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RELIANT RESOURCES INC
Form 10-K/A
July 05, 2002

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

FORM 10-K/A

AMENDMENT NO. 1

(MARK ONE)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2001

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 RESOURCES, INC.
(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

76-

(I.R.S. Employer I

1111 LOUISIANA
HOUSTON, TEXAS 77002

(Address and zip code of principal executive offices)

(713)

(Registrant's telephone

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS

NAME OF EACH EXCHANGE ON

Common Stock, par value \$.001 per share, and associated
rights to purchase Series A Preferred Stock

New York Stock

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: NONE

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

The aggregate market value of the voting stock held by non-affiliates of Reliant Resources, Inc. (Reliant Resources) was \$833,436,412 as of April 1, 2002, using the definition of beneficial ownership contained in Rule 13d-3 promulgated pursuant to the Securities Exchange Act of 1934 and excluding shares held by directors and executive officers. As of April 1, 2002, Reliant Resources had 289,354,781 shares of Common Stock outstanding including 240,000,000 shares which were held by Reliant Energy, Incorporated. Excluded from the number of shares of Common Stock outstanding are 10,449,219 shares held by Reliant Resources as treasury stock.

Portions of the definitive proxy statement relating to the 2002 Annual Meeting of Stockholders of Reliant Resources, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2001, are incorporated by reference in Item 10, Item 11, Item 12 and Item 13 of Part III of this Form 10-K.

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Reliant Resources, Inc. (Reliant Resources) hereby amends Items 1, 6, 7 and 8 of its Annual Report of Form 10-K for the year ended December 31, 2001 as originally filed on April 15, 2002.

Restatement

On May 9, 2002, Reliant Resources determined that it had engaged in same-day commodity trading transactions involving purchases and sales with the same counterparty for the same volume at substantially the same price, which the personnel who effected these transactions apparently did so with the sole objective of increasing volumes. Reliant Resources commenced a review to quantify the amount and assess the impact of these trades (round trip trades). The Audit Committees of each of the Board of Directors of Reliant Resources and Reliant Energy, Incorporated (Reliant Energy), a diversified international energy services and energy delivery company that owns approximately 83% of our outstanding common stock, also directed an internal investigation by outside legal counsel, with assistance by outside accountants, of the facts and circumstances relating to the round trip trades and related matters.

We currently report all trading, marketing and risk management services transactions on a gross basis with such transactions being reported in revenues and expenses except primarily for financial gas transactions such as swaps. Therefore, the round trip trades were reflected in both our revenues and expenses (i.e. they should have been reflected on a net basis). The round trip trades should not have been recognized in revenues or expenses. However, since the round trip trades were done at the same volume and substantially the same price, they had no impact on our reported cash flows, operating income or net income. In addition to the round trip trades reported on May 13, 2002, we also identified an additional transaction in 1999, which based on available information, Reliant Resources believes was also recorded with the sole objective of increasing volumes but also resulted in increased revenues and fuel and cost of gas sold expense.

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In addition, during the May 2001 through September 2001 time frame, we entered into four structured transactions involving a series of forward or swap contracts to buy and sell an energy commodity in 2001 and to buy and sell an energy commodity in 2002 or 2003 (four structured transactions). The four structured transactions were intended to increase future cash flow and earnings and to increase certainty associated with future cash flow and earnings, albeit at the expense of 2001 cash flow and earnings. Each series of contracts in a structure were executed contemporaneously with the same counterparty and were for the same commodities, quantities and locations. The contracts in each structure were offsetting in terms of physical attributes. The transactions that settled in 2001 were previously recorded on a gross basis with such transactions being reported in revenues and expenses which resulted in \$1.5 billion of revenues, \$364 million in fuel and cost of gas sold and \$1.2 billion of purchased power expense being recognized during the period from May 2001 through December 31, 2001. Having further reviewed the transactions, we now believe these transactions should have been accounted for on a net basis.

In the course of our review, we also identified and determined to record on a net basis several transactions for energy related services (not involving round trip trades) that totaled \$85 million over the three year period ended December 31, 2001. These transactions were originally recorded on a gross basis.

During the fourth quarter of 2000, two power generation swap contracts with a fair value of \$261 million were terminated and replaced with a substantially similar contract providing for physical delivery and designated to hedge electric generation. The termination of the original contracts and execution of the replacement contract represented a substantive modification to the original contract. As a result, upon termination of the original contracts, a contractual liability representing the fair value of the original contracts and a deferred asset of equal amount should have been recorded. As of January 1, 2001, in connection with the adoption of Statement of Financial Accounting Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended, the deferred asset should have been recorded as a transition adjustment to other comprehensive loss. The liability and transition adjustment should have been amortized on a straight-line basis over the term of the power generation contract replacing the terminated power generation contracts (through May 2004). We previously did not give accounting recognition to these transactions. As a result, we have restated our Consolidated Balance Sheets as of December 31, 2000 and 2001 and the Statement of Consolidated Stockholders' Equity and Comprehensive Income for the year ended December 31, 2001, to appropriately account for these transactions as described above. The restatement had no impact on our reported consolidated cash flows, operating income or net income.

As a result, Reliant Resources' consolidated financial statements (Original Consolidated Financial Statements) and related disclosures for 1999, 2000 and 2001 have been restated from amounts previously reported. The principal effects of the restatement on the consolidated financial statements are set forth in Note 1 to our consolidated financial statements contained in this Form 10-K/A.

For purposes of this Form 10-K/A, and in accordance with Rule 12b-15 under the Securities Exchange Act of 1934, as amended, each item of the Form 10-K for the year ended December 31, 2001 as originally filed on April 15, 2002 that was affected by the restatement has been amended to the extent affected and restated in its entirety. NO ATTEMPT HAS BEEN MADE IN THIS FORM 10-K/A TO MODIFY OR UPDATE OTHER DISCLOSURES AS PRESENTED IN THE ORIGINAL FORM 10-K EXCEPT AS REQUIRED TO REFLECT THE EFFECTS OF THE RESTATEMENT.

We are a party to numerous lawsuits and regulatory proceedings relating to our trading and marketing activities, including the round trip trades and the

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four structured transactions, and our activities in the California wholesale market. In addition, various state and federal governmental agencies have commenced investigations relating to such activities. For a description of certain of these lawsuits, proceedings and investigations, please read "Legal Proceedings" in Item 3 of this Form 10-K and Notes 13(e) and 13(i) to our consolidated financial statements, Notes 11 and 14(c) to our interim financial statements included in our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2002 (First Quarter Form 10-Q), and our Current Report on Form 8-K dated July 3, 2002.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

From time to time we make statements concerning our expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are not historical facts. These statements are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those expressed or implied by these statements. In some cases, you can identify our forward-looking statements by the words "anticipates," "believes," "continue," "could," "estimates," "expects," "forecast," "goal," "intends," "may," "objective," "plans," "potential," "predicts," "projection," "should," "will," or other similar words.

For a list of factors that could cause actual results to differ materially from those expressed or implied in our forward-looking statements, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings" in Item 7 of this Form 10-K.

We have based our forward-looking statements on management's beliefs and assumptions based on information available at the time the statements are made. We caution you that assumptions, beliefs, expectations, intentions and projections about future events may and often do vary materially from actual results. Therefore, actual results may differ materially from those expressed or implied by our forward-looking statements.

You should not place undue reliance on forward-looking statements. Each forward-looking statement speaks only as of the date of the particular statement, and we undertake no obligation to publicly update or revise any forward-looking statements.

The following sections of this Form 10-K contain forward-looking statements:

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GENERAL

Reliant Resources, Inc., a Delaware corporation, was incorporated in August 2000. In this Form 10-K, we refer to Reliant Resources, Inc. as "Reliant Resources," and to Reliant Resources and its subsidiaries collectively, as "we" or "us," unless the context clearly indicates otherwise. The executive offices of Reliant Resources are located at 1111 Louisiana, Houston, TX 77002 (telephone number 713-207-3000).

We provide electricity and energy services with a focus on the competitive wholesale and retail segments of the electric power industry in the United States. We acquire, develop and operate electric power generation facilities that are not subject to traditional cost-based regulation and therefore can generally sell power at prices determined by the market. We also trade and market power, natural gas and other energy-related commodities and provide related risk management services.

As of December 31, 2001, we owned or leased electric power generation facilities with an aggregate net generating capacity of 14,585 megawatts (MW), including 11,109 MW in the United States and 3,476 MW in the Netherlands. Of the 11,109 MW in the United States, 1,179 MW represent our entitlement to capacity of facilities that we lease under operating leases. For additional information regarding these operating leases, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Consolidated Capital Requirements and Uses of Cash" in Item 7 of this Form 10-K, and Note 13(c) to our consolidated financial statements, which, together with the notes related to these statements, we refer to in this Form 10-K as our "consolidated financial statements." We acquired our first power generation facilities in 1998 and have increased our net generating capacity since then through a combination of acquisitions and development of new generation projects. Since December 31, 2001, we have added 5,644 MW of additional net generating capacity to our asset portfolio through our acquisition of Orion Power Holdings, Inc. According to Resource Data International, Inc., we are the second largest independent electric power producer in the United States based on total MW of wholesale generation capacity in operation as of February 28, 2002.

As of December 31, 2001, we had 3,587 MW (3,391 MW, net of 196 MW to be retired upon completion of one facility) of additional net generating capacity under construction, including 2,120 MW of facilities owned by off-balance sheet special purpose entities that are being constructed under construction agency agreements pursuant to synthetic leasing arrangements. Upon the completion of construction, we expect that we will lease these facilities from their owners. For additional information regarding the construction agency agreements, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Off-Balance Sheet Transactions" in Item 7 of this Form 10-K and Note 13(h) to our consolidated financial statements. We consider a project to be "under construction" once we have acquired the necessary permits to begin construction, broken ground on the project site and contracted to purchase machinery for the project, including the combustion turbines.

