

DYNEGY INC.
Form 10-Q
November 09, 2007

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

FORM 10-Q

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

For the quarterly period ended September 30, 2007

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

For the transition period from _____ to _____

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

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

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

**77002
(Zip Code)**

(713) 507-6400

(Registrant's telephone number, including area code)

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

Dynegy Inc. Yes No
Dynegy Holdings Inc. Yes No

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

| | Large accelerated filer | Accelerated filer | Non-accelerated filer |
|-----------------------------|-------------------------------------|--------------------------|-------------------------------------|
| Dynegy Inc. | <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| Dynegy Holdings Inc. | <input type="checkbox"/> | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

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

Dynegy Inc. Yes No
Dynegy Holdings Inc. Yes No

Indicate the number of shares outstanding of Dynegy Inc.'s classes of common stock, as of the latest practicable date: Class A common stock, \$0.01 par value per share, 500,281,206 shares outstanding as of November 1, 2007; Class B

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common stock, \$0.01 par value per share, 340,000,000 shares outstanding as of November 1, 2007. All of Dynegy Holdings Inc. s outstanding common stock is owned indirectly by Dynegy Inc. This combined Form 10-Q is separately filed by Dynegy Inc. and Dynegy Holdings Inc. Information contained herein relating to any individual registrant is filed by such registrant on its own behalf. Each registrant makes no representation as to information relating to a registrant other than itself.

**DYNEGY INC. and DYNEGY HOLDINGS INC.
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EXPLANATORY NOTE

This report includes the combined filing of Dynegy Inc. (Dynegy) and Dynegy Holdings Inc. (DHI). DHI is the principal subsidiary of Dynegy, providing approximately 100% of Dynegy s total consolidated revenue for the nine-month period ended September 30, 2007 and constituting approximately 100% of Dynegy s total consolidated asset base as of September 30, 2007 except for Dynegy s 50% interest in DLS Power Holdings, LLC and DLS Power Development Company, LLC. Unless the context indicates otherwise, throughout this report, the terms the Company , we , us , our and ours are used to refer to both Dynegy and DHI and their direct and indirect subsidiaries, including Dynegy Illinois Inc. (Dynegy Illinois) before it became a wholly owned subsidiary of Dynegy by way of the merger of Merger Sub Co., then Dynegy s wholly owned subsidiary, with and into Dynegy Illinois. Discussions or areas of this report that apply only to Dynegy or DHI will clearly be noted in such section.

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DEFINITIONS

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

| | |
|-----------------|--|
| APB | Accounting Principles Board |
| ARO | Asset retirement obligation |
| Cal ISO | The California Independent System Operator |
| CARB | California Air Resources Board |
| CDWR | California Department of Water Resources |
| CEC | California Energy Commission |
| CFTC | Commodity Futures Trading Commission |
| CO ₂ | Carbon Dioxide |
| CPUC | California Public Utilities Commission |
| CRA | Canada Revenue Agency |
| CRM | Our customer risk management business segment |
| CUSA | Chevron U.S.A. Inc., a wholly owned subsidiary of Chevron Corporation |
| DGC | Dynegy Global Communications |
| DHI | Dynegy Holdings Inc., Dynegy's primary financing subsidiary |
| DMG | Dynegy Midwest Generation, Inc. |
| DMSLP | Dynegy Midstream Services L.P. |
| DMT | Dynegy Marketing and Trade |
| DNE | Dynegy Northeast Generation |
| DPM | Dynegy Power Marketing Inc. |
| EBITDA | Earnings Before Interest, Taxes, Depreciation and Amortization |
| EITF | Emerging Issues Task Force |
| EMA | Energy management agreement |
| EPA | Environmental Protection Agency |
| ERCOT | Electric Reliability Council of Texas, Inc. |
| ERISA | The Employee Retirement Income Security Act of 1974, as amended |
| FASB | Financial Accounting Standards Board |
| FERC | Federal Energy Regulatory Commission |
| FIN | FASB Interpretation |
| FSP | FASB Staff Position |
| GAAP | Generally Accepted Accounting Principles of the United States of America |
| GEN | Our power generation business |
| GEN-MW | Our power generation business Midwest segment |
| GEN-NE | Our power generation business Northeast segment |
| GEN-SO | Our power generation business South segment, which was renamed GEN-WE |
| GEN-WE | Our power generation business West segment |
| ICC | Illinois Commerce Commission |
| IMA | In-market asset availability |
| IP | Illinois Power |
| IRS | Internal Revenue Service |
| ISO | Independent System Operator |
| LNG | Liquefied natural gas |
| LTSA | Long term service agreement |
| MISO | Midwest Independent Transmission Operator, Inc. |
| MMBtu | Millions of British thermal units |
| MW | Megawatts |
| MWh | Megawatt hour |

| | |
|-----------------|---|
| NGL | Our former natural gas liquids business segment |
| NNG | Northern Natural Gas Company |
| NOL | Net operating loss |
| NO _x | Nitrogen Oxide |
| NPDES | National Pollutant Discharge Elimination System |
| NRG | NRG Energy, Inc. |
| NYSDEC | New York State Department of Environmental Conservation |
| PRB | Powder River Basin coal |
| PUHCA | Public Utility Holding Company Act of 1935, as amended |
| RGGI | Regional Greenhouse Gas Initiative |
| SAB | SEC Staff Accounting Bulletin |
| SEC | U.S. Securities and Exchange Commission |
| SFAS | Statement of Financial Accounting Standards |
| SPN | Second Priority Senior Secured Notes |
| SPDES | State Pollutant Discharge Elimination System |
| VaR | Value at Risk |
| VIE | Variable Interest Entity |

