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DYNEGY INC /IL/
Form 10-Q/A
May 15, 2003

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

FORM 10-Q/A

AMENDMENT NO. 1

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2002

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: 1-15659

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

Illinois 74-2928353
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Class A Common Stock, no par value per share, 272,427,169 shares outstanding as of August 12, 2002; Class B Common Stock, no par value per share, 96,891,014 shares outstanding as of August 12, 2002.

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DYNEGY INC.
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INTRODUCTORY NOTE

Dynegy Inc. is filing this Amendment No. 1 on Form 10-Q/A ("Amendment No. 1") to reflect restatements relating to its audited consolidated financial statements as of December 31, 2001 and its unaudited condensed consolidated financial statements for the three- and six-month periods ended June 30, 2002 and 2001. These financial statements were previously included in Dynegy's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, which was originally filed with the SEC on August 14, 2002 (the "Original Filing"). These financial statements and the other financial information included in the Original Filing have been revised to reflect the restatement items described in the Explanatory Note to the accompanying unaudited condensed consolidated financial statements. Revised financial information for the periods presented reflecting these restatements was previously included in Dynegy's Annual Report on Form 10-K for the fiscal year ended December 31, 2001, which was most recently amended by Amendment No. 2 thereto filed with the SEC on April 11, 2003 (the "2001 Form 10-K/A"), and Dynegy's Annual Report on Form 10-K for the fiscal year ended December 31, 2002, which also was filed with the SEC on April 11, 2003 (the "2002 Form 10-K"). The restated financial and other information included in this Amendment No. 1 should be read together with the 2001 Form 10-K/A and the 2002 Form 10-K. Certain of the operating, investing and financing cash flow data included in this Amendment No. 1 has been revised from the comparable data included in Note 19--Quarterly Financial Information (Unaudited) beginning on page F-76 of the 2002 Form 10-K. This revised data, which reflects minor corrections for errors, should be read to replace and supersede the data previously included in the 2002 Form 10-K. In addition to the restatements described elsewhere herein, this Amendment No. 1 also includes certain other revisions to the Original Filing. Dynegy's periodic SEC reports, including this Amendment No. 1, remain subject to an ongoing review by the SEC Division of Corporation Finance.

PLEASE NOTE THAT THE INFORMATION CONTAINED IN THIS AMENDMENT NO. 1, INCLUDING THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND THE NOTES THERETO, DOES NOT REFLECT EVENTS OCCURRING AFTER AUGUST 14, 2002 (THE DATE OF THE ORIGINAL FILING). FOR A DESCRIPTION OF THESE EVENTS, PLEASE READ DYNEGY'S EXCHANGE ACT REPORTS FILED SINCE AUGUST 14, 2002, INCLUDING ITS ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002. SEE NOTE 16--SUBSEQUENT EVENTS FOR FURTHER DISCUSSION.

DYNEGY INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (RESTATED)

SEE EXPLANATORY NOTE--RESTATEMENTS
(unaudited) (in millions, except share data)

ASSETS

| | |
|---|----|
| Current Assets | |
| Cash and cash equivalents..... | \$ |
| Restricted cash..... | |
| Accounts receivable, net of allowance for doubtful accounts of \$122 million and \$113 million, respectively..... | |
| Accounts receivable, affiliates..... | |
| Inventory..... | |
| Assets from risk-management activities..... | |
| Prepayments and other assets..... | |
| Total Current Assets..... | |
| Property, Plant and Equipment..... | |
| Accumulated depreciation..... | |
| Property, Plant and Equipment, Net..... | |
| Other Assets | |
| Investments in unconsolidated affiliates (Note 11)..... | |
| Investment in Northern Natural Gas Company (Note 5)..... | |
| Assets from risk-management activities..... | |
| Goodwill..... | |
| Other assets..... | |
| Total Assets..... | \$ |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | |
|--|----|
| Current Liabilities | |
| Accounts payable..... | \$ |
| Accounts payable, affiliates..... | |
| Accrued liabilities and other..... | |
| Liabilities from risk-management activities..... | |
| Notes payable and current portion of long-term debt..... | |
| Total Current Liabilities..... | |
| Long-Term Debt | |
| Other Liabilities | |
| Transitional funding trust notes..... | |
| Liabilities from risk-management activities..... | |
| Deferred income taxes..... | |
| Other long-term liabilities..... | |
| Total Liabilities..... | |

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| | |
|--|----|
| Minority Interest..... | |
| Serial Preferred Securities of a Subsidiary..... | |
| Company Obligated Preferred Securities of Subsidiary Trust..... | |
| Series B Mandatorily Convertible Redeemable Preferred Securities..... | |
| Commitments and Contingencies (Note 12) | |
| Stockholders' Equity | |
| Class A Common Stock, no par value, 900,000,000 shares authorized at June 30, 2002 and December 31, 2001, 272,058,799 and 269,984,456 shares issued and outstanding at June 30, 2002 and December 31, 2001 respectively..... | |
| Class B Common Stock, no par value, 360,000,000 shares authorized at June 30, 2002 and December 31, 2001, 96,891,014 and 86,499,914 shares issued and outstanding at June 30, 2002 and December 31, 2001 respectively..... | |
| Additional paid-in capital..... | |
| Subscriptions receivable..... | |
| Accumulated other comprehensive income (loss), net of tax..... | |
| Retained earnings..... | |
| Treasury stock, at cost, 1,679,183 shares at June 30, 2002 and 1,766,800 shares at December 31, 2001..... | |
| Total Stockholders' Equity..... | |
| Total Liabilities and Stockholders' Equity..... | \$ |

See the notes to condensed consolidated financial statements.

DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (RESTATED)

SEE EXPLANATORY NOTE--RESTATEMENTS
(unaudited) (in millions, except per share data)

| | Three Months Ended June 30, | |
|--|--------------------------------|----------|
| | 2002 | 2001 |
| Revenues..... | \$9,676 | \$11,898 |
| Cost of sales (exclusive of depreciation shown below)..... | 9,548 | 11,543 |
| Depreciation and amortization..... | 144 | 114 |
| Impairment and other charges (Note 4)..... | 660 | -- |
| General and administrative expenses..... | 103 | 148 |
| Gain on sale of assets..... | (1) | (29) |
| Operating income (loss)..... | (778) | 122 |
| Earnings from unconsolidated investments (Notes 4 and 11)..... | 14 | 78 |
| Other income (expense), net (Note 4)..... | (2) | 9 |
| Interest expense..... | (92) | (68) |
| Minority interest expense..... | (10) | (49) |
| Accumulated distributions associated with trust preferred securities | (4) | (6) |
| Income (loss) before income taxes..... | (872) | 86 |

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| | | |
|--|-----------|---------|
| Income tax provision (benefit)..... | (311) | 47 |
| | ----- | ----- |
| Net Income (Loss)..... | \$ (561) | \$ 39 |
| Less: preferred stock dividends..... | 82 | -- |
| | ----- | ----- |
| Net Income (Loss) applicable to common stockholders..... | \$ (643) | \$ 39 |
| | ----- | ----- |
| Net Income (Loss) Per Share: | | |
| Basic earnings (loss) per share..... | \$ (1.76) | \$ 0.12 |
| | ----- | ----- |
| Diluted earnings (loss) per share (Note 9)..... | \$ (1.76) | \$ 0.12 |
| | ----- | ----- |
| Basic shares outstanding..... | 366 | 326 |
| | ----- | ----- |
| Diluted shares outstanding..... | 370 | 339 |
| | ----- | ----- |

See the notes to condensed consolidated financial statements.

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DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (RESTATED)--(Continued)

SEE EXPLANATORY NOTE--RESTATEMENTS
(unaudited) (in millions, except per share data)

| | Six Months Ended June 30, | |
|--|------------------------------|----------|
| | 2002 | 2001 |
| | ----- | ----- |
| Revenues..... | \$18,102 | \$25,143 |
| Cost of sales (exclusive of depreciation shown below)..... | 17,623 | 24,286 |
| Depreciation and amortization..... | 271 | 222 |
| Impairment and other charges (Note 4)..... | 670 | -- |
| General and administrative expenses..... | 238 | 236 |
| Gain on sale of assets..... | (1) | (34) |
| | ----- | ----- |
| Operating income (loss)..... | (699) | 433 |
| Earnings from unconsolidated investments (Notes 4 and 11)..... | 3 | 110 |
| Other income (expense), net (Note 4)..... | 20 | (1) |
| Interest expense..... | (181) | (134) |
| Minority interest expense..... | (40) | (68) |
| Accumulated distributions associated with trust preferred securities.... | (8) | (12) |
| | ----- | ----- |
| Income (loss) before income taxes and change in accounting principle.... | (905) | 328 |
| Income tax provision (benefit)..... | (331) | 136 |
| | ----- | ----- |
| Income (loss) from operations..... | (574) | 192 |
| Cumulative effect of change in accounting principle, net (Notes 3 and 6) | (234) | 2 |
| | ----- | ----- |
| Net Income (Loss)..... | \$ (808) | \$ 194 |
| Less: preferred stock dividends..... | 165 | -- |

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| | | |
|--|-----------|---------|
| Net Income (Loss) applicable to common stockholders..... | \$ (973) | \$ 194 |
| Net Income (Loss) Per Share: | | |
| Basic Earnings (Loss) Per Share: | | |
| Income (loss) from operations..... | \$ (2.03) | \$ 0.59 |
| Cumulative effect of change in accounting principle..... | (0.64) | 0.01 |
| Basic earnings (loss) per share..... | \$ (2.67) | \$ 0.60 |
| Diluted Earnings (Loss) Per Share: | | |
| Income (loss) from operations..... | \$ (2.03) | \$ 0.56 |
| Cumulative effect of change in accounting principle..... | (0.64) | 0.01 |
| Diluted earnings (loss) per share (Note 9)..... | \$ (2.67) | \$ 0.57 |
| Basic shares outstanding..... | 364 | 325 |
| Diluted shares outstanding..... | 369 | 338 |

See the notes to condensed consolidated financial statements.

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DYNEGY INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (RESTATED)

SEE EXPLANATORY NOTE--RESTATEMENTS
(unaudited) (in millions)

| | Six Months Ended June 30, | |
|---|------------------------------|-------|
| | 2002 | 2001 |
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss)..... | \$ (808) | \$ |
| Items not affecting cash flows from operating activities: | | |
| Depreciation and amortization..... | 278 | |
| Impairment and other charges..... | 670 | |
| (Earnings) losses from unconsolidated investments, net of cash distributions..... | 43 | |
| Risk-management activities..... | 399 | |
| Deferred income taxes..... | (338) | |
| Cumulative effect of change in accounting principle..... | 234 | |
| Other..... | 41 | |
| Operating cash flows before changes in working capital..... | 519 | |
| Change in working capital: | | |
| Accounts receivable..... | 63 | |
| Inventory..... | (19) | |
| Prepayments and other assets..... | (6) | |
| Accounts payable and accrued liabilities..... | (211) | |
| Other, net..... | (18) | |

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| | | |
|--|--------|-----|
| Net cash provided by operating activities..... | 328 | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures..... | (631) | (1, |
| Investments in unconsolidated affiliates..... | (12) | |
| Business acquisitions, net of cash acquired..... | (20) | |
| Proceeds from asset sales..... | 10 | |
| Other investing, net..... | -- | (|
| Net cash used in investing activities..... | (653) | (|
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net proceeds from long-term borrowings..... | 574 | 1, |
| Repayments of long-term borrowings..... | (216) | (|
| Net proceeds from short-term borrowings..... | 245 | |
| Net cash flow from commercial paper and revolving lines of credit..... | (233) | |
| Proceeds from sale of capital stock, options and warrants..... | 236 | |
| Purchase of serial preferred securities of a subsidiary..... | (28) | |
| Decrease (increase) in restricted cash..... | 14 | |
| Purchase of treasury stock..... | (1) | |
| Dividends and other distributions, net..... | (55) | |
| Other financing, net..... | (17) | |
| Net cash provided by financing activities..... | 519 | |
| Effect of exchange rate changes on cash..... | (35) | |
| Net increase in cash and cash equivalents..... | 159 | |
| Cash and cash equivalents, beginning of period..... | 208 | |
| Cash and cash equivalents, end of period..... | \$ 367 | \$ |

See the notes to condensed consolidated financial statements.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

EXPLANATORY NOTE--RESTATEMENTS

This Amendment No. 1 on Form 10-Q/A of Dynegy Inc. ("Dynegy" or the "Company") includes restatements relating to the Company's audited consolidated financial statements as of December 31, 2001 and its unaudited condensed consolidated financial statements for the three- and six-month periods ended June 30, 2002 and 2001. On April 11, 2003, Dynegy filed its Annual Report on Form 10-K for the fiscal year ended December 31, 2002 (the "2002 Form 10-K"), which included restated financial statements for each of the two years in the period ended December 31, 2001. The Form 10-K also included restated financial information for the three- and six-month periods ended June 30, 2002 and 2001. The restatements relate to the following:

- . the Project Alpha structured natural gas transaction,

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- . a balance sheet reconciliation project relating principally to the Company's natural gas marketing business,
- . corrections to the Company's previous hedge accounting for certain contracts resulting in the Company accounting for these contracts pursuant to the mark-to-market method under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended ("Statement No. 133"); in addition, the Company determined that it had incorrectly accounted for certain derivative transactions prior to the adoption of Statement No. 133,
- . the valuation used in the Company's 2000 acquisition of Extant, Inc.,
- . the restatement of the Company's forward power curve methodology to reflect forward power and market prices more closely,
- . the recognition of additional assets, accrued liabilities and debt associated with certain lease arrangements, as well as impairment, depreciation and amortization expense for the related assets,
- . a correction to the measurement date relating to the implied dividend the Company previously recorded related to the in-the-money beneficial conversion option in the \$1.5 billion in Series B preferred stock issued to ChevronTexaco Corporation in November 2001,
- . the recognition of an other-than-temporary decline in value of a technology investment in the third quarter of 2001 rather than the second quarter of 2002,
- . corrections to the Company's previous accounting for income taxes, and
- . other adjustments that arose during the re-audit of the Company's 1999-2001 financial statements.

Specifically, the restatements are as follows:

Project Alpha. Dynegy entered into the Project Alpha structured natural gas transaction in April 2001. As described in a Current Report on Form 8-K dated April 25, 2002 (the "Alpha Form 8-K"), Dynegy restated the cash flow associated with the related gas supply contract as a financing activity in its Consolidated Statement of Cash Flows for 2001. The effect of this restatement was to reclassify approximately \$70 million and \$290 million of previously disclosed operating cash flow to financing cash flow for the six-month period ended June 30, 2001 and year ended December 31, 2001, respectively. Following the disclosure in the Alpha Form 8-K and in connection with a further review of Project Alpha, Arthur Andersen LLP ("Andersen") informed the Company that it could no longer support its tax opinion relating to the transaction. Andersen's change in position was based in part on its conclusion that the reclassification of cash flow from operations to cash flow from financing

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

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lessened the factual basis for the opinion. Dynegy's financial statement recognition of the tax benefit in 2001 was based principally on the Company's assessment of the relevant issues, as corroborated by Andersen's tax opinion. After the withdrawal of Andersen's tax opinion, management concluded that sufficient support to include the income tax benefit for financial statement presentation purposes no longer existed, the effect of which was a reversal of approximately \$79 million of tax benefit previously recognized by the Company during the 2001 period, \$27 million of which related to the three and six months ended June 30, 2001. Andersen further advised the Company that its audit opinion relating to 2001 should no longer be relied upon as a result of the pending restatements relating to Project Alpha and such audit opinion has been withdrawn. Dynegy subsequently concluded that its 2001 restated consolidated financial statements would include the consolidation of ABG Gas Supply, LLC ("ABG"), one of the entities formed in connection with the transaction. The consolidation of ABG is included herein based on compilations of financial information received from an agent of ABG's equity holders.

The table below reflects the impact of the Project Alpha restatements on net income and diluted earnings per share for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 ----- | Six Months Ended June 30 ----- |
|-----------------------------------|---|---|
| | (in millions, except per share data) | |
| Net Income (Loss) | | |
| 2001..... | \$ (27) | \$ (27) |
| 2002..... | -- | -- |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$(0.08) | \$(0.08) |
| 2002..... | -- | -- |

Balance Sheet Reconciliation Project. Dynegy originally recognized an after-tax charge of approximately \$80 million (\$124 million pre-tax) in the second quarter 2002 related to a balance sheet reconciliation project undertaken by the Company at the beginning of 2002. The charge related principally to the Company's natural gas marketing business and was associated with the process of reconciling accrued to actual results. Accrual accounting for natural gas marketing involves the estimation of gas volumes, bought, sold, transported and stored, as well as the subsequent reconciliation of estimated to actual volumes. The Company has restated its financial statements to allocate this \$80 million charge from the second quarter 2002 back to the periods in which the transactions giving rise to the charge originally occurred.

The table below reflects the impact on net income and diluted earnings per share of this restatement for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 ----- | Six Months Ended June 30 ----- |
|--|---|---|
| | (in millions, except per share data) | |

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| | | |
|-----------------------------------|-----------|---------|
| Net Income (Loss) | | |
| 2001..... | \$ (18) | \$ 4 |
| 2002..... | 89 | 93 |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ (0.05) | \$ 0.01 |
| 2002..... | 0.24 | 0.25 |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

Corrected Hedge Accounting. The Company adopted Statement No. 133 effective January 1, 2001 and reflected certain contracts as cash flow hedges upon such adoption. Management has subsequently determined that following the initial adoption of Statement No. 133, the documentation of compliance requirements under the standard, particularly as it relates to documentation and the periodic assessment of hedge effectiveness, was inadequate to support the accounting method previously applied. In addition, the Company determined that it had incorrectly accounted for certain derivative transactions prior to the adoption of Statement No. 133. The resulting restatement reflects the accounting for these contracts on a mark-to-market basis rather than on the hedge accounting basis previously employed. This correction had no impact on previously reported cash flows from operations in any period.

The table below reflects the impact of this restatement on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|-------------------------------------|----------------------------------|--------------------------------|
| ----- | | |
| (in millions, except share data) | | |
| Net Income (Loss) | | |
| 2001..... | \$ (12) | \$ 3 |
| 2002..... | 5 | (22) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ (0.04) | \$ 0.01 |
| 2002..... | 0.01 | (0.06) |

Valuation of Extant, Inc. Purchase. On September 29, 2000, Dynegy completed the acquisition of Extant, Inc., a privately held entity engaged in the communications business. The transaction was accounted for as a purchase. In 2000, the Company incorrectly valued the shares of Class A common stock it issued as consideration for the acquisition at \$49.59 per share, rather than \$36.59 per share, which amount represented the average share price during the

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five days surrounding the announcement of the acquisition. The \$49.59 per share originally utilized in the valuation was incorrectly based on the average closing price of Dynegy's Class A common stock during the 30 days prior to the closing date, which was consistent with the valuation provisions in the merger agreement. As a result, the purchase price allocated to the assets acquired and liabilities assumed in the purchase was overstated by \$23 million in 2000. This error resulted in an overstatement of the amortization of goodwill acquired in the transaction during 2001 and 2000. Additionally, as a result of this error, the Company overstated by \$22 million the impairment of goodwill recorded in 2002 associated with the Company's January 1, 2002 adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The table below reflects the impact of this restatement on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|-----------------------------------|-------------------------------------|--------------------------------|
| | ----- | |
| | (in millions, except share data) | |
| Net Income (Loss) | | |
| 2001..... | \$0.25 | \$ 0.50 |
| 2002..... | -- | 22.00 |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$0.00 | \$ 0.00 |
| 2002..... | -- | 0.06 |

Restated Forward Power Curve Methodology. The Company values substantially all of its natural gas marketing, power marketing and portions of its natural gas liquids marketing operations under a mark-to-market accounting methodology. The estimated fair value of the marketing and trading portfolio is computed by multiplying all existing positions in the portfolio by estimated prices, reduced by a LIBOR-based time value of money adjustment and deduction of reserves for credit, price and market liquidity risks. Dynegy uses a combination of market quotes, derivatives of market quotes and proprietary models to periodically value this portfolio as required by generally accepted accounting principles. Market quotes are used for near-term transactions, where such quotes are generally available; derivatives of market quotes are used for mid-term transactions, where broker quotes are only marginally available; and proprietary models are used for long-term transactions, where broker quotes or other objective pricing indicators typically are not available. Beginning in the third quarter 2001, the Company began to enter into longer-term power transactions in the United States with respect to which no broker quotes or

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other market data was available; consequently, the Company applied a proprietary model to estimate forward prices and, in turn, the fair market value of these longer-term power transactions.

During January 2003, in connection with the re-audit of the Company's 1999-2001 financial statements and an assessment of various accounting policies, the Company reconsidered the model-based methodology used to value the portions of its power marketing and trading portfolio for which broker quotes were not available. Under the Company's prior methodology, forward curves used to calculate the value of its long-term U.S. power contracts were derived from a proprietary model based on a required rate of return on investments in new generation facilities. The primary disadvantage of this type of methodology, which was confirmed by the Company's former independent auditors prior to the withdrawal of their audit opinion for unrelated matters, is that, in certain circumstances, it may not reflect true market prices in future years. After reconsidering the appropriateness of this methodology in light of changing industry circumstances and in connection with the re-audit, in late January 2003, the Company determined that, beginning with the third quarter 2001, a different forward power curve methodology would more appropriately reflect the value of its long-term power contracts.

Upon making this determination, the Company corrected the forward power curve methodology it used to estimate the fair market value of its U.S. power marketing and trading portfolio. This corrected methodology incorporates forward energy prices derived from broker quotes and values from executed transactions to estimate forward price curves for periods where broker quotes and transaction data cannot be obtained. Further, the Company determined that in order to adequately reflect its results, it was appropriate to restate its prior period financial statements, beginning with the third quarter 2001, to reflect the corrected methodology.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The table below reflects the impact of this restatement on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|-----------------------------------|-------------------------------------|--------------------------------|
| | ----- | |
| | (in millions, except share data) | |
| Net Income (Loss) | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | (128) | (202) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ -- | \$ -- |

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2002..... (0.35) (0.55)

Restated Lease Accounting. The Company previously accounted for seven generation lease arrangements and one communications lease arrangement as operating leases. Its previous accounting treatment of these lease arrangements, which was confirmed by the Company's former independent auditors prior to the withdrawal of their audit opinion for unrelated matters, reflected its belief that these arrangements satisfied the applicable generally accepted accounting principles ("GAAP") requirements so as to justify their treatment as operating leases. However, these requirements are very technical and subject to a high degree of interpretation. During the course of the re-audit of the Company's financial statements for 1999-2001, the Company analyzed its accounting for these arrangements and considered a variety of factors, including interpretations of the applicable GAAP requirements. Upon completion of this analysis and discussions with PricewaterhouseCoopers LLP, in January 2003, the Company determined it necessary to correct its accounting for these lease arrangements to recognize on its balance sheet the related assets as of the inception of six of these arrangements. Although the Company previously amended the agreements relating to six generation lease arrangements so as to require them to be treated as capital leases in the second quarter 2002, the restatement of the accounting originally applied to these arrangements results in the recognition of the related assets as of an earlier date. Consequently, the Company's previously reported net income has been reduced, reflecting the recognition of impairment, depreciation and amortization expenses associated with the related assets. In addition, balance sheet amounts have been adjusted for this change as follows:

| | June 30, 2002 | December 31, 2001 |
|-------------------------------|------------------|----------------------|
| | ----- | |
| | (\$ in millions) | |
| Restricted cash..... | \$ 3 | \$ 17 |
| Property, plant and equipment | (23) | 1,094 |
| Accrued liabilities and other | 107 | 445 |
| Long-term debt..... | 345 | 666 |

Please read Note 7--Debt in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001, as most recently amended by Amendment No. 2 thereto filed with the SEC on April 11, 2003 (the "2001 Form 10-K/A"), for further discussion.

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The table below reflects the impact of this restatement on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

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| | Three Months Ended June 30 | Six Months Ended June 30 |
|-----------------------------------|-------------------------------------|--------------------------------|
| | ----- | ----- |
| | (in millions, except share data) | |
| Net Income (Loss) | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | (214) | (228) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | (0.58) | (0.63) |

Change in Implied Preferred Dividends. In November 2001, the Company issued \$1.5 billion in Series B preferred stock to ChevronTexaco. This preferred stock is convertible by ChevronTexaco into shares of Dynegy's Class B common stock at a conversion price of \$31.64. This conversion price represents an approximate 5% discount to the Company's stock price on November 7, 2001, the date the conversion price was negotiated. Based on the implied value of this beneficial conversion option as of November 7, Dynegy recognized a \$65 million preferred stock dividend to be amortized over the two-year period leading up to the mandatory redemption date for the shares. During the course of the re-audit of the Company's financial statements for 1999-2001, the Company analyzed its accounting for the beneficial conversion option and determined it necessary to correct the commitment date used for valuing this beneficial conversion option to November 13, 2001, the date ChevronTexaco funded and consummated its preferred stock purchase and the preferred securities were issued. The Company's stock price increased significantly between November 7 and November 13 after the announcement of the proposed Enron Corp. merger. As a result of the increase in the intrinsic value of ChevronTexaco's beneficial conversion option, the restated preferred stock dividend amount is calculated based on a two-year amortization of the beneficial conversion option's implied value of approximately \$660 million--an increase of approximately \$595 million over the \$65 million originally reported.

The table below reflects the impact of this restatement on net income available to common stockholders and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001. The restatement had no impact on net income or cash flows.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|--|-------------------------------------|--------------------------------|
| | ----- | ----- |
| | (in millions, except share data) | |
| Net Income (Loss) Available to Common Stockholders | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | (74) | (149) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | (0.20) | (0.41) |

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Valuation of Technology Investment. The Company acquired the common stock of a technology investment in the second quarter 2000. In the second quarter 2002, after several quarters of declines in the market

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

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price of the investment, the Company determined that the decline in value was other-than-temporary. As such, the Company recognized a \$12 million after-tax charge during the second quarter 2002. Upon further review, the Company determined that it incorrectly delayed recognition of the charge associated with this investment, as the decline in value through September 30, 2001 met the "other-than-temporary" threshold. Therefore, the Company has restated the financial statements to record the impairment in the third quarter 2001.

The table below reflects the impact of this restatement on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|-----------------------------------|-------------------------------------|--------------------------------|
| | ----- | |
| | (in millions, except share data) | |
| Net Income (Loss) | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | 10 | 10 |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ -- | \$ -- |
| 2002..... | 0.03 | 0.03 |

Correction for Income Taxes. During the course of the re-audit of its 1999-2001 financial statements, the Company reviewed its previous accounting for income taxes and determined that it made errors in accounting for certain tax matters. These errors related to book-tax basis differences that were reflected as permanent differences as opposed to temporary differences, the failure to record differences between the amounts recognized as income tax provision and the amounts actually reflected in the applicable income tax returns, adjustments related to book and tax-basis balance sheet reconciliations and changes in estimates of tax contingencies. The Company has restated its financial statements to correct these errors, resulting in additional deferred tax expense as further described below.

