equity		
Capital Stock, $1 par value, 1,000 shares authorized at September 30, 2008 and December 31, 2007, respectively	—	—
Additional paid-in capital	5,684	5,684
Affiliate receivable	(811)	(825)
Accumulated other comprehensive loss, net of tax	(52)	(25)
Accumulated deficit	(53)	(237)
Total Stockholder's Equity	4,768	4,597
Total Liabilities and Stockholder's Equity	$ 14,100	$ 13,107

See the notes to condensed consolidated financial statements.

DYNEGY HOLDINGS INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited) (in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenues	$ 1,886	$ 1,046	$ 2,754	$ 2,379
Cost of sales	(558)	(535)	(1,465)	(1,144)
Operating and maintenance expense, exclusive of depreciation shown separately below	(130)	(114)	(367)	(334)
Depreciation and amortization expense	(91)	(92)	(277)	(232)
Gain on sale of assets	57	4	83	4
General and administrative expenses	(48)	(62)	(126)	(144)
Operating income	1,116	247	602	529
Earnings (losses) from unconsolidated investments	(5)	12	(7)	12
Interest expense	(105)	(117)	(322)	(268)
Minority interest income (expense)	1	1	3	(8)
Other income and expense, net	11	17	45	33
Income from continuing operations before income taxes	1,018	160	321	298
Income tax expense (Note 12)	(412)	(62)	(137)	(94)
Income from continuing operations	606	98	184	204
Income from discontinued operations, net of tax expense of $1, $93, zero and $98, respectively (Notes 3 and 12)	—	124	—	130
Net income	$ 606	$ 222	$ 184	$ 334

See the notes to condensed consolidated financial statements.

DYNEGY HOLDINGS INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited) (in millions)

	Nine Months Ended September 30,	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 184	$ 334
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	281	239
Earnings (losses) from unconsolidated investments, net of cash distributions	7	(12)
Risk-management activities	(127)	(137)
Gain on sale of assets, net	(83)	(214)
Deferred income taxes	123	161
Legal and settlement charges	7	29
Other	30	20
Changes in working capital:		
Accounts receivable	43	(64)
Inventory	27	(5)
Prepayments and other assets	(75)	(43)
Accounts payable and accrued liabilities	76	111
Changes in non-current assets	(84)	(43)
Changes in non-current liabilities	(16)	(1)
Net cash provided by operating activities	393	375
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(460)	(236)
Unconsolidated investments	10	—
Proceeds from asset sales, net	452	466
Business acquisitions, net of cash acquired	—	16
Increase in short-term investments	(120)	—
Decrease (increase) in restricted cash and restricted investments	17	(598)
Affiliate transactions	2	(11)
Other investing	7	—
Net cash used in investing activities	(92)	(363)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term borrowings, net	153	2,705
Repayments of long-term borrowings	(21)	(2,025)
Dividend to affiliate	—	(342)
Other financing, net	(1)	1

Net cash provided by financing activities		131		339
Net increase in cash and cash equivalents		432		351
Cash and cash equivalents, beginning of period		292		243
Cash and cash equivalents, end of period	$	724	$	594
Other non-cash investing activity:				
Noncash construction expenditures	$	3	$	13

See the notes to condensed consolidated financial statements.

DYNEGY HOLDINGS INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited) (in millions)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Net income	$ 606	$ 222
Cash flow hedging activities, net:		
Unrealized mark-to-market losses arising during period, net	(21)	(15)
Reclassification of mark-to-market gains to earnings, net	3	12
Deferred gains on cash flow hedges, net	2	—
Changes in cash flow hedging activities, net (net of tax benefit of $4 and $3, respectively)	(16)	(3)
Allocation to minority interest	10	—
Total cash flow hedging activities	(6)	(3)
Recognized prior service cost and actuarial loss	—	1
Foreign currency translation adjustment	—	2
Unrealized gain on securities, net:		
Unrealized gain on securities	—	6
Less: Reclassification adjustments for gains realized in net income	—	(4)
Net unrealized gain, (net of tax expense of zero and $1, respectively)	—	2
Unconsolidated investment other comprehensive loss, net (net of tax benefit of $3)	(4)	—
Other comprehensive income (loss), net of tax	(10)	2
Comprehensive income	$ 596	$ 224