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PART I. FINANCIAL INFORMATION
Item 1 FINANCIAL STATEMENTS DYNEGY INC. AND DYNEGY HOLDINGS INC.
DYNEGY INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited) (in millions, except share data)

| ASSETS | September 30, 2007 | December 31, 2006 |
|--|-----------------------------------|------------------------------|
| Current Assets | | |
| Cash and cash equivalents | \$ 638 | \$ 371 |
| Restricted cash | 140 | 280 |
| Accounts receivable, net of allowance for doubtful accounts of \$21 and \$48, respectively | 386 | 257 |
| Accounts receivable, affiliates | | 1 |
| Inventory | 197 | 194 |
| Assets from risk-management activities | 509 | 701 |
| Deferred income taxes | 22 | 93 |
| Prepayments and other current assets | 160 | 92 |
| Assets held for sale (Note 3) | 58 | |
| Total Current Assets | 2,110 | 1,989 |
| Property, Plant and Equipment | 10,579 | 6,473 |
| Accumulated depreciation | (1,604) | (1,522) |
| Property, Plant and Equipment, Net | 8,975 | 4,951 |
| Other Assets | | |
| Unconsolidated investments | 96 | |
| Restricted cash and investments | 912 | 83 |
| Assets from risk-management activities | 230 | 16 |
| Goodwill | 532 | |
| Intangible assets | 321 | 347 |
| Deferred income taxes | 6 | 12 |
| Other long-term assets | 222 | 139 |
| Total Assets | \$ 13,404 | \$ 7,537 |

LIABILITIES AND STOCKHOLDERS EQUITY

Current Liabilities

| | | |
|---|--------|--------|
| Accounts payable | \$ 307 | \$ 172 |
| Accrued interest | 130 | 66 |
| Accrued liabilities and other current liabilities | 252 | 231 |
| Liabilities from risk-management activities | 502 | 629 |
| Notes payable and current portion of long-term debt | 53 | 68 |
| Liabilities held for sale (Note 3) | 2 | |

| | | |
|--|-----------|----------|
| Total Current Liabilities | 1,246 | 1,166 |
| Long-term debt | 5,691 | 2,990 |
| Long-term debt, affiliates | 200 | 200 |
| Long-Term Debt | 5,891 | 3,190 |
| Other Liabilities | | |
| Liabilities from risk-management activities | 220 | 35 |
| Deferred income taxes | 1,087 | 469 |
| Other long-term liabilities | 421 | 410 |
| Total Liabilities | 8,865 | 5,270 |
| Minority Interest | (14) | |
| Commitments and Contingencies (Note 11) | | |
| Stockholders Equity | | |
| Class A Common Stock, \$0.01 par value, 2,100,000,000 shares authorized at September 30, 2007; 502,672,821 shares issued and outstanding at September 30, 2007; and no par value, 900,000,000 shares authorized at December 31, 2006; 403,137,339 shares issued and outstanding at December 31, 2006 | 5 | 3,367 |
| Class B Common Stock, \$0.01 par value, 850,000,000 shares authorized at September 30, 2007; 340,000,000 shares issued and outstanding at September 30, 2007; and no par value, 360,000,000 shares authorized at December 31, 2006; 96,891,014 shares issued and outstanding at December 31, 2006 | 3 | 1,006 |
| Additional paid-in capital | 6,457 | 39 |
| Subscriptions receivable | (7) | (8) |
| Accumulated other comprehensive income (loss), net of tax | (16) | 67 |
| Accumulated deficit | (1,818) | (2,135) |
| Treasury stock, at cost, 2,448,380 shares at September 30, 2007 and 1,787,004 shares at December 31, 2006, respectively | (71) | (69) |
| Total Stockholders Equity | 4,553 | 2,267 |
| Total Liabilities and Stockholders Equity | \$ 13,404 | \$ 7,537 |

See the notes to condensed consolidated financial statements.

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

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ 1,046 | \$ 508 | \$ 2,379 | \$ 1,427 |
| Cost of sales, exclusive of depreciation shown separately below | (649) | (319) | (1,478) | (907) |
| Depreciation and amortization expense | (92) | (54) | (232) | (164) |
| Impairment and other charges | | (96) | | (107) |
| Gain on sale of assets, net | 4 | | 4 | 3 |
| General and administrative expenses | (62) | (59) | (163) | (160) |
| Operating income (loss) | 247 | (20) | 510 | 92 |
| Earnings from unconsolidated investments | 8 | 4 | 6 | 6 |
| Interest expense | (117) | (105) | (268) | (310) |
| Debt conversion costs | | (2) | | (249) |
| Minority interest income (expense) | 1 | | (8) | |
| Other income and expense, net | 16 | 11 | 34 | 41 |
| Income (loss) from continuing operations before income taxes | 155 | (112) | 274 | (420) |
| Income tax (expense) benefit (Note 14) | (59) | 41 | (95) | 150 |
| Income (loss) from continuing operations | 96 | (71) | 179 | (270) |
| Income (loss) from discontinued operations, net of tax expense of \$93, \$8, \$97 and \$1, respectively (Notes 3 and 14) | 124 | 2 | 131 | (6) |
| Income (loss) before cumulative effect of change in accounting principle | 220 | (69) | 310 | (276) |
| Cumulative effect of change in accounting principle, net of tax expense of zero | | | | 1 |
| Net income (loss) | 220 | (69) | 310 | (275) |
| Less: preferred stock dividends | | | | 9 |
| Net income (loss) applicable to common stockholders | \$ 220 | \$ (69) | \$ 310 | \$ (284) |
| Earnings (Loss) Per Share (Note 10): | | | | |
| Basic earnings (loss) per share: | | | | |
| Income (loss) from continuing operations | \$ 0.11 | \$ (0.14) | \$ 0.25 | \$ (0.63) |
| Income (loss) from discontinued operations | 0.15 | | 0.18 | (0.01) |
| Cumulative effect of change in accounting principle | | | | |