The table below reflects the impact of these restatements on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

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| | Three Months Ended June 30 | Six Months Ended June 30 |
|-------------------------------------|----------------------------------|--------------------------------|
| ----- | | |
| (in millions, except share data) | | |
| Net Income (Loss) | | |
| 2001..... | \$ (3) | \$ (8) |
| 2002..... | (1) | (4) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ (0.00) | \$ (0.02) |
| 2002..... | (0.00) | (0.01) |

Other Adjustments Arising During the Re-Audit. PricewaterhouseCoopers LLP re-audited Dynegy's 1999-2001 financial statements. The re-audit was completed in April 2003. The Company has restated its 1999-

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

2001 financial statements to correct various errors that were identified during the course of the re-audit, which restatements are reflected in the 2001 Form 10-K/A and the 2002 Form 10-K. These corrections principally relate to the timing on which various transactions were recorded in the ordinary course of business.

The table below reflects the impact of these restatements on net income and diluted earnings per share as originally reported for the three and six months ended June 30, 2002 and 2001.

| | Three Months Ended June 30 | Six Months Ended June 30 |
|-------------------------------------|----------------------------------|--------------------------------|
| ----- | | |
| (in millions, except share data) | | |
| Net Income (Loss) | | |
| 2001..... | \$ (47) | \$ (63) |
| 2002..... | 6 | (9) |
| Diluted Earnings (Loss) per Share | | |
| 2001..... | \$ (0.14) | \$ (0.19) |
| 2002..... | 0.03 | (0.02) |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

A synopsis of the aggregate financial impact of these restatements on the amounts originally reported in the Original Filing is as follows (in millions):

RESTATED SELECTED BALANCE SHEET DATA

| | June 30, 2002 |
|----------------------|---------------------------|
| | ----- (in millions) |
| Current Assets | |
| As Reported..... | \$ 9,692 |
| Restatement Effect. | (834) |
| | ----- |
| As Restated..... | \$ 8,858 |
| | ===== |
| Total Assets | |
| As Reported..... | \$28,989 |
| Restatement Effect. | (1,043) |
| | ----- |
| As Restated..... | \$27,946 |
| | ===== |
| Current Liabilities | |
| As Reported..... | \$10,833 |
| Restatement Effect. | (470) |
| | ----- |
| As Restated..... | \$10,363 |
| | ===== |
| Total Liabilities | |
| As Reported..... | \$22,644 |
| Restatement Effect. | (365) |
| | ----- |
| As Restated..... | \$22,279 |
| | ===== |
| Stockholders' Equity | |
| As Reported..... | \$ 4,471 |
| Restatement Effect. | (254) |
| | ----- |
| As Restated..... | \$ 4,217 |
| | ===== |

DYNEGY INC.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

RESTATED RESULTS OF OPERATIONS

| | Three Months Ended June 30, | Six Months Ended June 30, |
|--|--|---------------------------------|
| | ----- | ----- |
| | (in millions, except per share amounts) | |
| 2002 | | |
| Net Loss: | | |
| As Reported..... | \$ (328) | \$ (468) |
| Restatement Effect..... | (233) | (340) |
| | ----- | ----- |
| As Restated..... | \$ (561) | \$ (808) |
| | ===== | ===== |
| Net Loss Available to Common Stockholders: | | |
| As Reported..... | \$ (336) | \$ (484) |
| Restatement Effect..... | (307) | (489) |
| | ----- | ----- |
| As Restated..... | \$ (643) | \$ (973) |
| | ===== | ===== |
| Loss Per Diluted Share: | | |
| As Reported..... | \$(0.92) | \$(1.33) |
| Restatement Effect..... | (0.84) | (1.34) |
| | ----- | ----- |
| As Restated..... | \$(1.76) | \$(2.67) |
| | ===== | ===== |
| 2001 | | |
| Net Income: | | |
| As Reported..... | \$ 146 | \$ 285 |
| Restatement Effect..... | (107) | (91) |
| | ----- | ----- |
| As Restated..... | \$ 39 | \$ 194 |
| | ===== | ===== |
| Net Income Available to Common Stockholders: | | |
| As Reported..... | \$ 146 | \$ 285 |
| Restatement Effect..... | (107) | (91) |
| | ----- | ----- |
| As Restated..... | \$ 39 | \$ 194 |
| | ===== | ===== |
| Earnings Per Diluted Share: | | |
| As Reported..... | \$ 0.43 | \$ 0.84 |
| Restatement Effect..... | (0.31) | (0.27) |
| | ----- | ----- |
| As Restated..... | \$ 0.12 | \$ 0.57 |
| | ===== | ===== |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

RESTATED SELECTED CASH FLOW DATA

| | Six Months Ended June 30, ----- (in millions) |
|-----------------------|--|
| 2002 | |
| Operating Cash Flows: | |
| As Reported..... | \$ 375 |
| Restatement Effect. | (47) |
| | ----- |
| As Restated..... | \$ 328 |
| | ===== |
| Investing Cash Flows: | |
| As Reported..... | \$ (597) |
| Restatement Effect. | (56) |
| | ----- |
| As Restated..... | \$ (653) |
| | ===== |
| Financing Cash Flows: | |
| As Reported..... | \$ 417 |
| Restatement Effect. | 102 |
| | ----- |
| As Restated..... | \$ 519 |
| | ===== |
| 2001 | |
| Operating Cash Flows: | |
| As Reported..... | \$ 371 |
| Restatement Effect. | 5 |
| | ----- |
| As Restated..... | \$ 376 |
| | ===== |
| Investing Cash Flows: | |
| As Reported..... | \$ (577) |
| Restatement Effect. | (318) |
| | ----- |
| As Restated..... | \$ (895) |
| | ===== |
| Financing Cash Flows: | |
| As Reported..... | \$ 644 |
| Restatement Effect. | 331 |
| | ----- |
| As Restated..... | \$ 975 |
| | ===== |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

PLEASE NOTE THAT THESE FINANCIAL STATEMENTS AND THE NOTES THERETO DO NOT REFLECT EVENTS OCCURRING AFTER AUGUST 14, 2002 (THE DATE ON WHICH DYNEGY ORIGINALLY FILED ITS SECOND QUARTER 2002 FORM 10-Q). FOR A DESCRIPTION OF THESE EVENTS, PLEASE READ THE COMPANY'S EXCHANGE ACT REPORTS FILED SINCE AUGUST 14, 2002, INCLUDING ITS ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002. SEE NOTE 16--SUBSEQUENT EVENTS FOR FURTHER DISCUSSION.

NOTE 1--ACCOUNTING POLICIES

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to interim financial reporting as prescribed by the Securities and Exchange Commission ("SEC"). These interim financial statements should be read in conjunction with the restated consolidated financial statements and notes thereto included in the 2001 Form 10-K/A, which includes restated financial statements for 1999-2001 reflecting the revisions described in the Explanatory Note above.

The financial statements include all material adjustments, which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods. Interim period results are not necessarily indicative of the results for the full year. The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to develop estimates and make assumptions that affect reported financial position and results of operations and that impact the nature and extent of disclosure, if any, of contingent assets and liabilities. Actual results could differ materially from those estimates. Certain reclassifications have been made to prior period amounts in order to conform to current year presentation.

NOTE 2--LIQUIDITY AND INDUSTRY CONDITIONS

During 2002, a number of events negatively impacted Dynegy as well as the merchant energy industry in general. These events have resulted in downgrades in the Company's credit ratings to non-investment grade by each of the major rating agencies and a reduction in available liquidity resulting from a combination of lower than expected cash flow from operations, reduced access to sources of capital and increased collateralization of its trading and commercial obligations. The credit ratings downgrades have limited and will likely continue to limit significantly the Company's ability to refinance its debt obligations and to access the capital markets and will likely increase the borrowing costs incurred by the Company in connection with any refinancing activities. The Company's financial and operating flexibility is likely to be similarly reduced as a result of restrictive covenants and other terms that are typically imposed on non-investment grade borrowers. The Company has significant debt maturities over the next 12 months, which are further described in Note 8 below. Additionally, the increased collateralization of the Company's trading and commercial obligations has decreased capital otherwise available to satisfy the Company's debt service, debt maturities and other obligations.

In response to these events, on June 24, 2002 Dynegy announced a \$2 billion capital plan designed to enhance liquidity and reduce debt. Pursuant to this capital plan, Dynegy negotiated the elimination of \$301 million in credit

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ratings triggers relating to its financings and completed several interim financings. On July 28, 2002, Dynegy entered into an agreement to sell Northern Natural Gas Company ("Northern Natural") to MidAmerican Energy Holdings Company ("MidAmerican") for \$928 million in cash, subject to adjustment for working capital changes.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The closing of the Northern Natural sale and the execution of the remaining elements of the Company's capital plan are expected to provide sufficient near-term liquidity for the Company. The Northern Natural sale is expected to close in August 2002 and is subject to customary closing conditions, including expiration of the Hart-Scott-Rodino waiting period, and the continuation of certain transition services to Northern Natural. The remaining elements of the capital plan are subject to a number of risks including factors beyond the Company's control. These factors include, among others, market conditions for asset sales, the timeliness and ability to obtain required regulatory approvals, ongoing investigations and litigation, and the effect of commodity prices and continued contraction in the markets in which the Company operates, which may negatively impact its operating cash flow. The Company also must seek to rationalize its customer and risk-management business either through the formation of a joint venture or an alternative strategy that would reduce Dynegy's capital commitments to this business.

As is discussed in greater detail in "Management's Discussion and Analysis of Financial Condition and Results of Operations," the Company's liquidity will be improved by the closing of the Northern Natural sale. Dynegy has no significant maturities prior to November 2002 and believes that its current liquidity will be sufficient to meet the collateral requirements of its business through the expected closing of the Northern Natural sale. However, a delay in the closing of the Northern Natural sale or other adverse developments affecting the Company's liquidity could materially adversely affect Dynegy's financial condition. If Dynegy is unable to complete the Northern Natural sale in the near term or other elements of its strategy prior to the second quarter 2003, it may be forced to consider other strategic alternatives or a possible reorganization under the protection of bankruptcy laws.

The accompanying unaudited condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. This basis of accounting contemplates the recovery of the Company's assets and the satisfaction of its liabilities in the normal course of conducting business, which in turn is dependent upon the Company's ability to consummate the Northern Natural sale and successfully execute its capital plan as well as the performance of the Company's operations for the foreseeable future. Management believes that actions presently being taken relative to the Company's capital plan and other strategic alternatives should enable the Company to meet its obligations in a manner consistent with this accounting treatment.

NOTE 3--CHANGES IN ACCOUNTING PRINCIPLES

In July 2001, the FASB issued Statement of Financial Accounting Standards

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No. 142, "Goodwill and Other Intangible Assets" ("Statement No. 142"). Statement No. 142 discontinues goodwill amortization over its estimated useful life and provides that goodwill is subject to at least an annual fair-value based impairment test. The Company adopted Statement No. 142 effective January 1, 2002. The changes in the carrying amount of goodwill for each of Dynegy's reportable business segments for the six-month period ended June 30, 2002 are as follows (in millions):

| | Wholesale Energy Network | Dynegy Midstream Services | Transmission & Distribution | Dynegy Global Communications | Total |
|---|--------------------------------|---------------------------------|-----------------------------------|---------------------------------|---------|
| Balances as of January 1, 2002..... | \$930 | \$16 | \$ 381 | \$ 234 | \$1,561 |
| Cumulative effect of change in accounting principle..... | -- | -- | -- | (234) | (234) |
| Goodwill acquired during the period..... | -- | -- | 887 | -- | 887 |
| Purchase price adjustments..... | (7) | -- | (28) | -- | (35) |
| | ---- | ---- | ----- | ----- | ----- |
| Balances as of June 30, 2002..... | \$923 | \$16 | \$1,240 | \$ -- | \$2,179 |
| | ==== | === | ===== | ===== | ===== |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The Company recognized a \$234 million charge in the first quarter 2002 related to its Dynegy Global Communications ("DGC") segment in accordance with Statement No. 142 and reflected such charge as a cumulative effect of change in accounting principle. The fair value of that reporting segment was estimated using the expected present value of future cash flows. The value was negatively impacted by continued weakness in the telecommunications and broadband markets. Goodwill acquired during the period relates to the acquisition of Northern Natural, the previously announced sale of which is further described in Note 6 below. The purchase price adjustments relate to the United Kingdom natural gas storage assets purchased in late 2001 and to the acquisition of Northern Natural in early 2002.

The following table sets forth what Dynegy's net income and earnings per share ("EPS") would have been in the three- and six-month periods ended June 30, 2001, if goodwill had not been amortized during those periods, compared to the net loss and loss per share Dynegy recorded for the three- and six-month periods ended June 30, 2002 (in millions, except per share data).

| Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|-------|------------------------------|-------|
| 2002 | 2001 | 2002 | 2001 |
| ----- | ----- | ----- | ----- |

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| | | | | |
|--|-----------|--------|-----------|--------|
| Reported net income (loss)..... | \$ (561) | \$ 39 | \$ (808) | \$ 194 |
| Add back: Goodwill amortization..... | -- | 12 | -- | 24 |
| Adjusted net income (loss)..... | \$ (561) | \$ 51 | \$ (808) | \$ 218 |
| Less: preferred stock dividends..... | 82 | -- | 165 | -- |
| Net income (loss) available to common stockholders | \$ (643) | \$ 51 | \$ (973) | \$ 218 |
| Basic EPS: | | | | |
| Reported net income (loss)..... | \$ (1.76) | \$0.12 | \$ (2.67) | \$0.60 |
| Goodwill amortization..... | -- | 0.04 | -- | 0.07 |
| Adjusted net income (loss)..... | \$ (1.76) | \$0.16 | \$ (2.67) | \$0.67 |
| Diluted EPS: | | | | |
| Reported net income (loss)..... | \$ (1.76) | \$0.12 | \$ (2.67) | \$0.57 |
| Goodwill amortization..... | -- | 0.04 | -- | 0.07 |
| Adjusted net income (loss)..... | \$ (1.76) | \$0.16 | \$ (2.67) | \$0.64 |

In August 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("Statement No. 144"). Statement No. 144 addresses the accounting and reporting for the impairment or disposal of long-lived assets and supersedes FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and APB Opinion No. 30, "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." The Company's adoption of Statement No. 144 on January 1, 2002 did not have any impact on its financial position, results of operations or cash flows. However, see Note 4 below regarding the impairment of the communications business in the second quarter 2002.

Accounting Principles Not Yet Adopted. FASB Statement No. 143. Also during 2001, the FASB issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("Statement No. 143"). Statement No. 143 requires that the fair value of a liability for an asset retirement

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

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obligation is recognized in the period in which it is incurred with the associated asset requirement costs being capitalized as a part of the carrying amount of the long-lived assets. The Company is evaluating the future financial effects of adopting Statement No. 143 and will adopt the standard effective January 1, 2003.

FASB Statement No. 145. In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4,

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44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("Statement No. 145"). The adoption of Statement No. 145 effective January 1, 2003 is not expected to impact the Company.

FASB Statement No. 146. In July 2002, the FASB issued Statement of Financial Accounting Standards No. 146, "Accounting for Exit or Disposal Activities" ("Statement No. 146"). Statement No. 146 addresses issues regarding the recognition, measurement and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are accounted for pursuant to the guidance that the Emerging Issues Task Force ("EITF" or the "Task Force") has set forth in EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The scope of Statement No. 146 also includes (1) costs related to terminating a contract that is not a capital lease and (2) termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract. Statement No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002, although early adoption of the standard is allowed. If the Company had adopted Statement No. 146 early, it would not have affected the Company's accounting for restructuring activities which occurred in the second quarter 2002.

EITF Issue 02-3. In June 2002, the EITF reached consensus on two of three issues presented in EITF Issue 02-3, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" ("EITF Issue 02-3"). First, the Task Force concluded that all mark-to-market gains and losses on energy trading contracts (whether realized or unrealized) should be shown net in the income statement, irrespective of whether the contract is physically or financially settled. In addition, the Task Force concluded that an entity should disclose the gross transaction volumes for those energy trading contracts that are physically settled. Beginning in the third quarter 2002, Dynegy will present all mark-to-market gains and losses on a net basis and will expand its volumetric disclosures to comply with the consensus. Additionally, in accordance with the transition provisions in the consensus, comparative financial statements will be conformed to meet the requirements mandated by the Task Force. This change in accounting classification will have no impact on operating income, net income, earnings per share or cash flow from operations.

The second consensus reached by the Task Force related to required disclosures regarding energy trading operations. The Task Force agreed to clarify the application of APB Opinion No. 22, "Disclosure of Accounting Policies" and SOP 94-6, "Disclosure of Significant Risks and Uncertainties" to an entity's energy trading operations by requiring that entities disclose the applicability of EITF Issue 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," the types of contracts that are accounted for as energy trading contracts, a description of the methods and significant assumptions used to estimate the fair value of various classes of energy trading contracts and the sensitivity of its estimates to changes in the near term. The Task Force indicated that additional disclosure regarding the fair value of contracts, aggregated by source or method of estimating fair value and by maturity date, would also be meaningful. The Company will assess its disclosures with respect to these matters.

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For the Interim Periods Ended June 30, 2002 and 2001

The third issue addressed by the Task Force in EITF Issue 02-3 deals with the recognition of unrealized gains and losses at inception of an energy trading contract (commonly referred to as dealer profit). The Task Force reached no consensus on this issue, and the issue was assigned to a working group for resolution by the end of 2002. It is not possible to predict how the working group will resolve issues related to the recognition of dealer profit. Further, it is unclear how the working group will address the accounting transition resulting from adoption of new guidance. Three transition alternatives exist in practice. These transition alternatives include: (a) a retroactive restatement to eliminate dealer profit recognized in previous periods; (b) a cumulative effect adjustment for a change in accounting principle, which eliminates the recognition of previous periods' dealer profit in the current period; or, (c) as a prospective change, eliminating the recognition of dealer profit on future transactions but leaving past transactions unaffected.

Finally, it is unclear whether the scope of the working group's activities will include a comprehensive conclusion regarding the appropriateness of the use of models as a fundamental method for valuing transactions when market quotations are unavailable. Should the Task Force issue definitive guidance on any one or all of these issues, it will impact Dynegy. However, the extent of the financial impact to Dynegy, if any, cannot be predicted with any degree of certainty until the scope of the Task Force's conclusion is known and the transition alternative is determined. If the Task Force prefers a retroactive or a cumulative effect transition alternative, then Dynegy's historical financial position and results of operations will be impacted negatively. If the Task Force prefers a prospective transition alternative, then Dynegy's current financial position will be unaffected and the impact to future operations in the near term is not expected to be material (largely as a result of a reduction in these types of transactions in the marketplace).

NOTE 4--RESTRUCTURING AND IMPAIRMENT CHARGES

During the second quarter 2002, the Company recognized a \$683 million pre-tax (\$444 million after-tax) charge principally related to the impairment, write-off or obsolescence of certain assets and an accrual for severance related to a corporate restructuring. The charge primarily relates to the impairment of the Company's investment in the telecommunications business, the impairment of investments in securities of entities engaged in technology-related ventures and a severance charge related to a plan of restructuring of the Company's operations. The pre-tax charges, which were substantially non-cash in nature, consisted of the following (in millions):

| | |
|---|-------|
| Impairment of telecommunications business | \$611 |
| Impairment of technology investments..... | 23 |
| Severance charge..... | 37 |
| Write-off of other obsolete assets..... | 12 |
| | ---- |
| | \$683 |
| | ---- |

During the second quarter 2002, prospects for the communications sector continued to deteriorate as evidenced by an increased number of bankruptcies in the sector, continued devaluation of debt and equity securities, a lack of

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financing sources and further pricing pressures resulting from challenges faced by major industry participants. As a result of this deterioration, a continuing negative outlook for the industry and Dynegy's desire to improve its own liquidity, management began to take measures to reduce cash losses in the business, including reducing capital spending and lowering operating and administrative expenses. Management is aggressively pursuing alternatives for exiting this business segment, although no formal plans are in place and no assurance can be provided as to the timing or structure of any such transaction.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

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For the Interim Periods Ended June 30, 2002 and 2001

Statement No. 144 requires long-lived assets to be tested for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable from future cash-flows of the segment or there is an expectation that it is more likely than not that a long-lived asset group will be sold or otherwise disposed of before the end of its previously estimated useful life.

Dynegy's impairment analysis of its communications business at June 30, 2002, calculated in accordance with the guidelines set forth in Statement No. 144, indicated future cash flows from DGC's operations were insufficient to cover the carrying value of that segment's long-lived assets. As a result, non-cash impairment charges totaling \$611 million (\$397 million after-tax) were recorded in Impairment and Other Charges in the accompanying Condensed Consolidated Statements of Operations for the three- and six-month periods ended June 30, 2002.

At June 30, 2002, the valuations of certain technology investments were assessed in light of the Company's decision to pursue a managed exit strategy from its telecommunications business. These investments were originally entered into in order to leverage existing commercial relationships or as a means of expanding new relationships. Historically, the Company viewed these investments as strategic and core to its telecommunications strategy. Accordingly, Dynegy expected to hold these investments for the long-term and viewed trends in the sector as cyclical. These investments include ownership in public and private companies and investment funds focused in the technology sector. The continued downturn in the technology sector during the second quarter 2002 combined with the Company's change in strategy resulted in a decision to recognize an impairment charge relative to these investments. After recognition of the impairment, values for these investments represent expected realizable value at June 30, 2002. The \$23 million pre-tax (\$15 million after-tax) charge was recorded in Earnings of Unconsolidated Affiliates in the accompanying Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2002.

The Company recognized a pre-tax charge of approximately \$37 million (\$24 million after-tax) for severance benefits for approximately 325 employees who were from various segments and included all staffing levels, including the Company's former Chief Executive Officer and Chief Financial Officer. The charge is included in Impairment and Other Charges in the accompanying Condensed Consolidated Statements of Operations. No severance amounts were paid

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as of June 30, 2002, thus the entire amount is included within Accrued Liabilities and Other in the accompanying June 30, 2002 Condensed Consolidated Balance Sheet.

The remaining pre-tax non-cash charge of \$12 million (\$8 million after-tax) relates to the retirement of partially depreciated information technology equipment and software replaced during the quarter with new system applications and arrangements as well as miscellaneous deposits that are not expected to provide future value. The charge was recorded in Impairment and Other Charges in the accompanying Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2002.

During the three months ended March 31, 2002, the Company incurred an \$18 million pre-tax (\$13 million after-tax) charge associated with a commitment to deliver gas assumed in the acquisition of Northern Natural. The pre-tax charge is included in Revenues in the accompanying Condensed Consolidated Statement of Operations for the six months ended June 30, 2002.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

NOTE 5--BUSINESS COMBINATIONS AND OTHER ACQUISITIONS

In November 2001, Dynegy acquired 1,000 shares of Series A Preferred Stock ("Series A Preferred Stock") in Northern Natural for \$1.5 billion. In connection with the investment, Dynegy Holdings Inc. ("DHI"), a wholly owned subsidiary of Dynegy, acquired an option to purchase all of the equity of Northern Natural's indirect parent company. DHI exercised its option to acquire the indirect parent of Northern Natural in November 2001 upon termination of Dynegy's merger agreement with Enron Corp. ("Enron"), and the closing of the option exercise occurred on January 31, 2002. Enron retained an option to reacquire Northern Natural, which expired unexercised on July 1, 2002.

On July 28, 2002, Dynegy executed an agreement to sell Northern Natural to MidAmerican for \$928 million in cash, subject to adjustment for working capital changes. Under the terms of this agreement, MidAmerican is expected to acquire all of the common and preferred stock of Northern Natural and to assume all of Northern Natural's \$950 million of debt with a fair value of approximately \$890 million. The transaction is expected to close in August 2002 and is subject to customary closing conditions, including expiration of the Hart-Scott-Rodino waiting period. No assurance can be given as to the timing of such approval or the consummation, if at all, of the transaction. Because Dynegy paid approximately \$1.5 billion for Northern Natural, Dynegy expects to incur a significant loss associated with the sale.

Northern Natural was consolidated with Dynegy's operations beginning February 1, 2002. The following table reflects certain unaudited pro forma information for Dynegy for the periods presented as if Dynegy's acquisition of Northern Natural had taken place on January 1, 2001 (in millions, except per share data).

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|----------|---------------------------|----------|
| | 2002 | 2001 | 2002 | 2001 |
| Pro forma revenues..... | \$9,676 | \$12,006 | \$18,160 | \$25,000 |
| Pro forma income (loss) from operations before change in accounting principle (Notes 4 and 7)..... | (561) | 56 | (551) | 0 |
| Pro forma income (loss) from operations before change in accounting principle per share (diluted)..... | (1.76) | 0.17 | (1.97) | 0 |
| Pro forma net income (loss) before preferred stock dividends..... | (561) | 56 | (785) | 0 |
| Pro forma net income (loss) available to common shareholders..... | (643) | 56 | (950) | 0 |
| Pro forma earnings (loss) per share (diluted)..... | (1.76) | 0.17 | (2.61) | 0 |

NOTE 6--COMMERCIAL OPERATIONS, RISK MANAGEMENT ACTIVITIES AND FINANCIAL INSTRUMENTS

Provisions in Statement No. 133, as amended, affect the accounting and disclosure of certain contractual arrangements and operations of the Company. Under Statement No. 133, as amended, all derivative instruments are recognized in the balance sheet at their fair values and changes in fair value are recognized immediately in earnings, unless the derivatives (which are not part of the Company's marketing activities) qualify, and are designated, as hedges of future cash flows, fair values or net investments or qualify, and are designated, as normal purchases and sales. Derivatives treated as normal purchases or sales are recorded and recognized in income using accrual accounting.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

The nature of the Company's business necessarily involves certain market and financial risks. The Company routinely enters into financial instrument contracts in an attempt to mitigate or eliminate these various risks. These risks and the Company's strategy for mitigating these risks are more fully described in Note 3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001 (the "2001 Form 10-K").

Changes in stockholders' equity related to derivatives for the six-month period ended June 30, 2002 were as follows, net of tax (in millions):

| | |
|---|------|
| Balance at December 31, 2001..... | \$ 8 |
| Current period changes in fair value, net | (3) |
| Reclassifications to earnings, net..... | 2 |
| | --- |
| Balance at June 30, 2002..... | \$ 7 |

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Accumulated other comprehensive income, net of tax is included in Stockholders' Equity on the Condensed Consolidated Balance Sheet as follows (in millions):

| | |
|--|------|
| Statement No. 133, net..... | \$ 7 |
| Currency translation adjustment..... | 3 |
| Unrealized loss on available-for-sale securities, net..... | 1 |
| | --- |
| Accumulated other comprehensive income, net of tax, at June 30, 2002 | \$11 |
| | --- |

Other comprehensive income (loss) is as follows (in millions):

| | Six Months Ended June 30, | |
|-----------------------------------|---------------------------------|--------|
| | 2002 | 2001 |
| | ----- | ----- |
| Net income (loss)..... | \$ (808) | \$ 194 |
| Other comprehensive income..... | 38 | 30 |
| | ----- | ----- |
| Total comprehensive income (loss) | \$ (770) | \$ 224 |
| | ----- | ----- |

Additional disclosures required by Statement No. 133, as amended, are provided in the following paragraphs.