Additionally, we became a retail electric provider (i.e., a seller of electricity to retail customers) in Texas when that market began opening to retail electric competition in late 2001 and fully opened to retail competition in January 2002. Since then, all classes of customers of most investor-owned Texas utilities, as well as those of any municipal utility or electric cooperative that opted to participate in the competitive marketplace, have been able to choose their retail electric provider. Under Texas regulation, retail electric providers procure or buy electricity from wholesale generators at unregulated rates, sell electricity at generally unregulated rates to their retail customers and pay the local transmission and distribution regulated

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utilities a regulated tariff rate for delivering the electricity to their customers. In January 2002, we became the retail electric provider for all of Reliant Energy HL&P's (formerly the integrated electric utility serving the Houston, Texas metropolitan area) (Reliant Energy's electric utility) approximately 1.7 million customers in the Houston area who did not take action to select another retail electric provider. At that time, we were also able to acquire and serve new retail electric customers in other Texas competitive markets.

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We conduct our operations through the following business segments:

- o Wholesale Energy - provides electricity and energy services in the competitive segments of the United States wholesale energy industries,
- o European Energy - includes power generation assets in the Netherlands and a related trading and power origination business,
- o Retail Energy - provides electricity and related services to retail customers primarily in Texas, and
- o Other Operations - includes the operations of our venture capital and Communications businesses, and unallocated corporate costs.

For information about the revenues, operating income, assets and other financial information relating to our business segments, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations by Business Segment" in Item 7 of this Form 10-K and Note 18 to our consolidated financial statements. For information regarding the decision to exit our Communications business, please read Note 16 to our consolidated financial statements.

FORMATION, INITIAL PUBLIC OFFERING AND ANTICIPATED DISTRIBUTION

Reliant Energy, Incorporated (Reliant Energy) owns more than 80% of our outstanding common stock. Reliant Energy has adopted a business separation plan in response to the Texas Electric Choice Plan (Texas electric restructuring law) adopted by the Texas legislature in June 1999. The Texas electric restructuring law substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail electric competition with respect to all customer classes beginning in January 2002. Under its business separation plan filed with the Public Utility Commission of Texas (Texas Utility Commission), Reliant Energy has transferred substantially all of its unregulated businesses to us in order to separate its regulated and unregulated operations. In accordance with the plan, we completed our initial public offering (IPO) of nearly 20% of our common stock in May 2001 and received net proceeds from the IPO of \$1.7 billion. Pursuant to the terms of the master separation agreement between Reliant Energy and us, we used \$147 million of the net proceeds to repay certain indebtedness owed to Reliant Energy. We used the remainder of the net proceeds of the IPO for repayment of third party borrowings, capital expenditures, repurchases of our common stock and to increase our working capital. For additional information regarding the IPO, please read Notes 1 and 9(a) to our consolidated financial statements. For additional information regarding agreements and transactions between Reliant Resources and Reliant Energy, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Related-Party Transactions" in Item 7 of this Form 10-K and Notes 3 and 4 to our consolidated financial statements.

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As part of its business separation plan, Reliant Energy has publicly disclosed that it intends to restructure its corporate organization into a public utility holding company structure (Reorganization) and to distribute, subject to further governmental and corporate approvals, market and other conditions, its remaining equity interest in our common stock to its or its successor's shareholders (Distribution). In December 2001, Reliant Energy's shareholders voted to approve the merger required for the holding company reorganization. As a result of the Reorganization and the Distribution, Reliant Energy's successor holding company will be named "CenterPoint Energy, Inc." and will own essentially all of Reliant Energy's regulated businesses (CenterPoint Energy), and we will become a separate company unaffiliated with CenterPoint Energy. Reliant Energy has publicly disclosed its goal to complete the Reorganization and subsequent Distribution as quickly as possible after all the necessary conditions are fulfilled, including receipt of an order from the Securities and Exchange Commission (SEC) granting the required approvals under the Public Utility Holding Company Act of 1935 (1935 Act) and an extension from the IRS for a private letter ruling obtained by Reliant Energy regarding tax-free treatment of the Distribution. Reliant Energy has filed an application with the SEC requesting the required approvals. The IRS private letter ruling is predicated on the completion of the Distribution by April 30, 2002. Reliant Energy is in the process of requesting an extension of this deadline. Reliant Energy currently expects to complete the Reorganization and Distribution in the summer of 2002. We cannot assure you that the Distribution will be completed as described or within the time period outlined above.

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ORION POWER ACQUISITION

On February 19, 2002, we acquired all of the outstanding shares of common stock of Orion Power Holdings, Inc. (Orion Power) for \$26.80 per share in cash pursuant to a definitive merger agreement for an aggregate purchase price of \$2.9 billion. At the time of closing, Orion Power had approximately \$2.4 billion of debt obligations (\$2.1 billion net of cash acquired, some of which is restricted pursuant to debt covenants). Orion Power is an independent electric power generating company that was formed in March 1998 to acquire, develop, own and operate power generating facilities in certain deregulated wholesale markets in North America. Orion Power has a diversified portfolio of generating assets, both geographically across the states of New York, Pennsylvania, Ohio and West Virginia, and by fuel type, including gas, oil, coal and hydropower. As of February 28, 2002, Orion Power owned 81 power plants with an aggregate net generating capacity of 5,644 MW and had two development projects with an additional 804 MW of capacity under construction. We consider most of the Orion Power facilities to be part of our Northeast regional portfolio and the remainder to be part of our Midwest regional portfolio. For additional information regarding our acquisition of Orion Power and its operations, please read " - Wholesale Energy - Northeast Region," and " - Midwest Region," and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Integration and Other Risks Associated with Our Orion Power Assets" and " - Uncertainty Related to the New York Regulatory Environment" in Item 7 of this Form 10-K, and Note 19 to our consolidated financial statements.

WHOLESALE ENERGY

Our Wholesale Energy business segment provides energy and energy services

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with a focus on the competitive wholesale segment of the United States energy industry. We acquire, develop and operate electric power generation facilities that are not subject to traditional cost-based regulation and therefore can generally sell power at prices determined by the market, subject to regulatory limitations in certain regions. We also trade and market power, natural gas, natural gas transportation capacity and other energy-related commodities and provide related risk management services.

POWER GENERATION OPERATIONS

As of December 31, 2001, our Wholesale Energy business segment owned or leased electric power generation facilities with an aggregate net generating capacity of 11,109 MW located in five regions of the United States. We also had 3,587 MW (3,391 MW, net of 196 MW to be retired upon completion of one facility) of net generating capacity under construction as of that date. In addition, by acquiring Orion Power in February 2002, we added 81 power plants with an aggregate net generating capacity of 5,644 MW and two development projects with an additional 804 MW of capacity under construction to our regional portfolios.

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The following table describes our Wholesale Energy business segment's electric power generation facilities by region as of December 31, 2001.

REGIONAL SUMMARY OF OUR GENERATION FACILITIES (AS OF DECEMBER 31, 2001)

REGION	NUMBER OF GENERATION FACILITIES (1)	TOTAL NET GENERATING CAPACITY (MW)	DISPATCH TYPE (2)
NORTHEAST			
Operating(3)	21	4,262	Base, Inter, Peak
Under Construction(4) (5) (6)	1	1,120	Base, Inter, Peak
Combined	22	5,382	
MIDWEST			
Operating	2	1,063	Peak
Under Construction(7)	--	154	Peak
Combined	2	1,217	
SOUTHEAST			
Operating(8)	3	979	Inter, Peak, CoGen
Under Construction(5) (9)	1	958	Base, Inter, Peak
Combined	4	1,937	
WEST			
Operating(7)	7	4,635	Base, Inter, Peak
Under Construction	1	548	Base, Peak
Combined	8	5,183	
ERCOT(10)			
Operating	1	170	Base, CoGen

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Under Construction(4)	--	611	Base, CoGen
	-----	-----	
Combined	1	781	
TOTAL			
Operating	34	11,109	
Under Construction	3	3,391	
	-----	-----	
Combined	37	14,500	
	=====	=====	

- (1) Unless otherwise indicated, we own a 100% interest in each facility listed.
- (2) We use the designations "Base," "Inter," "Peak" and "CoGen" to indicate whether the facilities described are base-load, intermediate, peaking or cogeneration facilities, respectively.
- (3) We lease a 100%, 16.67% and 16.45% interest in three Pennsylvania facilities having 613 MW, 285 MW and 281 MW, respectively, through facility lease agreements having terms of 26.5 years, 33.75 years and 33.75 years, respectively.
- (4) One of our two construction projects in this region will replace one of our existing facilities upon completion. Therefore, this project is not included in the facility count for the "Under Construction" group of this region.
- (5) Our two construction projects in the Northeast region and one of our projects in the Southeast region are owned by off-balance sheet special purpose entities and are being constructed under construction agency agreements pursuant to synthetic leasing arrangements. We expect that we will lease these facilities from their owners upon completion.
- (6) The 1,120 MW of net capacity under construction is based on 1,316 MW of capacity currently under construction less 196 MW of operating capacity that will be retired upon completion of one of the projects.
- (7) Five of the six generating units of one of the facilities in this region are operational while the sixth unit is under construction. This partially operational facility is included in the facility count for the "Operating" group of this region.
- (8) We own a 50% interest in one of these facilities. An independent third party owns the other 50%.
- (9) Two of the three generating units of one of the facilities in this region are operational while the third unit is under construction. This partially operational facility is included in the facility count for the "Operating" group of this region.

- (10) We also have an option, which is exercisable in January 2004, subject to completion of the Distribution, to acquire Reliant Energy's approximate 80% interest in a company that is currently expected to own approximately 13,900 MW of net generating capacity in the Electric Reliability Council of

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Texas (ERCOT) in January 2004. For additional information regarding this option, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Related-Party Transactions - Agreements between Reliant Energy and Reliant Resources - Genco Option Agreement" in Item 7 of this Form 10-K and Note 4(b) to our consolidated financial statements.

The following table describes our Orion Power electric power generation facilities by region as of February 28, 2002.

REGIONAL SUMMARY OF OUR ORION POWER FACILITIES (AS OF FEBRUARY 28, 2002)

REGION	NUMBER OF GENERATION FACILITIES	TOTAL NET GENERATING CAPACITY (MW)	DISPATCH TYPE(1)	
NORTHEAST				
Operating(2)	78	4,174	Base, Inter, Peak	Gas/
Under Construction	2	804	Base, Inter	Gas
Combined	80	4,978		
MIDWEST				
Operating	3	1,470	Base, Inter, Peak	Coal
TOTAL				
Operating(2)	81	5,644		
Under Construction	2	804		
Combined(2)	83	6,448		

(1) We use the designations "Base," "Inter" and "Peak" to indicate whether the facilities described are base-load, intermediate or peaking, respectively.