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| | | | | | | | | |
|---|----|------|----|--------|----|------|----|--------|
| Basic earnings (loss) per share | \$ | 0.26 | \$ | (0.14) | \$ | 0.43 | \$ | (0.64) |
| Diluted earnings (loss) per share: | | | | | | | | |
| Income (loss) from continuing operations | \$ | 0.11 | \$ | (0.14) | \$ | 0.25 | \$ | (0.63) |
| Income (loss) from discontinued operations | | 0.15 | | | | 0.18 | | (0.01) |
| Cumulative effect of change in accounting principle | | | | | | | | |
| Diluted earnings (loss) per share | \$ | 0.26 | \$ | (0.14) | \$ | 0.43 | \$ | (0.64) |
| Basic shares outstanding | | 836 | | 495 | | 721 | | 446 |
| Diluted shares outstanding | | 838 | | 497 | | 723 | | 512 |

See the notes to condensed consolidated financial statements.

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DYNEGY INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited) (in millions)

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$ 310 | \$ (275) |
| Adjustments to reconcile net income (loss) to net cash flows from operating activities: | | |
| Depreciation and amortization | 239 | 206 |
| Impairment and other charges | | 107 |
| Earnings from unconsolidated investments, net of cash distributions | (6) | (6) |
| Risk-management activities | (137) | (70) |
| Gain on sale of assets, net | (214) | (3) |
| Deferred income taxes | 172 | (147) |
| Cumulative effect of change in accounting principle, net of tax | | (1) |
| Legal and settlement charges | 29 | 14 |
| Sithe subordinated debt exchange charge | | 36 |
| Debt conversion costs | | 249 |
| Other | 22 | 39 |
| Changes in working capital: | | |
| Accounts receivable | (64) | 353 |
| Inventory | (5) | 12 |
| Prepayments and other assets | (43) | 119 |
| Accounts payable and accrued liabilities | 109 | (817) |
| Changes in non-current assets | (45) | 11 |
| Changes in non-current liabilities | (1) | (7) |
| Net cash provided by (used in) operating activities | 366 | (180) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (236) | (92) |
| Unconsolidated investments | (7) | |
| Proceeds from asset sales, net | 466 | 18 |
| Business acquisitions, net of cash acquired | (128) | |
| Net proceeds from exchange of unconsolidated investments, net of cash acquired | | 165 |
| Decrease (increase) in restricted cash and restricted investments | (598) | 125 |
| Other investing | | (3) |
| Net cash provided by (used in) investing activities | (503) | 213 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term borrowings, net | 2,705 | 1,071 |
| Repayments of long-term borrowings | (2,300) | (1,780) |
| Debt conversion costs | | (249) |
| Redemption of Series C Preferred | | (400) |

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| | | |
|--|--------|---------|
| Proceeds from issuance of capital stock | 4 | 183 |
| Dividends and other distributions, net | | (17) |
| Other financing, net | (5) | (2) |
| Net cash provided by (used in) financing activities | 404 | (1,194) |
| Net increase (decrease) in cash and cash equivalents | 267 | (1,161) |
| Cash and cash equivalents, beginning of period | 371 | 1,549 |
| Cash and cash equivalents, end of period | \$ 638 | \$ 388 |
| Other non-cash investing activity: | | |
| Noncash construction expenditures | \$ 13 | \$ |
| Other non-cash financing activity: | | |
| Conversion of Convertible Subordinated Debentures due 2023 | \$ | \$ 225 |
| Site subordinate debt exchange charge, net | | 122 |

See the notes to condensed consolidated financial statements.

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DYNEGY INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(unaudited) (in millions)

| | Three Months Ended | |
|---|---------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| Net income (loss) | \$ 220 | \$ (69) |
| Cash flow hedging activities, net: | | |
| Unrealized mark-to-market gains (losses) arising during period, net | (15) | 38 |
| Reclassification of mark-to-market losses to earnings, net | 12 | 2 |
| Changes in cash flow hedging activities, net (net of tax benefit (expense) of \$3 and (\$23), respectively) | (3) | 40 |
| Recognized prior service cost and actuarial loss | 1 | |
| Foreign currency translation adjustment | 2 | (1) |
| Unrealized gain on securities, net: | | |
| Unrealized gain on securities | 6 | |
| Less: Reclassification adjustments for gains realized in net income (loss) | (4) | |
| Net unrealized gains, net (net of tax expense of \$1) | 2 | |
| Other comprehensive income, net of tax | 2 | 39 |
| Comprehensive income (loss) | \$ 222 | \$ (30) |

| | Nine Months Ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| Net income (loss) | \$ 310 | \$ (275) |
| Cash flow hedging activities, net: | | |
| Unrealized mark-to-market gains (losses) arising during period, net | (74) | 63 |
| Reclassification of mark-to-market gains to earnings, net | (16) | (10) |
| Changes in cash flow hedging activities, net (net of tax benefit (expense) of \$54 and (\$31), respectively) | (90) | 53 |
| Recognized prior service cost and actuarial loss | 3 | |
| Foreign currency translation adjustment | 4 | 2 |
| Unrealized gain on securities, net: | | |
| Unrealized gain on securities | 4 | |
| Less: Reclassification adjustments for gains realized in net income (loss) | (4) | |
| Net unrealized gain, net (net of tax of zero) | | |
| Other comprehensive income (loss), net of tax | (83) | 55 |
| Comprehensive income (loss) | \$ 227 | \$ (220) |

See the notes to condensed consolidated financial statements.