The Company enters into various financial derivative instruments which qualify as cash flow hedges. For derivatives treated as hedges of future cash flows, the effective portion of changes in fair value is recorded in other comprehensive income until the related hedged items impact earnings. Any ineffective portion of a hedge is reported in earnings immediately. Instruments related to the Company's customer and risk-management and midstream liquids businesses are entered into for purposes of hedging forward fuel requirements for certain power generation facilities, locking in future margin in the domestic midstream liquids business and hedging price risk in the global liquids business. Interest rate swaps are used to convert the floating interest rate component of certain obligations to fixed rates.

Dynegy recognized a charge of less than \$1 million relating to hedge ineffectiveness during the six months ended June 30, 2002, and no amounts were excluded from the assessment of hedge effectiveness related to the

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For the Interim Periods Ended June 30, 2002 and 2001

hedge of future cash flows. Additionally, no amounts were reclassified to earnings in connection with forecasted transactions that were no longer considered probable of occurring.

The balance in other comprehensive income at June 30, 2002 associated with these cash flow hedges is expected to be reclassified to future earnings contemporaneously with the related purchases of fuel, sales of electricity or liquids and payments of interest, as applicable to each type of hedge. Of this amount, approximately \$9 million in losses, net of taxes, is estimated to be reclassified into earnings over the 12-month period ending June 30, 2003. The actual amounts that will be reclassified to earnings over the next 12 months could vary materially from this estimated amount as a result of changes in market conditions.

The Company also enters into derivative instruments which qualify as fair value hedges. For derivatives treated as fair value hedges, changes in the fair value of the derivative and changes in the fair value of the related asset or liability are recorded in current period earnings. The Company uses interest rate swaps to convert a portion of its fixed-rate debt into variable-rate debt. During the six months ended June 30, 2002 and 2001, there was no ineffectiveness from changes in fair value of hedge positions, and no amounts were excluded from the assessment of hedge effectiveness. Additionally, no amounts were recognized in relation to firm commitments that no longer qualified as fair value hedge items.

The Company has investments in foreign subsidiaries, and the net assets of these subsidiaries are exposed to currency exchange-rate volatility. The Company uses derivative financial instruments, including foreign exchange forward contracts and cross currency interest rate swaps, to hedge this exposure. For the six months ended June 30, 2002, approximately \$64 million of net losses related to these contracts were included in the cumulative translation adjustment. During the six months ended June 30, 2002, ineffectiveness from changes in fair value of net investment hedge positions was a loss of approximately \$5 million. There were no net investment hedges for the six months ended June 30, 2001.

NOTE 7--CAPITAL LEASES

In response to the initiatives underway at the FASB, on June 28, 2002, the Company unilaterally undertook certain actions, the effect of which altered the accounting for one of its existing lease obligations. These actions included the delivery of a guarantee of the lessor debt in the lease of a power generation facility. As a result of these actions, the lease is now accounted for as a capital lease and approximately \$165 million of generation assets and the associated debt were brought on-balance sheet. The Company has the option to purchase the related assets at lease maturity in 2005. This obligation bears interest at a rate of LIBOR plus 1.5% to 2.75%, depending on the tranche.

This non-cash action resulted in an increase to property, plant and equipment and a corresponding increase in long-term debt on the condensed consolidated balance sheets. This obligation was previously reported as a lease obligation in the footnotes to the financial statements and in the Commercial Financial Obligations and Contingent Financial Commitments tables in the 2001 Form 10-K.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

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The following is a schedule of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of June 30, 2002 (in millions):

| | |
|---|-------|
| Six months ending December 31, 2002..... | \$ 3 |
| Year ending December 31: | |
| 2003..... | 5 |
| 2004..... | 7 |
| 2005..... | 176 |
| | ---- |
| Total minimum lease payments..... | 191 |
| Less: Amount representing interest..... | (26) |
| | ---- |
| Present value of net minimum lease payments | \$165 |
| | ---- |

NOTE 8--DEBT

As of August 12, 2002, the Company's debt and preferred stock maturities through December 31, 2003, inclusive of letters of credit issued under revolving credit facilities, were as follows: remainder of third quarter 2002--\$33 million; fourth quarter 2002--\$400 million (not including a \$450 million secured line of credit at Northern Natural that will be assumed by MidAmerican in the sale of Northern Natural, as further described in Note 5 above); first quarter 2003--\$259 million; second quarter 2003--\$1,875 million; third quarter 2003--\$252 million; and fourth quarter 2003--\$1,562 million (including \$1.5 billion in Series B Mandatorily Convertible Redeemable Preferred Stock held by ChevronTexaco Corporation). Please read "Management's Discussion and Analysis of Financial Condition and Results of Operations--Liquidity and Capital Resources" for a discussion of the Company's current liquidity and capital plans.

In July 2002, the Company completed a \$200 million interim financing, bearing interest at LIBOR plus 1.38 percent. This loan matures in January 2003 and is secured by interests in Dynegy's Renaissance and Rolling Hills merchant power generation facilities.

In June 2002, the Company completed a \$250 million interim financing, bearing interest at LIBOR plus 1.75 percent. This loan matures in June 2003 and represents an advance on a portion of the proceeds from the expected sale of certain of the Company's United Kingdom natural gas storage facilities.

Dynegy completed an amendment to the Catlin Associates, LLC transaction also referred to as "Black Thunder" in June 2002 that permanently removed a \$270 million obligation that could have been triggered by declines in our credit ratings. The amended agreement requires one of our subsidiaries to make periodic payments totaling \$275 million over the remaining three years of the transaction with \$577 million due in June 2005. The subsidiary has already paid approximately \$73 million of this total. Quarterly maturities are approximately

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\$20 million through the first quarter 2005. Balances outstanding incur interest based on market conditions in accordance with the agreement. In addition, we agreed to grant mortgages on the Midwest generation assets covered by the transaction, post a letter of credit to secure a contingent obligation expiring December 31, 2002 and to make certain structural changes to enhance the security of the third-party lenders involved in the transaction. As a result of this amendment, \$796 million related to Catlin Associates, LLC was reclassified from minority interest to debt on Dynegy's Condensed Consolidated Balance Sheet at June 30, 2002.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

Also in June 2002, West Coast Power, LLC ("West Coast Power"), a joint venture owned equally by Dynegy and NRG Energy with generation assets in California, repaid a non-recourse project financing with cash on hand within the joint venture entity. This payment eliminated a \$31 million obligation which could have been triggered by declines in Dynegy's credit ratings. Concurrent with the retirement of the project financing, West Coast Power entered into an amended \$120 million bank facility consisting of a \$100 million letter of credit facility that will be used to collateralize West Coast Power's obligations, a \$10 million term loan and a \$10 million working capital facility. The facility has resulted in the release of approximately \$100 million in letters of credit previously posted by Dynegy on behalf of West Coast Power.

Dynegy incurred upfront fees aggregating approximately \$19 million in connection with the interim financings, Black Thunder amendment and West Coast Power transactions described above. Such amounts are capitalized and amortized over the terms of the respective financing transactions.

On May 17, 2002, Illinois Power Company ("IP"), an indirect wholly owned Dynegy subsidiary, exercised the "term-out" provision contained in its \$300 million 364-day revolving credit facility, which was scheduled to mature on May 20, 2002. In connection with this conversion, IP borrowed the remaining \$60 million available under this facility. The exercise of the "term-out" provision converted the facility to a one-year term loan that matures in May 2003. As such, the amounts outstanding under this loan are classified as current. Borrowings of \$300 million were outstanding under this loan at June 30, 2002.

On April 29, 2002, DHI closed a \$900 million unsecured revolving credit agreement with a syndicate of commercial banks. This facility, which matures on April 28, 2003, replaced an expiring \$1.2 billion revolving credit agreement. The new facility provides funding for working capital, capital expenditures and general corporate purposes. Generally, borrowings under the credit agreement bear interest at a Eurodollar rate plus a margin that is determined based on designated unsecured debt ratings. Facility fees are payable on the full amount of the facility and are determined based on designated unsecured debt ratings. Dynegy will incur higher interest costs and fees associated with the new facility as compared to those incurred under the expired facility. Specifically, assuming that all amounts were outstanding under this facility, DHI would pay approximately \$10 million in additional interest expense on the

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new facility compared to what it would have paid under the expired facility. Additionally, as compared to similar fees paid by DHI under the expired facility, DHI expects to pay approximately \$2 million in additional facility fees during the term of the new facility and paid approximately \$3 million in additional upfront fees.

Financial covenants under the new DHI revolver include a debt-to-capitalization test (which takes into account certain lease and similar commitments of DHI and its subsidiaries) and a newly added 3.5 times earnings before interest, taxes and depreciation and amortization ("EBITDA")-to-interest test. The permissible threshold for the debt-to-capitalization test was lowered in the new facility from 65% to 60%. Other newly added covenants in the facility include subordination of certain intercompany debt owed to Dynegy and its subsidiaries (other than DHI and its subsidiaries), restrictions on liens and limitations prohibiting subsidiary debt at Dynegy Marketing & Trade, Dynegy Power Marketing, Inc. and Dynegy Midstream Services, Limited Partnership. Default provisions include cross payment default of Dynegy, DHI or any principal subsidiary with respect to debt or other similar obligations that exceed \$100 million, cross acceleration of Dynegy, DHI or any principal subsidiary under any instrument covering debt or similar obligations that exceed \$100 million and bankruptcy or receivership of Dynegy, DHI or any principal subsidiary. The new facility does not contain any defaults relating to material adverse changes in the condition of Dynegy or DHI after the closing date or to changes in Dynegy's

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

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or DHI's credit ratings. The new facility also does not contain a "term-out" provision that would permit Dynegy to extend the maturity for borrowings under the facility beyond the facility's April 28, 2003 maturity date. As such, the amounts outstanding under this facility are classified as current. Management believes DHI is in compliance with the covenants contained in this agreement.

On April 10, 2001, ABG Gas Supply entered into a credit agreement with a consortium of lenders in order to provide financing associated with Project Alpha. Advances under the agreement allowed ABG Gas Supply to purchase NYMEX natural gas contracts with the underlying physical gas supply to be sold to Dynegy Marketing and Trade under an existing natural gas purchases and sales agreement. The credit agreement requires ABG Gas Supply to repay the advances in monthly installments commencing February 2002 through December 2004 from funds received from Dynegy Marketing and Trade under the natural gas purchases and sales agreement. The advances bear interest at a Eurodollar rate plus a margin as defined in the agreement. Advances of \$290 million were outstanding under this agreement at June 30, 2002.

On February 21, 2002, DHI issued \$500 million of 8.75% senior notes due 2012. Interest on the notes is due on February 15 and August 15 of each year, beginning August 15, 2002. The notes are unsecured and are not subject to a sinking fund. DHI may redeem the notes prior to maturity, in whole or in part, at a redemption price equal to the greater of the principal amount of the notes and the make-whole price specified in the indenture relating to the notes.

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On January 31, 2002, the Company acquired debt with a face value of approximately \$950 million (and a fair value of approximately \$890 million) through the acquisition of Northern Natural. Approximately \$500 million of the Northern Natural debt consists of senior unsecured notes with maturities ranging from 2005 to 2011. The remaining \$450 million consists of a secured line of credit that matures in November 2002. See Note 5 for discussion of Dynegy's previously announced sale of Northern Natural. In the event the Company cannot consummate the sale of Northern Natural, management believes, based on an internal analysis of Northern Natural's credit capacity, including a review of other regulated pipelines, that Northern Natural will be able to refinance the \$450 million secured line of credit, and it is Northern Natural's management's current intention to do so. On April 26, 2002, DHI purchased \$90 million of Northern Natural's senior unsecured notes due 2005 pursuant to a tender offer. The Company is considering alternatives relating to the sale of these notes.

During the six-month period ended June 30, 2002, the Company repaid commercial paper borrowings and revolving credit facilities for DHI and IP of approximately \$293 million in the aggregate and borrowed approximately \$60 million under IP's revolving credit facility. Additionally, during the six months ended June 30, 2002, Dynegy and DHI issued an aggregate of \$433 million of letters of credit under their revolving credit facilities. During the period from June 30, 2002 through August 12, 2002, Dynegy paid at maturity \$200 million in senior notes of DHI and \$96 million in IP mortgage bonds, borrowed an aggregate of \$137 million and issued an aggregate of \$251 million of letters of credit under the Dynegy and DHI revolving credit facilities.

NOTE 9--EARNINGS PER SHARE

Basic earnings (loss) per share represents the amount of earnings (loss) for the period available to each share of common stock outstanding during the period. Diluted earnings (loss) per share represents the amount of earnings (loss) for the period available to each share of common stock outstanding during the period plus each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the period. In-the-money outstanding options contribute to the differences

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

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between basic and diluted shares outstanding in all periods. The diluted shares in the 2002 periods do not include the effect of the assumed conversion to Class A common stock of the Series B Mandatorily Convertible Redeemable Preferred Securities held by ChevronTexaco as it would be anti-dilutive.

When an entity has a net loss from continuing operations, Statement of Financial Accounting Standards No. 128, "Earnings per Share," prohibits the inclusion of dilutive potential common shares in the computation of diluted per-share amounts. Accordingly, the Company has utilized the basic shares outstanding amount to calculate both basic and diluted loss per share for the three and six months ended June 30, 2002.

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NOTE 10--CAPITAL STOCK

Chevron U.S.A. Inc., a ChevronTexaco subsidiary, purchased approximately 10.4 million shares of Class B common stock in January 2002 pursuant to its preemptive right under its shareholder agreement with Dynegy. Proceeds from this sale totaled approximately \$205 million and were held in cash to enhance short-term liquidity.

Dynegy's Board of Directors has elected not to pay a dividend on Dynegy's Class A or Class B common stock for the third quarter 2002. Payments of dividends for subsequent periods will be at the discretion of the Board of Directors.

NOTE 11--UNCONSOLIDATED INVESTMENTS

Investments in affiliates that are not controlled by the Company but where the Company has significant influence over operations are accounted for by the equity method. The Company's share of net income from these affiliates is reflected in the consolidated statements of operations as earnings (losses) from unconsolidated investments. The Company's principal equity method investments consist of entities that operate generation assets and natural gas liquids assets. These equity investments totaled \$854 million and \$830 million at June 30, 2002 and December 31, 2001, respectively. The Company entered into these ventures principally for the purpose of sharing risk and leveraging existing commercial relationships. These ventures maintain independent capital structures and have financed their operations on a non-recourse basis to the Company. Dynegy holds investments in joint ventures in which ChevronTexaco or its affiliates are investors. For additional information about these investments, please read Note 11--Related Party Transactions in the 2001 Form 10-K.

Generation Assets. These investments include ownership interests in eight joint ventures that own fossil fuel electric generation facilities in diverse geographic regions as well as a limited number of international ventures. The Company's ownership is generally 50 percent in the majority of these ventures. The Company's aggregate net investment of \$720 million at June 30, 2002 represents approximately 2,400 MW of net generating capacity. The Company's most significant investment in generating capacity is its interest in West Coast Power, representing approximately 1,400 MW of net generating capacity in California. The net investment in West Coast Power totaled approximately \$348 million at June 30, 2002. West Coast Power provided equity earnings of approximately \$37 million and \$70 million in the six months ended June 30, 2002 and 2001, respectively.

Midstream Investments. These investments primarily include ownership interests in three ventures that operate natural gas liquids ("NGL") processing, extraction, fractionation and storage facilities in the Gulf Coast region as well as an interstate NGL pipeline. The Company's ownership interest in these ventures ranges from 23 percent to 39 percent. At June 30, 2002, the Company's aggregate net investment in these midstream businesses totaled approximately \$134 million.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

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Summarized aggregate financial information for these generation and midstream investments and Dynegy's equity share thereof was (in millions):

| | Six Months Ended June 30, | | | |
|---------------------|---------------------------|-----------------|---------|-----------------|
| | 2002 | | 2001 | |
| | Total | Equity Share | Total | Equity Share |
| Revenues..... | \$1,851 | \$703 | \$2,455 | \$936 |
| Operating margin \$ | 397 | \$135 | \$ 388 | \$152 |
| Net income..... \$ | 210 | \$ 72 | \$ 253 | \$ 94 |

Other Investments. In addition to these equity investments, the Company holds interests in non-public companies for which it does not have significant influence over the operations. These investments are generally accounted for by the cost method. Such investments totaled \$52 million and \$91 million at June 30, 2002 and December 31, 2001, respectively. The change is primarily attributed to the impairment of technology investments resulting from unfavorable market conditions. See Note 4 for further discussion regarding these impairments.

The Company also owns equity securities that have a readily determinable fair market value and are considered available-for-sale. The market value of these investments at June 30, 2002 and December 31, 2001 was determined to be \$12 million and \$23 million, respectively. The change is primarily attributed to the decline in value of available-for-sale technology investments resulting from unfavorable market conditions. The Company wrote off the unrealized losses related to such dealings in the second quarter 2002. The Company is in the process of selling these investments.

NOTE 12--COMMITMENTS AND CONTINGENCIES

PLEASE NOTE THAT THE INFORMATION CONTAINED IN THIS NOTE 12, WHICH WAS PRESENTED IN THE COMPANY'S SECOND QUARTER 2002 FORM 10-Q ORIGINALLY FILED WITH THE SEC ON AUGUST 14, 2002 IN ORDER TO REFLECT MATERIAL CHANGES IN OR UPDATES TO THE COMPANY'S MATERIAL LEGAL PROCEEDINGS SINCE THE ORIGINAL FILING OF ITS 2001 FORM 10-K AND FIRST QUARTER 2002 FORM 10-Q, DOES NOT REFLECT EVENTS OCCURRING AFTER AUGUST 14, 2002. FOR A DESCRIPTION OF THESE EVENTS, INCLUDING MATERIAL CHANGES IN OR UPDATES TO THE COMPANY'S MATERIAL LEGAL PROCEEDINGS, PLEASE READ ITS EXCHANGE ACT REPORTS FILED SINCE AUGUST 14, 2002, INCLUDING ITS ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002. SEE NOTE 16--SUBSEQUENT EVENTS FOR FURTHER DISCUSSION.

Please see Note 11, "Commitments and Contingencies," in the 2001 Form 10-K and Note 9, "Commitments and Contingencies," in the Company's Form 10-Q for the quarter ended March 31, 2002 (the "Form 10-Q") for a description of the Company's material legal proceedings. Set forth below is a description of any material developments that have occurred with respect to such proceedings since the Company's filing of the Form 10-Q for the first quarter 2002 and a description of any new matters that have arisen during the quarter.

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We record reserves for estimated losses from contingencies when information available indicates that a loss is probable and the amount of the loss is reasonably estimable in accordance with SFAS No. 5, "Accounting for

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Contingencies." For environmental matters, we record liabilities when environmental assessment indicates that remedial efforts are probable and the costs can be reasonably estimated. Please read Note 2--Accounting Policies of the 2001 Form 10-K for further discussion.

With respect to several of the items listed below, Dynegy has determined that a loss is not probable or that any such loss, to the extent probable, is not reasonably estimable. Notwithstanding the foregoing, Dynegy's management has assessed the matters described below based on currently available information and made an informed judgment concerning the potential outcome of such matters, giving due consideration to the nature of the claim, the amount and nature of damages sought and the possibility of success. Management's judgment may, as a result of facts arising prior to resolution of these matters or other factors, prove inaccurate and investors should be aware that such judgment is made subject to the known uncertainty of litigation.

Baldwin Station Litigation. IP and Dynegy Midwest Generation, Inc., (collectively, the "Defendants") are the subject of a Notice of Violation ("NOV") from the Environmental Protection Agency (the "EPA") and a complaint filed by the EPA and the Department of Justice alleging violations of the Clean Air Act (the "Act") and the regulations promulgated under the Act. Similar notices and complaints have been filed against a number of other utilities. Both the NOV and the complaint allege that certain equipment repairs, replacements and maintenance activities at the Defendants' three Baldwin Station generating units constituted "major modifications" under the Prevention of Significant Deterioration and/or New Source Performance Standards regulations. When activities that meet the definition of "major modifications" occur and they are not otherwise exempt, the Act and related regulations generally require that generating facilities meet more stringent emissions standards, which may entail the installation of potentially costly pollution control equipment. The Defendants filed an answer denying all claims and asserting various specific defenses and a trial date of February 11, 2003 has been set.

The Company believes that it has meritorious defenses to the EPA allegations and will vigorously defend against these claims. The Company has undertaken activities to significantly reduce emissions at the Baldwin Station since the complaint was filed in 1999. In 2000, the Baldwin Station was converted from high to low sulfur coal. This conversion resulted in sulfur dioxide emission reductions of over 90% from 1999 levels. Furthermore, selective catalytic reduction equipment has been installed at two of the three units at Baldwin Station resulting in significant emission reductions of nitrogen oxides. However, the EPA may seek to require the installation of the "best available control technology" (or the equivalent) at the Baldwin Station. Independent experts hired by Dynegy estimate capital expenditures of up to \$380 million if

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the installation of best available control technology is required. The EPA also has the authority to seek penalties for the alleged violations in question at the rate of up to \$27,500 per day for each violation. The Company has filed a motion for summary judgment based on the five-year statute of limitations, which could affect the EPA's ability to collect penalties.

None of the Defendants' other facilities are covered in the complaint and NOV, but the EPA has officially requested information concerning activities at the Defendants' Vermilion, Wood River and Hennepin Plants as well as Dynegy Northwest Generation's Danskammer and Roseton Plants. It is possible that the EPA will eventually commence enforcement actions based on activities at those plants as well.

On June 13, 2002, the EPA announced its intention to implement several reforms to its regulations governing new source review. These reforms, if made, would clarify the routine maintenance, repair and

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DYNEGY INC.

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(UNAUDITED AND RESTATED)

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replacement exclusion, provide more certainty in evaluating permit requirements and increase operational flexibility for affected facilities.

California Market Litigation. Six class action lawsuits have been filed against various Dynegy entities based on the events occurring in the California power market. The complaints allege violations of California's Business and Professions Code, Unfair Trade Practices Act and various other statutes. The plaintiffs allege that the defendants, including the owners of in-state generation and various power marketers, conspired to manipulate the California wholesale power market to the detriment of California consumers. Included among the acts forming the basis of the plaintiffs' claims are the alleged improper sharing of generation outage data, improper withholding of generation capacity and the manipulation of power market bid practices. The plaintiffs seek unspecified treble damages.

All six lawsuits were consolidated before Judge Sammartino, Superior Court Judge for the County of San Diego. Subsequent to the consolidation, two defendants filed cross complaints against a number of corporations and governmental agencies that sold power in California's wholesale energy markets. Four cross defendants removed the six cases to the United States District Court for the Southern District of California (San Diego). Following removal, certain cross defendants filed motions to dismiss the cross complaints, which motions are pending. The original plaintiffs in the six consolidated complaints filed motions to remand the consolidated cases back to state court, which motions are pending. The defendants in the six consolidated cases have filed motions to dismiss the complaints based on the filed rate doctrine and preemption defense, which motions are pending. Federal Judge Whaley has decided that the Court will hear the motion to remand and the cross defendants' motion to dismiss on September 19, 2002. If the Court decides that it has jurisdiction over the claims, the defendants' motion to dismiss will be heard as soon as possible after September 19th.

On March 11, 2002, the California Attorney General filed, on behalf of the

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People of the State of California, complaints in San Francisco Superior Court against several owners of power generation facilities, including subsidiaries of West Coast Power. The complaints allege that since June 1998, these generators sold power in the open market that should have been held in emergency reserve for the State. In the aggregate, the complaints seek more than \$150 million in penalties, restitution and return of profits from the generators. These lawsuits were subsequently removed to the United States District Court for the Northern District of California. The California Attorney General filed motions to remand the cases back to state court. By Order issued on August 6, 2002, Judge Walker denied the motions to remand, thus keeping the cases in federal court. The Company intends to vigorously defend against these claims.

In addition to the six consolidated lawsuits discussed above, eight new putative class actions were filed on behalf of business and residential electricity consumers, including consumers residing in the State of Washington. The lawsuits were filed in various state courts and in Northern California, and in respect to the lawsuit on behalf of consumers in the State of Washington, in the United States District Court for the Northern District of California. Named as defendants are various generators and marketers, including Dynegy and some of our affiliates. The complaints allege unfair, unlawful, and deceptive practices in violation of the California Unfair Business Practices Act and seek to enjoin illegal conduct, restitution and unspecified damages. While some of the allegations in these lawsuits are similar to the allegations in the other six lawsuits, these lawsuits include additional allegations based on events occurring subsequent to the filing of the other six lawsuits. These additional allegations include allegations similar to those made by the California Attorney General in the March 11, 2002 lawsuit described above as well as allegations that contracts between these power generators and the California Department of Water Resources (the "DWR") constitute unfair business practices resulting from

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market manipulation. The lawsuits filed in state court have been removed to federal courts in the Northern and Eastern Districts of California. Some defendants have filed a petition with the Judicial Panel For Multidistrict Litigation seeking to consolidate the new cases with the six cases consolidated in the United States District Court for the Southern District of California. The Company intends to vigorously defend against these claims.

On May 13, 2002, two California law firms filed suit in California State Court against more than 20 energy generators, including those owned directly by West Coast Power and indirectly by Dynegy. This suit principally alleges the defendant generators, in connection with their execution of long-term power supply contracts with the DWR, took advantage of a manipulated market to overcharge for electricity. The suit, which was filed on behalf of California taxpayers, seeks to halt enforcement of the existing DWR contracts to the extent that the agreed prices are found to be unfair. The suit further seeks damages in the amount of the alleged excess prices under the contracts. The Company intends to vigorously defend against these claims.

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Enron Litigation. As previously described, Dynegy and DHI were sued on December 2, 2001 by Enron and Enron Transportation Services Co. in the United States Bankruptcy Court for the Southern District of New York, Adversary Proceeding No. 01-03626 (AJG). Enron claims that Dynegy materially breached the Merger Agreement dated November 9, 2001 between Enron and Dynegy and related entities by wrongfully terminating that Agreement on November 28, 2001. Enron also claimed that DHI wrongfully exercised its option to take ownership of Northern Natural under an Option Agreement dated November 9, 2001. Enron sought damages in excess of \$10 billion and declaratory relief against Dynegy for breach of the Merger Agreement. Enron also sought unspecified damages against Dynegy and DHI for breach of the Option Agreement. Dynegy filed an answer on February 4, 2002, denying all material allegations. On April 12, 2002, the Bankruptcy Court granted Dynegy's motion to transfer venue in the proceeding to the United States District Court for the Southern District of Texas (Houston Division).