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net income	$ 184	$ 334
Cash flow hedging activities, net:		
Unrealized mark-to-market losses arising during period, net	(27)	(74)
Reclassification of mark-to-market gains (losses) to earnings, net	10	(16)
Changes in cash flow hedging activities, net (net of tax benefit of $4 and $54, respectively)	(17)	(90)

Allocation to minority interest	12	—
Total cash flow hedging activities	(5)	(90)
Recognized prior service cost and actuarial loss	1	3
Foreign currency translation adjustment	—	4
Unrealized gain (loss) on securities, net:		
Unrealized gain (loss) on securities	(3)	4
Less: Reclassification adjustments for gains realized in net income	(9)	(4)
Net unrealized losses, (net of tax benefit of $8 and zero, respectively)	(12)	—
Unconsolidated investment other comprehensive loss, net (net of tax benefit of $7)	(11)	—
Other comprehensive loss, net of tax	(27)	(83)
Comprehensive income	$ 157	$ 251

See the notes to condensed consolidated financial statements.

DYNEGY INC. and DYNEGY HOLDINGS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For the Interim Periods Ended September 30, 2008 and 2007

Note 1—Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to interim financial reporting as prescribed by the SEC. The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These interim financial statements should be read together with the consolidated financial statements and notes thereto included in Dynegy's and DHI's Annual Report on Form 10-K for the year ended December 31, 2007 filed on February 28, 2008, which we refer to as each registrant's "Form 10-K".

The unaudited condensed consolidated financial statements contained in this report include all material adjustments of a normal and recurring nature that, in the opinion of management, are necessary for a fair statement of the results for the interim periods. The results of operations for the interim periods presented in this Form 10-Q are not necessarily indicative of the results to be expected for the full year or any other interim period due to seasonal fluctuations in demand for our energy products and services, changes in commodity prices, timing of maintenance and other expenditures and other factors. The preparation of the unaudited condensed consolidated financial statements in conformity with GAAP requires management to make informed estimates and judgments that affect our reported financial position and results of operations. These estimates and judgments also impact the nature and extent of disclosure, if any, of our contingent liabilities based on currently available information. We review significant estimates and judgments affecting our consolidated financial statements on a recurring basis and record the effect of any necessary adjustments. Uncertainties with respect to such estimates and judgments are inherent in the preparation of financial statements. Estimates and judgments are used in, among other things, (i) developing fair value assumptions, including estimates of future cash flows and discount rates, (ii) analyzing tangible and intangible assets, including goodwill, for possible impairment, (iii) estimating the useful lives of our assets, (iv) assessing future tax exposure and the realization of tax assets, (v) determining amounts to accrue for contingencies, guarantees and indemnifications, (vi) estimating various factors used to value our pension assets and liabilities and (vii) determining the primary beneficiary of certain VIEs from a set of related parties. Actual results could differ materially from any such estimates.

Available-for-Sale Securities

For securities classified as available-for-sale that have readily determinable fair values, the change in the unrealized gain or loss, net of deferred income tax, is recorded as a separate component of accumulated other comprehensive income in the unaudited condensed consolidated statements of comprehensive income. Realized gains and losses on investment transactions are determined using the specific identification method.

As of September 30, 2008, Dynegy and DHI had approximately $127 million and $120 million, respectively, invested in the Reserve Primary Fund (the "Fund"), which "broke the buck" on September 16, 2008, when the value of its shares fell below $1.00. On September 22, 2008, the SEC granted the Fund's request to suspend all rights of redemption from the Fund, in order to ensure an orderly disposition of the securities. Since distributions from the Fund were suspended on September 30, 2008, investments in the Fund are no longer readily convertible to cash, and therefore do not meet the definition of "cash and cash equivalents" as set forth in SFAS No. 95, "Statement of Cash Flows". As such, we have reclassified our investment in the Fund from cash and cash equivalents to short-term investments as of September 30, 2008 and recorded a $2 million impairment, based on management's estimate of the fair value of our proportionate share of the Fund's holdings, which is included in Other income and expense, net, in our unaudited condensed consolidated statements of operations. This investment is classified as a current asset, as

DYNEGY INC. and DYNEGY HOLDINGS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2008 and 2007

all of the assets held by the Fund will mature by September 30, 2009, and distributions from the Fund will be made as assets reach maturity or are sold.