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DYNEGY HOLDINGS INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited) (in millions)

| | September 30, 2007 | December 31, 2006 |
|---|-------------------------------|------------------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 594 | \$ 243 |
| Restricted cash | 140 | 280 |
| Accounts receivable, net of allowance for doubtful accounts of \$14 and \$48 respectively | 391 | 263 |
| Accounts receivable, affiliates | | 7 |
| Inventory | 197 | 194 |
| Assets from risk-management activities | 509 | 701 |
| Deferred income taxes | | 48 |
| Prepayments and other current assets | 160 | 92 |
| Assets held for sale (Note 3) | 58 | |
| Total Current Assets | 2,049 | 1,828 |
| Property, Plant and Equipment | 10,579 | 6,473 |
| Accumulated depreciation | (1,604) | (1,522) |
| Property, Plant and Equipment, Net | 8,975 | 4,951 |
| Other Assets | | |
| Unconsolidated investments | 35 | |
| Restricted cash and investments | 912 | 83 |
| Assets from risk-management activities | 230 | 16 |
| Long-term accounts receivable, affiliate | 784 | 781 |
| Goodwill | 532 | |
| Intangible assets | 321 | 347 |
| Deferred income taxes | 6 | 12 |
| Other long-term assets | 211 | 118 |
| Total Assets | \$ 14,055 | \$ 8,136 |
| LIABILITIES AND STOCKHOLDER S EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 307 | \$ 172 |
| Accrued interest | 130 | 66 |
| Accrued liabilities and other current liabilities | 243 | 230 |
| Deferred income taxes | 45 | |
| Liabilities from risk-management activities | 502 | 629 |
| Notes payable and current portion of long-term debt | 53 | 68 |
| Liabilities held for sale (Note 3) | 2 | |
| Total Current Liabilities | 1,282 | 1,165 |

| | | |
|---|------------------|-----------------|
| Long-term debt | 5,691 | 2,990 |
| Long-term debt to affiliates | 200 | 200 |
| Long-Term Debt | 5,891 | 3,190 |
| Other Liabilities | | |
| Liabilities from risk-management activities | 220 | 35 |
| Deferred income taxes | 818 | 325 |
| Other long-term liabilities | 417 | 385 |
| Total Liabilities | 8,628 | 5,100 |
| Minority Interest | (14) | |
| Commitments and Contingencies (Note 11) | | |
| Stockholder s Equity | | |
| Capital Stock, \$1 par value, 1,000 shares authorized at September 30, 2007 and December 31, 2006, respectively | | |
| Additional paid-in capital | 5,684 | 3,543 |
| Accumulated other comprehensive income (loss), net of tax | (16) | 67 |
| Accumulated deficit | (227) | (574) |
| Total Stockholder s Equity | 5,441 | 3,036 |
| Total Liabilities and Stockholder s Equity | \$ 14,055 | \$ 8,136 |

See the notes to condensed consolidated financial statements.

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DYNEGY HOLDINGS INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited) (in millions)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ 1,046 | \$ 508 | \$ 2,379 | \$ 1,427 |
| Cost of sales, exclusive of depreciation shown separately below | (649) | (319) | (1,478) | (907) |
| Depreciation and amortization expense | (92) | (54) | (232) | (164) |
| Impairment and other charges | | (96) | | (107) |
| Gain on sale of assets, net | 4 | | 4 | 3 |
| General and administrative expenses | (62) | (58) | (144) | (158) |
| Operating income (loss) | 247 | (19) | 529 | 94 |
| Earnings from unconsolidated investments | 12 | 4 | 12 | 6 |
| Interest expense | (117) | (105) | (268) | (303) |
| Debt conversion costs | | (2) | | (204) |
| Minority interest income (expense) | 1 | | (8) | |
| Other income and expense, net | 17 | 9 | 33 | 36 |
| Income (loss) from continuing operations before income taxes | 160 | (113) | 298 | (371) |
| Income tax (expense) benefit (Note 14) | (62) | 43 | (94) | 132 |
| Income (loss) from continuing operations | 98 | (70) | 204 | (239) |
| Income (loss) from discontinued operations, net of tax expense of \$93, \$7, \$98 and \$1, respectively (Notes 3 and 14) | 124 | 3 | 130 | (6) |
| Net income (loss) | \$ 222 | \$ (67) | \$ 334 | \$ (245) |

See the notes to condensed consolidated financial statements.