Dynegy also previously described a suit filed against Dynegy and DHI by Ann C. Pearl and Joel Getzler in the United States District Court for the Southern District of New York, Cause No. 01 CU 11652. Plaintiffs filed the lawsuit as a purported class action on behalf of all persons or entities who owned common stock of Enron Corp. as of November 28, 2001. A similar suit was filed by Bernard D. Shapiro and Peter Strub in the 129th Judicial District Court for Harris County, Texas, Cause No. 2002-00080. Plaintiffs in each case allege that they are intended third party beneficiaries of the Merger Agreement dated November 9, 2001 among Enron and Dynegy and related entities. Plaintiffs claim that Dynegy materially breached the Merger Agreement by, inter alia, wrongfully terminating that agreement. Plaintiffs also claim that Dynegy breached the implied covenant of good faith and fair dealing. Plaintiffs seek unspecified damages and other relief. Enron moved for an order of the Bankruptcy Court in the Southern District of New York, directing that the Pearl and Shapiro plaintiffs be enjoined from prosecuting their actions and immediately dismiss those actions. The Bankruptcy Court held that the claims asserted by the Pearl and Shapiro plaintiffs were the exclusive property of the Enron bankruptcy estate, and that the plaintiffs lacked standing to sue as third party beneficiaries of the Merger Agreement. Accordingly, by an order entered on April 19, 2002, the Bankruptcy Court granted Enron's motion, enjoined the prosecution of both actions, and directed that they be dismissed. The Pearl and Shapiro plaintiffs thereafter complied with that order, but filed an appeal to the United States District Court for the Southern District of New York, which remains pending.

Dynegy believes that it has meritorious defenses against these claims and intends to vigorously defend against them. Dynegy is unable to estimate the range of possible loss that could be incurred with respect to these

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lawsuits. However, an adverse result in any of these proceedings could have a material adverse effect on its financial position and results of operations.

As previously described, as a result of Enron's bankruptcy filing, Dynegy recognized in its fourth quarter 2001 financial statements a pre-tax charge

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related to the Company's net exposure for commercial transactions with Enron. As of June 30, 2002, the Company's net exposure to Enron, inclusive of certain liquidated damages and other amounts relating to the termination of the transactions, was approximately \$84 million and was calculated by setting off approximately \$230 million owed from various Dynegy entities to various Enron entities against approximately \$314 million owed from various Enron entities to various Dynegy entities. The master netting agreement between Dynegy and Enron as well as the valuation of the commercial transactions covered by the agreement, which valuation is based principally on the parties' assessment of market prices for such period, remain subject to dispute by Enron with respect to which there have been negotiations between the parties. These negotiations have focused on the scope of the transactions covered by the master netting agreement and the parties' valuations of those transactions. If any disputes cannot be resolved by the parties, the agreements call for arbitration. If the setoff rights were modified or disallowed, either by agreement or otherwise, the amount available for Dynegy entities to set off against sums that might be due Enron entities could be reduced materially.

Shareholder Litigation. Since April 2002, a number of class action lawsuits have been filed on behalf of purchasers of publicly traded securities of Dynegy generally during the period between April 2001 and April 2002. These lawsuits principally assert that Dynegy and certain of its executive officers violated the federal securities laws in connection with Dynegy's accounting treatment and disclosure of Project Alpha. These lawsuits have been consolidated in the United States District Court for the Southern District of Texas. Under the Private Securities Litigation Reform Act of 1995, the court in which the cases have been consolidated will appoint a lead plaintiff, and the lead plaintiff will, in turn, select class counsel. Following that process, a consolidated complaint will be filed which may differ materially from the complaints presently on file. Dynegy intends to vigorously defend against these lawsuits. It is not possible to predict with certainty whether Dynegy will incur any liability or to estimate the damages, if any, that might be incurred in connection with these lawsuits, but an adverse result could have a material adverse effect on the Company's financial condition or results of operations.

In addition, three derivative lawsuits have been filed in which the Company is a nominal defendant. Two of these three lawsuits relate to Project Alpha and the third relates to severance for the Company's former Chief Executive Officer. All three lawsuits seek recovery on behalf of the Company from various present and former officers and directors. These actions have only recently been filed and the Company is analyzing them. The Company does not expect to incur any material liability with respect to these derivative claims.

Farnsworth Litigation. On August 2, 2002, Bradley Farnsworth filed a lawsuit against Dynegy in Texas state district court claiming that he was demoted and ultimately fired from the position of Controller for refusing to participate in illegal activities. Specifically, Mr. Farnsworth alleges, in the words of his complaint, that certain of Dynegy's former executive officers requested that he "shave or reduce for accounting purposes" the forward price curves associated with the natural gas business in the United Kingdom for the period of October 1, 2000 through March 31, 2001, in order to indicate a reduction in Dynegy's mark-to-market losses. Mr. Farnsworth, who seeks unspecified actual and exemplary damages and other compensation, also alleges that he is entitled to a termination payment under his employment agreement equal to 2.99 times the greater of his average base salary and incentive compensation for the highest three calendar years preceding termination or his base salary and target bonus amount for the year of termination (estimated at a range of approximately \$700,000 to \$1,200,000).

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Dynegy believes that it has meritorious defenses against these claims and intends to vigorously defend against them. Dynegy does not believe that any liability it might incur as a result of this litigation would have a material adverse effect on its financial condition or results of operations.

Roundtrip Transactions. On November 15, 2001, Dynegy executed two sets of simultaneous buy and sale trades with CMS Energy Corp. In the first set of trades, Dynegy purchased 5 million megawatts of power from CMS Energy for delivery in December 2001 at \$25.50 per megawatt hour; concurrently, CMS Energy purchased from Dynegy the same amount of power at the same price per megawatt hour for delivery during the same period. In the second set of trades, Dynegy purchased 20 million megawatts of power from CMS Energy for delivery in the period January-December 2002 at \$34.00 per megawatt hour; concurrently, CMS Energy purchased from Dynegy the same amount of power at the same price per megawatt hour for delivery during the same period. Dynegy and CMS have terminated the 2002 trades.

During the second quarter 2002, the Company undertook a comprehensive review of these CMS Energy trades and its trading operations generally. The Company's review confirmed that the CMS Energy trades were consummated outside the view of other trading parties and could not have impacted market prices. In an April 30, 2002 press release, 2002 first quarter Revenues and 2002 first quarter Costs of Sales each contained \$236 million related to these trades. These amounts netted to zero in the operating margin line, resulting in no net income effect from the trades in that press release. For the purposes of reporting for the first quarter 2002 in the 2002 Form 10-K and herein, the revenues and costs of sales for accrued portions of the CMS Energy trades were not included in the Company's December 31, 2001, March 31, 2002 or June 30, 2002 Revenues or Cost of Sales in the Consolidated Statements of Operations. The volumes related to these CMS Energy trades were excluded from the Operating Statistics for the WEN segment in the 2001 Forms 10-K and 10-K/A and the 2002 Forms 10-Q and 10-Q/A.

Based on the Company's review of its trading operations to date, although certain simultaneous buy and sell trades have been consummated, Dynegy believes that it has not executed any simultaneous buy and sell trades with counterparties for the purpose of artificially increasing its trading volumes or revenues.

SEC Investigation. The SEC has commenced an investigation into the facts and circumstances surrounding Project Alpha and the roundtrip trades described above. The Company has produced documents and witnesses for interviews in connection with this investigation. The Company has assured the SEC that it intends to cooperate fully with this investigation. Dynegy has been informed by the Staff of the SEC that they believe that, among other things, Dynegy's disclosures and reports relating to both Project Alpha and the CMS Energy trades violate various antifraud and other provisions of the federal securities laws. The Company cannot predict the ultimate outcome of this matter.

CFTC Investigation. The U.S. Commodity Futures Trading Commission ("CFTC") has commenced an investigation relating to, among other things, trading activities on Dynegydirect, the Company's on-line trading platform, and any roundtrip gas or power trades since January 2000, including all trades or

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trading activities between Dynegy and CMS Energy in November 2001. The investigation also relates to the Company's trading activities in the California power market. The Company has produced documents in connection with this investigation. The Company has assured the Staff of the CFTC that it intends to cooperate fully with this investigation. The Company cannot predict the ultimate outcome of this matter.

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FERC and Related Regulatory Investigations. On February 13, 2002, the FERC initiated an investigation of possible manipulation of natural gas and power prices in the western United States during the period from January 2001 through the present. On May 8, 2002, in response to three memoranda (authored by individuals employed by or previously employed by Enron) discovered by the FERC allegedly containing evidence of market manipulation by Enron in California, the FERC issued requests for information to all sellers in the California Independent System Operator (the "ISO") and the California Power Exchange (the "PX") markets during 2000 and 2001 seeking information with respect to whether those sellers engaged in trading strategies described in the three Enron memoranda.

Dynegy responded to these requests on May 22, 2002, and updated its responses on July 30, 2002 at the conclusion of its due diligence. A California State Senate committee subsequently issued similar requests, and Dynegy's responses were consistent with those submitted to the FERC. Based on its investigation to date, Dynegy believes that its trading practices are consistent with applicable law and tariffs and will continue to cooperate fully with these investigations. The California State Senate committee has not issued its preliminary findings on its investigation, and Dynegy cannot predict with certainty how such allegations will ultimately be resolved.

On August 13, 2002, the FERC issued a notice requesting comments on a proposal made by the FERC staff to change the method for determining natural gas prices for purposes of computing the market mitigation clearing price that it intends to utilize in calculating refunds for sales of power in California power markets during the period from October 2, 2000 to June 19, 2001. As drafted, the proposal would likely reduce gas prices used in the computation, thus reducing the market mitigation clearing price for power and potentially increasing calculated refunds, subject to a provision that would generally provide full recoverability of fuel costs by the generators. The FERC has provided parties to the refund proceeding with 30 days to provide comments and it may or may not adopt the staff's recommendation. Dynegy is evaluating the staff's recommendation and is unable to assess at this time the impact, if any, that this proposal may have on any refunds which the FERC may order from Dynegy or West Coast Power pursuant to the FERC's investigation of the California power market for the period from October 2, 2000 to June 19, 2001.

On May 21, 2002, the FERC issued requests for information to all sellers of wholesale electricity and/or ancillary services in the Western Systems Coordinating Council ("WSCC") seeking information with respect to whether those sellers engaged in "wash," "round trip" or "sale/buyback" transactions in the

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WSCC during the years 2000-2001. Dynegy responded on May 31, 2002. On May 22, 2002, the FERC issued requests for information to all sellers of natural gas in the WSCC or Texas seeking information with respect to whether those sellers engaged in "wash," "round trip" or "sale/buyback" transactions in the WSCC or Texas during the years 2000-2001. Dynegy responded on June 5, 2002. On August 12, 2002, Dynegy updated its May 31 and June 5 responses at the conclusion of its due diligence. Requests for similar information with respect to electric power trading activities in the Electric Reliability Council of Texas were received from the Texas Public Utility Commission on June 12, 2002. Dynegy responded to these requests on July 2, 2002.

Based on the investigation conducted in order to make these filings, although certain simultaneous buy and sell trades were discovered, Dynegy believes that it has not executed any simultaneous buy and sell trades with counterparties for the purpose of artificially increasing its trading volumes or revenues in these markets. Please read "IFTC Investigation" above for discussion of the restated accounting treatment of these trades.

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In addition, on February 25, 2002 the California Public Utilities Commission and the California Electricity Oversight Board filed complaints with the FERC asking that it void or reform power supply contracts between the DWR and, among others, West Coast Power. A rehearing order issued on July 23, 2002 affirmed the underlying findings and conclusions related to West Coast Power's contract with the DWR. The complaints allege that prices under the contracts exceed just and reasonable prices permitted under the Federal Power Act. The FERC recently set these complaints for evidentiary hearing. The hearing, however, is being held in abeyance pending completion of settlement talks. While West Coast Power continues in good faith negotiations with the State of California on reforming the terms of its DWR contract, settlement ultimately may not be possible. If a hearing on the contracts entered into by West Coast Power or others is necessary, the first phase of the hearing will be limited to the question of whether the California real-time market adversely affected the long-term bilateral markets. While the Company believes the terms of its contracts are just and reasonable and do not reflect alleged market manipulation, it cannot predict the outcome of this matter.

U.S. Attorney Investigation. In May 2002, Dynegy received a subpoena from the U.S. Attorney's office in Houston requesting documents relating to Project Alpha, roundtrip trades with CMS Energy and the Black Thunder transaction. The Company is cooperating fully with the U.S. Attorney's office in its investigation of these matters. The Company cannot predict the ultimate outcome of this matter.

Telstra Litigation. On January 25, 2002, Telstra Corporation, Ltd. and Telstra Wholesale Inc. filed suit in Delaware Chancery Court against DynegyConnect, L.P. ("DynegyConnect"), a limited partnership in which Dynegy acquired a combined 80% interest, as well as certain of Dynegy's other affiliates. DynegyConnect is a vehicle established by Dynegy to participate in the U.S. communications business. Telstra Wholesale originally acquired the

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remaining 20% interest in DynegyConnect pursuant to a limited partnership agreement that was executed in October 2000 and details the partners' rights and obligations. Under the agreement, Telstra Wholesale was granted a put option permitting it to require Dynegy or its designee, at any time on or before September 20, 2002, to purchase its 20% partnership interest for a purchase price equal to the value of Telstra Wholesale's capital account in DynegyConnect, subject to certain adjustments. The plaintiffs brought this action in connection with Telstra Wholesale's attempted exercise of this put option. The plaintiffs allege breach of contract and bad faith, among other things, in connection with the valuation of Telstra Wholesale's capital account and, as a result, the put option purchase price, as well as the administration of the partnership. The plaintiffs seek approximately \$50 million plus interest in damages together with fees and other litigation expenses. Minority Interest on Dynegy's Condensed Consolidated Balance Sheet includes amounts relating to Telstra Wholesale's investment in DynegyConnect.

NOTE 13--REGULATORY ISSUES

Dynegy is subject to regulation by various federal, state, local and foreign agencies, including extensive rules and regulations governing transportation, transmission and sale of energy commodities as well as the discharge of materials into the environment or otherwise relating to environmental protection. Compliance with these regulations requires general and administrative, capital and operating expenditures including those related to monitoring, pollution control equipment, emission fees and permitting at various operating facilities and remediation obligations. In addition, the U.S. Congress has before it a number of bills that could impact regulations or impose new regulations applicable to Dynegy and its subsidiaries. Dynegy cannot predict the outcome of these bills or other regulatory developments or the effects that they might have on its business. For a more detailed description of regulatory issues affecting the Company's business, please refer to "Item 1. Business--Regulation" in the 2001 Form 10-K.

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NOTE 14--RELATED PARTY TRANSACTIONS

ChevronTexaco Commercial Arrangements. In March 2002, Dynegy and ChevronTexaco executed agreements to expand their commercial relationships to include substantially all of the natural gas and domestic mixed NGLs and NGL products produced or controlled by the former Texaco. This expanded relationship increased the volume of natural gas Dynegy purchases from ChevronTexaco from approximately 1.7 Bcf/d to approximately 2.9 Bcf/d. Dynegy also provides supply and service for in excess of 1.6 Bcf/d of natural gas for the combined ChevronTexaco facilities and third-party term markets. In addition, the expanded contract with ChevronTexaco includes substantially all of the U.S. NGL production of the former Texaco.

Concurrent with the expanded commercial agreements, the two companies executed a new security agreement designed to improve Dynegy's liquidity position by reducing its reliance upon the financial markets for surety bonds

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and letters of credit and to significantly reduce ChevronTexaco's open credit exposure. The new security agreement involved the replacement of historic credit support arrangements with a perfected security interest in a portion of Dynegy's domestic natural gas receivables. Dynegy has the option to revert back to historic credit support arrangements, which included the issuance of surety bonds and/or letters of credit.

In July 2002, Dynegy and ChevronTexaco executed a 90-day amendment to their security agreement. This amendment was designed to address the reduction in activity in Dynegy's gas marketing business and the corresponding reduction in Dynegy's gas marketing receivables relative to the required coverage ratio contained in the security agreement. The amendment, which was executed in conjunction with a six-month netting agreement between the parties that has since been made permanent, reduced the required coverage ratio contained in the security agreement.

In August 2002, Dynegy executed an agreement with ChevronTexaco pursuant to which the parties amended the existing gas purchase agreement, security agreement, netting agreement and certain related agreements. Under this new agreement, Dynegy agreed to accelerate payment to the month of delivery for a portion of the natural gas it purchases from ChevronTexaco, with the amount of the accelerated payment generally being equal to 75 percent of the value of the prior month's gas deliveries, after reduction pursuant to the netting agreement between us and ChevronTexaco. This payment arrangement will be effective upon the closing of the sale of Northern Natural described in Note 5 above. The initial payment amount, upon consummation of the Northern Natural sale, is estimated to be \$187.5 million. The amount of the payment could change materially as a result of changes in commodity prices. If the Northern Natural sale does not close on or prior to August 30, 2002, then a special report concerning the security agreement coverage ratios would be due by September 4, 2002. Dynegy's right to withdraw sums from the designated account in which the proceeds from the gas receivables covered by the security agreement in favor of ChevronTexaco are deposited would be suspended pending receipt of that report, and that report demonstrating compliance with the required coverage ratios. Management believes that absent the agreed payment with proceeds from the Northern Natural sale, this special report likely would require Dynegy to pay additional amounts in order to be in compliance with the coverage ratios under the security agreement. The new agreement also suspends ChevronTexaco's right to request special reports concerning the security agreement coverage ratios as long as those payments are made, and makes permanent the netting agreement and reduction in the coverage ratios referred to above.

Also in August 2002, in partial satisfaction of certain of its obligations to ChevronTexaco under these agreements, the Company sold to ChevronTexaco its 39.2% ownership interest in West Texas LPG Pipeline

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Limited Partnership ("WTLPS"), which is the owner of West Texas LPG Pipeline. ChevronTexaco was already the owner of the largest interest in WTLPS and the operator of the pipeline. The interest sold to ChevronTexaco was valued at approximately \$45 million.

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The obligation to make payments as described above will be suspended if Dynegy or a successor to its gas and natural gas liquids customer and risk-management business carries at least two of the following three credit ratings: at least BBB+ by Standard & Poor's, at least Baal by Moody's and at least BBB+ by Fitch.

Dan Dienstbier Contract for Services. Dynegy entered into a services agreement with Daniel L. Dienstbier effective as of May 28, 2002, the date on which Mr. Dienstbier assumed the position of interim Chief Executive Officer. Mr. Dienstbier agreed to serve as Dynegy's interim Chief Executive Officer until either Dynegy or Mr. Dienstbier terminate the arrangement on 30 days' written notice. Pursuant to the terms of the agreement, Dynegy agreed to pay Mr. Dienstbier \$1 million per year, to be paid ratably once per month, in the form of cash or Dynegy's Class A common stock as the parties shall agree. Upon termination of the agreement, Mr. Dienstbier is eligible to receive a bonus payment and a Class A common stock grant, in each case at Dynegy's discretion. The agreement contains customary indemnification, confidentiality and non-compete provisions relating to Mr. Dienstbier's provision of services.

Short-Term Executive Stock Purchase Loan Program. In July 2001, Dynegy established the Dynegy Inc. Short-Term Executive Stock Purchase Loan Program pursuant to which eligible employees were loaned funds to acquire Class A common stock through market purchases. Dynegy terminated this program as it relates to new loans effective as of June 30, 2002. The notes bear interest at the greater of five percent or the applicable federal rate as of the loan date, are full recourse to the participants and mature on December 19, 2004. At June 30, 2002, there were approximately \$12 million in loans outstanding under this program to a total of 30 participants.

December 2001 Equity Purchases. In December 2001, certain executive officers purchased Class A common stock from Dynegy in a private placement pursuant to Section 4(2) of the Securities Act of 1933. These executives received loans totaling approximately \$25 million from Dynegy to purchase the common stock at a price of \$19.75 per share. The purchase price equaled the net proceeds per share received by Dynegy from a concurrent public offering (after a \$1.00 per share underwriting discount). The notes bear interest at 3.25 percent per annum and are full recourse to the borrowers. Such loans are accounted for as subscriptions receivable within stockholders' equity on the consolidated balance sheets. Dynegy recognized compensation expense in the fourth quarter 2001 of approximately \$1.2 million related to the shares purchased by these officers. This amount, which was recorded as general and administrative expense, is derived from the \$1.00 per share discount these officers received based on the initial public offering price of \$20.75 per share. At June 30, 2002, there were approximately \$3.5 million in loans outstanding with respect to these purchases to a total of five Dynegy officers.

NOTE 15--SEGMENT INFORMATION

Dynegy's operations for the periods presented have been reported in four segments: Dynegy Wholesale Energy Network ("WEN"), Dynegy Midstream Services ("DMS"), Transmission and Distribution ("T&D") and Dynegy Global Communications ("DGC"). WEN is engaged in a broad array of businesses, including physical supply of, and risk-management activities around, wholesale natural gas, power, coal and other similar products. This segment is focused on optimizing Dynegy's and its customers' global portfolio of energy assets and contracts, as well as direct commercial and industrial sales and retail marketing alliances. DMS consists of the

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Company's North American midstream gas processing and natural gas liquids marketing businesses and worldwide natural gas liquids marketing and transportation operations. Dynegy's T&D segment includes the operations of IP and Northern Natural. IP is an energy-delivery company engaged in the transmission, distribution and sale of electricity and natural gas to customers across a 15,000-square-mile area of Illinois. Northern Natural's 16,600 miles of pipeline extend from the Permian Basin in Texas to the Upper Midwest, providing extensive access to major utilities and industrial customers. Northern Natural's storage capacity is 59 billion cubic feet ("Bcf") and its market area capacity is approximately 4.3 Bcf per day. As reflected in Note 5, the Company is expecting to close the sale of Northern Natural in August 2002. DGC is engaged in the communications business. DGC has a global long-haul fiber optic network and metropolitan network in cities in the United States and Europe. Management is aggressively pursuing alternatives for exiting this business segment and has impaired substantially all of the historical cost of the fiber optic network at June 30, 2002. Dynegy accounts for intercompany transactions at prevailing market rates. Unaudited operating segment information for the three- and six-month periods ended June 30, 2002 and 2001 is presented below. See the Explanatory Note for a discussion of the restatements made to the financial information included herein.

DYNEGY'S SEGMENT DATA FOR THE QUARTER ENDED JUNE 30, 2002 (\$ IN MILLIONS)

| | WEN | DMS | T&D | DGC | Eliminations | Total |
|---------------------------------------|----------|---------|---------|----------|--------------|----------|
| Unaffiliated revenues: | | | | | | |
| Domestic..... | \$ 5,964 | \$ 578 | \$ 411 | \$ 4 | \$ -- | \$ 6,957 |
| Canadian..... | 725 | 361 | -- | -- | -- | 1,086 |
| European and other..... | 1,431 | 200 | -- | 2 | -- | 1,633 |
| | 8,120 | 1,139 | 411 | 6 | -- | 9,676 |
| Intersegment revenues: | | | | | | |
| Domestic..... | 175 | 41 | 13 | -- | (229) | -- |
| | 8,295 | 1,180 | 424 | 6 | (229) | 9,676 |
| Depreciation and amortization..... | (53) | (22) | (52) | (17) | -- | (144) |
| Impairment and other charges..... | (31) | (5) | (11) | (613) | -- | (660) |
| Operating income (loss)..... | (198) | 11 | 66 | (657) | -- | (778) |
| Interest expense..... | (33) | (14) | (42) | (3) | -- | (92) |
| Other income (expense)..... | (1) | (12) | (3) | -- | -- | (16) |
| Earnings (losses) from unconsolidated | | | | | | |
| Investments..... | 15 | 4 | (2) | (3) | -- | 14 |
| Income tax provision (benefit)..... | (79) | (3) | 9 | (238) | -- | (311) |
| Net income (loss)..... | \$ (138) | \$ (8) | \$ 10 | \$ (425) | \$ -- | \$ (561) |
| Identifiable assets: | | | | | | |
| Domestic..... | \$15,817 | \$1,957 | \$6,361 | \$ 114 | \$ -- | \$24,249 |
| Canadian..... | 611 | 139 | -- | -- | -- | 750 |
| European and other..... | 2,894 | -- | -- | 53 | -- | 2,947 |

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| | | | | | | |
|--|-------|------|------|------|----|-------|
| Investments in unconsolidated affiliates | 772 | 146 | -- | -- | -- | 918 |
| Capital expenditures and investments in unconsolidated affiliates..... | (259) | (22) | (43) | (13) | -- | (337) |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

DYNEGY'S SEGMENT DATA FOR THE QUARTER ENDED JUNE 30, 2001 (\$ IN MILLIONS)

| | WEN | DMS | T&D | DGC | Eliminations | Total |
|--|----------|---------|---------|---------|--------------|----------|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Unaffiliated revenues: | | | | | | |
| Domestic..... | \$ 8,075 | \$ 901 | \$ 334 | \$ 2 | \$ -- | \$ 9,312 |
| Canadian..... | 1,369 | 340 | -- | -- | -- | 1,709 |
| European and other..... | 715 | 160 | -- | 2 | -- | 877 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | 10,159 | 1,401 | 334 | 4 | -- | 11,898 |
| Intersegment revenues: | | | | | | |
| Domestic..... | 264 | 71 | 8 | -- | (343) | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total revenues..... | 10,423 | 1,472 | 342 | 4 | (343) | 11,898 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Depreciation and amortization..... | (45) | (20) | (43) | (6) | -- | (114) |
| Operating income (loss)..... | 99 | 32 | 40 | (49) | -- | 122 |
| Interest expense..... | (22) | (14) | (31) | (1) | -- | (68) |
| Other income (expense)..... | (44) | (6) | -- | 4 | -- | (46) |
| Earnings from unconsolidated investments | 59 | 5 | -- | 14 | -- | 78 |
| Income tax provision (benefit)..... | 46 | 7 | 6 | (12) | -- | 47 |
| Net income (loss)..... | \$ 46 | \$ 10 | \$ 3 | \$ (20) | \$ -- | \$ 39 |
| Identifiable assets: | | | | | | |
| Domestic..... | \$15,638 | \$1,889 | \$3,667 | \$ 662 | \$ -- | \$21,856 |
| Canadian..... | 714 | 227 | -- | -- | -- | 941 |
| European and other..... | 715 | -- | -- | 178 | -- | 893 |
| Investment in unconsolidated affiliates. | 728 | 161 | -- | 25 | -- | 914 |
| Capital expenditures and investments in unconsolidated affiliates..... | (112) | (25) | (38) | (265) | -- | (440) |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

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For the Interim Periods Ended June 30, 2002 and 2001

DYNEGY'S SEGMENT DATA FOR THE SIX MONTHS ENDED JUNE 30, 2002 (\$ in millions)

| | WEN | DMS | T&D | DGC | Eliminations | Total |
|---|----------|---------|---------|----------|--------------|----------|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Unaffiliated revenues: | | | | | | |
| Domestic..... | \$10,601 | \$1,228 | \$ 894 | \$ 6 | \$ -- | \$12,729 |
| Canadian..... | 1,430 | 592 | -- | -- | -- | 2,022 |
| European and other..... | 2,951 | 396 | -- | 4 | -- | 3,351 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | 14,982 | 2,216 | 894 | 10 | -- | 18,102 |
| Intersegment revenues: | | | | | | |
| Domestic..... | 314 | 74 | 21 | -- | (409) | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total revenues..... | 15,296 | 2,290 | 915 | 10 | (409) | 18,102 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Depreciation and amortization..... | (99) | (41) | (98) | (33) | -- | (271) |
| Impairment and other charges..... | (31) | (5) | (11) | (623) | -- | (670) |
| Operating income (loss)..... | (194) | 50 | 162 | (717) | -- | (699) |
| Interest expense..... | (66) | (24) | (80) | (11) | -- | (181) |
| Other income (expense)..... | (23) | (11) | 1 | 5 | -- | (28) |
| Earnings (losses) from unconsolidated investments..... | 45 | 8 | (2) | (48) | -- | 3 |
| Income tax provision (benefit)..... | (111) | 9 | 36 | (265) | -- | (331) |
| Income (loss) from operations..... | (127) | 14 | 45 | (506) | -- | (574) |
| Cumulative effect of change in accounting principle..... | -- | -- | -- | (234) | -- | (234) |
| Net income (loss)..... | \$ (127) | \$ 14 | \$ 45 | \$ (740) | \$ -- | \$ (808) |
| Identifiable assets: | | | | | | |
| Domestic..... | \$15,817 | \$1,957 | \$6,361 | \$ 114 | \$ -- | \$24,249 |
| Canadian..... | 611 | 139 | -- | -- | -- | 750 |
| European and other..... | 2,894 | -- | -- | 53 | -- | 2,947 |
| Investments in unconsolidated affiliates..... | 772 | 146 | -- | -- | -- | 918 |
| Capital expenditures and investments in unconsolidated affiliates..... | (428) | (53) | (72) | (90) | -- | (643) |