Goodwill

We follow the guidance set forth in SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), when assessing the carrying value of our goodwill. We evaluate our goodwill for impairment on an annual basis on November 1st, and when events warrant an assessment. Although Dynegy's Class A common stock price significantly decreased in the third quarter 2008, management determined that since the market decline has been recent rather than sustained for a significant period of time, and there has not been a significant change to the underlying fundamentals of the business, it is not more likely than not that the fair value of our reporting units has dropped below their carrying amounts. Therefore, we did not evaluate our goodwill for impairment during the third quarter 2008 except in conjunction with our sale of Rolling Hills, as more fully discussed in Note 3—Dispositions and Discontinued Operations—Dispositions—Rolling Hills. However, with the downturn in the economic environment, if our market capitalization continues to be below our book value for a sustained period of time, we may be required to record a goodwill impairment in the future.

Accounting Principles Adopted

SFAS No. 157. On January 1, 2008, we adopted portions of SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). Please read Note 4—Risk Management Activities, Derivatives and Financial Instruments for further discussion.

SFAS No. 159. On January 1, 2008, we adopted SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"). SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. We have not elected the fair value option to measure eligible items. Accordingly, this statement had no impact on our financial statements.

Accounting Principles Not Yet Adopted

SFAS No. 141(R). On December 4, 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS No. 141(R)"). SFAS No. 141(R) requires the acquiring entity in a business combination to recognize the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008, except for certain income tax adjustments. We are currently evaluating the impact of this statement on our financial statements.

SFAS No. 160. On December 4, 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51" ("SFAS No. 160"). SFAS No. 160 requires ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently; and any retained

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noncontrolling equity investment in the former subsidiary be initially measured at fair value. SFAS No. 160 also requires that noncontrolling interest holders continue to be attributed their share of losses even if these attributions result in a deficit noncontrolling interest balance. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. We are currently evaluating the impact of this statement on our financial statements.

SFAS No. 161. On March 19, 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS No. 161"). SFAS No. 161 is meant to improve transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended; and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk–related and it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. SFAS No. 161 is effective for fiscal years beginning on or after November 15, 2008. We are currently evaluating the impact of this statement on our financial statements.

SFAS No. 162. On May 9, 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS No. 162"). SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. Prior to the issuance of SFAS No. 162, GAAP hierarchy was defined in the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" ("SAS No. 69"). SAS No. 69 has been criticized because it is directed to external auditors rather than the entity. SFAS No. 162 addresses these issues by establishing that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 is effective 60 days following the SEC's approval. This statement will have no impact on our financial statements.

Note 2—Acquisitions and Contributions

LS Power Business Combination. On April 2, 2007, Dynegy acquired through merger (the "Merger") entities that owned ten power plants and a power plant under construction (collectively, the "Contributed Entities") and 50 percent interests in DLS Power Holdings, LLC ("DLS Power Holdings"), a development joint venture, and DLS Power Development Company, LLC ("DLS Power Development") from LSP Gen Investors, L.P., LS Power Partners, L.P., LS Power Equity Partners PIE I, L.P., LS Power Equity Partners, L.P. and LS Power Associates, L.P. (the "LS Contributing Entities"). The aggregate purchase price was comprised of (i) $100 million cash, (ii) 340 million shares of the Class B common stock of Dynegy, (iii) the issuance of a promissory note in the aggregate principal amount of $275 million (the "Note") (which was simultaneously issued and repaid in full without interest or prepayment penalty), (iv) the issuance of an additional $70 million of project-related debt (the "Griffith Debt") (which was simultaneously issued and repaid in full without interest or prepayment penalty) via an indirect wholly owned subsidiary, and (v) transaction costs of approximately $52 million, approximately $44 million of which were paid in 2007. The Class B common stock issued by Dynegy was valued at $5.98 per share, which represents the average closing price of Dynegy's common stock on the New York Stock Exchange for the two days prior to, including, and two days subsequent to the September 15, 2006 public announcement of the Merger, or approximately $2,033 million. Dynegy funded the cash payment and the repayment of the Note and the Griffith Debt using cash on hand and borrowings by DHI (and subsequent permitted distributions to Dynegy) of (i) an aggregate $275 million under the revolving portion of our Fifth Amended and Restated Credit Facility, subsequently amended (the "Credit Agreement") and (ii) an aggregate $70 million under a senior secured term loan facility.