(2) Two hydro plants with a net generating capacity of approximately 5 MW are not currently operational.

NORTHEAST REGION

Facilities. As of December 31, 2001, we owned or leased 21 electric power generation facilities with an aggregate net generating capacity of 4,262 MW located in the control area of PJM Interconnection, L.L.C. (PJM ISO), the independent system operator in the Pennsylvania-New Jersey-Maryland market (PJM market). These facilities are owned or leased by subsidiaries of one of our wholly owned subsidiaries, Reliant Energy Mid-Atlantic Power Holdings, LLC (REMA). The generating capacity of these facilities consists of approximately 40% of base-load, 40% of intermediate and 20% of peaking capacity, and represents approximately 7% of the total generation capacity located in the PJM ISO's control area. For additional information regarding our acquisition of these facilities, please read Note 5(a) to our consolidated financial statements.

By acquiring Orion Power in February 2002, we added 78 power generation facilities, of which 75 are currently operational, with an aggregate net

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generating capacity of 4,174 MW to our Northeast regional portfolio. These facilities include 70 hydroelectric facilities, of which 68 are currently operational, located in central and northern New York State, three facilities located in New York City, one facility located in East Syracuse, New York, and four facilities, three of which are currently fully operational, located in Pennsylvania. The generating capacity of these facilities consists of approximately 45% of base-load, 35% of intermediate and 20% of peaking capacity. For a discussion of factors that may affect the future earnings generated by these Orion Power facilities, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Integration and Other Risks Associated With Our Orion Power Assets" and " - Uncertainty Related to the New York Regulatory Environment" in Item 7 of this Form 10-K.

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We have begun construction on a 795 MW gas-fired base-load and intermediate facility located in Pennsylvania. We expect this facility will begin commercial operation in the second quarter of 2003. We have also begun construction on a 521 MW coal-fired base-load facility, also located in Pennsylvania, that will replace one of our existing facilities. This facility will add 325 MW of additional capacity to our Northeast regional portfolio, net of the 196 MW of capacity of the currently existing facility that will be retired upon commencement of commercial operations of the new facility. We expect this facility will begin commercial operation near the end of 2004. These facilities are owned by off-balance sheet special purpose entities and are being constructed under the terms of separate construction agency agreements pursuant to synthetic leasing arrangements. Upon completion of the construction of these facilities, we expect that we will lease these facilities from their owners, purchase or remarket each facility. For additional information regarding the construction agency agreements, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Off-Balance Sheet Transactions - Construction Agency Agreements" in Item 7 of this Form 10-K and Note 13(h) to our consolidated financial statements.

By acquiring Orion Power in February 2002, we added two additional development projects with an additional 804 MW of capacity under construction. The first project is the construction of a 550 MW gas-fired base-load facility located south of Philadelphia, Pennsylvania. We expect this facility will begin commercial operation in the second quarter of 2002. The second project is the conversion and upgrade of a peaking facility located near downtown Pittsburgh, Pennsylvania. We expect this project will be completed by the third quarter of 2002 and will increase the aggregate generating capacity of this facility by 254 MW to a total capacity of 308 MW.

Market Framework. We currently sell the power generated by our Northeast regional facilities in the PJM market, the wholesale energy market of the State of New York (New York wholesale market) operated by the New York Independent System Operator (NYISO) and to buyers in adjacent power markets, such as the region covered by the East Central Area Reliability Coordinating Council (ECAR market). We also expect to sell power in a newly created extension of the PJM market in western Pennsylvania (PJM West market). Each of the PJM Market, the New York wholesale market and the PJM West market operate as centralized power pools with open-access, non-discriminatory transmission systems administered by independent system operators approved by the Federal Energy Regulatory Commission (FERC). Although the transmission infrastructure within these markets is generally well developed and independently operated, transmission constraints exist between, and to a certain extent within, these markets. In particular,

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transmission of power from eastern Pennsylvania to western Pennsylvania and into New York City may be constrained from time to time. Depending on the timing and nature of transmission constraints, market prices may vary from market to market, or between sub-regions of a particular market. For example, as a result of transmission constraints into New York City, power prices are generally higher there than in other parts of the state.

In addition to managing the transmission system for each market, the respective independent system operator for each of the PJM market, the New York wholesale market and the PJM West market is responsible for maintaining competitive wholesale markets, operating the spot wholesale energy market and determining the market clearing price based on bids submitted by participating generators in each market. Each independent system operator generally matches sellers with buyers within a particular market that meet specified minimum credit standards. We sell capacity, energy and ancillary services into the markets maintained by the applicable independent system operator for each of these types of products for both real-time sales and forward sales for periods of up to one year. Our customers include the members of each market, consisting of municipalities, electric cooperatives, integrated utilities, transmission and distribution utilities, retail electric providers and power marketers. We also sell capacity, energy and ancillary services to customers in the Northeast region under negotiated bilateral contracts. Bilateral contracts, in addition to other physical and financial transactions enable us to hedge a portion of our generation portfolio. For a more complete description of our hedging strategy and a summary of the consolidated hedge position of our United States generating assets, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K.

Our markets in the Northeast region are subject to constant and significant regulatory oversight and control and the results of our operations in the region may be adversely affected by any changes or additions to the current regulatory structure. Our sales into markets administered by the PJM ISO are governed by the PJM ISO's operating

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agreements, tariffs and protocols (PJM Protocols). The PJM Protocols provide the structure, rules and pricing mechanisms for the PJM ISO's energy, capacity and ancillary services markets, and establish rates, terms and conditions for transmission service in the PJM ISO's control area and the PJM West market, including transmission congestion pricing. Wholesale energy prices in the markets administered by the PJM ISO are currently capped at \$1,000 per megawatt hour. Lower caps are utilized in other regions and it is possible that this price cap might be lowered in the future.

Our sales into markets administered by the NYISO are governed by the NYISO's tariff and protocols (NYISO Protocols). The NYISO Protocols provide the structure, rules and pricing mechanisms for the NYISO's energy, capacity and ancillary services markets, and establish rates, terms and conditions for transmission service in the NYISO's control area. The NYISO Protocols allow energy demand, commonly referred to as "load," to respond to high prices in

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emergency and non-emergency situations. The lack of programs, however, to implement load response to prices has been cited as one of the primary reasons for retaining wholesale energy bid caps, which are currently set at \$1,000 per megawatt hour. Lower price caps are utilized in other regions and it is possible that this price cap might be lowered in the future.

A capacity market has been established by the NYISO that ensures that there is enough generation capacity to meet retail energy demand and ancillary services requirements. All power retailers are required to demonstrate commitments for capacity sufficient to meet their peak forecasted load plus a reserve requirement, currently set at 18%. As an extra reliability measure, power retailers located in New York City are required to procure the majority of this capacity, currently 80% of their peak forecasted load, from generating units located in New York City. Because New York City is currently short of this capacity requirement and the existing capacity is owned by only a few entities, a price cap has been instituted for in-city generators.

For additional discussion of the impact of current regulations on the markets in the Northeast region and the related risks of re-regulation, please read " - Regulation - Federal Energy Regulatory Commission" and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Industry Restructuring, the Risk of Re-regulation and the Impact of Current Regulations" and " - Uncertainty Related to the New York Regulatory Environment" in Item 7 of this Form 10-K.

MIDWEST REGION

Facilities. As of December 31, 2001, we owned two electric power generation facilities located in the State of Illinois with an aggregate net generating capacity of 1,063 MW in operation. One of these facilities is a 344 MW gas-fired peaking generation facility located in Shelby County, Illinois. The first phase of this facility was initially placed in commercial operation in June 2000 and the second phase was placed in commercial operation in May 2001. We also have an 873 MW gas-fired peaking generation facility under construction in Aurora, Illinois. As of December 31, 2001, five of the six generating units at this facility with an aggregate net generating capacity of 719 MW had been placed in commercial operation. We expect the remaining unit at this facility will begin commercial operation in the second quarter of 2002.

By acquiring Orion Power in February 2002, we added three power generation facilities with an aggregate net generating capacity of 1,470 MW to our Midwest regional portfolio. Two of these facilities are located in Ohio and one is located in West Virginia. The generating capacity of these facilities consists of approximately 50% of base-load, 15% of intermediate and 35% of peaking capacity. For a discussion of the factors that may affect the future earnings generated by these Orion Power assets, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Integration and Other Risks Associated With Our Orion Power Assets" in Item 7 of this Form 10-K.

Market Framework. We sell the power generated by our Midwest regional facilities into the ECAR market and the region covered by the Mid-America Interconnected Network Reliability Council (MAIN market). These markets include all or portions of the states of Illinois, Wisconsin, Missouri, Indiana, Ohio, Michigan, Virginia, West Virginia, Tennessee, Maryland and Pennsylvania. These markets are currently in a state of transition and are in the process of establishing regional transmission organizations (RTO) that would define the rules and

requirements around which competitive wholesale markets in the region would develop. The FERC has approved proposals by the Midwest Independent System Operator (Midwest ISO) to administer a substantial portion of the transmission facilities in the Midwest region. The FERC also has ordered the Alliance RTO, which had a separate proposal to be the RTO for parts of the Midwest region, to explore joining the Midwest ISO. As a result, the final market structure for the Midwest region remains unsettled. The timing of the development of a RTO and the extent to which the Midwest ISO and the Alliance RTO would combine is currently unknown. In addition, some states within these markets have restructured their electric power markets to competitive markets from traditional utility monopoly markets, while others have not. Currently the transmission infrastructure in these markets is generally owned by non-independent market participants, some of which are our competitors, which has the potential to create market anomalies. Transmission constraints exist in these markets and have been managed by the owners of the transmission infrastructure, subject to transmission tariffs and protocols regulated by the FERC.