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

(UNAUDITED AND RESTATED)

For the Interim Periods Ended June 30, 2002 and 2001

DYNEGY'S SEGMENT DATA FOR THE SIX MONTHS ENDED JUNE 30, 2001 (\$ in millions)

| WEN | DMS | T&D | DGC | Eliminations | Total |
|-------|-------|-------|-------|--------------|-------|
| ----- | ----- | ----- | ----- | ----- | ----- |

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| | | | | | | |
|--|----------|---------|---------|---------|-------|----------|
| Unaffiliated revenues: | | | | | | |
| Domestic..... | \$15,839 | \$2,412 | 860 | \$ 4 | \$ -- | \$19,115 |
| Canadian..... | 3,276 | 680 | -- | -- | -- | 3,956 |
| European and other..... | 1,720 | 349 | -- | 3 | -- | 2,072 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | 20,835 | 3,441 | 860 | 7 | -- | 25,143 |
| Intersegment revenues: | | | | | | |
| Domestic..... | 300 | 176 | 13 | -- | (489) | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total revenues..... | 21,135 | 3,617 | 873 | 7 | (489) | 25,143 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Depreciation and amortization..... | (89) | (40) | (83) | (10) | -- | (222) |
| Operating income (loss)..... | 297 | 89 | 116 | (69) | -- | 433 |
| Interest expense..... | (43) | (28) | (60) | (3) | -- | (134) |
| Other income (expense)..... | (79) | (11) | (1) | 10 | -- | (81) |
| Earnings from unconsolidated investments..... | 90 | 6 | -- | 14 | -- | 110 |
| Income tax provision (benefit)..... | 109 | 19 | 27 | (19) | -- | 136 |
| Income (loss) from operations..... | 156 | 37 | 28 | (29) | -- | 192 |
| Cumulative effect of change in accounting principle..... | 2 | -- | -- | -- | -- | 2 |
| Net income (loss)..... | \$ 158 | \$ 37 | \$ 28 | \$ (29) | \$ -- | \$ 194 |
| Identifiable assets: | | | | | | |
| Domestic..... | \$15,638 | \$1,889 | \$3,667 | \$ 662 | \$ -- | \$21,856 |
| Canadian..... | 714 | 227 | -- | -- | -- | 941 |
| European and other..... | 715 | -- | -- | 178 | -- | 893 |
| Investments in unconsolidated affiliates..... | 728 | 161 | -- | 25 | -- | 914 |
| Capital expenditures and investments in unconsolidated affiliates..... | (1,253) | (58) | (65) | (337) | -- | (1,713) |

NOTE 16--SUBSEQUENT EVENTS

DYNEGY HAS EXPERIENCED A NUMBER OF MATERIAL DEVELOPMENTS SINCE THE ORIGINAL FILING OF ITS SECOND QUARTER 2002 FORM 10-Q ON AUGUST 14, 2002. FOR FURTHER DISCUSSION OF THE EVENTS THAT HAVE AFFECTED THE COMPANY SINCE AUGUST 14, 2002, PLEASE READ ITS EXCHANGE ACT REPORTS FILED SINCE SUCH DATE, INCLUDING ITS ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002, WHICH DISCUSSION IS INCORPORATED HEREIN BY THIS REFERENCE.

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DYNEGY INC.

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

For the Interim Periods Ended June 30, 2002 and 2001

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements of Dynegy Inc. ("Dynegy" or the "Company") and the notes thereto included elsewhere herein and with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001, as filed with the SEC. As discussed in the Introductory Note to this Form 10-Q/A, the financial information contained in this report has been revised to reflect the restatement items described in the Explanatory Note to the accompanying unaudited Condensed Consolidated Financial Statements. Dynegy has also amended its 2001 Form 10-K, most recently with Amendment No. 2 thereto

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filed with the SEC on April 11, 2003. The restatements to the Company's 2001 financial statements and related information are further described therein, and this Form 10-Q/A should be read together with such Amendment No. 2.

PLEASE NOTE THAT THE INFORMATION CONTAINED IN THIS FORM 10-Q/A, INCLUDING THE FINANCIAL STATEMENTS AND THE NOTES THERETO, DOES NOT REFLECT EVENTS OCCURRING AFTER AUGUST 14, 2002 (THE DATE ON WHICH DYNEGY ORIGINALLY FILED ITS JUNE 30, 2002 FORM 10-Q). FOR A DESCRIPTION OF THESE EVENTS, PLEASE READ THE COMPANY'S EXCHANGE ACT REPORTS FILED SINCE AUGUST 14, 2002, INCLUDING ITS ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002. SEE NOTE 16--SUBSEQUENT EVENTS FOR FURTHER DISCUSSION.

Dynegy is a global energy merchant. Through its owned and contractually controlled network of physical assets and its marketing, logistics and risk-management capabilities, the Company provides services to customers in North America, the United Kingdom and Continental Europe. Dynegy's operations are reported in four segments: Wholesale Energy Network ("WEN"), Dynegy Midstream Services ("DMS"), Transmission and Distribution ("T&D") and Dynegy Global Communications ("DGC").

Like many companies in the merchant energy industry, Dynegy has faced a number of challenges since the end of 2001. These challenges include, among others, the effects of contraction in the trading markets and downgrades in the Company's credit ratings on its ability to conduct its customer and risk-management business, a weak commodity price environment for natural gas and power, the impact of various legal proceedings and investigations involving Project Alpha, roundtrip trades and the Company's failed merger with Enron, increased collateralization requirements for the Company's commercial obligations resulting from downgrades in its credit ratings and the effect of these and other issues on public confidence in Dynegy's long-term business strategy and its ability to generate sustainable cash flows.

Since the Company filed its first quarter 2002 Form 10-Q on May 15, 2002, Dynegy has announced a number of significant developments. On May 24, 2002, Dynegy announced that it received a subpoena from the U.S. Attorney's office in Houston requesting documents relating to the Company's transactions, including Project Alpha and the roundtrip trades with CMS Energy. On May 28, 2002, Dynegy announced that Charles L. Watson had resigned as its Chairman of the Board and Chief Executive Officer and that two of its Board members, Glenn F. Tilton and Daniel L. Dienstbier, respectively, had been appointed to fill those positions on an interim basis. On June 19, 2002, Dynegy announced that Robert D. Doty, Jr. had resigned as its Chief Financial Officer and that Louis J. Dorey had been appointed to fill that position. Also on June 19th, Dynegy announced a workforce reduction that affected approximately 325 employees.

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On June 24, 2002, Dynegy announced a \$2 billion capital plan designed to enhance liquidity and reduce debt. Dynegy also announced that PricewaterhouseCoopers would re-audit Dynegy's 2001 financial statements as part of the previously announced 2001 restatement process. Dynegy further announced that its second quarter results were expected to include one-time pre-tax charges of up to \$450 million related to the communications business, severance expenses, consulting fees and other charges. On July 15, 2002, Dynegy announced that it would adjust upward its previously disclosed estimated second quarter pre-tax charge from \$450 million to \$500 million as the result of an increase in an expected non-cash charge in the Company's natural gas marketing business. Dynegy also announced that it had requested PricewaterhouseCoopers to expand its re-audit to include the Company's 1999 and 2000 financial statements. On July 23, 2002, Dynegy announced that it was lowering its earlier

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fiscal year 2002 guidance for cash flow from operations to a range of \$600 million to \$700 million from its previous estimate of up to \$1 billion. The Company attributed the reduction to a downturn in its customer and risk-management activities, partially the result of industry conditions, and lower-than-expected prices for power, natural gas and natural gas liquids. The Company also indicated that the previously announced \$325 million mortgage bond offering by Illinois Power Company, its indirect wholly owned subsidiary ("IP"), had been terminated because of credit rating downgrades.

These and other issues facing the Company have resulted in a precipitous decline in the Company's stock price and downgrades to the Company's credit ratings by all three major credit rating agencies to below investment grade. The Company's trading and commercial counterparties have also required additional postings of collateral or ceased conducting business with the Company. These actions, together with the general contraction in the trading markets, contributed to lower than anticipated operating results and cash flows during the second quarter 2002 and have materially adversely affected the Company's business and operating capabilities. Dynegy remains committed to addressing these issues. However, the Company's future financial condition will depend upon its ability to successfully execute its \$2 billion capital plan. Important factors impacting the Company's ability to execute this plan and to otherwise continue its operations and achieve its business strategy include the following:

- . Dynegy's ability to address its significant financial obligations given its non-investment grade status and lack of borrowing capacity;
- . Dynegy's ability to rationalize its customer and risk-management business, either through the formation of a joint venture or the execution of an alternative strategy;
- . Dynegy's ability to generate sustainable cash flows from its assets and businesses;
- . ongoing investigations and litigation relating to Project Alpha, Black Thunder, the California power markets and roundtrip transactions;
- . confidence in Dynegy's financial reporting in light of the previously announced restatements and the re-audit of its 1999-2001 financial statements; and
- . Dynegy's ability to eliminate or further reduce net cash outflows associated with its telecommunications business.

Please read "Liquidity and Capital Resources" for additional details with respect to these factors and "Uncertainty of Forward-Looking Statements and Information" for additional factors that could impact future operating results.

LIQUIDITY AND CAPITAL RESOURCES

Capital Plan

On June 24, 2002, Dynegy announced a \$2 billion capital plan designed to enhance liquidity and reduce debt. These measures are in addition to the equity sales and capital expenditure reductions totaling approximately \$1.25 billion previously achieved through its December 2001 capital plan. The new plan proposed removing \$301 million in obligations triggered by declines in Dynegy's credit ratings, a \$100 million reduction in capital expenditures, a sale or

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joint venture of a portion of Dynegy's ownership interest in Northern Natural and in its United Kingdom natural gas storage facilities, a proposed initial public offering of Dynegy Energy Partners L.P., a proposed \$300-\$400 million mortgage bond offering by IP, workforce reductions and certain other measures.

As part of the capital plan, on June 27, 2002, Dynegy completed an amendment to the Catlin Associates, LLC minority interest transaction (also referred to as "Black Thunder"), which permanently removed a \$270 million obligation which could have been triggered by declines in Dynegy's credit ratings. The amended agreement requires a subsidiary of Dynegy to amortize \$275 million over the remaining three years of the transaction. The subsidiary has already paid approximately \$73 million of the amortization. Quarterly maturities are approximately \$20 million through the first quarter 2005. In addition, Dynegy agreed to grant mortgages on the midwest power generation assets covered by the transaction, post a letter of credit to secure a contingent obligation expiring on December 31, 2002 and make certain structural changes to enhance the security of the third-party lenders involved in the transaction. As a result of this amendment, \$796 million related to Catlin Associates, LLC was reclassified from Minority Interest to debt on Dynegy's Condensed Consolidated Balance Sheets at June 30, 2002.

On June 28, 2002, Dynegy completed a \$250 million interim financing, which bears interest at LIBOR plus 1.75 percent. This loan matures in June 2003 and represents an advance on a portion of the proceeds from the expected sale of certain of the Company's United Kingdom natural gas storage facilities. Dynegy also completed a restructuring of the financing arrangements for West Coast Power, LLC ("West Coast Power"), a joint venture owned equally by Dynegy and NRG Energy, that resulted in the release of approximately \$100 million in letters of credit that Dynegy had posted on behalf of West Coast Power. In connection with this restructuring, West Coast Power repaid bank borrowings that resulted in the permanent elimination of a \$31 million net obligation which could have been triggered by declines in Dynegy's credit ratings.

On July 15, 2002, Dynegy completed a \$200 million interim financing, bearing interest at LIBOR plus 1.38 percent. This loan matures in January 2003 and is secured by interests in Dynegy's Renaissance and Rolling Hills merchant power generation facilities.

Dynegy incurred upfront fees aggregating approximately \$19 million in connection with the interim financings, Black Thunder amendment and West Coast Power transaction described above.

In addition, on July 28, 2002 Dynegy entered into an agreement to sell Northern Natural Gas Company ("Northern Natural") to MidAmerican Energy Holdings Company ("MidAmerican") for \$928 million in cash, subject to adjustment for working capital changes. Under the terms of this agreement, MidAmerican is expected to acquire all of the common and preferred stock of Northern Natural and to assume \$950 million in outstanding Northern Natural debt. The transaction is expected to close in August 2002 and is subject to customary closing conditions, including expiration of the Hart-Scott-Rodino waiting period, and the continuation of certain transition services to Northern Natural. The sale will eliminate approximately \$800 million of Northern Natural debt on Dynegy's consolidated balance sheet.

Following is a list of items that remain to be completed under Dynegy's original \$2 billion capital plan:

- . Closing of the pending sale of Northern Natural;
- . Sale or joint venture transaction of Dynegy's natural gas storage and gas processing facilities in the United Kingdom;

- . Sale of additional assets totaling \$200 million;
- . Issuance of \$300-\$400 million of IP mortgage bonds to repay or refinance existing obligations;
- . Initial public offering of Dynegy Energy Partners L.P., a newly formed master limited partnership expected to own and operate a portion of the Company's downstream natural gas liquids business; and
- . Consideration of an equity-like offering based on market conditions and the results of capital-enhancing transactions.

The closing of the Northern Natural sale and the execution of the remaining elements of the Company's capital plan are expected to provide sufficient near-term liquidity for the Company. The remaining elements of the capital plan are subject to a number of risks including factors beyond the Company's control. These factors include, among others, market conditions for asset sales, the timeliness and ability to obtain required regulatory approvals, ongoing investigations and litigation, and the effect of commodity prices and continued contraction in the markets in which the Company operates, which may negatively impact the Company's operating cash flow. Current conditions have caused the termination of a previously announced \$325 million mortgage bond offering by IP and delayed the proposed initial public offering of Dynegy Energy Partners L.P. These conditions will also impact any potential capital-raising activities for the Company in the near future. In addition, Dynegy has previously announced its intention to rationalize its customer and risk-management business through a joint venture or another strategic alternative. Dynegy cannot guarantee that any of these planned transactions will be successfully completed or that if completed they will occur on terms that the Company anticipates.

Available Credit Capacity, Liquidity and Debt Maturities

Dynegy is satisfying its capital requirements primarily with cash from operations, cash on hand and limited borrowings available under its revolving credit facilities. Dynegy does not have access to the commercial paper market and has only limited access to the capital markets due to its non-investment grade credit ratings, the ongoing re-audit of the Company's historical financial statements and other factors. Given these facts, Dynegy expects to continue to rely primarily on cash from operations, cash on hand and proceeds from its capital plan initiatives to fund its near-term obligations.

The following table summarizes Dynegy's credit capacity and liquidity position at June 30, 2002:

| | Dynegy | | | | |
|-------------------------------|-------------|---------------|----------------|------------------|--------|
| Total | Dynegy Inc. | Holdings Inc. | Illinois Power | Northern Natural | |
| ----- | ----- | ----- | ----- | ----- | ----- |
| (\$ in millions) | | | | | |
| Total Credit Capacity..... | \$ 2,390 | \$ 300 | \$1,340 | \$ 300 | \$ 450 |
| Outstanding Loans..... | (1,140) | -- | (390) | (300) | (450) |
| Outstanding Letters of Credit | (810) | (240) | (570) | -- | -- |
| ----- | ----- | ----- | ----- | ----- | ----- |
| Unused Borrowing Capacity.... | \$ 440 | \$ 60 | \$ 380 | \$ -- | \$ -- |

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| | | | | | |
|-------------------------------|----------|-------|--------|-------|-------|
| Cash..... | 378 | 26 | 322 | 30 | -- |
| Highly Liquid Inventory(1)... | 214 | -- | 214 | -- | -- |
| | ----- | ----- | ----- | ----- | ----- |
| Total Available Liquidity.... | \$ 1,032 | \$ 86 | \$ 916 | \$ 30 | \$ -- |
| | ----- | ----- | ----- | ----- | ----- |

(1) Consists principally of natural gas inventories that the Company believes could be monetized within 60 days based on current spot market prices.

During July and August 2002, Dynegy repaid approximately \$296 million in debt maturities and posted substantial additional collateral to support its business resulting in a reduction in total liquidity from June 30, 2002. The Company's total available liquidity as of August 12, 2002 was approximately \$593 million, including approximately \$330 million in cash, \$52 million in available borrowing capacity and \$211 million in highly liquid inventory. Completion of the Northern Natural sale should enable Dynegy to have sufficient time and

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financial resources to rationalize its customer and risk-management business through a joint venture or another strategic alternative, thereby reducing its capital requirements and enhancing its liquidity position.

Dynegy's current liquidity levels and its dependence on the sale of Northern Natural and other elements of its capital plan for financing expose the Company to substantial risk. In the event that the Northern Natural sale is not completed or is significantly delayed or if other adverse developments impact cash liquidity, the Company may not be able to meet its near-term obligations. Over the longer term, particularly in the second quarter 2003 when Dynegy expects to have approximately \$1.9 billion in debt maturities and in the fourth quarter 2003 when Dynegy has a redemption obligation with respect to \$1.5 billion in preferred stock issued to ChevronTexaco, Dynegy's ability to meet its obligations will require the successful execution of remaining elements of the capital plan and the rationalization of its customer and risk-management business. Dynegy faces execution risk with respect to its capital plan and other strategies both in the near and longer term. If Dynegy is unable to complete the Northern Natural sale in the near term or other elements of its strategy prior to the second quarter 2003, it may be forced to consider other strategic alternatives or a possible reorganization under the protection of bankruptcy laws.

As of August 12, 2002, the Company's debt and preferred stock maturities through December 31, 2003, inclusive of letters of credit issued under revolving credit facilities, were as follows: remainder of third quarter 2002--\$33 million; fourth quarter 2002--\$400 million (not including a \$450 million secured line of credit at Northern Natural that will be assumed by MidAmerican in the sale of Northern Natural as further described above); first quarter 2003--\$259 million; second quarter 2003--\$1,875 million; third quarter 2003--\$252 million; and fourth quarter 2003--\$1,562 million (including \$1.5 billion in Series B Mandatorily Convertible Redeemable Preferred Stock held by ChevronTexaco).

Trade Credit and Other Collateral Obligations

During the second quarter 2002, Dynegy continued to experience increased demands to provide collateral in both its trading and other commercial operations. Counterparties have increased their collateral demands and, in some cases, have refused to transact little more than spot gas trades with Dynegy.

Most commercial agreements typically include "adequate assurance" provisions or specific ratings triggers. Specific ratings triggers give counterparties the right to suspend or terminate credit if the Company's credit ratings fall below investment grade; "adequate assurance" provisions permit a counterparty to request adequate assurance (which is generally not specified in the agreement) of continued performance. Parties engaged in the customer and risk-management business, including Dynegy, are attempting to implement standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Dynegy has executed or is in the process of negotiating such agreements with a number of its trading partners.

Dynegy's counterparties have historically relied upon DHI's investment grade credit rating to satisfy their credit support requirements. Prior to April 25, 2002, Dynegy had approximately \$350 million in letters of credit posted in connection with its commercial operations. Since that date, Dynegy has posted approximately \$910 million in additional cash and letters of credit to collateralize its commercial obligations. Outstanding letters of credit and cash collateral totaled approximately \$1.26 billion as of August 12, 2002.

As further described in Note 14 to the accompanying financial statements, following the closing of the Northern Natural sale, Dynegy has agreed to accelerate payment to the month of delivery for a portion of the natural gas sold to Dynegy by ChevronTexaco under the parties' gas purchase agreement, with the amount of the accelerated payment generally being equal to 75 percent of the value of the prior month's gas deliveries, after reduction pursuant to the parties' netting agreement. Upon consummation of the Northern Natural sale, the initial payment amount will be \$187.5 million. The amount of the payment could change materially as a result of changes in commodity prices.

As a result of downgrades to Dynegy's credit ratings, the Company received a request from Sithe/Independence Funding to provide adequate assurance for its obligations under a long-term tolling agreement, and

three other related contracts, with the Sithe/Independence Power Project. The Company's annual payments under these arrangements approximate \$66 million and the contracts extend through 2014. The Company has offered to post an additional amount of collateral as adequate assurance under the contracts. The Company has yet to reach agreement with Sithe/Independence Funding regarding a mutually acceptable amount of collateral. Sithe/Independence Funding has sent the Company a notice of default in this regard and the two parties are continuing to negotiate with regard to these issues.

Dynegy intends to continue to manage its customer and risk-management business in a manner consistent with its liquidity position. In response to the decreasing liquidity in the trading markets and the actions of counterparties either requiring additional collateral or refusing to trade with the Company, Dynegy has reduced the level of its customer and risk-management business activities. The impact of this reduction in activities has adversely impacted earnings and cash flow. Accordingly, Dynegy is assessing alternative strategies for its customer and risk-management business. These alternatives include, among others, an independently rated joint venture comprising this business and potentially other complimentary assets or businesses. Dynegy's ability to execute a joint venture or other alternative transaction with respect to its customer and risk-management business will significantly affect its liquidity position and future results of operations. For example, if Dynegy were to contribute its customer and risk-management business to a joint venture with an investment grade credit rating and independently established trade credit, Dynegy's capital commitments with respect to that business would be

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significantly reduced. Similarly, a reduction in the size of this business would reduce Dynegy's capital commitments. However, the amount of this reduction will depend upon the Company's ability to execute such a transaction and the structure of any such transaction.

Credit Rating Discussion

Credit ratings impact the Company's ability to obtain short- and long-term financing, the cost of such financing and the execution of its commercial strategies, including counterparty confidence and the Company's ability to conduct its customer and risk-management business. In determining the Company's credit ratings, the rating agencies consider a number of factors. Quantitative factors that management believes are given significant weight include, among other things, EBITDA; operating cash flow; total debt outstanding; off balance sheet obligations and other commitments; fixed charges such as interest expense, rent or lease payments; payments to preferred stockholders; liquidity needs and availability; and various ratios calculated from these factors. Qualitative factors include, among other things, predictability of cash flows, business strategy, industry position, regulatory investigations and other contingencies. Although these factors are among those considered by the rating agencies, each agency may calculate and weigh each factor differently.

Since the Company originally filed its first quarter 2002 Form 10-Q on May 15, 2002, all three major credit rating agencies have downgraded Dynegy's credit ratings. On June 24, 2002, following the announcement of Dynegy's new capital plan, Fitch, Inc. lowered its credit ratings for, and maintained its Ratings Watch Negative status on, Dynegy and its subsidiaries. The senior unsecured debt of Dynegy and Dynegy Holdings was downgraded to "BB+," which is below investment grade. Fitch subsequently downgraded the senior unsecured debt ratings of Dynegy and Dynegy Holdings to "BB-" and then to "B," which is five notches below investment grade. Fitch stated that these ratings actions were based on a continued weakening in Dynegy's credit profile and concerns over Dynegy's ability to generate sustainable cash flows and to execute its \$2 billion capital plan.

On June 25, 2002, Standard & Poor's Rating Services lowered its ratings on Dynegy and its subsidiaries and stated that these ratings would remain on CreditWatch with negative implications. Standard & Poor's lowered its long-term corporate credit ratings of Dynegy and its subsidiaries to "BBB-," its lowest investment grade credit rating. Standard & Poor's subsequently lowered its long-term corporate credit ratings of Dynegy and its subsidiaries to "BB" and then to "B+," which is four notches below investment grade. Standard & Poor's stated that these ratings actions reflected pronounced erosion in Dynegy's core merchant energy business, including the unwillingness of counterparties to transact in little more than spot gas trades with Dynegy, and Dynegy's failure to provide sustainable cash flow necessary for investment grade status.

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On June 28, 2002, Moody's Investors Service lowered its ratings on Dynegy and its subsidiaries and stated that the ratings outlook remained negative. The senior unsecured debt of Dynegy Holdings was downgraded from "Baa3" to "Ba1," which is below investment grade. Moody's subsequently lowered its senior unsecured debt ratings on Dynegy to "B3," which is six notches below investment grade, and DHI to "B1," which is four notches below investment grade. Moody's stated that these ratings actions were based on continuing concerns over Dynegy's liquidity and operating cash flow, increased amounts of secured debt and the expectation that future renewals of existing bank debt will likely be done on a secured basis, effectively subordinating DHI's senior unsecured lenders.

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As of August 12, 2002, Dynegy's credit ratings, as assessed by the three major credit rating agencies, were as follows:

| Rated Enterprises | Standard & Poor's Moody's Fitch | | |
|-------------------------------|------------------------------------|-----|-----|
| Senior Unsecured Debt Rating: | | | |
| Dynegy Inc.(1)..... | B- | B3 | B |
| Dynegy Holdings Inc.(2)... | B- | B1 | B |
| Illinois Power(3)..... | * | Ba3 | B |
| Illinova Corporation(4)... | B- | B1 | B |
| Northern Natural..... | B+ | B3 | B |
| Senior Secured Debt Rating: | | | |
| Illinois Power..... | B+ | Ba2 | BB- |

* Not rated.

- (1) Dynegy Inc. is the parent holding company. This entity generally provides financing to the enterprise through issuance of capital stock.
- (2) Dynegy Holdings Inc. is the primary debt financing entity for the enterprise. This entity is a subsidiary of Dynegy Inc. and is a holding company that includes substantially all of the operations of the WEN and DMS business segments and Northern Natural, which is reported in the T&D segment.
- (3) This entity includes the Company's regulated transmission and distribution business in Illinois.
- (4) Illinova Corporation is the holding company for Illinois Power and is no longer used to raise capital.

The recent downgrades in Dynegy's credit ratings have caused further reductions in the amount of trade credit extended by Dynegy's counterparties. Counterparties have generally increased their collateral demands relating to Dynegy's trading and commercial obligations. Counterparties in Dynegy's customer and risk-management business have refused to trade or are unwilling to transact little more than spot gas trades with the Company. See "Trade Credit and Other Collateral Obligations" discussion above. Additionally, Dynegy's non-investment grade status has limited and will likely continue to limit significantly its ability to refinance its debt obligations and to access the capital markets and will likely increase the borrowing costs incurred by the Company in connection with any refinancing activities. The Company's financial flexibility is likely to be reduced as a result of, among other things, restrictive covenants and other terms typically imposed on non-investment grade borrowers.