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DYNEGY HOLDINGS INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited) (in millions)

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$ 334 | \$ (245) |
| Adjustments to reconcile net income (loss) to net cash flows from operating activities: | | |
| Depreciation and amortization | 239 | 203 |
| Impairment and other charges | | 107 |
| Earnings from unconsolidated investments, net of cash distributions | (12) | (6) |
| Risk-management activities | (137) | (70) |
| Gain on sale of assets, net | (214) | (3) |
| Deferred income taxes | 161 | (130) |
| Legal and settlement charges | 29 | 14 |
| Sith the subordinated debt exchange charge | | 36 |
| Debt conversion costs | | 205 |
| Other | 20 | 38 |
| Changes in working capital: | | |
| Accounts receivable | (64) | 353 |
| Inventory | (5) | 12 |
| Prepayments and other assets | (43) | 95 |
| Accounts payable and accrued liabilities | 111 | (805) |
| Changes in non-current assets | (43) | 11 |
| Changes in non-current liabilities | (1) | (7) |
| Net cash provided by (used in) operating activities | 375 | (192) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (236) | (92) |
| Proceeds from asset sales, net | 466 | 15 |
| Business acquisitions, net of cash acquired | 16 | |
| Net proceeds from exchange of unconsolidated investments, net of cash acquired | | 165 |
| Decrease in restricted cash and restricted investments | (598) | 125 |
| Affiliate transactions | (11) | 2 |
| Other investing | | (3) |
| Net cash provided by (used in) investing activities | (363) | 212 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term borrowings, net | 2,705 | 1,071 |
| Repayments of long-term borrowings | (2,025) | (1,780) |
| Debt conversion costs | | (203) |
| Borrowings from affiliate, net of affiliate | | (120) |
| Dividend to affiliate | (342) | (50) |

| | | |
|---|--------|---------|
| Other financing, net | 1 | (1) |
| Net cash provided by (used in) financing activities | 339 | (1,083) |
| Net increase (decrease) in cash and cash equivalents | 351 | (1,063) |
| Cash and cash equivalents, beginning of period | 243 | 1,326 |
| Cash and cash equivalents, end of period | \$ 594 | \$ 263 |
| Other non-cash investing activity: | | |
| Noncash construction expenditures | \$ 13 | \$ |
| Other non-cash financing activity: | | |
| Sithe subordinated debt exchange charge, net | \$ | \$ 122 |
| See the notes to condensed consolidated financial statements. | | |

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DYNEGY HOLDINGS INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(unaudited) (in millions)

| | Three Months Ended | |
|---|---------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| Net income (loss) | \$ 222 | \$ (67) |
| Cash flow hedging activities, net: | | |
| Unrealized mark-to-market gains (losses) arising during period, net | (15) | 38 |
| Reclassification of mark-to-market gains to earnings, net | 12 | 2 |
| Changes in cash flow hedging activities, net (net of tax benefit (expense) of \$3 and (\$23), respectively) | (3) | 40 |
| Recognized prior service cost and actuarial loss | 1 | |
| Foreign currency translation adjustment | 2 | (1) |
| Unrealized gain on securities, net: | | |
| Unrealized gain on securities | 6 | |
| Less: Reclassification adjustments for gains realized in net income (loss) | (4) | |
| Net unrealized gains, net (net of tax expense of \$1) | 2 | |
| Other comprehensive income, net of tax | 2 | 39 |
| Comprehensive income (loss) | \$ 224 | \$ (28) |

| | Nine Months Ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2007 | 2006 |
| Net income (loss) | \$ 334 | \$ (245) |
| Cash flow hedging activities, net: | | |
| Unrealized mark-to-market gains (losses) arising during period, net | (74) | 63 |
| Reclassification of mark-to-market gains to earnings, net | (16) | (10) |
| Changes in cash flow hedging activities, net (net of tax benefit (expense) of \$54 and (\$31), respectively) | (90) | 53 |
| Recognized prior service cost and actuarial loss | 3 | |
| Foreign currency translation adjustment | 4 | 2 |
| Unrealized gain on securities, net: | | |
| Unrealized gain on securities | 4 | |
| Less: Reclassification adjustments for gains realized in net income (loss) | (4) | |
| Net unrealized gains, net (net of tax of zero) | | |
| Other comprehensive income (loss), net of tax | (83) | 55 |
| Comprehensive income (loss) | \$ 251 | \$ (190) |

See the notes to condensed consolidated financial statements.

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**DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

For the Interim Periods Ended September 30, 2007 and 2006

Note 1 Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to interim financial reporting as prescribed by the SEC. The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These interim financial statements should be read together with the consolidated financial statements and notes thereto included in Dynegy's Form 10-K for the year ended December 31, 2006 filed on February 27, 2007, as amended on April 30, 2007, and DHI's Form 10-K for the year ended December 31, 2006 filed on March 14, 2007, which we refer to as each registrant's Form 10-K.

In April 2007, Dynegy completed its acquisition of 11 power generation facilities and a 50% interest in certain power generation development projects from LS Power Associates, L.P. Dynegy's interests in the 11 power generation facilities were subsequently contributed to DHI. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion.

In April 2007, Dynegy contributed to DHI its interest in Dynegy New York Holdings Inc. (New York Holdings). This contribution was accounted for as a transaction between entities under common control. As such, the assets and liabilities of New York Holdings were recorded by DHI at Dynegy's historical cost on the acquisition date. This Form 10-Q with respect to DHI reflects the contribution as though DHI had owned New York Holdings in all periods presented. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions - Sthe Assets Contribution for further discussion.

