

RELIANT ENERGY INC
Form 10-Q
November 09, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from _____ to _____

Commission file number: 1-16455

Reliant Energy, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

76-0655566

(I.R.S. Employer Identification No.)

**1000 Main Street
Houston, Texas 77002**

(Address of Principal Executive Offices) (Zip Code)

(713) 497-3000

(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. Yes No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of October 31, 2006, the latest practicable date for determination, Reliant Energy, Inc. had 308,488,738 shares of common stock outstanding and no shares of treasury stock.

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FORWARD-LOOKING INFORMATION

Projections, estimates or assumptions about revenues, costs, income, cash flow and other future events are called forward-looking statements. These forward-looking statements are within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Act of 1934. In some cases, you can identify forward-looking statements by words like anticipate, estimate, believe, intend, may, expect or similar words. Forward-looking statements are not guarantees of future performance. Actual results may differ from forward-looking statements. Each forward-looking statement speaks only as of its date and we are under no obligation to update these statements. For information about factors that could cause our actual results to differ from forward-looking statements, see Risk Factors in Item 1A of Reliant Energy, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2005 (Form 10-K), note 14 to our interim financial statements in Item 1 of this Quarterly Report on Form 10-Q and Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 2 of this Quarterly Report on Form 10-Q.

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PART I.
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

RELIANT ENERGY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Thousands of Dollars, Except Per Share Amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Revenues (including \$(14,579), \$(226,509), \$187,320 and \$(326,849) unrealized gains (losses) on energy derivatives)	\$ 3,305,568	\$ 2,963,021	\$ 8,533,156	\$ 7,111,730
Expenses:				
Purchased power, fuel and cost of gas sold (including \$(340,886), \$(127,367), \$(467,288) and \$235,483 unrealized gains (losses) on energy derivatives)	2,989,956	2,697,009	7,473,913	5,877,446
Operation and maintenance	220,460	178,393	635,990	556,106
Selling, general and administrative	116,465	99,085	278,895	241,982
Western states settlement	35,000	350,805	35,000	350,805
Gains on sales of assets and emission allowances, net	(3,457)	(91,874)	(159,787)	(115,793)
Depreciation and amortization	108,256	124,159	279,853	336,530
Total operating expense	3,466,680	3,357,577	8,543,864	7,247,076
Operating Loss	(161,112)	(394,556)	(10,708)	(135,346)
Other Income (Expense):				
Income of equity investments, net	1,268	27,029	3,655	23,185
Other, net	(163)	62	666	(22,817)
Interest expense	(100,840)	(99,774)	(312,446)	(293,680)
Interest income	6,889	3,228	22,784	15,280
Total other expense	(92,846)	(69,455)	(285,341)	(278,032)
Loss from Continuing Operations Before Income Taxes	(253,958)	(464,011)	(296,049)	(413,378)
Income tax benefit	(100,135)	(197,226)	(25,886)	(155,228)
Loss from Continuing Operations	(153,823)	(266,785)	(270,163)	(258,150)
Income (loss) from discontinued operations	(1,340)	(3,512)	(4,911)	61,655
Loss Before Cumulative Effect of Accounting Change	(155,163)	(270,297)	(275,074)	(196,495)
Cumulative effect of accounting change, net of tax			968	
Net Loss	\$ (155,163)	\$ (270,297)	\$ (274,106)	\$ (196,495)
Basic and Diluted Earnings (Loss) per Share:				
Loss from continuing operations	\$ (0.50)	\$ (0.88)	\$ (0.88)	\$ (0.86)
Income (loss) from discontinued operations		(0.01)	(0.01)	0.21

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Loss before cumulative effect of accounting change	(0.50))	(0.89))	(0.89))	(0.65))				
Cumulative effect of accounting change, net of tax												
Net loss	\$	(0.50))	\$	(0.89))	\$	(0.89))	\$	(0.65))