Financing Trigger Events

Dynegy's debt instruments and other financial obligations include routine provisions, which, if not met, could require early payment, additional collateral support or similar actions. For Dynegy, these trigger events include leverage ratios, insolvency events, defaults on scheduled principal or interest payments, acceleration of other financial obligations and change of control provisions. Dynegy does not have any trigger events tied to specified credit ratings or stock price in its debt instruments and has not executed any transactions that require it to issue equity based on credit rating or other trigger events.

Capital Leases

In response to the initiatives underway at the FASB, on June 28, 2002, the Company unilaterally undertook certain actions, the effect of which altered the accounting for one of its existing lease obligations. These actions included the delivery of a guarantee of the lessor debt in the lease of a power generation facility. As a result of these actions, the lease is now accounted for as a capital lease and approximately \$165 million of generation assets and the associated debt were brought on-balance sheet. The Company has the option to purchase the related assets at lease maturity in 2005. This obligation bears interest at a rate of LIBOR plus 1.5% to 2.75%, depending on the tranche.

This non-cash action resulted in an increase to property, plant and equipment and a corresponding increase in long-term debt on the Company's condensed consolidated balance sheets. This obligation was previously reported as a lease obligation in the footnotes to the Company's financial statements and in the Commercial Financial Obligations and Contingent Financial Commitments tables in the 2001 Form 10-K.

OTHER MATTERS

California Market/West Coast Power

Dynegy and NRG Energy each own 50 percent of West Coast Power, a joint venture owning power generation plants in southern California. Dynegy's net interest in West Coast Power represents approximately 1,400 MW of generating capacity. Dynegy also participates in the California markets independently, as a wholesale marketer of gas and power. Through its interest in West Coast Power, Dynegy has credit exposure for past transactions to certain state agencies ("ISO" and "PX"), which primarily relied on receipts from California utilities to pay their bills. West Coast Power currently sells directly to the California Department of Water Resources ("DWR") pursuant to other bilateral agreements.

As described in Note 12 to the accompanying financial statements, on February 25, 2002, the California Public Utilities Commission and the California Electricity Oversight Board filed complaints with the FERC asking that it void or reform power supply contracts between DWR and, among others, West Coast Power. The complaints allege that prices under the contracts exceed just and reasonable prices permitted under the Federal Power Act. The FERC recently set these complaints for evidentiary hearing. The hearing, however, is being held in abeyance pending completion of settlement talks. While West Coast Power continues in good faith negotiations with the State of California on reforming the terms of its DWR contract, settlement ultimately may not be possible. If a hearing on the contracts entered into by West Coast Power or others is necessary, the first phase of the hearing will be limited to the question of whether the California real-time market adversely affected the long-term bilateral markets. Please read Note 11, "Commitments and Contingencies," to the 2001 Form 10-K and Note 12 to the accompanying financial statements for additional discussion of the Company's activities in the California power market.

As a result of West Coast Power's previously announced long-term sales arrangement with the DWR, ongoing management of credit risk associated with direct sales to customers in California and other factors, management believes that Dynegy's primary exposure relates to the realization of its share of West Coast Power's receivables from the ISO and PX and potential refunds or offsets associated with related transactions. Transactions with the aforementioned counterparties, other than the ISO and PX, are current under the terms of each individual arrangement. At June 30, 2002, Dynegy's portion of the receivables

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owed to West Coast Power by the ISO and PX approximated \$208 million. Management is continually assessing Dynegy's exposure, as well as its exposure through West Coast Power, relative to its California receivables and establishes reserves for contingent liabilities where the amount of potential loss is determined to be probable and estimable. Dynegy's share of reserves taken by West Coast Power totaled \$(0.2) million and \$14.2 million for the three-month periods ended June 30, 2002 and 2001, respectively. Dynegy's share of reserves taken by West Coast Power totaled zero

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and \$99.6 million for the six-month periods ended June 30, 2002 and 2001, respectively. Dynegy's share of the total reserve at June 30, 2002 and December 31, 2001 was \$151.8 million and \$151.8 million, respectively.

Dividend Policy

In further support of the Company's \$2 billion capital plan, Dynegy's Board of Directors has elected not to pay a dividend on Dynegy's Class A or Class B common stock for the third quarter 2002. Payments of dividends for subsequent periods will be at the discretion of the Board of Directors, but Dynegy does not foresee reinstating the dividend in the near term. During the six-month periods ended June 30, 2002 and 2001, the Company paid approximately \$55 million and \$49 million in cash dividends, respectively, on common stock.

New Power Plants

In the second quarter 2002, Dynegy started commercial operation at three new merchant power plants in Kentucky and Michigan. The combined generating capacity of the facilities is 1,510 MW. These three peaking facilities will sell the power generated through the East Central Area Reliability Council and other regions of the country.

Recent Accounting Pronouncements

See Note 3 to the accompanying financial statements for a discussion of recently issued accounting pronouncements that could affect the Company. Additionally, the following further describes proposed rules that are likely to affect the Company if they are issued.

EITF Issue 02-3. In June 2002, the EITF reached consensus on two of three issues presented in EITF Issue 02-3 "Accounting for Contracts Involved in Energy Trading and Risk Management Activities." First, the Task Force concluded that all mark-to-market gains and losses on energy trading contracts (whether realized or unrealized) should be shown net in the income statement, irrespective of whether the contract is physically or financially settled. In addition, the Task Force concluded that an entity should disclose the gross transaction volumes for those energy trading contracts that are physically settled. Beginning in the third quarter of 2002, Dynegy will present all mark-to-market gains and losses on a net basis and will expand its volumetric disclosures to comply with the consensus. Additionally, in accordance with the transition provisions in the consensus, comparative financial statements will be conformed to meet the requirements mandated by the Task Force. It is estimated that this accounting change will reduce Dynegy's reported revenues and cost of sales by as much as 85 percent in any given period. The change in accounting classification will have no impact on operating income, net income, earnings per share or cash flow from operations.

The second consensus reached by the Task Force related to required disclosures regarding energy trading operations. The Task Force agreed to

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clarify the application of APB Opinion No. 22, "Disclosure of Accounting Policies" and SOP 94-6, "Disclosure of Significant Risks and Uncertainties" to an entity's energy trading operations by requiring that entities disclose the applicability of EITF Issue 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," the types of contracts that are accounted for as energy trading contracts, a description of the methods and significant assumptions used to estimate the fair value of various classes of energy trading contracts and the sensitivity of its estimates to changes in the near term. The Task Force indicated that additional disclosure regarding the fair value of contracts, aggregated by source or method of estimating fair value and by maturity date, would also be meaningful. The Company will assess its disclosures with respect to these matters.

The third issue addressed by the Task Force in EITF Issue 02-3 deals with the recognition of unrealized gains and losses at inception (commonly referred to as dealer profit) of an energy trading contract. The Task Force reached no consensus on this issue and the issue was assigned to a working group for resolution by no later

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than the end of the calendar year. Inherent in these discussions is the fundamental conclusion of whether and when an enterprise should use valuation models for the purpose of valuing energy contracts that are transacted in regions or in periods which lack significant trading activity (i.e., market liquidity).

Consistent with SFAS No. 107, SFAS No. 125, and SFAS No. 133, EITF Issue No. 98-10 footnote 2, stated that quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for measuring transactions, if available. The footnote further states that if a quoted market price is unavailable, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar energy contracts and the results of valuation techniques to the extent available. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, future expenses, interest rates, default risk, prepayment risk, and volatility. The guidance goes on to explain that examples of valuation techniques include the present value of expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

In EITF Issue No. 00-17, the Task Force reiterated its consensus that energy contracts, including energy-related contracts, that are within the scope of EITF Issue No. 98-10 should be reported at fair value on a stand-alone, or individual contract, basis. In Issue No. 00-17, the Task Force declined to specify whether any specific measurement techniques for estimating fair value of individual contracts should be considered unacceptable or to proscribe any specific valuation methodologies. Rather, the Task Force reiterated that the estimate of fair value should be based on the best information available in the circumstances. The Task Force stated in Issue No. 00-17 that:

- . The price at which an energy contract is exchanged normally is its initial fair value;
- . Current market transactions also may provide evidence for recognition of dealer profit;
- . When available, current market transactions provide the basis for estimating subsequent changes in fair value;

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- . Valuation models, including option pricing models, should be used only when market transactions are not available to evidence fair values; and
- . When valuation models are used, the best information available would consider, but is not limited to, recent spot prices and forward prices, and for option pricing models, the volatility implied by recent transactions, when available, or the historical volatility of the commodities and/or services underlying the contract.

As stated previously, a working group of the Task Force was assigned the task of definitively resolving this issue by the end of the calendar year. However, upon issuing the EITF minutes of the June 19-20 EITF meeting (which meeting included a discussion of Issue No. 02-3), the FASB staff stated that it will continue to hold the view that EITF 98-10 and 00-17 do not allow for recognition of dealer profit (i.e., unrealized gain or loss at inception of a transaction) unless evidenced by quoted market prices or other current market transactions for energy trading contracts with similar terms and counterparties. The businesses affected, the models employed and the assumptions underlying these models are disclosed in the 2001 Form 10-K.

Management is uncertain as to how the working group will resolve issues related to recognition of dealer profit. Further, it is unclear how the working group will address dealer profit and the accounting transition resulting from adoption of new guidance. Three transition alternatives exist in practice. These transition alternatives include: (a) a retroactive restatement to eliminate dealer profit recognized in previous periods; (b) a cumulative effect adjustment for a change in accounting principle, which eliminates the recognition of previous periods' dealer profit in the current period; or, (c) as a prospective change, eliminating the recognition of dealer profit on future transactions but leaving past transactions unaffected. Finally, it is unclear whether the scope of the working group's activities will include a comprehensive conclusion regarding the appropriateness of the use

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of models as a fundamental method for valuing transactions when market quotations are unavailable. Should the Task Force issue definitive guidance on any one or all of these issues, it will impact Dynegy. However, the extent of the financial impact to Dynegy, if any, cannot be predicted with any degree of certainty until the scope of the Task Force's conclusion is known and the transition alternative is mandated. If the Task Force prefers a retroactive or a cumulative effect transition alternative, then Dynegy's historical financial position and results of operations will be impacted negatively. If the Task Force prefers a prospective transition alternative, then Dynegy's current financial position will be unaffected and the impact to future operations in the near term is not expected to be material (largely as a result of a reduction in these types of transactions in the marketplace). As an order of magnitude, approximately \$42 million of liabilities valued using models are included in Dynegy's net risk management assets at June 30, 2002.

EITF Issue 01-08. The EITF is deliberating the issue of when an energy-related contract under EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," is a lease. This issue impacts the accounting for tolling arrangements that are considered energy-related contracts. A working group has been formed to assess the implications of this issue and their work is continuing. The working group agreed that the evaluation of whether an arrangement conveys the right to use property, plant, or equipment should be based on the substance of an arrangement and that the property that is the subject of a lease must be

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specified (explicitly or implicitly) either at inception of the arrangement or at the beginning of the lease term. The working group generally agreed that when property, plant, or equipment is explicitly identified and the benefits of the property, plant, or equipment are conveyed based on the passage of time, the arrangement is likely a lease. The difficulty in determining whether an arrangement is a lease arises when the property, plant, or equipment is not explicitly identified and/or the benefits of property, plant, or equipment are conveyed based on the output of the property, plant, or equipment. Management is uncertain as to how the working group will conclude on this issue but will continue to assess the potential impact to the Company as more definitive guidance from the working group is made public.

ACCOUNTING METHODOLOGY

The Company has identified three critical accounting policies that require a significant amount of judgment and are considered to be the most important to the portrayal of Dynegy's financial position and results of operations. These policies include the accounting for long-lived assets, the evaluation of counterparty credit and other similar risks and revenue recognition. See Note 3 to the financial statements included in the 2001 Form 10-K for a discussion of the process surrounding the evaluation of counterparty credit and other similar risks. For disclosure on the Company's accounting for long-lived assets and revenue recognition, refer to Note 2 to the financial statements included in the 2001 Form 10-K. Accounting methodology and application of accounting methodologies are more fully described in the 2001 Form 10-K.

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ENTERPRISE RISK MANAGEMENT, VALUATION AND MONITORING

Market Risk. The Company is exposed to commodity price variability related to its natural gas, NGLs, crude oil, electricity and coal businesses. In addition, fuel requirements at its power generation, gas processing and fractionation facilities represent additional commodity price risks to the Company. In order to manage these commodity price risks, Dynegy routinely utilizes certain types of fixed-price forward purchase and sales contracts, futures and option contracts traded on the New York Mercantile Exchange and swaps and options traded in the over-the-counter financial markets to:

- . Manage and hedge its fixed-price purchase and sales commitments;
- . Provide fixed-price commitments as a service to its customers and suppliers;
- . Reduce its exposure to the volatility of cash market prices;
- . Protect its investment in storage inventories; and
- . Hedge fuel requirements.

The potential for changes in the market value of Dynegy's commodity, interest rate and currency portfolios is referred to as "market risk." A description of each market risk category is set forth below:

- . Commodity price risks result from exposures to changes in spot rates, forward prices and volatilities in commodities, such as electricity, natural gas, coal, NGLs, crude oil and other similar products;
- . Interest rate risks primarily result from exposures to changes in the level, slope and curvature of the yield curve and the volatility of

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interest rates; and

- . Currency rate risks result from exposures to changes in spot rates, forward rates and volatilities in currency rates.

Dynegy seeks to manage these market risks through diversification, controlling position sizes and executing hedging strategies. The ability to manage an exposure may, however, be limited by adverse changes in market liquidity or other factors.

Valuation Criteria and Management Estimates. As more fully described in the 2001 Form 10-K, Dynegy utilizes a fair value accounting model for certain aspects of its operations as required by generally accepted accounting principles. The net gains or losses resulting from the revaluation of these contracts during the period are recognized currently in the Company's results of operations. For financial reporting purposes, assets and liabilities associated with these transactions are reflected on the Company's balance sheet as risk management assets and liabilities, classified as short- or long-term pursuant to each contract's individual tenor. Net unrealized gains and losses from these contracts are classified as revenue in the accompanying statement of operations. Transactions that have been realized and settled are currently reflected gross in revenues and cost of sales. Upon adoption of EITF 02-3, effective for the third quarter 2002, realized and settled amounts will be reflected net in the income statement.

As more fully described in the Explanatory Note to the accompanying unaudited Condensed Consolidated Financial Statements, the Company corrected the forward power curve methodology it used to estimate the fair market value of its U.S. power marketing and trading portfolio. Further, the Company restated its financial statements, beginning with the third quarter 2001, to reflect the revised methodology.

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Risk-Management Asset and Liability Disclosures. The following tables depict the mark-to-market value and cash flow components of the Company's net risk-management assets and liabilities at June 30, 2002 and December 31, 2001:

MARK-TO-MARKET VALUE OF NET RISK-MANAGEMENT ASSETS (1)

| | Total | 2002(2) | 2003 | 2004 | 2005 | 2006 | Thereafter |
|---|------------------|---------|-------|-------|-------|--------|------------|
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| | (\$ in Millions) | | | | | | |
| Mark-to-Market Value of Net Risk-Management Assets and Liabilities: | | | | | | | |
| June 30, 2002..... | \$ 373 | \$ (17) | \$164 | \$111 | \$18 | \$ 2 | \$95 |
| December 31, 2001..... | 901 | 576 | 113 | 70 | 21 | 30 | 91 |
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| Increase (Decrease)..... | \$(528) | \$(593) | \$ 51 | \$ 41 | \$(3) | \$(28) | \$ 4 |
| | ----- | ----- | ----- | ----- | ----- | ----- | ----- |

 (1) The table reflects the fair value of Dynegy's risk-management asset position after deduction of time value, credit, price and other reserves necessary to determine fair value. These amounts exclude the fair value associated with certain derivative instruments designated as hedges. The net risk-management assets of \$478 million on the Condensed Consolidated

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Balance Sheet include the \$373 million herein as well as emission allowance credits, other comprehensive income balances and other non-trading amounts.
 (2) Amounts represent July 1 to December 31, 2002 values in the June 30, 2002 row and January 1 to December 31, 2002 values in the December 31, 2001 row.

The increases (decreases) in the Net Risk Management Asset and Liabilities were impacted by the following:

- . A net deferral of the anticipated timing of cash inflows totaling \$95 million from the 2002 through 2004 time periods to beyond 2006 related to long-term natural gas storage transactions. The change in the timing of cash inflows on these transactions results from the decision to extend the term of the contract through 2007;
- . The realization of approximately \$522 million of cash related to contracts settled during the first and second quarters of 2002; and
- . The impact of the recognition of other net mark-to-market gains, change in reserves, changes in interest rates and changes in foreign exchange rates and their related impact on the discounted value of the portfolio and related annual cash flow amounts.

CASH FLOW COMPONENT OF NET RISK-MANAGEMENT ASSET

| | Six Months Ended June 30, 2002 | Six Months Ended December 31, 2002 | Total 2002 | 2003 | 2004 | 2005 | 2006 | Thereafter |
|--|---|---|---------------|-------|-------|--------|--------|------------|
| (\$ in Millions) | | | | | | | | |
| Cash Flow of Risk-Management Assets and Liabilities(1): | | | | | | | | |
| June 30, 2002..... | \$522 | \$83 | \$605 | \$195 | \$136 | \$ 22 | \$ -- | \$212 |
| December 31, 2001..... | | | 646 | 154 | 112 | 53 | 58 | 281 |
| Increase (Decrease)..... | | | \$(41) | \$ 41 | \$ 24 | \$(31) | \$(58) | \$(69) |

(1) The cash flow values at June 30, 2002 reflect realized cash flows for the six months ended June 30, 2002 and anticipated undiscounted cash inflows and outflows by contract based on tenor of individual contract position for the remaining periods and have not been adjusted for counterparty credit or other reserves. These amounts exclude the cash flows associated with derivative instruments designated as hedges as well as emission allowance credits and other non-trading amounts.

The following table provides a reconciliation of the risk-management data on the balance sheet, statement of operations and statement of cash flows (\$ in millions):

Six Months
Ended
June 30,
2002

BALANCE SHEET RISK-MANAGEMENT ACCOUNTS

| | |
|--|--------|
| Fair value of portfolio at January 1, 2002..... | \$ 935 |
| Risk-management gains recognized through the income statement in the period, net.... | 64 |
| Cash received related to contracts settled in the period, net..... | (522) |
| Changes in fair value as a result of a change in valuation technique(1)..... | -- |
| Non-cash adjustments and other..... | 1 |
| | ----- |
| Fair value of portfolio June 30, 2002..... | \$ 478 |
| | ----- |

INCOME STATEMENT RECONCILIATION

| | |
|--|-------|
| Risk-management gains recognized through the income statement in the period, net.... | \$ 64 |
| Physical business recognized through the income statement in the period, net..... | (30) |
| Non-cash adjustments and other..... | (2) |
| | ----- |
| Net recognized operating margin(2)..... | \$ 32 |
| | ----- |

CASH FLOW STATEMENT

| | |
|--|--------|
| Cash received related to risk-management contracts settled in the period, net..... | \$ 522 |
| Estimated cash paid related to physical business settled in the period, net..... | (30) |
| Timing and other, net(3)..... | (61) |
| | ----- |
| Cash received (paid) during the period..... | \$ 431 |
| | ----- |
| Risk Management cash flow adjustment for the six-month period ended June 30, 2002(4) | \$ 399 |
| | ----- |

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- (1) Dynegy's modeling methodology has been consistently applied period over period.
 - (2) This amount consists primarily of the customer and risk-management portion of WEN's operating income before the deduction of Depreciation and Amortization, Impairment and Other Charges and General and Administrative Expenses.
 - (3) Primarily represents cash paid for emission credits and physical inventory utilized in customer and risk-management business.
 - (4) This amount is calculated as "Cash received (paid) during the period" less "Net recognized operating margin."

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The following table provides an assessment of net contract values by year based on the Company's valuation methodology described above.

NET FAIR VALUE OF MARKETING PORTFOLIO

| | Total 2002(1) | 2003 | 2004 | 2005 | 2006 | Thereafter | |
|---------------------------|------------------|---------|-------|-------|---------|------------|-------|
| | ----- | ----- | ----- | ----- | ----- | ----- | |
| | (\$ in Millions) | | | | | | |
| Market Quotations(2)..... | \$229 | \$ (17) | \$ 78 | \$ 35 | \$ (18) | \$ (4) | \$155 |
| Other External Sources(3) | 186 | -- | 83 | 74 | 25 | (1) | 5 |
| Prices Based on Models(4) | (42) | -- | 3 | 2 | 11 | 7 | (65) |

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| | | | | | | |
|-------|---------|-------|-------|-------|-------|-------|
| ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| \$373 | \$ (17) | \$164 | \$111 | \$ 18 | \$ 2 | \$ 95 |
| ----- | ----- | ----- | ----- | ----- | ----- | ----- |

-
- (1) Amount represents July 1 to December 31, 2002 values.
 - (2) Prices obtained from actively traded, liquid markets for commodities other than natural gas positions. All natural gas positions for all periods are contained in this line based on available market quotations.
 - (3) Mid-term prices validated against industry posted prices.
 - (4) See "Critical Accounting Policies" in the 2001 Form 10-K/A for a discussion of Dynegy's use of long-term models.

The Company is evaluating the possibility of presenting the Net Fair Value of the Marketing Portfolio in two categories, "Market Quotations and Other External Sources" and "Prices Based on Models" beginning in the third quarter 2002.

Value at Risk ("VaR"). In addition to applying business judgment, senior management uses a number of quantitative tools to manage the Company's exposure to market risk. These tools include:

- . Risk limits based on a summary measure of market risk exposure, referred to as VaR; and
- . Stress and scenario analyses performed daily that measure the potential effects of various market events, including substantial swings in volatility factors, absolute commodity price changes and the impact of interest rate and foreign exchange rate movements.

The modeling of the risk characteristics of Dynegy's marketing portfolio involves a number of assumptions and approximations. Dynegy estimates VaR using a JP Morgan RiskMetrics(TM) approach assuming a one-day holding period. Inputs for the VaR calculation are prices, positions, instrument valuations and the variance-covariance matrix. While management believes that these assumptions and approximations are reasonable, there is no uniform industry methodology for estimating VaR, and different assumptions and/or approximations could produce materially different VaR estimates.

Dynegy uses historical data to estimate the Company's VaR and, to better reflect current asset and liability volatilities, this historical data is weighted to give greater importance to more recent observations. Given its reliance on historical data, VaR is effective in estimating risk exposures in markets in which there are not sudden fundamental changes or shifts in market conditions. An inherent limitation of VaR is that past changes in market risk factors, even when weighted toward more recent observations, may not produce accurate predictions of future market risk. VaR should be evaluated in light of this and the methodology's other limitations.

VaR represents the potential loss in value of Dynegy's enterprise-wide marketing portfolio due to adverse market movements over a defined time horizon within a specified confidence level. For the VaR numbers reported below, a one-day time horizon and a 95% confidence level were used. This means that there is a one in 20 statistical chance that the daily portfolio value will fall below the expected maximum potential reduction in portfolio value at least as large as the reported VaR. Thus, a change in portfolio value greater than the expected change in portfolio value on a single trading day would be anticipated to occur, on average, about once a month. Gains or losses on a single day can exceed reported VaR by significant amounts. Gains or losses can also accumulate over a longer time horizon such as a number of consecutive trading days.

In addition, Dynegy has provided its VaR using a one-day time horizon and a 99% confidence level. The purpose of this disclosure is to provide an indication of earnings volatility using a higher confidence level. Under this presentation, there is one in one hundred statistical chance that the daily portfolio value will fall below the expected maximum potential reduction in portfolio value at least as large as the reported VaR. Average VaR is not available for the six-month period ended June 30, 2002 or year ended December 31, 2001 due to the restatement of historical results. While VaR can be calculated at a single point in time, it is not feasible to recalculate the historical results necessary to calculate an average.

The following table sets forth the aggregate daily VaR of Dynegy's marketing portfolio:

DAILY VaR FOR MARKETING PORTFOLIO

| | June 30, 2002 | December 31, 2001 |
|-----------------------------------|------------------|----------------------|
| | ----- | |
| | (\$ in Millions) | |
| One Day VaR--95% Confidence Level | \$17 | \$17 |
| | --- | --- |
| One Day VaR--99% Confidence Level | \$24 | \$24 |
| | --- | --- |

Credit Risk. Credit risk represents the loss that the Company would incur if a counterparty fails to perform under its contractual obligations. To reduce the Company's credit exposure, the Company seeks to enter into netting agreements with counterparties that permit Dynegy to offset receivables and payables with such counterparties. Dynegy attempts to further reduce credit risk with certain counterparties by entering into agreements that enable the Company to obtain collateral or to terminate or reset the terms of transactions after specified time periods or upon the occurrence of credit-related events. The Company may, at times, use credit derivatives or other structures and techniques to provide for third-party guarantees of the Company's counterparties' obligations.

Dynegy's industry has historically operated under negotiated credit lines for physical delivery contracts. Dynegy's Credit Department, based on guidelines set by Dynegy's Credit Policy Committee, establishes Dynegy's counterparty credit limits. For collateralized transactions, the Company also evaluates potential exposure over a shorter collection period and gives effect to the value of collateral received. The Company further seeks to measure credit exposure through the use of scenario analyses and other quantitative tools. Dynegy's credit management systems monitor current and potential credit exposure to individual counterparties and on an aggregate basis to counterparties and their affiliates. Recent events in the merchant energy industry have affected historical credit activities in the industry. Please read "Trade Credit and Other Collateral Obligations" above.

The following table displays the value of Dynegy's marketing portfolio, inclusive of hedging activities, at June 30, 2002 (in millions):

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| | |
|---|--------|
| Investment Grade Credit Quality..... | \$ 696 |
| Below Investment Grade Quality or Unrated | 176 |
| | ----- |
| Value of portfolio before reserves..... | 872 |
| Credit and market reserves..... | (499) |
| | ----- |
| | 373 |
| Other(1)..... | 105 |
| | ----- |
| Net risk-management assets(2)..... | \$ 478 |
| | ----- |

-
- (1) Amount represents emission allowance credits, other comprehensive income balances and other non-trading amounts.
 - (2) Represents amounts included in "Current Assets--Assets from Risk Management Activities," "Other Assets--Assets from Risk-Management Activities," "Current Liabilities--Liabilities from Risk-

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Management Activities," and "Other Liabilities--Liabilities from Risk-Management Activities" on the Condensed Consolidated Balance Sheet.

Interest Rate Risk. Interest rate risk primarily results from variable rate financial obligations and from providing risk-management services to customers, since changing interest rates impact the discounted value of future cash flows used to value risk-management assets and liabilities. Management continually monitors its exposure to fluctuations in interest rates and may execute swaps or other financial instruments to hedge and mitigate this exposure.

The following table sets forth the daily VaR associated with the interest rate component of the marketing portfolio. Average VaR is not available for the six-month period ended June 30, 2002 or the year ended December 31, 2001 due to the restatement of historical results. While VaR can be calculated at a single point in time, it is not feasible to recalculate the historical results necessary to calculate an average. Dynegy seeks to manage its interest rate exposure through application of various hedging strategies. Hedging instruments executed to mitigate such interest rate exposure in the marketing portfolio are included in the VaR as of June 30, 2002 and December 31, 2001 and are reflected in the table below.