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

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

Goodwill and Other Intangible Assets

Goodwill represents, at the time of an acquisition, the amount of purchase price paid in excess of the fair value of net assets acquired. We follow the guidance set forth in SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142), when assessing the carrying value of our goodwill. Accordingly, we will evaluate our goodwill for impairment on an annual basis and when events warrant an assessment. Our evaluation is based, in part, on our estimate of future cash flows. The estimation of fair value is highly subjective, inherently imprecise and can change materially from period to period based on, among other things, an assessment of market conditions, projected cash flows and discount rates.

Intangible assets represent the fair value of assets, apart from goodwill, that arise from contractual rights or other legal rights. In accordance with SFAS No. 141, *Business Combinations* (SFAS No. 141), we record only those intangible assets that are distinctly separable from goodwill and can be sold, transferred, licensed, rented, or otherwise exchanged in the open market. Additionally, we recognize intangible assets for those assets that can be exchanged in combination with other rights, contracts, assets or liabilities.

In accordance with SFAS No. 142, we initially record and measure intangible assets based on the fair value of those rights transferred in the transaction in which the assets were acquired. Those measurements are based on quoted market prices for the assets, if available, or measurement techniques based on the best information available such as a present value of future cash flows measurement. Present value measurement techniques involve judgments and estimates made by management about prices, cash flows, discount factors and other variables and the actual value realized from those assets could vary materially from these judgments and estimates. We amortize intangible assets based on the useful life of the respective asset as measured by either the life of the contract or right that the asset is derived from. If the intangible asset does not have a finite life based on the contractual or legal right, an estimate is made of the useful life based on the pattern in which the economic benefits of the asset are expected to be consumed. Intangible assets are subject to impairment testing on an annual basis or as events warrant, and an impairment loss is recognized if the carrying amount of an intangible exceeds its fair value. Please see Note 2 *LS Power Business Combination and Dynegy Illinois Entity Contributions* for further discussion.

Accounting Principles Adopted

FIN No. 48. On July 12, 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes* (FIN No. 48), which provides clarification of SFAS 109, *Accounting for Income Taxes* with respect to the recognition of income tax benefits of uncertain tax positions in the financial statements. FIN No. 48 requires that uncertain tax positions be reviewed and assessed with recognition and measurement of the tax benefit based on a *more-likely-than-not* standard. We adopted the provisions of FIN No. 48 on January 1, 2007 and recorded a decrease of \$7 million and \$13 million, respectively, to Dynegy's and DHI's accumulated deficits as of January 1, 2007 to reflect the cumulative effect of adopting FIN No. 48.

As of January 1, 2007, Dynegy and DHI had approximately \$111 million and \$75 million, respectively, of unrecognized tax benefits, of which \$67 million and \$37 million, respectively, would impact their effective tax rates. As of September 30, 2007, Dynegy and DHI had approximately \$30 million and \$15 million, respectively, of unrecognized tax benefits, of which \$25 million and \$11 million, respectively, would impact their effective tax rates if recognized. The changes to Dynegy's and DHI's unrecognized tax benefits during the nine months ended September 30, 2007 primarily resulted from effective settlement of an IRS audit for the tax years 2001 and 2002 and a CRA tax audit for the tax years 2002 to 2004. The adjustments to our reserves for uncertain tax positions as a result of these settlements had an insignificant impact on our net income.

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

Additionally, in conjunction with the adoption of FIN No. 48, as of January 1, 2007, we reduced our regular federal tax NOL carryforwards by \$253 million, from \$948 million to \$695 million. The reduction was offset by corresponding changes to our net deferred tax liability and reserve for uncertain tax positions.

We recognize accrued interest expense and penalties related to unrecognized tax benefits as income tax expense.

Dynegy had approximately \$4 million and \$5 million accrued for the payment of interest and penalties at September 30, 2007 and January 1, 2007, respectively. DHI had approximately \$4 million and \$6 million accrued for the payment of interest and penalties at September 30, 2007 and January 1, 2007, respectively.

We expect that our unrecognized tax benefits could continue to change due to the settlement of audits and the expiration of statutes of limitation in the next twelve months; however, we do not anticipate any such change to have a significant impact on our results of operations, our financial position or cash flows.

Dynegy files a consolidated income tax return in the U.S. federal jurisdiction, and we file other income tax returns in various states and foreign jurisdictions. DHI is included in Dynegy's consolidated federal tax returns. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2004. The IRS commenced an examination of Dynegy's U.S. consolidated income tax returns for 2004 and 2005 in the second quarter 2006 and fieldwork is anticipated to be completed by the end of 2007. During the third quarter 2007, Dynegy finalized its IRS examination for 2001 through 2002 and effectively settled all audit issues related to the CRA audit of its Canadian income tax returns for 2002 through 2004.

Accounting Principles Not Yet Adopted

SFAS No. 157. On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 does not require any new fair value measurements; however, the application of SFAS No. 157 will change current practice for some entities. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our financial statements.

SFAS No. 159. On February 15, 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our financial statements.

Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions

LS Power Business Combination. On March 29, 2007, at a special meeting of the shareholders of Dynegy Illinois, the shareholders of Dynegy Illinois (i) adopted the Plan of Merger, Contribution and Sale Agreement, dated as of September 14, 2006 (the Merger Agreement), by and among Dynegy, Dynegy Illinois, Falcon Merger Sub Co., an Illinois corporation and a then-wholly owned subsidiary of Dynegy (Merger Sub), LSP Gen Investors, L.P., LS Power Partners, L.P., LS Power Equity Partners PIE I, L.P., LS Power Equity Partners, L.P. and LS Power Associates, L.P. (LS Associates and, collectively, the LS Contributing Entities) and (ii) approved the merger of Merger Sub with and into Dynegy Illinois (the Merger).