See Notes to our Unaudited Consolidated Interim Financial Statements

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RELIANT ENERGY, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Thousands of Dollars, Except Share and Per Share Amounts)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 66,670	\$ 88,397
Restricted cash	10,409	26,906
Accounts and notes receivable, principally customer, net of allowance of \$52,602 and \$34,054	1,390,954	1,171,673
Inventory	283,620	299,099
Derivative assets	448,755	725,964
Margin deposits	1,495,326	1,716,035
Accumulated deferred income taxes	333,879	361,547
Prepayments and other current assets	128,462	137,498
Current assets of discontinued operations	6,253	203,332
Total current assets	4,164,328	4,730,451
Property, plant and equipment, gross	7,160,153	7,112,684
Accumulated depreciation	(1,381,810)	(1,178,624)
Property, Plant and Equipment, net	5,778,343	5,934,060
Other Assets:		
Goodwill	386,594	386,594
Other intangibles, net	433,877	510,582
Derivative assets	258,872	527,799
Prepaid lease	279,085	259,412
Other	329,782	339,112
Long-term assets of discontinued operations		880,796
Total other assets	1,688,210	2,904,295
Total Assets	\$ 11,630,881	\$ 13,568,806
LIABILITIES AND EQUITY		
Current Liabilities:		
Current portion of long-term debt and short-term borrowings	\$ 483,958	\$ 789,325
Accounts payable, principally trade	794,934	886,965
Derivative liabilities	1,068,776	1,219,954
Margin deposits	15,200	15,588
Other	519,992	397,942
Current liabilities of discontinued operations	24,446	96,456
Total current liabilities	2,907,306	3,406,230
Other Liabilities:		
Derivative liabilities	567,009	812,695
Other	363,193	389,083
Long-term liabilities of discontinued operations		779,678
Total other liabilities	930,202	1,981,456
Long-term Debt	4,095,470	4,317,427
Commitments and Contingencies		
Temporary Equity Stock-based Compensation	1,330	
Stockholders Equity:		
Preferred stock; par value \$0.001 per share (125,000,000 shares authorized; none outstanding)		
Common stock; par value \$0.001 per share (2,000,000,000 shares authorized; 308,424,830 and 304,900,193 issued)	69	66
Additional paid-in capital	5,906,298	5,846,747
Retained deficit	(1,972,610)	(1,698,504)
Accumulated other comprehensive loss	(237,184)	(284,281)

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Accumulated other comprehensive loss of discontinued operations		(335)
Total stockholders' equity	3,696,573		3,863,693
Total Liabilities and Equity	\$ 11,630,881	\$	13,568,806

See Notes to our Unaudited Consolidated Interim Financial Statements

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RELIANT ENERGY, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Thousands of Dollars)
(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
Cash Flows from Operating Activities:		
Net loss	\$ (274,106)	\$ (196,495)
(Income) loss from discontinued operations	4,911	(61,655)
Net loss from continuing operations and cumulative effect of accounting change	(269,195)	(258,150)
Adjustments to reconcile net loss to net cash used in operating activities:		
Cumulative effect of accounting change	(968)	
Depreciation and amortization	279,853	336,530
Deferred income taxes	(58,324)	(177,844)
Net changes in energy derivatives	351,711	101,107
Amortization of deferred financing costs	12,101	11,208
Gains on sales of assets and emission allowances, net	(159,787)	(115,793)
Western states settlement	35,000	350,805
Income of equity investments, net	(3,655)	(23,185)
Other, net	12,657	24,960
Changes in other assets and liabilities:		
Accounts and notes receivable, net	(187,224)	(329,166)
Inventory	13,698	(21,224)
Margin deposits, net	220,321	(881,568)
Net derivative assets and liabilities	(127,512)	170,208
Western states and Cornerstone settlement payments	(159,885)	
Accounts payable	25,712	298,690
Other current assets	14,972	51,546
Other assets	(25,598)	(62,263)
Taxes payable/receivable	(8,141)	1,788
Other current liabilities	77,330	(21,140)
Other liabilities	(3,341)	23,949
Net cash provided by (used in) continuing operations from operating activities	39,725	(519,542)
Net cash provided by (used in) discontinued operations from operating activities	(45,093)	105,307
Net cash used in operating activities	(5,368)	(414,235)
Cash Flows from Investing Activities:		
Capital expenditures	(63,887)	(59,117)
Proceeds from sales of assets, net	1,417	149,345
Proceeds from sales of emission allowances	205,186	130,040
Purchases of emission allowances	(12,443)	(142,794)
Restricted cash	16,497	29,593
Other, net	5,750	2,500
Net cash provided by continuing operations from investing activities	152,520	109,567
Net cash provided by discontinued operations from investing activities	967,566	39,112
Net cash provided by investing activities	1,120,086	148,679
Cash Flows from Financing Activities:		
Payments of long-term debt	(331,028)	(42,164)
Increase (decrease) in short-term borrowings and revolving credit facilities, net	(189,364)	227,446
Proceeds from issuances of stock	21,947	25,975
Net cash provided by (used in) continuing operations from financing activities	(498,445)	211,257
Net cash used in discontinued operations from financing activities	(638,000)	
Net cash provided by (used in) financing activities	(1,136,445)	211,257
Net Change in Cash and Cash Equivalents	(21,727)	(54,299)
Cash and Cash Equivalents at Beginning of Period	88,397	105,054
Cash and Cash Equivalents at End of Period	\$ 66,670	\$ 50,755