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Please read Note 15—Debt—Fifth Amended and Restated Credit Facility in Dynegy's and DHI's Form 10-K for discussion of DHI's borrowings. We paid a premium over the fair value of the net tangible and identified intangible assets acquired due to the (i) scale and diversity of assets acquired in key regions of the United States; (ii) financial benefits of such assets; and (iii) proven nature of the asset development platform that was subsequently contributed to DLS Power Holdings and DLS Power Development.

In connection with the completion of the Merger, Dynegy contributed to Dynegy Illinois its interest in the Contributed Entities. Following such contribution, Dynegy Illinois contributed to DHI its interest in the Contributed Entities and, as a result, the Contributed Entities are subsidiaries of DHI. Accordingly, all of the entities acquired in the Merger are included within DHI with the exception of Dynegy's 50 percent interests in DLS Power Holdings and DLS Power Development, which are directly owned by Dynegy.

The application of purchase accounting under SFAS No. 141, "Business Combinations" ("SFAS No. 141"), required that the total purchase price be allocated to the fair value of assets acquired and liabilities assumed based on their fair values at the acquisition date, with amounts exceeding the fair values being recorded as goodwill in accordance with SFAS No. 142). The allocation process included an analysis of acquired fixed assets, contracts, and contingencies to identify and record the fair value of all assets acquired and liabilities assumed. Dynegy's allocation of the purchase price to specific assets and liabilities was based upon customary valuation procedures and techniques.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash	$	16
Restricted cash and investments (including $37 million current)		91
Accounts receivable		52
Inventory		37
Assets from risk management activities (including $11 million current)		37
Prepaids and other current assets		12
Property, plant and equipment		4,223
Intangible assets (including $9 million current)		224
Goodwill		486
Unconsolidated investments		83
Other		35
Total assets acquired	$	5,296
Current liabilities and accrued liabilities	$	(92)
Liabilities from risk management activities (including $14 million current)		(75)
Long-term debt (including $32 million current)		(1,898)
Deferred income taxes		(627)
Other		(96)
Minority interest		22
Total liabilities and minority interest assumed	$	(2,766)

Net assets acquired	$ 2,530

Included in Other liabilities was an intangible liability of $35 million in GEN-MW primarily related to a contract held by LSP Kendall Holding LLC, one of the entities acquired by Dynegy. LSP Kendall Holding LLC was party to a power tolling agreement with another of our subsidiaries. This power tolling agreement had a fair value of approximately $31 million as of April 2, 2007, representing an intangible liability from the perspective of LSP Kendall Holding LLC. Upon completion of the Merger, this power tolling agreement was effectively settled, which resulted in a $31 million second quarter 2007 gain equal to the fair value of this contract, in accordance with EITF Issue 04-1, "Accounting for Pre-existing Contractual Relationships Between the Parties to a Purchase Business Combination". The gain is included in Cost of sales in our unaudited condensed consolidated statements of operations.

Sithe Assets Contribution. On January 31, 2005, Dynegy acquired, and subsequently contributed to DHI in April 2007, 100 percent of the outstanding common shares of ExRes SHC, Inc. ("ExRes"), the parent company of Sithe Energies, Inc. ("Sithe Energies") and Sithe/Independence Power Partners, L.P. ("Independence"). The results of the operations of ExRes have been included in Dynegy's consolidated financial statements since January 31, 2005. Through this acquisition, Dynegy acquired the 1,064 MW Independence power generation facility located near Scriba, New York, as well as natural gas-fired merchant facilities in New York and hydroelectric generation facilities in Pennsylvania (the "Sithe Assets").

In April 2007, Dynegy Illinois contributed to DHI all of its interest in New York Holdings Inc. ("New York Holdings"), together with its indirect interest in the subsidiaries of New York Holdings. New York Holdings, together with its wholly owned subsidiaries, owns the Sithe Assets. The Sithe Assets primarily consist of the Independence power generation facility. This contribution was accounted for as a transaction between entities under common control. As such, the assets and liabilities of New York Holdings were recorded by DHI at Dynegy's historical cost on Dynegy's date of acquisition, January 31, 2005. In addition, DHI's historical financial statements have been adjusted in all periods presented to reflect the contribution as though DHI had owned New York Holdings beginning January 31, 2005.