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

On April 2, 2007, in accordance with the Merger Agreement, (i) the Merger was effected, as a result of which Dynegy Illinois became a wholly owned subsidiary of Dynegy and each share of the Class A common stock and Class B common stock of Dynegy Illinois outstanding immediately prior to the Merger was converted into the right to receive one share of the Class A common stock of Dynegy, and (ii) the LS Contributing Entities transferred all of the interests owned by them in entities that own 11 power generation facilities to Dynegy (the Contributed Entities).

As part of the transactions contemplated by the Merger Agreement, LS Associates transferred its interests in certain power generation development projects to DLS Power Holdings, LLC, a newly formed Delaware limited liability company (DLS Power Holdings), and contributed 50% of the membership interests in DLS Power Holdings to Dynegy. In addition, immediately after the completion of the Merger, LS Associates and Dynegy each contributed \$5 million to DLS Power Holdings as their initial capital contributions, and also contributed their respective interests in certain additional power generation development projects to DLS Power Holdings. In connection with the formation of DLS Power Holdings, LS Associates formed DLS Power Development Company, LLC, a Delaware limited liability company (DLS Power Development). LS Associates and Dynegy each now own 50% of the membership interests in DLS Power Development.

The aggregate purchase price payable under the Merger Agreement was comprised of (i) \$100 million cash, (ii) 340 million shares of the Class B common stock of Dynegy, (iii) the issuance of a promissory note in the aggregate principal amount of \$275 million (the Note) (which was simultaneously issued and repaid in full without interest or prepayment penalty), (iv) the issuance of an additional \$70 million of project-related debt (the Griffith Debt) (which was simultaneously issued and repaid in full without interest or prepayment penalty) via an indirect wholly owned subsidiary, and (v) transaction costs of approximately \$52 million, approximately \$8 million of which were paid in 2006. The Class B common stock issued by Dynegy was valued at \$5.98 per share, which represents the average closing price of Dynegy's common stock on the New York Stock Exchange for the two days prior to, including, and two days subsequent to the September 15, 2006 public announcement of the Merger, or approximately \$2,033 million. Dynegy funded the cash payment and the repayment of the Note and the Griffith Debt using cash on hand and borrowings by DHI (and subsequent permitted distributions to Dynegy) of (i) an aggregate \$275 million under the Revolving Facility (as defined below) and (ii) an aggregate \$70 million under the new Term Loan B (as defined below). Please read Note 6 Debt Fifth Amended and Restated Credit Facility for further discussion. We paid a premium over the fair value of the net tangible and identified intangible assets acquired due to the (i) scale and diversity of assets acquired in key regions of the United States; (ii) financial stability, and (iii) proven nature of the LS Power asset development platform that were subsequently contributed to DLS Power Holdings and DLS Power Development.

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

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

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

| | | |
|--|-----------|----------------|
| Cash | \$ | 16 |
| Restricted cash and investments (including \$37 million current) | | 91 |
| Accounts receivable | | 52 |
| Inventory | | 37 |
| Assets from risk management activities (including \$11 million current) | | 37 |
| Prepays and other current assets | | 21 |
| Property, plant and equipment | | 4,223 |
| Goodwill | | 594 |
| Unconsolidated investments | | 83 |
| Other | | 48 |
| Total assets acquired | \$ | 5,202 |
| | | |
| Current liabilities and accrued liabilities | \$ | (92) |
| Liabilities from risk management activities (including \$14 million current) | | (75) |
| Long-term debt (including \$32 million current) | | (1,898) |
| Deferred income taxes | | (533) |
| Other | | (96) |
| Minority interest | | 22 |
| Total liabilities and minority interest assumed | \$ | (2,672) |
| | | |
| Net assets acquired | \$ | 2,530 |

The purchase price allocation is preliminary, as Dynegy is finalizing its valuation of deferred taxes acquired. Dynegy expects to complete the purchase price allocation in the fourth quarter 2007. However, the differences between the final and preliminary purchase price allocations, if any, are not expected to have a material effect on Dynegy's financial position or results of operations. During the third quarter 2007, Dynegy revised the determination of the tax basis of the assets acquired and the liabilities assumed and revised its purchase price allocation. The revision reduced the excess of the fair value of the assets acquired and the liabilities assumed. Accordingly, in the third quarter 2007, Dynegy reduced deferred income taxes and decreased goodwill by approximately \$72 million.

As noted above, Dynegy recorded preliminary goodwill of approximately \$594 million. Of the goodwill recorded, \$76 million was assigned to the GEN-MW reporting unit, \$387 million was assigned to the GEN-WE reporting unit and \$131 million was assigned to the GEN-NE reporting unit.

Dynegy recorded net intangible liabilities of \$7 million. This consisted of intangible assets of \$32 million in GEN-WE offset by intangible liabilities of \$4 million and \$35 million, respectively, in GEN-NE and GEN-MW. The intangible assets primarily relate to power tolling agreements that are being amortized over their respective contract terms ranging from 6 months to 7 years. Aggregate amortization expense associated with the above intangibles recorded in the six months ended September 30, 2007 was approximately \$5 million. The estimated amortization expense for the three months ended December 31, 2007 is approximately \$3 million and for each of the five succeeding years is approximately \$8 million, \$8 million, \$8 million, less than \$1 million and less than \$1 million, respectively.