DAILY VaR ON INTEREST COMPONENT OF MARKETING PORTFOLIO

| | June 30, 2002 | December 31, 2001 |
|-----------------------------------|------------------|----------------------|
| | ----- | ----- |
| | (\$ in Millions) | |
| One Day VaR--95% Confidence Level | \$2.1 | \$0.1 |
| | ---- | ---- |

The increase in One Day VaR is due to changes in the interest rate exposure on the underlying risk-management marketing portfolio. Interest rate swaps entered into to manage such exposure were not simultaneously adjusted, resulting in net interest rate exposure to the Company.

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In addition to the marketing portfolio, the Company is exposed to fluctuating interest rates as it relates to other variable rate financial obligations. Based on sensitivity analysis as of June 30, 2002, it is estimated that a one percentage point interest rate movement in the average market interest rates (either higher or (lower)) over the twelve months ended June 30, 2003 would decrease (increase) income before taxes by approximately \$20 million. This amount was determined based on hypothetical interest rate movement on our variable rate financial obligations as of June 30, 2002.

Foreign Currency Exchange Rate Risk. Foreign currency risk arises from the Company's investments in affiliates and subsidiaries owned and operated in foreign countries. Such risk is also a result of risk management transactions with customers in countries outside the U.S. Management continually monitors its exposure to fluctuations in foreign currency exchange rates. When possible, contracts are denominated in or indexed to the U.S. dollar, or such risk may be hedged through debt denominated in the foreign currency or through financial contracts. At June 30, 2002, the Company's primary foreign currency exchange rate exposures were the United Kingdom Pound, Canadian Dollar, European Euro and Norwegian Kroner.

The following table sets forth the daily and average foreign currency exchange VaR. Hedging instruments executed to mitigate such foreign currency exchange exposure are included in the VaR as of June 30, 2002 and December 31, 2001 reflected in the table below.

DAILY AND AVERAGE FOREIGN CURRENCY EXCHANGE VaR

| | June 30, 2002 | December 31, 2001 |
|---|------------------|----------------------|
| | ----- | |
| | (\$ in Millions) | |
| One Day VaR--95% Confidence Level..... | \$0.7 | \$0.6 |
| | ---- | ---- |
| Average VaR for the Year-to-Date Period--95% Confidence Level | \$0.4 | \$1.1 |
| | ---- | ---- |

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Derivative Contracts. The absolute notional financial contract amounts associated with the Company's commodity risk-management, interest rate and foreign currency exchange contracts were as follows at June 30, 2002 and December 31, 2001, respectively:

ABSOLUTE NOTIONAL CONTRACT AMOUNTS

| | June 30, 2002 | December 31, 2001 |
|--|------------------|----------------------|
| | ----- | |
| Natural Gas (Trillion Cubic Feet)..... | 17.592 | 12.044 |
| Electricity (Million Megawatt Hours)..... | 152.842 | 79.931 |
| Natural Gas Liquids (Million Barrels)..... | 37.267 | 5.655 |
| Crude Oil (Million Barrels)..... | 37.250 | -- |

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| | | |
|---|----------|----------|
| Weather Derivatives (In thousands of \$/Degree Day)..... | \$ 224 | \$ 190 |
| Coal (Millions of Tons)..... | 9.8 | 18.5 |
| Variable Rate Financial Obligation Interest Rate Swaps (In Millions of U.S. Dollars)..... | \$ 2,000 | \$ -- |
| Weighted Average Fixed Interest Rate Paid (Percent)..... | 2.755 | -- |
| Fair Value Hedge Interest Rate Swaps (In Millions of U.S. Dollars)..... | \$ 626 | \$ 206 |
| Fixed Interest Rate Received on Swaps (Percent)..... | 5.619 | 5.284 |
| Cash Flow Hedge Interest Rate Swaps (In Millions of U.S. Dollars)..... | \$ -- | \$ 100 |
| Fixed Interest Rate Paid on Swaps (Percent)..... | -- | 4.397 |
| Interest Rate Risk-Management Contract (In Millions of U.S. Dollars)..... | \$ 932 | \$ 503 |
| Fixed Interest Rate Paid (Percent)..... | 5.999 | 6.150 |
| U.K. Pound Sterling Net Investment Hedges (In Millions of U.S. Dollars).... | \$ 764 | \$ 906 |
| Average U.K. Pound Sterling Contract Rate (In U.S. Dollars)..... | \$ 1.430 | \$ 1.423 |
| Euro (In Millions of U.S. Dollars)..... | \$ 27 | \$ 18 |
| Average Euro Contract Rate (In U.S. Dollars)..... | \$ 0.930 | \$ 0.886 |
| Canadian Dollar (In Billions of U.S. Dollars)..... | \$ 1.141 | \$ 1,395 |
| Average Canadian Dollar Contract Rate (In U.S. Dollars)..... | \$ 0.640 | \$ 0.644 |

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RESULTS OF OPERATIONS

The following table reflects certain operating and financial data for the Company's business segments for the three- and six-month periods ended June 30, 2002 and 2001. This financial data has been revised to reflect the restatement items described in the Explanatory Note to the accompanying unaudited Consolidated Financial Statements. Please read this Explanatory Note for further discussion of these restatement items. For segment reporting purposes, all general and administrative expenses incurred by Dynegy on behalf of its subsidiaries are charged to the applicable subsidiary as incurred. Dynegy allocates indirect general and administrative expenses to its subsidiaries using a two-step formula that considers both payroll expense and the net book value of property, plant and equipment. Interest expense incurred by Dynegy on behalf of its subsidiaries is allocated based on the subsidiaries' debt to equity relationship. Other income (expense) items incurred by Dynegy on behalf of its subsidiaries are allocated equally among sub-components of the four segments.

Net income (loss) and EPS include the following charges (in millions, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | | 2002 | | 2001 | |
|---|-----------------------------|--------|---------------------------|------|---------|--------|---------|-------|
| | Charges | EPS | Charges | EPS | Charges | EPS | Charges | EPS |
| Impairment of communications assets(1)... | \$412 | \$1.13 | \$-- | \$-- | \$456 | \$1.25 | \$-- | \$ -- |
| Severance (2)..... | 24 | 0.07 | -- | -- | 24 | 0.07 | -- | -- |
| Loss on gas delivery commitment(3)..... | -- | -- | -- | -- | 13 | 0.04 | -- | -- |
| Cumulative effect of change in accounting principle(4)..... | -- | -- | -- | -- | 234 | 0.64 | (2) | (0.0) |
| Other(5)..... | 8 | 0.02 | -- | -- | 8 | 0.02 | -- | -- |
| Special dividend(6)..... | -- | 0.22 | -- | -- | -- | 0.45 | -- | -- |

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- (1) The Company recognized an after-tax charge of \$412 million (\$634 million pre-tax) and \$456 million (\$699 million pre-tax) associated with the write-down of certain communications assets and technology investments for the three- and six-month periods ended June 30, 2002, respectively. The pre-tax charge is primarily included in Impairment and Other Charges (\$611 million and \$621 million for the three-month and six-month periods ended September 30, 2002, respectively) and Earnings (Losses) of Unconsolidated Affiliates (\$23 million and \$68 million for the three-month and six-month periods ended September 30, 2002, respectively) in the accompanying Condensed Consolidated Statements of Operations.
- (2) The Company recognized an after-tax charge of approximately \$24 million (\$37 million pre-tax) for severance benefits for approximately 325 employees, including the Company's former Chief Executive Officer and Chief Financial Officer. The charge is included in Impairment and Other Charges in the accompanying Condensed Consolidated Statements of Operations.
- (3) The Company incurred a \$13 million (\$18 million pre-tax) charge in the first quarter 2002 associated with a commitment to deliver gas assumed in the acquisition of Northern Natural. The pre-tax charge is included in Revenues in the accompanying Condensed Consolidated Statements of Operations.
- (4) Effective January 1, 2002, the Company adopted Statement No. 142, realizing an after-tax cumulative effect loss of approximately \$234 million. Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, realizing an after-tax cumulative effect gain of approximately \$2 million.
- (5) The amount represents \$4 million after-tax (\$6 million pre-tax) of fees related to a voluntary action that the Company took that altered the accounting for certain lease obligations. Additionally, the Company had \$4 million after-tax (\$6 million pre-tax) of write-offs related to information technology equipment. These amounts are included in Other Income and Other Expenses in the accompanying Condensed Consolidated Statements of Operations.
- (6) The special dividend in 2002 relates to the conversion price embedded in the Series B Preferred Stock held by Chevron U.S.A. Inc, a subsidiary of ChevronTexaco.

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Three-month Periods Ended June 30, 2002 and 2001

For the quarter ended June 30, 2002, Dynegy recorded a net loss of \$561 million or \$1.76 per diluted share, compared with second quarter 2001 net income of \$39 million or \$0.12 per diluted share. The second quarter 2002 net income includes after-tax charges of \$412 million related to the impairment of communications assets and technology investments and \$32 million primarily for severance and related exit costs and other write-offs. The \$600 million decrease in net income is due primarily to the impairment charges in the 2002 period and reduced energy trading and customer origination and lower sales prices received by the Company's generation and natural gas liquids businesses. Second quarter 2002 results benefited from inclusion of the BG Storage Limited ("BGS�") natural gas storage assets in the United Kingdom, which were acquired in the fourth quarter 2001.

As described in Note 3 to the accompanying financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("Statement No. 142"), effective January 1, 2002. The Company's net income and earnings per share for the three months ended June 30, 2001, had goodwill not been amortized during that period, would have been \$51 million or \$0.16 per diluted share.

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Operating income decreased \$900 million quarter-to-quarter due primarily to the \$660 million pre-tax impairment charges in the 2002 period, less price volatility for gas marketing in certain areas of the country, lower sales prices received by the Company's generation and natural gas liquids businesses and increased depreciation and amortization expense. Increased depreciation and amortization expense is associated with the expansion of Dynegy's depreciable asset base, primarily due to the acquisitions of Northern Natural and the BGS natural gas storage assets.

Impacting Dynegy's consolidated results was the Company's earnings from investments in unconsolidated affiliates, which were approximately \$14 million in 2002 compared to \$78 million in 2001. Variances period-to-period in these results primarily reflect the impact of the impairment of \$23 million of certain technology investments resulting from unfavorable market conditions and a \$36 million decrease in earnings related to West Coast Power.

Interest expense totaled \$92 million for the three-month period ended June 30, 2002, compared to \$68 million for the equivalent 2001 period. The variance is primarily attributable to higher average principal balances in the 2002 period compared to the 2001 period, partially offset by lower average interest rates on borrowings.

Other income and expenses, net (including minority interest expense and accumulated distributions associated with trust preferred securities) totaled \$16 million in expense in the quarter ended June 30, 2002. Combined other income and other expenses totaled \$46 million in expense in the 2001 period. Variances period-to-period in these results primarily reflect the impact of decreased minority interest expense. Additional items impacting the variance include increased litigation expense during 2002.

The Company reported an income tax benefit of \$311 million for the quarter ended June 30, 2002, compared to an income tax provision of \$47 million for the 2001 period. The effective tax rates approximated 36 percent and 55 percent in 2002 and 2001, respectively. The difference in the 2001 period from the effective tax rates and the statutory tax rate of 35 percent results principally from permanent differences arising from the amortization of certain intangibles, book-tax basis differences and the effect of certain foreign equity investments and state income taxes.

Six-month Periods Ended June 30, 2002 and 2001

For the six months ended June 30, 2002, Dynegy recorded a net loss of \$808 million or \$2.67 per diluted share, compared with net income of \$194 million or \$0.57 per diluted share in the same 2001 period. The six-month period ended June 30, 2002 net loss includes charges related to impairment of communications assets and

technology investments, severance, a loss on a gas delivery commitment and a cumulative effect of a change in accounting principle related to goodwill. The decrease in net income is due primarily to the impairment charges in the 2002 period, decline in price volatility and lower sales prices received by the Company's generation and natural gas liquids businesses in the second quarter, partially offset by increased origination in the first quarter. In addition, the 2002 period results benefited from the inclusion of Northern Natural, which the Company acquired effective February 1, 2002, and the BGS natural gas storage assets. Net income for the six-month period ended June 30, 2001 also includes the \$2 million cumulative effect of change in accounting principle

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recorded in connection with the Company's adoption of Statement No. 133.

As described in Note 3 to the accompanying financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("Statement No. 142"), effective January 1, 2002. The Company's net income and earnings per share for the six months ended June 30, 2001, had goodwill not been amortized during the period, would have been \$218 million or \$0.64 per diluted share.

Operating income decreased \$1,132 million period over period primarily due to the \$670 pre-tax impairment charge, less price volatility for gas marketing in certain areas of the country, lower sales prices received by the generation business and increased depreciation and amortization expense. Increased depreciation and amortization expense is associated with the expansion of Dynegy's depreciable asset base, primarily due to the acquisitions of Northern Natural and the BGSL natural gas storage assets.

Impacting Dynegy's consolidated results was the Company's earnings from investments in unconsolidated affiliates, which were approximately \$3 million and \$110 million in the 2002 and 2001 periods, respectively. Variances period-to-period in these results primarily reflect the impact of the impairment of \$68 million of investments in public and private companies and investment funds focused in the technology sector resulting from unfavorable conditions in that sector and a \$33 million decrease in earnings related to West Coast Power.

Interest expense totaled \$181 million for the six-month period ended June 30, 2002, compared to \$134 million for the equivalent 2001 period. The variance is primarily attributed to higher average principal balances in the 2002 period compared to the 2001 period, partially offset by lower average interest rates on borrowings.

Other income and expenses, net (including minority interest expense and accumulated distributions associated with trust preferred securities) totaled \$28 million in expense in the six-month period ended June 30, 2002 compared with \$81 million in expense in the same 2001 period. Variances period-to-period in these results primarily reflect reduced minority interest expense.

The Company reported an income tax benefit of \$331 million for the six-month period ended June 30, 2002, compared to an income tax provision of \$136 million for the 2001 period. The effective tax rates approximated 37 percent and 41 percent in 2002 and 2001, respectively. The difference from the effective tax rates and the statutory tax rate of 35 percent results principally from permanent differences arising from the amortization of certain intangibles, book-tax basis differences and the effect of certain foreign equity investments and state income taxes.

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Segment Disclosures

WHOLESALE ENERGY NETWORK

| Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|-------|------------------------------|-------|
| 2002 | 2001 | 2002 | 2001 |
| ----- | ----- | ----- | ----- |

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(\$ In Millions,
Except Operating Statistics)

| | | | | |
|---|----------|----------|----------|----------|
| Operating Income (Loss): | | | | |
| Customer and Risk-Management Activities..... | \$ (249) | \$ 32 | \$ (311) | \$ 157 |
| Asset Businesses..... | 51 | 67 | 117 | 140 |
| | ----- | ----- | ----- | ----- |
| Total Operating Income (Loss)..... | (198) | 99 | (194) | 297 |
| Earnings from Unconsolidated Investments..... | 15 | 59 | 45 | 90 |
| Other Items..... | (1) | (44) | (23) | (79) |
| | ----- | ----- | ----- | ----- |
| Earnings (Loss) Before Interest and Taxes..... | (184) | 114 | (172) | 308 |
| Interest Expense..... | (33) | (22) | (66) | (43) |
| | ----- | ----- | ----- | ----- |
| Pre-tax Earnings (Loss)..... | (217) | 92 | (238) | 265 |
| Income Tax Provision (Benefit)..... | (79) | 46 | (111) | 109 |
| | ----- | ----- | ----- | ----- |
| Income (Loss) From Operations..... | (138) | 46 | (127) | 156 |
| Cumulative Effect of Change in Accounting Principle.... | -- | -- | -- | 2 |
| | ----- | ----- | ----- | ----- |
| Net Income (Loss)..... | \$ (138) | \$ 46 | \$ (127) | \$ 158 |
| | ----- | ----- | ----- | ----- |
| Operating Statistics: | | | | |
| Natural Gas Marketing (Bcf/d)-- | | | | |
| Domestic Marketing Volumes..... | 8.5 | 8.2 | 9.1 | 8.3 |
| Canadian Marketing Volumes..... | 2.7 | 2.7 | 3.0 | 2.5 |
| European Marketing Volumes..... | 2.2 | 0.7 | 2.2 | 0.7 |
| | ----- | ----- | ----- | ----- |
| Total Marketing Volumes..... | 13.4 | 11.6 | 14.3 | 11.5 |
| | ----- | ----- | ----- | ----- |
| Million Megawatt Hours Generated-- Gross..... | 10.0 | 9.9 | 19.5 | 20.2 |
| Million Megawatt Hours Generated-- Net..... | 9.1 | 7.9 | 17.6 | 16.9 |
| North American Physical Million Megawatt Hours Sold. | 82.0 | 70.1 | 232.0 | 122.1 |
| European Physical Million Megawatt Hours Sold..... | 36.2 | -- | 96.2 | -- |
| | ----- | ----- | ----- | ----- |
| Total Physical Million Megawatt Hours Sold..... | 118.2 | 70.1 | 328.2 | 122.1 |
| | ----- | ----- | ----- | ----- |
| Coal Marketing Volumes (Millions of Tons)..... | 9.0 | 9.3 | 17.3 | 18.5 |
| Average Natural Gas Price--Henry Hub (\$/MMbtu)..... | \$ 3.38 | \$ 4.65 | \$ 2.86 | \$ 5.85 |
| Average On-Peak Market Power Prices | | | | |
| Cinergy..... | \$26.89 | \$ 39.71 | \$24.43 | \$ 41.01 |
| TVA..... | 28.06 | 51.71 | 25.11 | 47.25 |
| PJM..... | 35.84 | 44.09 | 30.54 | 44.19 |
| New York--Zone G..... | 46.52 | 57.97 | 39.48 | 58.57 |
| Platts SP 15..... | 32.14 | 188.92 | 30.49 | 206.58 |

Three-month Periods Ended June 30, 2002 and 2001

WEN reported segment net loss of \$138 million for the three-month period ended June 30, 2002, compared with segment net income of \$46 million in the 2001 quarter. The segment's customer and risk-management business incurred an operating loss of \$249 million during the second quarter 2002. The results reflect reduced energy trading and customer origination due to an overall decline in market liquidity because of increasing credit concerns in the merchant energy sector, counterparty concerns over Dynegy's lower credit ratings, a reduction in the spread between natural gas and power prices and an allocated charge of \$19 million associated with

severance and related costs. The segment's asset businesses recorded operating income of \$51 million in the second quarter 2002. The results reflect lower generation earnings due to an overall decrease in commodity prices compared to the second quarter 2001 and an allocated charge of \$7 million associated with severance and related costs. The lower earnings from generation were partially offset by margins associated with the BGSL natural gas storage and processing facilities in the United Kingdom not included in 2001 results. The loss from unconsolidated investments in the second quarter 2002 resulted primarily from the impairment of certain technology equity investments. Additionally, there was a \$36 million decline in earnings from the equity investment in West Coast Power due to a decrease in power prices and an overall decline in demand. Interest expense was higher in the second quarter 2002 due to higher average borrowings, partially offset by lower average interest rates.

Total physical MW hours sold in the second quarter 2002 increased to 118.2 million MW hours as compared to 70.1 million MW hours in the second quarter 2001 due primarily to increased physical MW hours sold in Europe. Total natural gas volumes sold in the second quarter 2002 increased to 13.4 billion cubic feet per day as compared to 11.6 billion cubic feet per day during last year's second quarter due primarily to increases in gas volumes sold in Europe.

Six-month Periods Ended June 30, 2002 and 2001

WEN reported segment net loss of \$127 million for the six-month period ended June 30, 2002, compared with net income of \$158 million in the same 2001 period. In addition to the items described above for the second quarter comparisons, there are unfavorable variances in marketing activities due to a continual decline in price volatility throughout the first quarter 2002 as well as reduced margins associated with power generation as a result of lower market prices.

Total physical MW hours sold in the six-month period ended June 30, 2002 increased to 328.2 million MW hours compared to 122.1 million MW hours in the same period in 2001 due primarily to increased physical MW hours sold in Europe and greater customer origination in the first quarter of 2002. Total natural gas volumes sold in the six months ended June 30, 2002 increased to 14.3 billion cubic feet per day as compared to 11.5 billion cubic feet per day during the same period last year due to the inclusion of incremental ChevronTexaco volumes associated with former Texaco equity production and increases in gas volumes sold in Europe.

Outlook for Remainder of 2002

The weak commodity price environment for natural gas and power has continued into the third quarter 2002. In addition, the above-described reduction in market liquidity has become more pronounced, as has the inability of the customer and risk-management business to hedge its positions. These and other factors, including counterparty concerns relating to Dynegy's non-investment grade credit ratings and Dynegy's ability to rationalize its customer and risk-management business through a joint venture or another strategic alternative, can be expected to negatively impact this segment's results of operations for the third quarter 2002 and beyond.

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2002 | 2001 | 2002 | 2001 |
| (\$ In Millions, Except Operating Statistics) | | | | |
| Operating Income: | | | | |
| Upstream..... | \$ 6 | \$ 21 | \$ 19 | \$ 62 |
| Downstream..... | 5 | 11 | 31 | 27 |
| | ----- | ----- | ----- | ----- |
| Total Operating Income..... | 11 | 32 | 50 | 89 |
| Earnings from Unconsolidated Investments..... | 4 | 5 | 8 | 6 |
| Other Items..... | (12) | (6) | (11) | (11) |
| | ----- | ----- | ----- | ----- |
| Earnings Before Interest and Taxes..... | 3 | 31 | 47 | 84 |
| Interest Expense..... | (14) | (14) | (24) | (28) |
| | ----- | ----- | ----- | ----- |
| Pre-tax Earnings (Loss)..... | (11) | 17 | 23 | 56 |
| Income Tax Provision (Benefit)..... | (3) | 7 | 9 | 19 |
| | ----- | ----- | ----- | ----- |
| Net Income (Loss)..... | \$ (8) | \$ 10 | \$ 14 | \$ 37 |
| | ----- | ----- | ----- | ----- |

Operating Statistics:

| | | | | |
|--|---------|---------|---------|---------|
| Natural Gas Processing Volumes (MBbbls/d): | | | | |
| Field Plants..... | 52.7 | 56.0 | 54.3 | 55.8 |
| Straddle Plants..... | 37.9 | 27.9 | 37.1 | 25.2 |
| | ----- | ----- | ----- | ----- |
| Total Natural Gas Processing Volumes..... | 90.6 | 83.9 | 91.4 | 81.0 |
| | ----- | ----- | ----- | ----- |
| Fractionation Volumes (MBbbls/d)..... | 241.6 | 250.6 | 223.2 | 224.9 |
| Natural Gas Liquids Sold (MBbbls/d)..... | 468.8 | 493.8 | 538.7 | 567.9 |
| Average Commodity Prices: | | | | |
| Natural Gas--Henry Hub (\$/MMBtu)..... | \$ 3.38 | \$ 4.65 | \$ 2.86 | \$ 5.85 |
| Crude Oil--Cushing (\$/Bbl)..... | 25.32 | 27.90 | 22.95 | 28.46 |
| Natural Gas Liquids (\$/Gal)..... | 0.39 | 0.49 | 0.36 | 0.55 |
| Fractionation Spread (\$ /MMBtu)..... | 1.02 | 0.92 | 1.16 | 0.45 |

Three-month Periods Ended June 30, 2002 and 2001

DMS reported net loss of \$8 million in the second quarter 2002 compared with net income of \$10 million in the second quarter 2001. The segment's results of operations were impacted by lower natural gas and NGL prices, the residual volume effect of low rig counts in the second half of 2001 and a temporary shutdown of a major third-party natural gas pipeline in North Texas, which resulted in a decline in volumes processed. In addition, as a result of slow economic recovery, high industry-wide inventory levels, reduced NGL liquidity and Dynegey specific credit limitations, the segment experienced a decline in domestic and foreign marketing volumes and margins.

Aggregate domestic NGL processing volumes totaled 90.6 thousand gross barrels per day in the second quarter 2002 compared to 83.9 thousand gross barrels per day during the same period in 2001. A small percentage of this volume increase resulted from the inclusion of incremental ChevronTexaco volumes associated with former Texaco equity production. The majority of the volume growth is related to the Louisiana straddle plants and is the direct result of an increasing need to process Gulf of Mexico natural gas production to meet third party pipeline dew point specification limits. This pipeline

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specification-driven need for processing has moved fractionation spread risk to the producer by shifting processing contract terms to a fee based arrangement when keep-whole processing is not economical. The fractionation spread represents the value

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relationship between natural gas liquids and its component parts. This trend is expected to continue as the volume of gas produced in the deep-water Gulf of Mexico increases.

The average fractionation spread was \$1.02 for the three months ended June 30, 2002, compared to \$0.92 for the comparable 2001 period. Despite the year-over-year increase in this spread, traditional keep-whole processing is still not economical at this level. Historically, the Louisiana straddle plants would not have operated in this pricing environment.

Gas processing volumes for the field plants were slightly lower for second quarter 2002 as compared to prior period volumes as the result of low drilling rig counts during the latter half of 2001 and second quarter 2002. DMS' business is dependent on producer drilling activity in the producing regions that its gathering systems serve. At current natural gas price levels, producers are actively drilling new wells and DMS' new connect gas volumes for processing are growing enough to more than offset natural decline in production. The producers supplying DMS' facilities are primarily independent producers who, as a group, react quickly to changes in gas prices. As natural gas prices decline significantly from current levels, these producers have historically reduced their drilling investment. If this occurs going forward, DMS could experience difficulty in acquiring enough volumes to offset natural declines. Conversely, as gas prices strengthen from current levels, producers have historically invested more heavily in drilling and development.

Six-month Periods Ended June 30, 2002 and 2001

DMS reported net income of \$14 million in the six months ended June 30, 2002 compared with net income of \$37 million in the six months ended June 30, 2001. In addition to the items described above for the second quarter comparisons, warmer winter temperatures influenced results of operations period-to-period.

Aggregate domestic NGL processing volumes totaled 91.4 thousand gross barrels per day in the six months ended June 30, 2002 compared to 81.0 thousand gross barrels per day during the same period in 2001. A small percentage of this volume resulted from the inclusion of incremental ChevronTexaco volumes associated with former Texaco equity production. The majority of the volume growth related to the Company's Louisiana straddle plants and is the direct result of an increasing need to process Gulf of Mexico natural gas production to meet third party pipeline dew point specification limits. This pipeline specification-driven need for processing has moved fractionation spread risk to the producer by shifting processing contract terms to a fee based arrangement when keep-whole processing is not economical. This trend is expected to continue as the volume of gas produced in the deep-water Gulf of Mexico increases.

The average fractionation spread was \$1.16 for the six months ended June 30, 2002, compared to \$0.45 for the comparable 2001 period. Despite the year-over-year increase in this spread, traditional keep-whole processing is still not economical at this level. Historically, the Louisiana straddle plants would not have operated in this pricing environment.

Outlook for Remainder of 2002

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The weak fractionation spread environment has continued into the third quarter 2002. The correlation of prices for propane relative to prices for oil is lower than historical levels, yielding lower than expected revenues for DMS in the current pricing environment. As described above, drilling activity, which is substantially dependent upon the commodity pricing environment, significantly impacts DMS' results of operations.