We currently sell power from our facilities in the Midwest region to customers under bilateral contracts that are generally non-standard with highly negotiated terms and conditions. Our customers include municipalities, electric cooperatives, integrated utilities, transmission and distribution utilities and power marketers. Direct customer sales, in addition to other physical and financial transactions enable us to hedge a portion of our generation portfolio. For a more complete description of our hedging strategy and a summary of the consolidated hedge position of our United States generating assets, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K.

FLORIDA AND OTHER SOUTHEASTERN MARKETS

Facilities. As of December 31, 2001, we owned, or owned interests in, three power generation facilities with an aggregate net generating capacity of 979 MW located in the states of Florida and Texas. These facilities include one gas and oil-fired generation facility with an aggregate net generating capacity of 619 MW located near Titusville, Florida. This facility can be operated as either an intermediate or a peaking facility. We also own a 464 MW gas and oil-fired peaking generation facility in Osceola County, Florida. Two of the three generating units of this plant with an aggregate net generating capacity of 310 MW commenced commercial operation in December 2001. We expect the remaining generating unit at this facility will begin commercial operation in the second quarter of 2002. In addition, we own a 50% interest in a 100 MW gas-fired base-load/cogeneration facility located in Orange, Texas. Air Liquide owns the other 50% interest in this plant which has been in commercial operation since December 1999.

We have begun construction on an 804 MW gas-fired intermediate/peaking facility in Choctaw County, Mississippi. We expect this facility will begin commercial operation in the second quarter of 2003. This facility is being constructed under the terms of a construction agency agreement under a synthetic leasing arrangement. Upon completion of the construction of this facility, we will have the right to lease, purchase or remarket the facility. For additional information regarding the construction agency agreement, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Off-Balance Sheet Transactions - Construction Agency Agreements" in Item 7 of this Form 10-K, and Note 13(h) to

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our consolidated financial statements.

Market Framework. We currently conduct the majority of our Southeast regional operations in the state of Florida. The state of Florida, other than a portion of the western panhandle, constitutes a single reliability council and contains approximately 5% of the United States population. The transmission-owning utilities in Florida have proposed establishing an independent system operator to assume control of the transmission system and undertake to define the rules and requirements for a competitive wholesale market. The timing of the development of an independent system operator for the Florida market is currently unknown. Under its present structure, the Florida market is dominated by incumbent utilities. There are a number of statutory and regulatory restrictions that negatively impact the development of additional power generation facilities in the region.

We currently sell power from our facilities in the Florida market under bilateral contracts that are non-standard and highly negotiated for terms and conditions. Until the rules for system operations are established, we expect limited trading opportunities will exist in the Florida market. The customers who participate in power transactions

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in this region include municipalities, electric cooperatives and integrated utilities. We sell capacity and energy to customers in the Florida market, however a market for ancillary services has not developed. Forward hedging of a portion of our Florida portfolio is generally accomplished through customer-tailored, multi-year sale agreements as no liquid, over-the-counter or auction markets currently exists in Florida. For a more complete description of our hedging strategy and a summary of the consolidated hedge position of our United States generation assets, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K.

With respect to our facilities in East Texas and Mississippi, several of the transmission-owning utilities in the Southeast region have formed the SETrans Grid Company (SETrans RTO) that they are proposing to serve as the region's RTO. The proposed SETrans RTO would manage, but not own, the transmission grid in the region and operate forward and spot markets for energy. The SETrans RTO has filed a status report with the FERC, but has not filed tariffs or protocols and has not been approved as the region's RTO.

WEST REGION

Facilities. As of December 31, 2001, we owned, or owned interests in, seven electric power generation facilities with an aggregate net generating capacity of 4,635 MW located in the states of California, Nevada and Arizona. These facilities include approximately 20% of base-load, 75% of intermediate and 5% of peaking capacity. Our facilities in the West region include five facilities with an aggregate net generating capacity of 3,800 MW located in California. We also own a 50% interest in a 490 MW gas-fired, base-load, peaking facility located near Las Vegas, Nevada. Semptra Energy owns the other 50% interest in this plant. In addition, we own a 590 MW gas-fired, base-load, peaking generation facility in Casa Grande, Arizona. This facility was placed in commercial operation in the fourth quarter of 2001. We also have a 548 MW gas-fired, base-load, peaking generation facility under construction in Nevada. We expect this facility will begin commercial operation in the fourth quarter of 2003.

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Market Framework. Our West regional market includes the states of Arizona, California, Oregon, Nevada, New Mexico, Utah and Washington. Generally we sell the power generated by our California and Nevada facilities to customers located in the Los Angeles basin of southern California. We also sell power generated by our Nevada facility to customers located in southern Nevada. Our customers in these states include power marketers, investor-owned utilities, electric cooperatives, municipal utilities and the California Independent System Operator (Cal ISO) acting on behalf of load-serving entities. We sell power and ancillary services to these customers through a combination of bilateral contracts and sales made in the Cal ISO's day-ahead and hour-ahead ancillary services markets and its real-time energy market. The Cal ISO does not currently maintain a market for capacity; however, a capacity market has recently been proposed by the Cal ISO under its market mitigation plan for the California market.

We have agreed to sell up to 100% of the power generated by our Arizona facility to the Salt River Project Agricultural Improvement and Power District of the State of Arizona under a long-term power purchase agreement. Bilateral contracts, in addition to other physical and financial transactions enable us to hedge a portion of our generation portfolio. For a more complete description of our hedging strategy and a summary of the consolidated hedge position of our United States generating assets, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K. In addition, although we do not own generation facilities in the states of Oregon, New Mexico, Utah and Washington, our trading and marketing operations purchase and deliver energy commodities in these states.

Our operations in the California market are subject to numerous environmental and other regulatory restrictions. Permits issued by local air districts restrict the output of some of our generating facilities. In addition, certain air districts require us to purchase emission credits to offset Nitrogen Oxides (NOx) emissions from our facilities.

In response to California's electricity market restructuring initiative, the FERC issued a series of orders in 1996 and 1997 approving a wholesale market structure administered by two independent non-profit corporations: the Cal ISO, responsible for operational control of the transmission system and the purchase or sale of electricity in "real-

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time" to balance actual supply and demand, and the California Power Exchange (Cal PX), responsible for conducting auctions for the purchase or sale of electricity on a day-ahead or day-of basis. As part of this market restructuring, California's distribution utilities sold essentially all of their gas-fired plants to third-party generators. The utilities were required to sell their remaining generation into the Cal PX markets and purchase all of their power requirements from the Cal PX markets at market-based rates approved by the FERC. California's regulatory system initially prohibited the utilities from entering into forward contracts to cover the bulk of their customers' requirements. Retail electricity rates were initially frozen at levels in effect on June 10, 1996, with a 10% rate reduction for residential and smaller commercial customers. When wholesale power costs began to rise dramatically in 2000, driven by a combination of factors, including higher natural gas prices and emission allowance costs, reduction in available hydroelectric generation resources, increased demand and decreases in net imports, some of the California

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utilities were unable to recover their purchased power costs through the retail rates they were allowed to charge. As a result, the utilities accumulated huge debts to wholesale power suppliers, including us. The Cal ISO currently is conducting a major market redesign process that, if approved by the FERC, could change the structure of the markets operated by the Cal ISO, including changes to market monitoring and mitigation, congestion management and capacity obligations. For a discussion of litigation and other legal proceedings related to energy sales in California, the impact of current regulations on our West region and related uncertainty associated with the California wholesale market, please read " - Regulation - Federal Energy Regulatory Commission," "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Uncertainty in the California Market" and Notes 13(e) and 13(i) to our consolidated financial statements.

In Nevada and Arizona, there is presently no RTO in place to manage the transmission systems or to operate energy markets, although one RTO working group is evaluating the establishment of an organization that would assume control, subject to FERC approval, over the transmission systems of the utilities operating in this region. The FERC has recently expressed its intention to pursue the establishment of an RTO in the West region.

Additionally, in Nevada and Arizona, state-level regulatory initiatives may impact competition in the electric sector. In Nevada, the state legislature has passed legislation prohibiting the state's investor-owned utilities from divesting generation. Similarly, in Arizona, proceedings are pending before the Arizona Corporation Commission that would allow the Arizona Public Service Company to avoid a requirement to seek competitive bids for 50% of the Arizona Public Service Company's generation needs.

ERCOT REGION

Facilities. We currently own a partially operational 781 MW gas-fired, combined cycle, cogeneration facility in Channelview, Texas. 170 MW of this facility's capacity is currently operational and 611 MW are under construction. We expect the remaining generating units for this facility will begin commercial operations in the third quarter of 2002.

In addition to our Channelview facility, we have an option exercisable in January 2004, subject to completion of the Distribution, to acquire Reliant Energy's ownership interest in a company (Texas Genco) that is currently expected to own approximately 13,900 MW of aggregate net generation capacity in Texas in January 2004 (Texas Genco Option). Reliant Energy has agreed to publicly offer or distribute to its shareholders approximately 20% of the common stock of Texas Genco before December 31, 2002. The generating capacity of these facilities consists of approximately 60% of base-load, 35% of intermediate and 5% of peaking capacity, and represents approximately 20% of the total capacity in ERCOT. As part of Reliant Energy's business separation plan, Reliant Energy's electric utility will convey its generating assets to Texas Genco. The conveyance is part of the anticipated restructuring of Reliant Energy's businesses into a holding company structure. For additional information regarding the Texas Genco Option, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions - Agreements between Reliant Energy and Reliant Resources - Genco Option Agreement" in Item 7 of this Form 10-K, and Note 4(b) to our consolidated financial statements.

Market Framework. The state of Texas, other than a portion of the panhandle and a portion of the east bordering on Louisiana, constitutes a single reliability council (ERCOT market). As part of the transition to deregulation in Texas, ERCOT changed its operations from 10 control areas, managed by utilities in the state, to a single control area on July 31, 2001. The ERCOT independent

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system operator (ERCOT ISO) is responsible for

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maintaining reliable operations of the bulk electric power supply system in the ERCOT market. Its responsibilities include ensuring that information relating to a customer's choice of retail electric provider is conveyed in a timely manner to anyone needing the information. It is also responsible for ensuring that electricity production and delivery are accurately accounted for among the generation resources and wholesale buyers and sellers in the ERCOT market. Unlike independent systems operators in other regions of the country, ERCOT is not a centrally dispatched pool and the ERCOT ISO does not procure energy on behalf of its members other than to maintain the reliable operation of the transmission system. Members are responsible for contracting their energy requirements bilaterally. ERCOT also serves as agent for procuring ancillary services for those who elect not to provide their own ancillary services requirement.