Supplemental Disclosure of Cash Flow Information:

Cash Payments:

Interest paid (net of amounts capitalized) for continuing operations	\$	279,232	\$	254,560
Income taxes paid (net of income tax refunds received) for continuing operations	\$	40,027	\$	18,214

See Notes to our Unaudited Consolidated Interim Financial Statements

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RELIANT ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(1) Background and Basis of Presentation

(a) Background.

Reliant Energy refers to Reliant Energy, Inc. and we, us and our refer to Reliant Energy, Inc. and its consolidated subsidiaries. Our business consists primarily of two business segments, retail energy and wholesale energy. See note 12. Our consolidated interim financial statements and notes (interim financial statements) are unaudited, omit certain disclosures and should be read in conjunction with our audited consolidated financial statements and notes in our Form 10-K.

(b) Basis of Presentation.

Estimates. Management makes estimates and assumptions to prepare financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) that affect:

- the reported amount of assets, liabilities and equity,
- the reported amounts of revenues and expenses and
- our disclosure of contingent assets and liabilities at the date of the financial statements.

Adjustments and Reclassifications. The interim financial statements reflect all normal recurring adjustments necessary, in management's opinion, to present fairly our financial position and results of operations for the reported periods. Amounts reported for interim periods, however, may not be indicative of a full year period due to seasonal fluctuations in demand for electricity and energy services, changes in commodity prices, changes in our price-to-beat rate and other regulations, timing of maintenance and other expenditures, dispositions, changes in interest expense and other factors. We have reclassified certain immaterial amounts reported in this Form 10-Q from prior periods to conform to the 2006 presentation. These reclassifications had no impact on reported earnings/losses. We reclassified net purchases of emission allowances of \$57 million for the nine months ended September 30, 2005 from operating to investing cash flows.

Change in Estimate for Derivatives. See note 5 regarding a change in accounting estimate relating to our derivatives.

New Accounting Pronouncement Pension and Other Postretirement Plans. During September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. This statement requires recognition of the funded status of plans, measured as of fiscal year end. We are required to adopt the recognition provisions prospectively as of the end of 2006. We already use the required measurement date. Adopting this statement will increase our pension and postretirement liabilities, decrease other long-term assets, increase related deferred tax assets and increase accumulated other comprehensive loss. We are currently assessing the impact on our consolidated financial statements. As of December 31, 2005, the funded status of our pension and postretirement plans exceeded the amount recognized by \$32 million.

New Accounting Pronouncement Fair Value. During September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurement, which defines fair value, establishes a framework for measuring fair

value in GAAP and expands disclosures about fair value measurements. This statement is applicable for us beginning in 2008. It applies under other accounting pronouncements that require or permit fair value measurements. During 2007, we plan to assess the impact on our consolidated financial statements.

SEC Staff Guidance Quantifying Financial Statement Misstatements. During September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, which discusses the process of quantifying financial statement misstatements. We are not currently aware of any impact that Staff Accounting Bulletin No. 108 will have on our consolidated financial statements; however, we plan to adopt the guidance during the fourth quarter of 2006.

(2) Stock-based Compensation

Overview of Plans. The Compensation Committee of the Board of Directors administers our stock-based incentive plans. The Reliant Energy, Inc. 2002 Long-Term Incentive Plan and the Reliant Energy, Inc. 2002 Stock Plan permit us to grant various stock-based incentive awards to officers, key employees and directors. Awards include stock options, restricted stock, restricted stock units, performance awards, cash awards and stock awards.

As of September 30, 2006, 36 million shares are authorized for issuance under our stock-based incentive plans, with no more than 25% of these shares available for grant as awards of restricted stock and non-restricted grants of common stock or units denominated in common stock. We generally issue new shares when stock options are exercised and for the issuance of our other equity-based awards.