Note 3—Dispositions and Discontinued Operations

Dispositions

Rolling Hills. On July 31, 2008, we completed the sale of the Rolling Hills power generation facility ("Rolling Hills") to an affiliate of Tenaska Capital Management, LLC for approximately $368 million, net of transaction costs. We recorded a $57 million gain in the third quarter 2008 related to the sale, which is included in Gain on sale of assets in our unaudited condensed consolidated statements of operations. The gain includes the impact of allocating approximately $5 million of goodwill associated with the GEN-MW reporting unit to Rolling Hills. The amount of goodwill allocated to Rolling Hills was based on the relative fair values of Rolling Hills and the portion of the GEN-MW reporting unit being retained.

The sale of Rolling Hills represented the sale of a significant portion of a reporting unit. As such, in accordance with SFAS No. 142, we assessed the goodwill of the GEN-MW reporting unit for impairment during the third quarter 2008. No impairment was indicated as a result of this assessment.

In accordance with SFAS No. 144, we discontinued depreciation and amortization of Rolling Hills' property, plant and equipment during the second quarter 2008. Depreciation and amortization expense related to Rolling Hills totaled zero and approximately $3 million in the three and nine month periods ended September 30, 2008, respectively, compared to approximately $2 million and approximately $6 million in the three and nine month periods ended September 30, 2007, respectively.

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NYMEX Securities. In November 2006, the New York Mercantile Exchange ("NYMEX") completed its initial public offering. At the time, we had two membership seats on the NYMEX, and therefore, we received 90,000 NYMEX shares for each membership seat. During August 2007, we sold 30,000 shares for approximately $4 million, and we recognized a gain of $4 million. During the second quarter 2008, we sold our remaining 150,000 shares and both of our membership seats for approximately $16 million, and we recognized a gain of $15 million, which is included in Gain on sale of assets in our unaudited condensed consolidated statements of operations partially offset by a reduction of $8 million, net of tax of $5 million, in our unaudited condensed consolidated statements of other comprehensive income.

Oyster Creek. In May 2008, we sold the beneficial interest in Oyster Creek Limited to General Electric for approximately $11 million, which is included in Gain on sale of assets in our unaudited condensed consolidated statements of operations.

Discontinued Operations

CoGen Lyondell. On August 1, 2007, we completed the sale of the CoGen Lyondell power generation facility for approximately $470 million to EnergyCo, LLC, a joint venture between PNM Resources and a subsidiary of Cascade Investment, LLC.

In accordance with SFAS No. 144, we discontinued depreciation and amortization of CoGen Lyondell's property, plant and equipment during the second quarter 2007. Depreciation and amortization expense related to CoGen Lyondell totaled zero and $5 million in the three and nine month periods ended September 30, 2007, respectively. Also pursuant to SFAS No. 144, we are reporting the results of CoGen Lyondell's operations in discontinued operations for all periods presented.

Calcasieu. On March 31, 2008, we completed the sale of the Calcasieu power generation facility to Entergy Gulf States, Inc. for approximately $56 million, net of transaction costs.

In accordance with SFAS No. 144, we discontinued depreciation and amortization of Calcasieu's property, plant and equipment during the first quarter 2007. Depreciation and amortization expense related to Calcasieu totaled less than $1 million and approximately $1 million in the three and nine month periods ended September 30, 2007, respectively. Also pursuant to SFAS No. 144, we are reporting the results of Calcasieu's operations in discontinued operations for all periods presented.

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Summary. The following table summarizes information related to Dynegy's discontinued operations:

	GEN-WE	CRM	NGL	Total
		(in millions)		
Three Months Ended September 30, 2007				
Revenues	$ 14	$ —	$ —	$ 14
Income from operations before taxes	3	4	—	7
Income from operations after taxes	7	3	4	14
Gain on sale before taxes	210	—	—	210
Gain on sale after taxes	110	—	—	110
Nine Months Ended September 30, 2007				
Revenues	$ 81	$ —	$ —	$ 81
Income from operations before taxes	3	15	—	18
Income from operations after taxes	2	11	8	21
Gain on sale before taxes	210	—	—	210
Gain on sale after taxes	110	—	—	110

The following table summarizes information related to DHI's discontinued operations:

	GEN-WE	CRM	NGL	Total
		(in millions)		
Three Months Ended September 30, 2007				
Revenues	$ 14	$ —	$ —	$ 14
Income from operations before taxes	3	4	—	7
Income from operations after taxes	7	3	4	14
Gain on sale before taxes	210	—	—	210
Gain on sale after taxes	110	—	—	110
Nine Months Ended September 30, 2007				
Revenues	$ 81	$ —	$ —	$ 81
Income from operations before taxes	3	15	—	18
Income from operations after taxes	2	10	8	20
Gain on sale before taxes	210	—	—	210
Gain on sale after taxes	110	—	—	110

Note 4—Risk Management Activities, Derivatives and Financial Instruments

The nature of our business necessarily involves market and financial risks. Specifically, we are exposed to commodity price variability related to our power generation business. Our commercial team manages these commodity price risks with financially settled and other types of contracts. Our treasury team also manages our financial risks and exposures associated with interest expense variability. These risks and our strategy for mitigating them are more fully described in Note 6—Risk Management Activities and Financial Instruments of Dynegy's and DHI's Form 10-K. Consistent with our commodity risk management policy, our commercial team also uses financial instruments in an attempt to capture the benefit of fluctuations in market prices in the geographic regions where our assets operate.

The following table summarizes the carrying value of the derivatives used in our risk management activities. In the table below, commodity-based derivative contracts primarily represent derivative contracts related to our generation business that we have not designated as accounting hedges, that are entered into for purposes of hedging

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future fuel requirements and sales commitments and securing commodity prices we consider favorable under the circumstances.

	September 30, 2008	December 31, 2007
	(in millions)	
Net assets (liabilities):		
Interest rate derivatives designated as cash flow and fair value accounting hedges	$ (67)	$ (32)
Interest rate derivatives not designated as accounting hedges	—	(2)
Commodity-based derivative contracts not designated as accounting hedges	81	(66)
Net assets (liabilities) from risk management activities (1)	$ 14	$ (100)

(1) Included in both current and non-current assets and liabilities on the unaudited condensed consolidated balance sheets.

We do not offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement and we did not elect to adopt the netting provisions allowed under FSP FIN 39-1, "Amendment of FASB Interpretation No. 39", which allows an entity to offset the fair value amounts recognized for cash collateral paid or cash collateral received against the fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. As a result, our consolidated balance sheets present derivative assets and liabilities, as well as cash collateral paid or received, on a gross basis. As of September 30, 2008, included in Prepayments and other current assets on our unaudited condensed consolidated balance sheets, we had approximately $94 million of cash collateral postings, which represent the effect of net cash outflows arising from the daily settlements of our exchange-traded or brokered commodity futures positions held with our futures clearing manager.

Beginning April 2, 2007, we chose to cease designating derivatives related to our power generation business as cash flow hedges, and thus apply mark-to-market accounting treatment thereafter. Accordingly, as fair values fluctuate from period to period due to market price volatility, fair value changes and unrealized and realized gains and losses are reflected in the unaudited condensed consolidated statements of operations within Revenues pursuant to EITF Issue 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" ("EITF Issue No. 02-3"). As such, these mark-to-market gains and losses are not reflected in the unaudited condensed consolidated statements of operations in the same period as the underlying power sales from generation activity for which the derivative instruments serve as economic hedges.

For the three and nine months ended September 30, 2008, our revenues included approximately $889 million and $124 million, respectively, of mark-to-market gains related to this activity compared to $20 million and $54 million, respectively, of mark-to-market gains in the same periods in the prior year.

Cash Flow Hedges. We enter into financial derivative instruments that qualify, and that we may elect to designate, as cash flow hedges. Interest rate swaps have been used to convert floating interest rate obligations to fixed interest rate obligations. Additionally, prior to April 2, 2007, we applied the cash flow hedge accounting model to certain GEN derivatives as discussed above. The balance in Other comprehensive loss at April 2, 2007 related to these instruments will be reclassified to future earnings contemporaneously with the related purchases of fuel and sales of electricity. As of September 30, 2008, there was $3 million pre-tax income remaining in accumulated other comprehensive loss.