Members of ERCOT include retail customers, investor and municipal owned electric utilities, rural electric cooperatives, river authorities, independent generators, power marketers and retail electric providers. The ERCOT market operates under the reliability standards set by the North American Electric Reliability Council. The Texas Utility Commission has primary jurisdictional authority over the ERCOT market to ensure the adequacy and reliability of electricity across the state's main interconnected power grid. For information regarding ERCOT systems issues and delays, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations - Operational Risks" in Item 7 of this Form 10-K.

As part of the change to a single control area, ERCOT initially established three congestion zones; north, west and south. ERCOT will perform an annual analysis of the transmission capability in ERCOT to determine if changes to the congestions zones is required. Any required changes will take effect January 1 of the following year. Such an analysis was performed in the fall of 2001 and as a result, ERCOT was divided into four congestion zones on January 1, 2002. The current zones are north, south, west and Houston. In addition, ERCOT conducts annual and monthly auctions of Transmission Congestion Rights (TCR) which provide the entity owning TCRs the ability to financially hedge price differences between zones (basis risk). Entities are currently limited to owning a maximum of 25% of the available TCRs. The retail load obligation of our Retail Energy segment that was acquired as part of full retail deregulation on January 1, 2002 is predominately in the Houston zone. For additional information regarding the retail load obligations of our Retail Energy segment, please read " - Retail Energy - Retail Energy Supply."

LONG-TERM PURCHASE AND SALE AGREEMENTS

In the ordinary course of business, and as part of our hedging strategy, we enter into long-term sales arrangements for power, as well as long-term purchase arrangements. For information regarding our long-term fuel supply contracts, purchase power and electric capacity contracts and commitments, electric energy and electric sale contracts and tolling arrangements, please read Notes 6, 13(a) and 13(c) to our consolidated financial statements. For information regarding our hedging strategy relating to such long-term commitments, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting

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the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K.

DEVELOPMENT ACTIVITIES

As of December 31, 2001, we had 3,587 MW (3,391 MW, net of 196 MW to be retired upon completion of one facility) of additional net generating capacity under construction, including 2,120 MW of facilities owned by off-balance sheet special purpose entities, that are being constructed under construction agency agreements pursuant to synthetic leasing arrangements. Upon the completion of the construction of these facilities, we expect that we will lease these facilities from their owners. For additional information regarding the construction agency agreements, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Off-Balance Sheet Transactions - Construction Agency Agreements" in Item 7 of this Form 10-K and Note 13(h) to our consolidated financial statements.

In addition, Orion Power had three projects totaling 1,054 MW under construction as of December 31, 2001. However, at this time, we have decided to postpone a 250 MW project in Florida because of capital market and economic considerations. With improved capital market conditions and required approvals from Florida authorities

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on a newly configured 500 MW design, we would plan to proceed with construction in the future. Also, Orion Power had two projects under advanced development as of December 31, 2001, which have been deferred. A 1,088 MW project in Maryland has been postponed due to capital market considerations and because we believe that the PJM market will be sufficiently supplied for the next few years. A repowering project in New York City with a total capacity of 1,608 MW has been postponed until we see an improvement in the capital markets.

As a result of several recent events, including the United States economic recession, the price decline of our industry sector in the equity capital markets and the downgrading of the credit ratings of several of our significant competitors, the availability and cost of capital for our business and the businesses of our competitors has been adversely affected. In response to these events and the intensified scrutiny of companies in our industry sector by the rating agencies, we have reduced our planned capital expenditures by \$2.7 billion over the 2002 - 2006 time frame.

DOMESTIC TRADING, MARKETING, POWER ORIGINATION AND RISK MANAGEMENT SERVICES OPERATIONS

In addition to our power generation operations, we trade and market power, natural gas and other energy-related commodities and provide related risk management services to our customers. Our domestic trading, marketing, power origination and risk management operations complement our domestic power generation operations by providing a full range of energy management services. These services include management of the sales and marketing of energy, capacity and ancillary services from these facilities, and also management of the purchase and sale of fuels and emission allowances needed to operate these facilities. Generally, we seek to sell a portion of the capacity of our domestic

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facilities under fixed-price sale contracts, fixed-capacity payments or contracts to sell power at a predetermined multiple of either gas or oil prices. This provides us with certainty as to a portion of our margins while allowing us to maintain flexibility with respect to the remainder of our generation output. We evaluate the regional forward power market versus our own fundamental analysis of projected future prices in the region to determine the amount of our capacity we would like to sell and the terms of sale pursuant to longer-term contracts. We also take operational constraints and operating risk into consideration in making these determinations. Generally, we seek to hedge a portion of our fuel costs, which are usually linked to a percentage of our power sales. We also market energy-related commodities and offer physical and financial wholesale energy marketing and price risk management products and services to a variety of customers. These customers include natural gas distribution companies, electric utilities, municipalities, cooperatives, power generators, marketers or other retail energy providers, aggregators and large volume industrial customers.

The following table illustrates the growth of our physical power and gas trading volumes since 1999.

TRADING VOLUMES

	FOR THE YEAR ENDED DECEMBER 31	
	1999	2000
Total Power (MWh(1)).....	82,381,103	171,618,485
Total Gas (Bcf(2)).....	1,564	2,423

(1) Megawatt hours.

(2) Billion cubic feet.

Electric Power Trading and Marketing. We purchase electric power from other generators and marketers and sell power primarily to electric utilities, municipalities and cooperatives and other marketing companies. Our trading and marketing group is also responsible for the marketing of power produced from the power plants we own. We also provide risk management, physical and financial fuel purchase and power sales and optimization services to our customers.

Power Origination. Some of our employees focus on developing and providing customers with long-term customized products (power origination products). These products are designed and negotiated on a case-by-case basis to meet the specific energy requirements of our customers. Our power origination teams work closely with our trading and marketing group and our power generation group to sell long-term products from our power generation assets. They also work to leverage our market knowledge to capture attractive opportunities available through

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selling products that combine or repackage energy products purchased from third parties with other third-party products or with products from our power generation assets. Our efforts to sell power origination products from our power generation assets have been focused on longer-term forward sales to municipalities, cooperatives and other companies that serve end users, as well as sales of near-term products that are not widely traded. Our power origination products that combine or repackage third-party products are generally highly structured and therefore require the application of our commercial capabilities (e.g., power trading and asset positions).

Natural Gas Trading and Marketing. We purchase natural gas from a variety of suppliers under daily, monthly and term, variable-load and base-load contracts that include either market sensitive or fixed pricing provisions. We sell natural gas under sales agreements that have varying terms and conditions, most of which are intended to match seasonal and other changes in demand. We sold an average of 9.6 Bcf per day of natural gas in 2001, an average of 6.6 Bcf per day in 2000 and an average of 4.3 Bcf per day in 1999, some of which was sold to the natural gas distribution company subsidiaries of Reliant Energy. We plan to continue to purchase natural gas to supply to our power plants.

Our natural gas marketing activities include contracting to buy natural gas from suppliers at various points of receipt, aggregating natural gas supplies and arranging for their transportation, negotiating the sale of natural gas and matching natural gas receipts and deliveries based on volumes required by customers.

We arrange for, schedule and balance the transportation of the natural gas we market from the supply receipt point to the purchaser's delivery point. We generally obtain pipeline transportation to serve our customers. Accordingly, we use a variety of transportation arrangements for our customers, including short-term and long-term firm and interruptible agreements with intrastate and interstate pipelines. We also utilize brokered firm transportation agreements when dealing on the interstate pipeline system. As of December 31, 2001, we held over two bcf per day of firm transportation in the United States. In the normal course of business it is common for us to hedge the risk of pipeline transportation expenses through "basis swaps." To the extent we have contractually secured pipeline transportation rights in order to fulfill our obligations to sell gas at specific delivery points, or to acquire gas for our own requirements at generation facilities as part of our hedging strategy for power sales, and a pipeline experiences a force majeure event, our ability to transport gas on a contracted capacity basis could become impaired, which could affect the integrity of our hedged position.

We also enter into various short-term and long-term firm and interruptible agreements for natural gas storage in order to offer peak delivery services to satisfy winter heating and summer electric generating demands. Natural gas storage capacity allows us to better manage the unpredictable daily or seasonal imbalances between supply volumes and demand levels. In addition to entering into contracts of natural gas storage capacity in strategic locations throughout the country, we are actively pursuing a natural gas storage development plan. These services are also intended to provide an additional level of performance security and backup services to our customers.

Other Commodities and Derivatives. We trade and market other energy-related commodities. We use derivative instruments to manage and hedge our fixed-price purchase and sale commitments and to provide fixed-price or floating-price commitments as a service to our customers and suppliers. We also use derivative instruments to reduce our exposure relative to the volatility of the cash and forward market prices and to protect our investment in storage inventories. For

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additional information regarding our financial exposure to derivative instruments, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Risks Associated with Our Hedging and Risk Management Activities" in Item 7 of this Form 10-K and "Quantitative and Qualitative Disclosures About Market Risk" in Item 7A of this Form 10-K.

Intercontinental-Exchange. In July 2000, we, along with five other natural gas and power companies, American Electric Power, Aquila Energy, Duke Energy, El Paso Corporation and Mirant Corporation, made an investment in Intercontinental-Exchange, a new, web-based, on-line trading platform (www.intcx.com) for trading various commodities including precious metals, crude oil and refined products, natural gas and electricity. The other five natural gas and power companies, along with us, own less than 50% of Intercontinental - Exchange. In June 2001, Intercontinental-Exchange acquired the International Petroleum Exchange. With this acquisition, Intercontinental-Exchange became the first company to offer both an exchange trading over-the-counter commodity contracts and an exchange trading commodity futures contracts. At the same time, Intercontinental-Exchange announced plans to

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integrate the two types of exchanges into a single electronic trading platform. Our decision to invest, as one of a group of natural gas and power companies, in Intercontinental-Exchange was based on a desire to support the development of a neutral, anonymous, electronic trading platform for bi-lateral energy transactions. We believe the commercial success of such an exchange model will benefit us by contributing to improved price transparency and transaction liquidity in the wholesale energy markets. The principal online competitors of Intercontinental-Exchange are currently TradeSpark.com and the NYMEX, a traditional futures exchange that has announced an online initiative.