Summary. Prior to January 1, 2006, we applied the intrinsic value method of accounting for employee stock-based incentive plans (APB No. 25). Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS No. 123R) (using the modified prospective method), which requires compensation costs related to share-based transactions to be recognized in the financial statements based on estimated fair values at the grant dates. Our financial statements as of and for the nine months ended September 30, 2006 reflect the impact of SFAS No. 123R; however, our financial statements for prior periods have not been restated to reflect, and do not include, the impact of the new standard. Our compensation expense for our stock-based incentive plans was:

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	Nine Months Ended September 30,	
	2006	2005
	(in millions)	
Stock-based incentive plans compensation expense (pre-tax)	\$ 26	\$ 31
Income tax impact	(7)	(11)
After-tax expense	\$ 19	\$ 20

We did not capitalize any stock-based compensation costs as an asset during the nine months ended September 30, 2006 and 2005.

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We recorded a cumulative effect of an accounting change of \$2 million (\$1 million, net of tax of \$1 million) during the three months ended March 31, 2006 related to the adoption of SFAS No. 123R for the estimated future forfeitures on the compensation expense previously recognized in our consolidated financial statements for the unvested awards outstanding as of January 1, 2006.

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By the end of 2006, we will assess the income tax impacts and adopt one of the methods allowed under the transition provisions of SFAS No. 123R to account for excess tax benefits, if any, available to absorb tax deficiencies recognized subsequent to the adoption. During the nine months ended September 30, 2006, the accounting change did not impact cash flows from operating and financing activities due to our tax net operating loss carryforwards.

Valuation Data. Below is the description of the methods used during the indicated periods to estimate the fair value of our various awards.

	Prior to January 1, 2006 (APB No. 25)	After January 1, 2006 (SFAS No. 123R)
Award:		
Time-based stock options(1)	Intrinsic value on the grant date	Black-Scholes option-pricing model value on the grant date
Time-based restricted stock(2)	Market price of our common stock on the grant date	No change
Time-based cash(3)	Market price of our common stock on each reporting measurement date	No change
Key employee award program:		
Performance-based stock(1)	Market price of our common stock on each reporting measurement date	Market price of our common stock on each reporting measurement date until accounting grant date
Performance-based options(1)	Intrinsic value of option on each reporting measurement date	Black-Scholes option-pricing model value on each reporting measurement date until accounting grant date
Performance-based cash(1)(3)	Market price of our common stock on each reporting measurement date	No change
Employee stock purchase plan	No compensation expense recorded	Black-Scholes option-pricing model value on the first day of the offering period

(1) No awards were granted during the nine months ended September 30, 2006.

(2) Restricted stock and restricted stock units are referred to as restricted stock.

(3) These are liability-classified awards under SFAS No. 123R.

Time-Based Stock Options. We grant time-based stock options to officers, key employees and directors at an exercise price equal to the market value of our common stock on the grant date. Generally, options vest 33.33% per year for three years and have a term of 10 years. Beginning January 1, 2006, compensation expense is measured at fair value on the grant date, net of estimated forfeitures, and amortized to expense on a straight-line basis over the requisite service period for the entire award.

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Summarized time-based option activity is:

	Nine Months Ended September 30, 2006	
	Options	Weighted Average Exercise Price
Beginning of period	11,646,667	\$ 15.21
Granted		
Exercised	(1,538,777)	8.32
Forfeited	(20,638)	3.51
Expired	(1,693,376)	28.81
End of period	8,393,876	13.76
Weighted average grant date fair value	N/A	

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(1) Received proceeds of \$13 million. Intrinsic value was \$6 million on the exercise date. No tax benefits are expected to be realized in 2006 due to our tax net operating loss carryforwards.

During the nine months ended September 30, 2005, we granted 30,000 time-based options with a weighted average grant date fair value of \$7.18. During the nine months ended September 30, 2005, we received proceeds for

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the exercise of time-based options of \$27 million for which the intrinsic value was \$16 million. No tax benefits were realized during 2005 due to our tax net operating loss carryforwards.

For time-based options outstanding as of September 30, 2006:

	Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in millions)
Outstanding	8,393,876	(1)(2)	\$ 13.76	4.5	\$ 29
Exercisable	8,363,870		13.76	4.5	29

(1) We estimate that none of these will be forfeited.

(2) As of September 30, 2006, the total compensation cost related to nonvested time-based stock options not yet recognized and the weighted-average period over which it is expected to be recognized is \$0.2 million and one year, respectively.

Time-Based Restricted Stock Awards. We grant time-based restricted stock awards to officers, key employees and directors. In general, these awards vest, subject to the participant's continued employment, three years from the grant date. Beginning January 1, 2006, compensation expense is measured at fair value on the grant date, net of estimated forfeitures, and amortized to expense on a straight-line basis over the requisite service period.