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During the three and nine month periods ended September 30, 2008, we recorded $1 million and $3 million, respectively, of income related to ineffectiveness from changes in the fair value of cash flow hedge positions and no amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and nine month periods ended September 30, 2007, we recorded a $1 million loss and $4 million of income, respectively, related to ineffectiveness from changes in fair value of cash flow hedge positions. No amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and nine month periods ended September 30, 2008, no amounts were reclassified to earnings in connection with forecasted transactions that were no longer considered probable of occurring. During the three and nine months ended September 30, 2007, zero and $1 million, respectively, were reclassified to earnings in connection with forecasted transactions that were no longer considered probable of occurring.

The balance in cash flow hedging activities, net at September 30, 2008, is expected to be reclassified to future earnings when the hedged transaction impacts earnings. Of this amount, after-tax gains of approximately $2 million are currently estimated to be reclassified into earnings over the 12 month period ending September 30, 2009. The actual amounts that will be reclassified into earnings over this period and beyond could vary materially from this estimated amount as a result of changes in market conditions and other factors.

Fair Value Hedges. We also enter into derivative instruments that qualify, and that we designate, as fair value hedges. We use interest rate swaps to convert a portion of our non-prepayable fixed-rate debt into floating-rate debt. During the three and nine month periods ended September 30, 2008 and 2007, there was no ineffectiveness from changes in the fair value of hedge positions and no amounts were excluded from the assessment of hedge effectiveness. During the three and nine month periods ended September 30, 2008 and 2007, no amounts were recognized in relation to firm commitments that no longer qualified as fair value hedges.

Fair Value Measurements. On January 1, 2007, we adopted SFAS No. 157. We did not record a cumulative effect upon the adoption. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosure requirements for fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements. Accordingly, SFAS No. 157 does not require any new fair value measurements; however, for some entities the application of SFAS No. 157 will change current practice. The provisions of SFAS No. 157 are to be applied prospectively, except for the initial impact on three specific items: (i) changes in fair value measurements of existing derivative financial instruments measured initially using the transaction price under EITF No. 02-3, (ii) existing hybrid financial instruments measured initially at fair value using the transaction price and (iii) blockage factor discounts.

FASB Staff Position No. FAS 157-2 defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, with respect to non-financial assets and non-financial liabilities which are not recognized or disclosed at fair value in the financial statements on a recurring basis. Therefore, we have deferred application of SFAS No. 157 to such non-financial assets and non-financial liabilities until January 1, 2009.

On October 10, 2008, the FASB issued Staff Position No. FAS 157-3 ("FSP SFAS No. 157-3"). FSP SFAS No. 157-3 clarifies the application of SFAS No. 157 to a financial asset when the market for that financial asset is not active. FSP SFAS No. 157-3 was effective upon issuance by the FASB. The issuance of FSP SFAS No. 157-3 had no impact on our financial statements.

Fair value, as defined in SFAS No. 157, is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). However, as permitted under SFAS No. 157, we utilize a mid-market pricing convention (the mid-point price between bid and ask prices) as a practical expedient for valuing the majority of our assets and liabilities measured and reported at fair

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value. Where appropriate, valuation adjustments are made to account for various factors, including the impact of our credit risk, our counterparties’ credit risk and bid-ask spreads. We utilize market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. We primarily apply the market approach for recurring fair value measurements and endeavor to utilize the best available information. Accordingly, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. We classify fair value balances based on the observability of those inputs. SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). The three levels of the fair value hierarchy defined by SFAS No. 157 are as follows:

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 primarily consists of financial instruments such as exchange-traded derivatives, listed equities and U.S. government treasury securities.

- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace throughout the full term of the instrument, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Instruments in this category include non-exchange-traded derivatives such as over the counter forwards, options and repurchase agreements.

- Level 3 – Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management’s best estimate of fair value. Level 3 instruments include those that may be more structured or otherwise tailored to our needs as well as financial transmission rights. At each balance sheet date, we perform an analysis of all instruments subject to SFAS No. 157 and include in Level 3 all of those whose fair value is based on significant unobservable inputs.

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The following table sets forth by level within the fair value hierarchy our financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2008. These financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

	Fair Value as of September 30, 2008			
	Level 1	Level 2	Level 3	Total
	(in millions)			
Assets:				
Assets from risk management activities	$ —	$ 1,080	$ 41	$ 1,121
Other—DHI	—	118	—	118
Total—DHI	—	1,198	41	1,239
Other—Dynegy	—	7	—	7