Risk Management Controls. For information regarding our risk management structure and accounting policies, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Trading and Marketing Operations" in Item 7 of this Form 10-K and "Quantitative and Qualitative Disclosures About Market Risk" in Item 7A of this Form 10-K.

COMPETITION

For a discussion of competitive factors affecting our Wholesale Energy segment, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Wholesale Energy Operations - Increasing Competition in Our Industry" in Item 7 of this Form 10-K, which section is incorporated herein by reference.

EUROPEAN ENERGY

Our European Energy business segment includes 3,476 MW of power generation assets located in the Netherlands and a related trading and power origination operations. This segment includes the operations of Reliant Energy Power Generation Benelux N.V. (formerly UNA N.V.) (REPGb) and Reliant Energy Trading & Marketing B.V. and its affiliates.

In 2001, we evaluated strategic alternatives for our European Energy

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segment, including a possible sale. We completed our evaluation and have determined that given current market conditions and prices, it is not advisable to sell our European Energy operations. Consequently, we decided to continue to own and operate our European Energy segment and expand our trading and origination activities in Northwest Europe.

EUROPEAN POWER GENERATION OPERATIONS

Facilities. As of December 31, 2001 we owned five electric power generation facilities in the Netherlands with an aggregate net generating capacity of 3,476 MW and include approximately 39% of base-load, 36% of intermediate and 25% of peaking capacity. Our facilities are grouped in three clusters adjacent to the cities of Amsterdam, Utrecht and Velsen. In 2001, our generation facilities produced 14 million MWh, an amount which represented approximately 13% of the electricity production of the Netherlands (excluding electricity generated by cogeneration or other industrial processes). In addition to electricity, our generating stations sell heated water produced as a byproduct of the generation process for use in providing heating (district heating) to the cities of Amsterdam, Nieuwegein, Utrecht and Purmerend.

In 2001, approximately 51% of our European Energy segment's generation output was natural gas-fired, 30% was coal-fired, 18% was blast furnace gas-fired and less than 1% was oil-fired. Our European Energy segment purchases substantially all of its gas fuel requirements under medium to long-term gas purchase contracts with N.V. Nederlandse Gasunie, the primary supplier and transporter of natural gas in the Netherlands. The purchase price and transportation costs for natural gas under these contracts are calculated on the basis of regulated tariffs.

Our European Energy segment historically purchased all of its coal requirements under short-term contracts with a coal trading and supply company now owned by two of the Dutch generation companies. In December 2001, REPGB and the other shareholder of the coal trading and supply company agreed to terminate future coal purchases through this entity effective in mid-2002. Our European Energy segment intends to obtain its future coal requirements through short to medium-term forward purchase contracts on the open market through a variety of suppliers and brokers.

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One of our European Energy generation stations, which has a production capacity of 144 MW, uses blast furnace gas, an industrial waste gas generated by a steel plant adjacent to the generation station, as its fuel. Two of our other European Energy segment's generation plants have the flexibility to operate using blast furnace gas. We purchase the blast furnace gas from the adjacent steel plant under a medium-term and a long-term contract. We purchase our fuel oil requirements on the open market.

We acquired REPGB in October 1999 for approximately \$1.9 billion (based on the then applicable exchange rate of 2.06 Dutch Guilders (NLG) per U.S. dollar). For information regarding the acquisition, please read note 5(b) to our consolidated financial statements.

Market Framework. Our European Energy segment produces, buys and sells electricity, gas and other energy-related commodities in the Northern European wholesale market. Its generation production activities are centered in the Netherlands, where it is one of the four large-scale generation companies. It operates five generation facilities with an installed capacity of 3,476 MW. Its energy trading and origination operations concentrate their activities primarily

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in the Netherlands, Germany and the Scandinavian regions. In the fourth quarter of 2001, our European Energy segment expanded its electricity trading operations to the United Kingdom.

The primary customers of our European Energy segment are electric distribution companies, large industrial consumers and energy trading companies. We sell electricity and other energy-related commodities primarily in the form of forward purchase contracts transacted in the over-the-counter markets, on various European energy exchanges and in individually negotiated transactions with individual counterparties. To a lesser extent, we also engage in transactions involving financial energy-related derivative products.

The most significant factor affecting the markets in which our European Energy segment operates has been the recent deregulation of the Dutch and certain other European wholesale energy markets, including access on a non-discriminatory basis to high voltage transmission grid systems, the establishment of new energy exchanges and other events. Notwithstanding these factors, the scope and pace of the future liberalization of the European energy markets is uncertain. For example, access to some European markets continues to be subject to transmission and other constraints. In some cases, fuel suppliers continue to operate in largely regulated markets not yet open to full competition.

EUROPEAN TRADING AND POWER ORIGINATION OPERATIONS

Our European Energy segment's trading and power origination operations are centered in Amsterdam, Netherlands, with additional offices in London and Frankfurt. Our European Energy segment trades electricity and fuel products in the Netherlands, Germany, Austria, Switzerland, the United Kingdom and the Scandinavian countries. Our marketing operations focus on distribution companies and large industrial and commercial customers in the Benelux and German markets. As of December 31, 2001, our European Energy segment had entered into forward purchase and sale contracts, and associated hedging transactions, covering approximately 18.6 million MWh for delivery in 2002.

Our European Energy segment's trading and power origination operations seek to utilize a business model, including risk management and related control policies, similar to that utilized in our Wholesale Energy operations in the United States. There are, however, significant differences in the United States and European markets. Among other things, European energy markets involve increased currency hedging requirements (the Euro and non-Euro currencies), and more complicated cross-border tax and transmission tariff systems than in the United States. In addition, European energy markets are significantly less mature than United States energy markets in terms of liquidity, the scope and complexity of trading and marketing products, the use of standardized market-based trading contracts and other aspects.

In addition, there exist greater uncertainties in some European jurisdictions as to the enforceability of certain contract-based mechanisms to hedge risks, such as the enforceability of automatic termination rights and rights of set-off upon bankruptcy, limitations on liquidated damages and the rules by which European courts construct contracts. In many civil law jurisdictions, courts reserve the right to interpret contracts based upon principles of good faith and fairness as opposed to a literal construction of the contract.

As of December 31, 2001, we had provided an aggregate of \$831 million in guarantees with respect to contract obligations of the European Energy segment.

COMPETITION

For a discussion of competitive factors affecting our European Energy segment, please read "Management's Discussion and Analysis of Financial Condition and Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our European Energy Operations - Competition in the European Market" in Item 7 of this Form 10-K, which section is incorporated herein by reference.

RETAIL ENERGY

We provide electricity and related services to retail customers primarily in Texas through our wholly owned subsidiaries Reliant Energy Retail Services, LLC (Residential Services), Reliant Energy Solutions, LLC (Solutions) and StarEn Power, LLC (StarEn Power). As a retail electric provider, generally we procure or buy electricity from wholesale generators at unregulated rates, sell electricity at generally unregulated rates to our retail customers and pay the local transmission and distribution utilities a regulated tariff rate for delivering the electricity to our customers. We became a provider of retail electricity in Texas when that market began opening to retail competition in late 2001 and fully opened to retail competition in January 2002. In January 2002, we began to provide retail electricity services to all of the approximately 1.7 million customers of Reliant Energy's electric utility located in its service area who did not take action to select another retail electric provider. We provide electricity and related products and services to residential and small commercial (i.e., small and medium-sized business customers with a peak demand for power at or below one MW) customers through Residential Services, and offer customized, integrated electric commodity and energy management services to large commercial, industrial and institutional (e.g., hospitals, universities, school systems and government agencies) customers through Solutions for customers with a peak demand for power of greater than one MW. Residential Services, Solutions and StarEn Power have been certified as retail electric providers by the Texas Utility Commission. StarEn Power has been appointed by the Texas Utility Commission to be the provider of last resort (POLR) in certain areas of the State of Texas. Under the Texas electric restructuring law, a POLR is required to offer a standard retail electric service package to requesting customers of a class designated by the Texas Utility Commission within the POLR's territory at a fixed, nondiscountable rate.

In preparation for retail electric competition in Texas, we expanded our infrastructure of information technology systems, business processes and staffing levels to meet the needs of our retail businesses. These include a customer care system module and wholesale/retail energy supply, risk management, e-commerce, scheduling/settlement, customer relationship management and sales force automation systems. As of December 31, 2001, we had invested \$153 million in retail infrastructure development. For additional information regarding the Texas retail electric market, please read " - Market Framework," " - Regulation - Texas - Retail Energy" and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations - Competition in the Texas Market" in Item 7 of this Form 10-K.

RESIDENTIAL SERVICES

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Residential Services provides electricity to residential retail and small commercial customers in Texas. As of January 1, 2002, Residential Services was the retail electric provider for approximately 1.5 million residential customers located in the Houston metropolitan area, making us the second largest retail electric provider in Texas as of that date. Residential Services' marketing strategy for residential customers emphasizes reliability and trust with our customers, and focuses on savings, value and customer service. We launched an advertising campaign to reposition our brand in the Houston and Dallas/Fort Worth metropolitan areas in the second half of 2001.

As the affiliated retail electric provider, or successor in interest, to Reliant Energy's electric utility, Residential Services was also the retail electric provider for approximately 200,000 small commercial customers in the Houston metropolitan area as of January 1, 2002. Residential Services' marketing strategy for small commercial customers uses a combination of direct marketing and individual sales calls to establish our brand and to attract additional customers.

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As the affiliated retail electric provider, Residential Services will not be permitted to sell electricity to residential and small commercial customers in Reliant Energy's electric utility service territory at a price other than a fixed, specified price (price to beat) until January 1, 2005, unless before that date the Texas Utility Commission determines that 40% or more of the amount of electric power that was consumed in 2000 by the relevant class of customers in the service territory is committed to be served by other retail electric providers. In addition, the Texas electric restructuring law requires us, as the affiliated retail electric provider, to make the price to beat available to residential and small commercial customers in Reliant Energy's electric utility service territory through January 1, 2007, if requested by such customers. For more information about the price to beat, please read " - Regulation - Texas - Retail Energy."