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Summarized restricted stock award activity is:

	Nine Months Ended September 30, 2006	
	Shares	Weighted Average Grant Date Fair Value
Beginning of period	1,855,583	\$ 6.96
Granted	343,409	11.59
Vested	(999,844)	(1) 5.08
Forfeited	(97,788)) 9.06
End of period	1,101,360	(2) 9.93

(1) Based on the market price of our common stock on the vesting date, \$11 million in fair value vested.

(2) We estimate that 161,799 of these will be forfeited.

During the nine months ended September 30, 2005, \$9 million in fair value of our time-based restricted stock vested based on the market price of our common stock on the vesting date. During the nine months ended September 30, 2005, the weighted average grant date fair value of time-based restricted stock activity was \$12.61. As of September 30, 2006, the total compensation cost related to nonvested time-based restricted stock awards not yet recognized and the weighted-average period over which it is expected to be recognized is \$4 million and 2 years, respectively.

Time-Based Cash Awards. We grant time-based cash awards (cash units with each cash unit having an equivalent fair market value of one share of our common stock on the vesting date) to officers and key employees. In general, these awards vest, subject to the participant's continued employment, three years from the grant date. Compensation expense is measured at fair value on each financial reporting measurement date, net of estimated forfeitures, and amortized to expense on a straight-line basis over the requisite service period. We have a liability recorded of \$5 million for these time-based cash awards as of September 30, 2006.

During the nine months ended September 30, 2006 and 2005, no time-based cash awards vested and we did not pay cash for any stock-based liabilities. As of September 30, 2006, the total compensation cost related to nonvested time-based cash awards not yet recognized and the weighted-average period over which it is expected to be recognized is \$4 million and 2 years, respectively.

Performance-Based Awards. We grant performance-based awards to officers and key employees. The number of performance-based awards earned is determined at the end of each performance period. All of the outstanding performance-based awards as of September 30, 2006 are for the 2004-2006 performance period, which is the requisite service period. Beginning January 1, 2006, compensation expense is measured at fair value, net of

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estimated forfeitures, at each reporting measurement date preceding the grant date for accounting purposes. We have broadly interpreted the criteria for determining if the service inception date precedes the grant date for our performance-based awards under SFAS No. 123R. For our performance-based cash unit awards, we have a liability recorded of \$14 million as of September 30, 2006.

The Compensation Committee granted the 2004-2006 performance-based awards through the Key Employee Award Program (the Key Employee Program) established under the Reliant Energy, Inc. 2002 Long-Term Incentive Plan. Under the Key Employee Program, each performance-based award represents a targeted award of (a) 16,000 shares of performance-based stock, (b) 68,000 performance-based stock options and (c) 16,000 cash units with each cash unit having an equivalent fair market value of one share of our common stock on the vesting date. The Key Employee Program provides for a payout ranging from 0% to 140% of the targeted award level, as determined by the Compensation Committee in its sole discretion after considering various qualitative and quantitative performance criteria. These criteria include (a) reducing the ratio of our adjusted net debt to adjusted EBITDA to at least 3.5, (b) delivering superior customer value and (c) building a great company to work for, taking into consideration market conditions for each factor. The Compensation Committee has the discretion to weight the various performance objectives as it deems appropriate.

Summarized performance-based stock award activity of the Key Employee Program assuming a maximum payout (140%) is:

	Nine Months Ended September 30, 2006		Reporting Measurement Date Fair Value
	Shares		
Beginning of period	1,825,600		
Granted			
Vested			
Forfeited	(67,200)		
End of period	1,758,400	(1)	\$ 12.33

(1) We estimate no awards will be forfeited prior to vesting.

Summarized performance-based option activity of the Key Employee Program assuming a maximum payout (140%) is:

	Nine Months Ended September 30, 2006		Weighted Average Remaining Contractual Term (Years)
	Options	Weighted Average Exercise Price	
Beginning of period	7,758,800	\$ 8.35	
Granted			
Exercised			
Forfeited	(285,600)	8.14	
Expired			
End of period	7,473,200	(1)(2) 8.36	7.4
Exercisable at end of period			

(1) We estimate no awards will be forfeited prior to vesting.

(2) The aggregate intrinsic value is \$30 million.

During the nine months ended September 30, 2005, we granted 78,400 performance-based stock awards with a weighted average grant date fair value of \$12.63 and 333,200 performance-based stock options with a weighted average grant date fair value of \$5.54. However, during the nine months ended September 30, 2005, no performance-based options were exercised.