In addition, counterparty credit concerns and the resulting industry-wide contraction in trade credit have limited DMS' ability to purchase incremental volumes of natural gas liquids at historical levels. DMS cannot predict with any degree of certainty the effect that this contraction in credit will have on its results of operations in the future.

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TRANSMISSION AND DISTRIBUTION

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2002 | 2001 | 2002 | 2001 |
| | (\$ In Millions) | | | |
| Operating Income: | | | | |
| Northern Natural..... | \$ 10 | \$ -- | \$ 66 | \$ -- |
| Illinois Power..... | 56 | 40 | 96 | 116 |
| | 66 | 40 | 162 | 116 |
| Losses from Unconsolidated Investments.. | (2) | -- | (2) | -- |
| Other Items..... | (3) | -- | 1 | (1) |
| | 61 | 40 | 161 | 115 |
| Earnings Before Interest and Taxes... | 61 | 40 | 161 | 115 |
| Interest Expense..... | (42) | (31) | (80) | (60) |
| | 19 | 9 | 81 | 55 |
| Pre-tax Earnings..... | 19 | 9 | 81 | 55 |
| Income Tax Provision..... | 9 | 6 | 36 | 27 |
| | \$ 10 | \$ 3 | \$ 45 | \$ 28 |
| Net Income(1)..... | \$ 10 | \$ 3 | \$ 45 | \$ 28 |
| ILLINOIS POWER: | | | | |
| Electric Sales in kWh (Millions) | | | | |
| Residential..... | 1,206 | 1,097 | 2,510 | 2,479 |
| Commercial..... | 1,081 | 1,060 | 2,103 | 2,114 |
| Commercial distribution..... | -- | 11 | 1 | 34 |
| Industrial..... | 1,676 | 1,674 | 3,052 | 3,109 |
| Industrial distribution..... | 593 | 674 | 1,300 | 1,260 |
| Other..... | 92 | 90 | 185 | 190 |
| | 4,648 | 4,606 | 9,151 | 9,186 |
| Total Electric Sales..... | 4,648 | 4,606 | 9,151 | 9,186 |
| Gas Sales in Therms (Millions) | | | | |
| Residential..... | 43 | 32 | 196 | 205 |
| Commercial..... | 17 | 13 | 79 | 87 |
| Industrial..... | 19 | 19 | 37 | 45 |
| Transportation of Customer-Owned Gas. | 61 | 64 | 133 | 136 |

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| | | | | |
|--------------------------|-------|-------|-------|-------|
| Total Gas Delivered..... | 140 | 128 | 445 | 473 |
| | ----- | ----- | ----- | ----- |
| Heating Degree Days..... | 498 | 293 | 2,995 | 3,057 |
| NORTHERN NATURAL: | | | | |
| Heating Degree Days..... | 976 | N/A | 4,465 | N/A |
| Throughput (Bcf/d)..... | 3.2 | N/A | 12.8 | N/A |

 (1) Northern Natural was acquired effective February 1, 2002 and had a net loss of \$4 million and net income of \$23 million for the three and six months ended June 30, 2002.

Three-month Periods Ended June 30, 2002 and 2001

The T&D segment reported net income of \$10 million in the second quarter 2002 compared to \$3 million in the second quarter 2001. The operating results of Northern Natural are not included in prior year results. Northern Natural's net loss was \$4 million in the second quarter 2002. Illinois Power experienced favorable results from operations period-to-period that were influenced by increased electricity usage from commercial and residential customers due to favorable weather conditions, a reduction in operating expenses due to savings realized from a 2001 restructuring, the resolution of a contingent liability for a billing dispute with a large wholesale electric customer and a favorable litigation settlement related to a vendor dispute. These results were

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partially offset by a mandated five percent residential rate reduction effective May 1, 2002, the election of some commercial and industrial customers to pay for power at market-based prices, rather than under bundled tariffs, and a decrease in industrial customer demand due to a weakened economy in Illinois Power's principal market areas.

Six Month Periods Ended June 30, 2002 and 2001

The T&D segment reported net income of \$45 million in the six months ended June 30, 2002 compared to \$28 million in the same 2001 period. Net income for the six months ended June 30, 2002 includes a \$13 million after-tax (\$18 million pre-tax) charge associated with a gas delivery commitment that was assumed with the acquisition of Northern Natural. The T&D segment reflects five months of operating results from Northern Natural, which explains the increase in operating results. Northern Natural was acquired February 1, 2002 and, therefore, was not included in prior year results. Northern Natural's net income was \$23 million in the six months ended June 30, 2002. With respect to Illinois Power, in addition to the items described above for the second quarter comparisons, the results were influenced by decreased demand from commercial and residential customers due to unfavorable weather conditions experienced during the first quarter 2002 and a credit related to Illinois Power's exit from a nuclear mutual insurance company which occurred in 2001.

Outlook for Remainder of 2002

The T&D Segment's results of operations for the third quarter 2002 and beyond will exclude the operating results of Northern Natural upon consummation of the sale of Northern Natural as described in Note 6 to the accompanying financial statements. Future results of operations for IP may be affected, either positively or negatively, by general economic and capital market conditions, including overall economic growth, the demand for power and natural gas in IP's service area and interest rates. In addition, changes in Dynegy's financial condition may impact IP's capitalization as well as its ability to

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access the capital markets.

DYNEGY GLOBAL COMMUNICATIONS

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|------------------------------------|---------|------------------------------|---------|
| | 2002 | 2001 | 2002 | 2001 |
| | ----- (\$ In Millions) ----- | | | |
| Operating Loss..... | \$ (657) | \$ (49) | \$ (717) | \$ (69) |
| Earnings (Losses) from Unconsolidated Investments.. | (3) | 14 | (48) | 14 |
| Other Items..... | -- | 4 | 5 | 10 |
| | ----- | ----- | ----- | ----- |
| Loss Before Interest and Taxes..... | (660) | (31) | (760) | (45) |
| Interest Expense..... | (3) | (1) | (11) | (3) |
| | ----- | ----- | ----- | ----- |
| Pre-tax Loss..... | (663) | (32) | (771) | (48) |
| Income Tax Benefit..... | (238) | (12) | (265) | (19) |
| | ----- | ----- | ----- | ----- |
| Net Loss from Operations..... | (425) | (20) | (506) | (29) |
| Cumulative Effect of Change in Accounting Principle | -- | -- | (234) | -- |
| | ----- | ----- | ----- | ----- |
| Net Loss..... | \$ (425) | \$ (20) | \$ (740) | \$ (29) |
| | ----- | ----- | ----- | ----- |

Three-month Periods Ended June 30, 2002 and 2001

During the quarter, the communications sector continued to deteriorate at a rapid pace, as evidenced by an increased number of bankruptcies of both providers of long-distance high volume communications channels (long-haul) and providers of communication channels spanning a metropolitan area (metro loop), continued

devaluation of equity securities and lack of financing sources in the sector, and further pricing pressures resulting from challenges faced by major industry players. As a result of the significant deterioration in the sector, negative outlook on the industry and Dynegy's focus on significantly improving its liquidity (see Liquidity and Capital Resources section), management is aggressively taking measures to reduce cash losses in the business by eliminating capital spending and reducing operating and administrative expenses. Management also continues to pursue partnership and joint venture opportunities which are consistent with the Company's strategy of reducing its operating losses in this business.

Statement No. 144 requires long-lived assets to be tested for impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable from future cash flows of the long-lived asset group or it becomes more likely than not that a long-lived asset group will be sold or otherwise disposed of before the end of its previously estimated useful life. Dynegy's impairment analysis at June 30, 2002, under Statement No. 144, indicates future cash flows from DGC's operations are insufficient to cover the carrying value of segment long-lived assets. As a result, a pre-tax impairment charge totaling \$611 million (\$397 million after-tax) and \$621 million (\$404

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million after-tax) was recorded in Impairment and Other Charges in the Condensed Consolidated Statement of Operations for the three and six months ended June 30, 2002, respectively.

DGC's results reflect a \$425 million quarterly loss in the three-month period ended June 30, 2002 resulting from continued operating losses caused by the fact that the costs associated with operating a network in service have exceeded revenues. This compares to a \$20 million quarterly loss in the three-month period ended June 30, 2001. The increased loss was primarily caused by the impairment charges discussed above, as well as a decrease in Earnings from Unconsolidated Investments. At June 30, 2002, the valuations of certain technology investments were assessed in light of the Company's decision to pursue a managed exit strategy from the communications business. These investments were originally entered into in order to leverage existing commercial relationships or as a means of expanding new relationships. Historically, the Company viewed these investments as strategic and core to its telecommunications strategy. As a result, management's expectation was that Dynegy would hold these investments for the long-term and that trends in the sector were cyclical. The Company viewed the downturn in valuation as temporary.

Management is aggressively pursuing alternatives for exiting this business segment, although no formal plans are in place and no assurance can be provided as to the timing or structure of any such transaction. Continued losses through 2002 will negatively impact the Company's cash flows and earnings. As of June 30, 2002, Dynegy had approximately \$244 million, or approximately \$152 million on a discounted basis, in long-term operating commitments relating to its telecommunications business.

Six-month Periods Ended June 30, 2002 and 2001

DGC's results reflect a \$740 million quarterly loss in the six-month period ended June 30, 2002 resulting from continued operating losses caused by the fact that the costs associated with operating a network in service have exceeded revenues and vendor equipment problems which delayed anticipated revenues. This compares to a \$29 million loss in the six-month period ended June 30, 2001. The 2002 net loss includes the cumulative effect of change in accounting principle (see Note 4 to the accompanying condensed consolidated financial statements) and impairment of communications assets, principally underutilized equipment and certain investments. The increased loss includes the difference in equity earnings described above related to the 2001 second quarter and additional net operating losses in 2002.

Cash Flow Disclosures

The following table is a condensed version of the operating section of the Condensed Consolidated Statements of Cash Flows (in millions):

| | For The Six Months Ended June 30, 2002 | | | | | |
|--|--|-------|-------|----------|--------------------------------|--------------|
| | WEN | DMS | T&D | DGC | Corporate & Eliminations | Consolidated |
| Net Income (Loss)..... | \$ (127) | \$ 14 | \$ 45 | \$ (740) | \$ -- | \$ (808) |
| Net Non-Cash Items Included in Net Income (Loss) | 490 | 41 | 149 | 664 | (17) | 1,327 |

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| | | | | | | |
|---|--------|-------|-------|---------|------|--------|
| Operating Cash Flows Before Changes in Working Capital..... | 363 | 55 | 194 | (76) | (17) | 519 |
| Changes in Working Capital..... | (231) | 6 | 18 | (10) | 26 | (191) |
| Net Cash Provided by (Used in) Operating Activities..... | \$ 132 | \$ 61 | \$212 | \$ (86) | \$ 9 | \$ 328 |

For The Six Months Ended June 30, 2001

| | WEN | DMS | T&D | DGC | Corporate & Eliminations | Consolidated |
|---|--------|-------|-------|---------|--------------------------|--------------|
| Net Income (Loss)..... | \$ 158 | \$ 37 | \$ 28 | \$ (29) | \$ -- | \$ 194 |
| Net Non-Cash Items Included in Net Income (Loss) | 118 | 59 | 111 | (8) | 16 | 296 |
| Operating Cash Flows Before Changes in Working Capital..... | 276 | 96 | 139 | (37) | 16 | 490 |
| Changes in Working Capital..... | (129) | 53 | (72) | 48 | (14) | (114) |
| Net Cash Provided by (Used in) Operating Activities..... | \$ 147 | \$149 | \$ 67 | \$ 11 | \$ 2 | \$ 376 |

Operating Cash Flow. Cash flow from operating activities totaled \$328 million for the six-month period ended June 30, 2002 compared to \$376 million reported in the same 2001 period. Non-cash add-backs were greater in the 2002 period, primarily due to the following charges, which are further described in Note 4 to the accompanying financial statements:

- The \$234 million impairment of goodwill for DGC related to the adoption of Statement No. 142 as previously disclosed in the first quarter 2002 and \$611 million of additional pre-tax impairment charges for DGC during the second quarter 2002;
- Pre-tax write-offs within Earnings (Losses) from Unconsolidated Investments of \$68 million representing technology investment impairments based on the Company's change in business strategy and continued downturn in the technology sector. Of the total write-offs, \$17 million related to WEN and \$47 million related to DGC, with the remaining amounts allocated to DMS and T&D.

Other changes in non-cash items include the following:

- Depreciation and amortization expense increased by \$59 million primarily due to the addition of Northern Natural in January 2002 and the United Kingdom natural gas storage facilities in November 2001;
- A reduction in Earnings (Losses) from Unconsolidated Investments of approximately \$30 million related to West Coast Power;
- Deferred income taxes are a \$338 million benefit position for the six months ended June 30, 2002, compared to an expense of \$75 million in the same 2001 period, producing a \$413 million decreased add-back; and

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- . Risk Management activity produced a \$399 million add-back, compared to an add-back of \$58 million in the 2001 period. The add-backs represent cash realized for settled contracts in excess of gains recognized.

Changes in working capital had a negative impact on cash flow from operations for the six-month period ended June 30, 2002 primarily due to the following:

- . The timing on which the Company recorded customer accounts receivable and vendor accounts payable, primarily for WEN's natural gas and power accruals as well as IP's power receivables for seasonal trends beginning in the summer months;
- . Parts, supplies and natural gas inventory builds for the power generation business in anticipation of plants becoming commercial and increased summer generation demand;
- . Fuel oil and coal inventory builds to replenish supply for the Northeast generation plants in anticipation of seasonal summer generation demand;
- . Amortization of liabilities associated with previous acquisitions; and
- . Increased natural gas futures positions or contracts at June 30, 2002 versus December 31, 2001, representing cash remitted to brokers held on account for the WEN segment.

Capital Expenditures and Investing Activities. Cash used for investing activities during the six-month period ended June 30, 2002 totaled \$653 million. Capital spending and investments in unconsolidated investments totaled \$643 million and relate primarily to generation asset additions and improvements, environmental compliance and first quarter investments in technology infrastructure. Cash spent for the acquisition of Northern Natural totaled \$20 million, net of cash acquired. These cash outflows were offset by \$10 million in proceeds from asset sales.

Financing Activities. Cash provided by financing activities during the six-month period ended June 30, 2002 totaled \$519 million. The Company received \$205 million in cash proceeds relative to ChevronTexaco's preemptive right purchase of approximately 10.4 million shares of Class B common stock in January 2002. Additional capital stock proceeds include \$21 million in cash from members of senior management associated with the December 2001 private equity placement. Dividends declared and paid to holders of Class A and Class B common stock totaled \$40 million and \$15 million, respectively, for the six-month period ended June 30, 2002.

In March 2002, Illinova Corporation, a wholly owned subsidiary of Dynegy and the parent company of IP, paid \$28 million in cash for shares of IP's preferred stock through the consummation of a tender offer.

Long-term debt proceeds, net of issuance costs, for the six-months ended June 30, 2002 consisted of \$496 million from the issuance of 8.75 percent senior notes due February 2012, \$42 million from the construction of generation facilities and the U.S. fiber optic network and \$36 million related to borrowings entered into by ABG Gas Supply. Repayments of long-term debt totaled \$216 million for the six-months ended June 30, 2002 and consisted of \$44 million in payments of IP Transitional Funding Notes, \$90 million relating to the April 2002 purchase of Northern Natural's senior unsecured notes due 2005, \$54 million in June 2002 principal payments related to the restructuring of Black Thunder from Minority Interest to Long-Term Debt and \$28 million in repayments by ABG Gas Supply. Net proceeds from short-term financing consisted of \$245 million cash advance for the anticipated sale of certain United Kingdom gas storage assets. Additionally, during the six months ended June 30, 2002,

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Dynegy repaid \$293 million in commercial paper and borrowings under revolving credit lines for DHI and IP in the aggregate and borrowed \$60 million under IP's term loan.

Finally, other financing cash payments totaled \$17 million for the six-months ended June 30, 2002. These payments primarily consisted of \$13 million in interest associated with the Black Thunder transaction prior to the June 2002 restructuring.

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UNCERTAINTY OF FORWARD-LOOKING STATEMENTS AND INFORMATION

This Quarterly Report on Form 10-Q includes statements reflecting assumptions, expectations, projections, intentions or beliefs about future events that are intended as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. You can identify these statements by the fact that they do not relate strictly to historical or current facts. They use words such as "anticipate," "estimate," "project," "forecast," "may," "will," "should," "expect" and other words of similar meaning. In particular, these include, but are not limited to, statements relating to the following:

- . Projected operating or financial results, including the application of forecasted pricing curves to contractual commitments that may result in realized cash returns on these commitments which may vary significantly, either positively or negatively, from estimated values;
- . Expectations regarding capital expenditures, dividends and other payments;
- . The pending sale of Northern Natural, including the anticipated closing date and the financial impact of the sale on Dynegy's balance sheet and liquidity position;
- . Expectations regarding transaction volume and liquidity in wholesale energy markets in North America and Europe;
- . The Company's beliefs and assumptions relating to trade credit in the wholesale energy market and its liquidity position, including its ability to meet its obligations;
- . The Company's ability to execute additional capital-raising transactions such as asset sales, joint ventures or financings to enhance its liquidity position;
- . Beliefs or assumptions about the outlook for deregulation of retail and wholesale energy markets in North America and Europe and anticipated business developments in such markets;
- . The Company's ability to effectively compete for market share with industry participants;
- . Beliefs about the outcome of legal and administrative proceedings, including matters involving Enron, the California power market, shareholder class action lawsuits and environmental matters as well as the investigations primarily relating to Project Alpha, roundtrip trades and Black Thunder;
- . The Company's ability to rationalize its customer and risk-management business, either through the formation of a joint venture or the execution of an alternative strategy;

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- . The expected commencement date for commercial operations for new power plants; and
- . The Company's strategic plans relating to the DGC segment, including the Company's ability to eliminate or further reduce net cash outflows associated with this segment.

Any or all of Dynegy's forward-looking statements may turn out to be wrong. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties, including the following:

- . The timing and consummation of the Northern Natural sale;
- . The timing and extent of deregulation of energy markets in North America and Europe and the rules and regulations adopted on a transitional basis in such markets;
- . The condition of the capital markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions, and Dynegy's financial condition, including its ability to improve its credit ratings;

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- . Developments in the California power markets, including, but not limited to, governmental intervention, deterioration in the financial condition of our counterparties, default on receivables due and adverse results in current or future litigation;
- . The effectiveness of Dynegy's risk-management policies and procedures and the ability of Dynegy's counterparties to satisfy their financial commitments;
- . The liquidity and competitiveness of wholesale trading markets for energy commodities, including the impact of electronic or online trading in these markets;
- . The direct or indirect effects on Dynegy's business resulting from the financial difficulties of Enron, or other competitors of Dynegy, including, but not limited to, their effects on liquidity in the trading and power industry, and its effects on the capital markets views of the energy or trading industry and our ability to access the capital markets;
- . Operational factors affecting the start up or ongoing commercial operations of Dynegy's power generation or midstream natural gas facilities, including catastrophic weather related damage, unscheduled outages or repairs, unanticipated changes in fuel costs or availability of fuel emission credits, the unavailability of gas transportation, the unavailability of electric transmission service or workforce issues;
- . The cost of borrowing, availability of trade credit and other factor's affecting Dynegy's financing activities, including the effect of issues described in this Form 10-Q;
- . Dynegy's ability to successfully execute its \$2 billion capital plan and to otherwise satisfy its obligations as they become due;
- . The direct or indirect effects on Dynegy's business of downgrades in credit ratings (or actions we may take in response to changing credit

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ratings criteria), including increased collateral requirements to execute our business plan, demands for increased collateral by our counterparties, refusal by our counterparties to enter into transactions with us and our inability to obtain credit or capital in amounts or on terms favorable to us;

- . Cost and other effects of legal and administrative proceedings, settlements, investigations and claims, including legal proceedings related to the terminated merger with Enron, the California power market, shareholder claims and environmental liabilities that may not be covered by indemnity or insurance, as well as the SEC, and FERC, CFTC and other similar investigations primarily surrounding Project Alpha and roundtrip trades;
- . Other North American or European regulatory or legislative developments that affect the demand for energy generally, increase the environmental compliance cost for Dynegy's power generation or midstream gas facilities or impose liabilities on the owners of such facilities; and
- . General political conditions, including any extended period of war or conflict involving North America or Europe.

Many of these factors will be important in determining Dynegy's actual future results. Consequently, no forward-looking statement can be guaranteed. Dynegy's actual future results may vary materially from those expressed or implied in any forward-looking statements.

All of Dynegy's forward-looking statements, whether written or oral, are expressly qualified by these cautionary statements and any other cautionary statements that may accompany such forward-looking statements. In addition, Dynegy disclaims any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Quantitative and Qualitative Disclosures About Market Risk are set forth in "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" herein.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

See Note 12 to the accompanying financial statements for discussion of material recent developments in the Company's material legal proceedings.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The 2002 annual meeting of the shareholders of the Company was held on May 17, 2002. The purpose of the annual meeting was to consider and vote upon the following proposals:

1. to elect eleven Class A common stock directors and three Class B common stock directors to serve until the 2003 annual meeting of shareholders;
2. to consider and act upon a proposal to approve the Dynegy Inc. 2002 Long Term Incentive Plan; and

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3. to ratify the selection of PricewaterhouseCoopers LLP as independent auditors of the Company for the fiscal year ended December 31, 2002.

The Company's Board of Directors is comprised of fourteen members. At the annual meeting, each of the following individuals was re-elected to serve as a director of the Company: C.L. Watson; Stephen W. Bergstrom; Charles E. Bayless; Michael D. Capellas; Daniel L. Dienstbier; Patricia M. Eckert; Jerry L. Johnson; H. John Riley, Jr.; Sheli Z. Rosenberg; Joe J. Stewart; J. Otis Winters; Darald W. Callahan; Glenn F. Tilton; and John S. Watson. The votes cast for each nominee and the votes withheld were as follows:

CLASS A DIRECTORS

| | For | Withheld |
|--------------------------|-------------|-----------|
| | ----- | ----- |
| 1. C.L. Watson..... | 227,129,756 | 6,767,969 |
| 2. Stephen W. Bergstrom | 227,938,470 | 5,406,783 |
| 3. Charles E. Bayless.. | 226,979,906 | 6,398,851 |
| 4. Michael D. Capellas. | 227,933,542 | 5,418,793 |
| 5. Daniel L. Dienstbier | 227,941,706 | 5,388,900 |
| 6. Patricia M. Eckert.. | 227,923,503 | 5,428,083 |
| 7. Jerry L. Johnson.... | 226,567,550 | 6,643,704 |
| 8. H. John Riley, Jr... | 226,623,666 | 6,702,674 |
| 9. Sheli Z. Rosenberg.. | 227,899,769 | 5,446,158 |
| 10. Joe J. Stewart..... | 226,613,075 | 6,709,880 |
| 11. J. Otis Winters..... | 226,597,406 | 6,728,997 |

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CLASS B DIRECTORS

| | For | Withheld |
|-----------------------|------------|----------|
| | ----- | ----- |
| 1. Darald W. Callahan | 96,891,014 | 0 |
| 2. Glenn F. Tilton... | 96,891,014 | 0 |
| 3. John S. Watson.... | 96,891,014 | 0 |

The following votes were cast with respect to the proposal to approve the Dynegy Inc. 2002 Long Term Incentive Plan. There were no broker non-votes.

| | |
|---------|-------------|
| FOR | 298,932,107 |
| AGAINST | 29,112,925 |
| ABSTAIN | 2,063,927 |

The following votes were cast with respect to the ratification of the selection of PricewaterhouseCoopers LLP as independent auditors of the Company for the fiscal year ended December 31, 2002. There were no broker non-votes.

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FOR 321,459,217

AGAINST 7,216,161

ABSTAIN 1,433,581

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following instruments and documents are included as exhibits to this Form 10-Q/A:

- 10.1 Purchase and Sale Agreement dated July 28, 2002 among Dynegy Inc., NNGC Holding Company, I and MidAmerican Energy Holdings Company (incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K dated July 29, 2002).
- 10.2* Agreement dated as of July 31, 2002 among Chevron U.S.A. Inc., Dynegy Marketing and Trade, Dynegy Holdings Inc., Dynegy Inc. and the other parties thereto.
- 10.3* Contract for Services between Daniel L. Dienstbier and Dynegy Inc. effective as of May 28,
- 99.1+ Certification pursuant to Section 18 United States Code Section 1350, as adopted pursuant 906 of the Sarbanes-Oxley Act of 2002.
- 99.2+ Certification pursuant to Section 18 United States Code Section 1350, as adopted pursuant 906 of the Sarbanes-Oxley Act of 2002.

- * Previously filed.
- + Pursuant to Securities and Exchange Commission Release No. 33-8212, this certification will be treated as "accompanying" this Amendment No. 1 and not "filed" as part of such report for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or the Exchange Act, or otherwise subject to the liability of Section 18 of the Exchange Act and this certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act.

(b) Reports on Form 8-K of Dynegy Inc. for the second quarter 2002.

1. During the quarter ended June 30, 2002, the Company filed a Current Report on Form 8-K dated April 25, 2002. Items 5, 7 and 9 were reported and no financial statements were filed.

2. During the quarter ended June 30, 2002, the Company filed a Current Report on Form 8-K dated April 29, 2002. Items 5 and 7 were reported and no financial statements were filed.

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3. During the quarter ended June 30, 2002, the Company filed a Current Report on Form 8-K dated May 8, 2002. Items 5 and 7 were reported and no financial statements were filed.

4. During the quarter ended June 30, 2002, the Company filed a Current Report on Form 8-K dated May 28, 2002. Items 5 and 7 were reported and no financial statements were filed.

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5. During the quarter ended June 30, 2002, the Company filed a Current Report on Form 8-K dated June 19, 2002. Items 5 and 7 were reported and no financial statements were filed.

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DYNEGY INC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DYNEGY INC.

Date: May 14, 2003

By: /s/ NICK J. CARUSO

Nick J. Caruso
Executive Vice President and Chief Financial Officer

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SECTION 302 CERTIFICATION

I, Bruce A. Williamson , certify that:

1. I have reviewed this Amendment No. 1 to the Quarterly Report on Form 10-Q/A of Dynegy Inc. (the "Amendment No. 1");

2. Based on my knowledge, this Amendment No. 1 does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Amendment No. 1; and

3. Based on my knowledge, the financial statements, and other financial information included in this Amendment No. 1, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Amendment No. 1.

Date: May 14, 2003

By: /s/ BRUCE

Bruce A.
Chief Execu

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SECTION 302 CERTIFICATION

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I, Nick J. Caruso, certify that:

1. I have reviewed this Amendment No. 1 to the Quarterly Report on Form 10-Q/A of Dynegey Inc. (the "Amendment No. 1");

2. Based on my knowledge, this Amendment No. 1 does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Amendment No. 1; and

3. Based on my knowledge, the financial statements, and other financial information included in this Amendment No. 1, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Amendment No. 1.

Date: May 14, 2003

By: _____ /s/ NICK

Nick J
Chief Finan