SOLUTIONS

Solutions provides electricity and energy services to large commercial, industrial and institutional customers with whom it has signed contracts. In addition, it provides electricity at previously established default rates to those large commercial, industrial and institutional customers in the service territory of Reliant Energy's electric utility who have not entered into a contract with another retail electric provider. The majority of Solutions' revenues will come from the sale of electricity to its customers. In order to be classified as a large commercial customer, an electricity customer may aggregate the purchase of electricity for its own use at multiple locations such that the total peak demand exceeds one MW.

In addition to providing electricity, Solutions provides customized, integrated energy solutions, including risk management and energy services products, and demand side and energy information services to large commercial, industrial and institutional customers. Since its formation in April 1996, Solutions has completed over 220 energy services projects for large commercial, industrial and institutional clients. The services that Solutions provides its customers include the replacement or upgrade of energy-intensive capital equipment, the financing of energy-intensive equipment, infrastructure optimization, substation development and maintenance and power quality assurance.

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Solutions is recognized as the affiliated retail electric provider, or successor in interest, to Reliant Energy's electric utility for large commercial, industrial and institutional customers. Solutions targets institutional, manufacturing, industrial and other large commercial customers, including multisite retailers and restaurants, petroleum refineries, chemical companies, real estate management firms, educational institutions and healthcare providers. As of December 31, 2001, this customer segment in Texas included approximately 1,750 buying organizations consuming an aggregate of approximately 16,000 MW of electricity at peak demand. As of December 31, 2001, Solutions had signed contracts with customers representing a peak demand of approximately 3,700 MW and serving approximately 12,000 meter locations.

STAREN POWER

StarEn Power serves as the POLR in portions of the state of Texas, as designated by the Texas Utility Commission. For 2002, StarEn Power has been appointed to serve as the POLR for residential and small commercial customers in the western portion of the Dallas/Fort Worth metropolitan area formally served by TXU Electric Company. In addition, StarEn Power has been appointed as the POLR in the service territory of Reliant Energy's electric utility for large commercial, industrial and institutional customers. The rates and terms under which StarEn Power provides service are governed by the terms of a settlement agreement between StarEn Power and various interested parties approved by the Texas Utility Commission. For additional information regarding our POLR obligations, rates and terms of service, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations - Obligations as a Provider of Last Resort" in Item 7 of this Form 10-K.

MARKET FRAMEWORK

The Texas electric restructuring law substantially amended the regulatory structure governing electric utilities in Texas in order to allow retail competition, which fully began in January 2002. In order to prepare for the opening of the retail market, a retail pilot project for up to 5% of each utility's load in all customer classes began in August

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2001. For information regarding the retail market framework in Texas, please read " - Regulation - Texas - Retail Energy" and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations" in Item 7 of this Form 10-K. Generally, under the Texas electric restructuring law, the retail electric provider procures or buys electricity from wholesale generators, sells electricity at retail to its customers and pays the transmission and distribution utility a regulated tariffed rate for delivering electricity to its customers. All retail electric providers in an area pay the same rates and other charges for transmission and distribution, whether or not they are affiliated with the transmission and distribution utility for that area. The transmission and distribution rates in effect as of January 1, 2002 for each utility were set through rate cases before the Texas Utility Commission.

RETAIL ENERGY SUPPLY

In Texas, our Wholesale Energy group and our Retail Energy group work together in order to determine the price, demand and supply of energy required

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to meet the needs of our Retail Energy segment's customers. Our Wholesale Energy trading and marketing operations are responsible for commodity pricing, risk assessment and supply procurement for our Retail Energy segment. Our Retail Energy segment manages retail pricing decisions and forecasts the demand for the procurement of electricity by the Wholesale Energy segment. The costs of our trading, marketing and risk management services associated with obtaining the electricity supply for our retail customers in Texas are borne by our Retail Energy segment. Our Wholesale Energy group acquires supply for our Retail Energy segment by several means. We may purchase capacity from non-affiliated parties in the capacity auctions mandated by the Texas Utility Commission. Please read " - Regulation - Texas - Retail Energy" for more information about these auctions. Under the terms of the Master Separation Agreement between Reliant Resources and Reliant Energy, we may also participate in and purchase up to approximately 50% of the remaining capacity of the generation facilities to be owned by Texas Genco sold in auctions substantially similar to, but separate from, the capacity auctions mandated by the Texas Utility Commission in which 15% of the total capacity of these facilities is required to be auctioned. In addition, we have the right to purchase 50% (but not less than 50%) of the remaining capacity of Texas Genco following the state mandated capacity auctions at prices to be established in the aforementioned Texas Genco auctions. Please read Notes 3 and 4(b) to our consolidated financial statements for a discussion of our participation in these auctions. We also enter into bilateral contracts with third parties for capacity, energy and ancillary services. We continuously monitor and update these positions based on retail sales forecasts and market conditions.

COMPETITION

For a discussion of competitive factors affecting our Retail Energy segment, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations - Competition in the Texas Market" in Item 7 of this Form 10-K, which section is incorporated herein by reference.

OTHER OPERATIONS

For 2001, our Other Operations business segment included:

- o the operations of our venture capital division (New Ventures),
- o the operations of our communications business (Communications), and
- o unallocated corporate costs.

NEW VENTURES

Our New Ventures division manages our existing new technology investments and identifies and invests in promising new technologies and businesses that relate to our energy services operations. Focus areas for investment include distributed generation, clean energy and energy industry software and systems.

Generally, we make our investments either directly or indirectly as limited partners in venture capital funds. As of December 31, 2001, we have invested approximately \$35 million in five venture capital funds with an energy and utility focus and have made commitments to invest an additional \$11 million in these funds. As of December 31, 2001, these funds held investments in 43

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companies. Excluding our investment in Grande Communications, Inc. discussed below, New Ventures' direct investment portfolio consists of eight companies with a total of \$7 million invested as of December 31, 2001.

In September 2000, we committed to make a \$25 million investment in Grande Communications, Inc., which was completed in August 2001. Grande Communications is a Texas-based communications company building a deep fiber broadband network that will offer bundled services, including high-speed Internet, all-distance telephone and advanced cable entertainment to homes and businesses. We invested a further \$1 million in Grande Communications in October 2001 as part of a larger debt and equity financing for the company. Grande Communications has announced its intention to build a broadband network in the Houston area and has secured a cable franchise from the City of Houston. The Houston build out will be in addition to the Central Texas cities of Austin, San Marcos, and San Antonio which are already under development.

COMMUNICATIONS

During the third quarter of 2001, we decided to exit our Communications business. The business served as a facility-based competitive local exchange carrier and Internet services provider and owned network operations centers and managed data centers in Houston and Austin. Our exit plan was substantially completed in the first quarter of 2002. For more information regarding the exiting of our Communication business, please read Note 16 to our consolidated financial statements.

REGULATION

OVERVIEW

We are subject to regulation by various federal, state, local and foreign governmental agencies, including the regulations described below.

FEDERAL ENERGY REGULATORY COMMISSION

Electricity. Under the Federal Power Act, the FERC has exclusive rate-making jurisdiction over wholesale sales of electricity and the transmission of electricity in interstate commerce by "public utilities." Public utilities that are subject to the FERC's jurisdiction must file rates with the FERC applicable to their wholesale sales or transmission of electricity in interstate commerce. All of our generation subsidiaries sell power at wholesale and are public utilities under the Federal Power Act with the exception of two facilities in Texas, which are qualifying facilities and not regulated as public utilities. The FERC has authorized these subsidiaries to sell electricity and related services at wholesale at market-based rates. In its orders authorizing market-based rates, the FERC also has granted these subsidiaries waivers of many of the accounting, record keeping and reporting requirements that are imposed on public utilities with cost-based rate schedules.

The FERC's orders accepting the market-based rate schedules filed by our subsidiaries or their predecessors, as is customary with such orders, reserve the right to revoke or limit our market-based rate authority if the FERC subsequently determines that any of our affiliates possess excessive market power. If the FERC were to revoke or limit our market-based rate authority, we would have to file, and obtain the FERC's acceptance of, cost-based rate schedules for all or some of our sales. In addition, the loss of market-based rate authority could subject us to the accounting, record keeping and reporting requirements that the FERC imposes on public utilities with cost-based rate schedules.

The FERC issued Order No. 2000 in December 1999. Order No. 2000, which applies to all FERC jurisdictional transmission providers, describes the FERC's

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intention to promote the establishment of large RTOs and sets forth the minimum characteristics and functions of RTOs. Among the basic minimum characteristics are that the RTOs must be independent of market participants and must be of sufficient scope and geographical configuration. Order No. 2000 also encourages RTOs to work with each other to minimize or eliminate "seams" issues between RTOs

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that operate as barriers to inter-regional transactions. The FERC's goal is to encourage the growth of a robust competitive wholesale market for electricity. Although jurisdictional transmission providers are not required to join RTOs, they are encouraged to do so. Under Order No. 2000, RTOs were to be operational by December 15, 2001. However, because RTO development was in different stages in different regions of the country, the FERC issued an order on November 7, 2001 extending the deadline until it resolves issues relating to geographic scope and governance of qualifying RTOs across the country and issues relating to business and procedural needs. For organizations to accomplish the functions of Order No. 2000, the FERC is taking steps to create business standards and protocols to facilitate RTO formation. However, there can be no assurance that the FERC's goals will be achieved. Also there is considerable state-level resistance in some regions, including regions in which we operate, to the formation of RTOs. At least 14 separate organizations, covering the substantial majority of all the FERC jurisdictional transmission providers, are in various stages of organization and have made at least preliminary filings with the FERC.

Trading and Marketing. Our domestic trading and marketing operations are also subject to the FERC's jurisdiction under the Federal Power Act. As a gas marketer, we make sales of natural gas in interstate commerce at wholesale pursuant to a blanket certificate issued by the FERC, but the FERC does not otherwise regulate the rates, terms or conditions of these gas sales. We are also a "public utility" under the Federal Power Act, and our wholesale sales of electricity in interstate commerce are subject to a FERC-filed rate schedule that authorizes us to make sales at negotiated, market-based rates.