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Our option awards under the Key Employee Program are based on the following weighted average assumptions and resulting fair values:

	Nine Months Ended September 30, 2006	
Expected term in years(1)	3.25	
Estimated volatility(2)	40.96	%
Risk-free interest rate	4.60	%
Dividend yield	0	%
Weighted-average fair value	\$ 6.05	

-
- (1) The expected term is based on a projection of exercise behavior considering the contractual terms and the participants of the option awards.
- (2) We estimated volatility based on historical and implied volatility of our common stock.

During the nine months ended September 30, 2006, no performance-based awards vested. During the nine months ended September 30, 2005, \$1 million in fair value of our performance-based awards for the 2002-2004 performance period vested based on the market price of our common stock on the vesting date. As of September 30, 2006, the total compensation cost related to nonvested performance based awards not yet recognized and the weighted-average period over which it is expected to be recognized is \$6 million and 0.25 years, respectively.

Employee Stock Purchase Plan. We have 18 million shares of authorized common stock reserved and approved for issuance under the Reliant Energy, Inc. Employee Stock Purchase Plan (ESPP). Under the ESPP, substantially all employees can purchase our common stock through payroll deductions of up to 15% of eligible compensation during semiannual offering periods commencing on January 1 and July 1 of each year. The share price paid by participants equals 85% of the lesser of the average market price on the first or last business day of each offering period.

Our employee stock purchase plan awards are based on the following weighted average assumptions and resulting fair values:

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	Nine Months Ended September 30,			
	2006		2005(1)	
Expected term in years	0.5		0.5	
Estimated volatility(2)	46.42	%	33.56	%
Risk-free interest rate	4.62	%	2.84	%
Dividend yield	0	%	0	%
Weighted-average fair value	\$ 3.07		\$ 3.30	

(1) Because we applied APB No. 25 during 2005, this was only used for pro-forma data.

(2) We estimated volatility based on the historical volatility of our common stock.

During the nine months ended September 30, 2006 and 2005, we issued 859,549 shares and 838,120 shares, respectively, under the ESPP and received \$8 million each period from the sale of shares to employees. Approximately 10.7 million reserved unissued shares were available under the ESPP as of September 30, 2006.

Pro-forma Data for 2005. If employee stock-based compensation costs had been expensed based on the fair value (determined using the Black-Scholes model and market price of our common stock) method of accounting applied to all stock-based awards, our pro forma results would be:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	(in millions, except per-share amounts)	
Net loss, as reported	\$ (270)	\$ (196)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	15	20
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7)	(17)
Pro forma net loss	\$ (262)	\$ (193)
Loss per share:		
Basic, as reported	\$ (0.89)	\$ (0.65)
Basic, pro forma	\$ (0.87)	\$ (0.64)
Diluted, as reported	\$ (0.89)	\$ (0.65)
Diluted, pro forma	\$ (0.87)	\$ (0.64)

Classification. Through December 31, 2005, our accruals for our stock-based incentive awards were recorded as liabilities. Beginning January 1, 2006, for stock-based equity awards, we reclassified our accrual of \$23 million to equity, of which \$5 million was classified as temporary equity stock-based compensation based on the redemption amount of the award as of the grant date, and the remainder was classified as additional paid-in capital in stockholders equity. Some of our stock-based equity awards provide for the settlement of the award in cash by us pursuant to change of control provisions and we do not believe it is probable these awards will become redeemable.

Other. We did not use cash to settle equity instruments granted under stock-based compensation plans during the nine months ended September 30, 2006 and 2005. During the nine months ended September 30, 2006 and 2005, there were no significant modifications to our outstanding stock-based awards.

(3) Comprehensive Loss

The components of total comprehensive loss are:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in millions)		(in millions)	
Net loss	\$ (155)	\$ (270)	\$ (274)	\$ (196)
Other comprehensive income (loss), net of tax:				
Deferred loss from cash flow hedges	(23)	(73)	(134)	(188)
Reclassification of net deferred (gain) loss from cash flow hedges realized in net income/loss	110	16	181	(15)
Comprehensive income resulting from discontinued operations		3		4
Comprehensive loss	\$ (68)	\$ (324)	\$ (227)	\$ (395)

(4) Goodwill

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2006 Annual Goodwill Impairment Tests. We completed our annual goodwill impairment tests for our wholesale energy and retail energy reporting units effective April 1, 2006. No impairments occurred.

Estimation of Our Wholesale Energy Reporting Unit's Fair Value. We updated a number of subjective factors and significant assumptions to estimate fair value in our April 2006