In authorizing market-based rates for various of our subsidiaries, the FERC has imposed some restrictions on these entities' transactions with Reliant Energy's electric utility, including a prohibition on the receipt of goods or services on a preferential basis. The FERC also has imposed restrictions on natural gas transactions between us and Reliant Energy's natural gas pipeline subsidiaries to preclude any preferential treatment. Similar restrictions apply to transactions between us and Reliant Energy's electric utility under Texas utility regulatory laws.

Hydroelectric Facilities. The majority of our generating facilities located in the state of New York are hydroelectric facilities, many of which are subject to the FERC's exclusive authority under the Federal Power Act to license non-federal hydroelectric projects located on navigable waterways and federal lands. These FERC licenses must be renewed periodically and can include conditions on operation of the project at issue.

TEXAS - RETAIL ENERGY

In June 1999, Texas adopted the Texas electric restructuring law. The Texas electric restructuring law substantially amended the regulatory structure governing electric utilities in Texas. Full retail competition in the service territories of some investor-owned electric utilities began in January 2002, and in the territories of any municipally-owned utility and electric cooperative that opts to open its market to retail competition. Under the Texas electric

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restructuring law, the traditional, vertically-integrated utility is required to separate its generation, transmission and distribution, and retail activities. Unlike the vertically-integrated utility, which was subject to cost-of-service rate regulation, the profit earned by retail electric providers will not be subject to regulation, except for the price to beat requirement described below. The transmission and distribution business will continue to be subject to cost-of-service rate regulation and will be responsible for the delivery of electricity to retail customers through retail electric providers. Wholesale power generators will continue to sell electric energy to purchasers, including retail electric providers, at unregulated rates. To facilitate a competitive market, each power generator affiliated with a transmission and distribution utility is required to sell at auction 15% of the output of its installed generating capacity. This auction obligation continues until January 1, 2007, unless the Texas Utility Commission determines before that date that at least 40% of the quantity of electric power consumed in 2000 by residential and small commercial customers in the affiliated transmission and distribution utility's service area is being served by retail electric providers not affiliated with the incumbent utility. An affiliated retail electric provider may not purchase capacity sold by its affiliated power generation company in the state mandated capacity auctions.

The Texas electric restructuring law allows most retail electric customers of Texas investor-owned electric utilities, and those of any municipally-owned utility or electric cooperative that opts to open its market to retail competition, to take action to select their retail electric provider for service as of January 1, 2002. Retail electric providers which are affiliates of, or successors in interest to, electric utilities may compete substantially statewide for these sales, but prices they may charge to residential and small commercial customers within the affiliated

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electric utility's traditional service territory are subject to a fixed, specified price (price to beat) at the outset of retail competition. The price to beat is subject to potential adjustments up to two times per year, as described below. In December 2001, the Texas Utility Commission established the price to beat we are required to charge our residential and small commercial customers for electricity sales in the Houston metropolitan area. Our price to beat was set at a level resulting in an estimated 17% reduction to pre-existing rates for our residential customers and an estimated 22% reduction to pre-existing rates for our small commercial customers.

Municipally-owned utilities and electric cooperatives have the option to open their markets to retail competition any time after January 1, 2002. However, until a municipally-owned utility or electric cooperative adopts a resolution opting to open its market to retail competition, it may not offer electric energy at unregulated prices to retail customers outside its service area. In November 2001, Nueces Electric Cooperative and San Patricio Electric Cooperative received Texas Utility Commission approval of required filings necessary to open their markets to retail competition. Some large Texas cities, including San Antonio and Austin, are served by municipally-owned utilities that have not announced when or if they will open their markets to competition.

New, unaffiliated retail electric providers that enter a particular market may sell electricity to residential and small commercial customers at any price, including a price below the price to beat. By allowing non-affiliated retail electric providers to provide retail electric service to customers in an electric utility's traditional service territory at any price, including a price below the price to beat, the Texas electric restructuring law is designed to

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encourage competition among retail electric providers. Affiliated retail electric providers will not be permitted to sell electricity to residential and small commercial customers in the transmission and distribution utility's traditional service territory at a price other than the price to beat until January 1, 2005, unless before that date the Texas Utility Commission determines that 40% or more of the amount of electric power that was consumed in 2000 by the relevant class of customers in the certificated service area of the affiliated transmission and distribution utility is committed to be served by other retail electric providers. In addition, the Texas electric restructuring law requires the affiliated retail electric provider to make the price to beat available to residential and small commercial customers in the traditional service area of the related incumbent utility through January 1, 2007. The price to beat only applies to electric services provided to residential and small commercial customers (i.e., customers with an aggregate peak demand at or below one MW). Electric services provided to large commercial, industrial and institutional customers (i.e., customers with an aggregate peak demand of greater than one MW), whether by the affiliated retail electric provider or a non-affiliated retail electric provider, may be provided at any negotiated price.

The Texas Utility Commission's regulations allow an affiliated retail electric provider to adjust the wholesale energy supply cost component or "fuel factor," included in its price to beat based on a percentage change in the price of natural gas. The fuel factor included in our price to beat was initially set by the Texas Utility Commission at the then average forward 12 month gas price strip of approximately \$3.11/mmbtu. In addition, the affiliated retail electric provider may also request an adjustment as a result of changes in its price of purchased energy. In such a request, the affiliated retail electric provider may adjust the fuel factor to the extent necessary to restore the amount of headroom that existed at the time the initial price to beat fuel factor was set by the Texas Utility Commission. An affiliated retail electric provider may request that its price to beat be adjusted twice a year. Currently, we cannot estimate with any certainty the magnitude and timing of the adjustments required, if any, and the eventual impact of such adjustments on headroom. To the extent that the adjustments are not received on a timely basis, our results of operations may be adversely affected. Based on forward gas prices at the end of March 2002, we estimate that we would be able to increase our price to beat by between approximately 4% and 5%.

The Texas electric restructuring law requires the affiliated retail electric provider to reconcile and credit to the affiliated transmission and distribution utility in early 2004 any positive difference between the price to beat, reduced by a specified delivery charge, and the prevailing market price of electricity unless the Texas Utility Commission determines that, on or prior to January 1, 2004, 40% or more of the amount of electric power that was consumed in 2000 by residential or small commercial customers, as applicable, within the affiliated transmission and distribution utility's traditional service territory is committed to be served by other non-affiliated retail electric providers. If the 40% test is not met, the reconciliation and credit will be in the form of a payment to Reliant Energy, not to exceed \$150 per customer. For additional information regarding this payment, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Consolidated Capital Requirements and Uses of Cash - Payment to Reliant Energy" in Item 7 of this Form 10-K and Note 13(g) to our consolidated financial statements.

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to designate retail electric providers as POLR in areas of the state in which retail competition is in effect. A POLR is required to offer a standard retail electric service package for each class of customers designated by the Texas Utility Commission at a fixed, nondiscountable rate approved by the Texas Utility Commission, and is required to provide the service package to any requesting retail customer in the territory for which it is the POLR. In the event that another retail electric provider fails to serve any or all of its customers, the POLR is required to offer that customer the standard retail service package for that customer class with no interruption of service to the customer. For additional information regarding our obligation as a POLR, and regarding the Texas retail market framework in general, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Our Retail Energy Operations" in Item 7 of this Form 10-K.

SECURITIES AND EXCHANGE COMMISSION - PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Under the Energy Policy Act of 1992, a company engaged exclusively in the business of owning and/or operating facilities used for the generation of electric energy exclusively for sale at wholesale and selling electric energy at wholesale may be exempted from regulation under the Public Utility Holding Company Act of 1935 (1935 Act) as an exempt wholesale generator (EWG). Qualifying facilities, such as two of our projects in Texas, are similarly exempt from regulation under the 1935 Act. Our electric generation facilities have received determinations of EWG status from the FERC. If any of these subsidiaries lose their EWG or qualifying facility status, we would have to restructure our organization or risk being subjected to regulation under the 1935 Act.

Reliant Energy is both a holding company and an electric utility as defined in the 1935 Act. However, Reliant Energy is exempt from regulation as a holding company under Section 3(a)(2) of the 1935 Act.

REPGB is a foreign utility company exempt from regulation as a "public utility company" under the 1935 Act. The Texas Utility Commission and the state regulatory commissions of Arkansas and Minnesota have imposed limitations on the amount of investments that Reliant Energy or its subsidiaries may invest in foreign utility companies and, in some cases, foreign electric wholesale generating companies. These limitations are based upon Reliant Energy's consolidated net worth, retained earnings, and debt and stockholders' equity, respectively. Subject to some limited exceptions, the 1935 Act also prohibits any public utility from issuing any security for the purpose of financing the acquisition, ownership or operation of a foreign utility company, or assuming any obligation or liability in respect of any security of a foreign utility company.

In connection with its business separation plan, Reliant Energy plans to restructure its remaining businesses and to register as a public utility holding company under the 1935 Act or to seek an exemption from the registration requirements of the 1935 Act. If Reliant Energy becomes a registered public utility holding company prior to the distribution of our common stock to its shareholders, we will be subject to regulation as a "subsidiary company" under the 1935 Act. As a result, we would be subject to limitations under the 1935 Act related to, among other things, our acquisition, ownership and operation of energy assets outside of our current business plan and payments of dividends by us and our subsidiaries from unearned surplus. Additionally, we would need to obtain approval under the 1935 Act prior to acquiring the voting securities of any public utility or taking any other actions that would result in affiliation with another public utility. Following the Distribution, we would no longer be subject to the provisions of the 1935 Act either as a subsidiary or an affiliate of Reliant Energy.

THE NETHERLANDS

Prior to the deregulation of the Dutch wholesale market in 2001, our European Energy segment sold its generating output to a national production pool and, in return, received a standardized remuneration. The remuneration included fuel cost, return of and on capital and operation and maintenance expenses. Under a transitional agreement which expired in 2000, the non-fuel portion of this amount was fixed during the period 1997 through 2000. For additional information, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Factors Affecting Our Future Earnings - Factors Affecting the Results of Ou>