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

Of the \$39 million in intangible liabilities, \$8 million relates to power tolling agreements which are being amortized over their respective contract terms ranging from 2 years to 10 years. Aggregate amortization income associated with the intangible power tolling agreements recorded in the six months ended September 30, 2007 was less than \$2 million. The estimated amortization income for the three months ended December 31, 2007 is \$1 million and for each of the five succeeding years is \$4 million, \$4 million, \$2 million, \$2 million and \$2 million, respectively. In addition, LSP Kendall Holding LLC, one of the entities transferred to Dynegy, and ultimately DHI, by the LS Contributing Entities pursuant to the Merger Agreement, was party to a power tolling agreement with another of our subsidiaries. This power tolling agreement had a fair value of approximately \$31 million as of April 2, 2007, representing a liability from the perspective of LSP Kendall Holding LLC. Upon completion of the Merger Agreement, this power tolling agreement was effectively settled, which resulted in a second quarter 2007 gain equal to the fair value of this contract, in accordance with EITF Issue 04-01, Accounting for Pre-existing Contractual Relationships Between the Parties to a Purchase Business Combination (EITF Issue 04-1). We recorded a second quarter 2007 pre-tax gain of approximately \$31 million, included as a reduction to cost of sales on the unaudited condensed consolidated statements of operations.

The differences between the financial and tax bases of purchased intangibles and goodwill are not deductible for tax purposes. However, purchase accounting allows for the establishment of deferred tax liabilities on purchased intangibles (other than goodwill) that will be reflected as a tax benefit on our future consolidated statements of operations in proportion to and over the amortization period of the related intangible asset.

Dynegy's results of operations include the results of the acquired entities for the period beginning April 2, 2007. The following table presents unaudited pro forma information for 2006, as if the acquisition had occurred on July 1, 2006:

| | Three Months Ended | |
|--|--|------------------|
| | September 30, 2006 | |
| | Actual | Pro Forma |
| | (in millions, except per share amounts) | |
| Revenue | \$ 508 | \$ 945 |
| Loss before cumulative effect of a change in accounting principal | (69) | (72) |
| Net loss applicable to common stockholders | (69) | (72) |
| Basic and diluted loss per share before cumulative effect of accounting change | \$ (0.14) | \$ (0.09) |
| Basic and diluted loss per share | (0.14) | (0.09) |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

The following table presents unaudited pro forma information for 2007 and 2006, as if the acquisition had occurred on January 1, 2007 or 2006, respectively:

| | Nine Months Ended September 30, 2007 | | Nine Months Ended September 30, 2006 | |
|---|---|------------------|---|------------------|
| | Actual | Pro Forma | Actual | Pro Forma |
| | (in millions, except per share amounts) | | | |
| Revenue | \$ 2,379 | \$ 2,668 | \$ 1,427 | \$ 2,076 |
| Income (loss) before cumulative effect of a change in accounting principal | 310 | 261 | (276) | (264) |
| Net income (loss) applicable to common stockholders | 310 | 261 | (284) | (272) |
| Basic earnings (loss) per share before cumulative effect of accounting change | \$ 0.43 | \$ 0.36 | \$ (0.64) | \$ (0.35) |
| Diluted earnings (loss) per share before cumulative effect of accounting change | 0.43 | 0.36 | (0.64) | (0.35) |
| Basic earnings (loss) per share | 0.43 | 0.36 | (0.64) | (0.35) |
| Diluted earnings (loss) per share | 0.43 | 0.36 | (0.64) | (0.35) |

These unaudited pro forma results, based on assumptions deemed appropriate by management, have been prepared for informational purposes only and are not necessarily indicative of Dynegy's results if the Merger had occurred on July 1, 2006 for the three months ended September 30, 2006 or on January 1, 2007 and 2006, respectively, for the nine months ended September 30, 2007 and 2006. Pro forma adjustments to the results of operations include the effects on depreciation and amortization, interest expense, interest income and income taxes. The unaudited pro forma condensed consolidated financial statements reflect the Merger in accordance with SFAS No. 141 and SFAS No. 142. The consummation of the Merger Agreement with the LS Contributing Entities constituted a change in control as defined in our severance pay plans, as well as the various long-term incentive award grant agreements. As a result, all outstanding restricted stock and stock option awards previously granted to employees vested in full on April 2, 2007 upon the closing of the Merger Agreement. Specifically, the vesting of the restricted stock awards granted in 2005 and 2006 and the unvested tranches of stock option awards granted in those years were accelerated. Accordingly, we recorded a charge of approximately \$6 million in the second quarter 2007, included in general and administrative expense on our unaudited condensed consolidated statement of operations.

LS Assets Contribution. In April 2007, in connection with the completion of the Merger Agreement, Dynegy contributed to Dynegy Illinois its interest in the Contributed Entities. Following such contribution, Dynegy Illinois contributed to DHI its interest in the Contributed Entities and, as a result, the Contributed Entities are subsidiaries of DHI. Accordingly, all of the entities acquired in the Merger are included within DHI with the exception of Dynegy's 50% interests in DLS Power Holdings and DLS Power Development, which are directly owned by Dynegy. DHI's results of operations include the results of the acquired entities for the period beginning April 2, 2007. The following table presents unaudited pro forma information for 2006, as if the acquisition and subsequent contribution had occurred on April 1, 2006:

**Three Months Ended
September 30, 2006**
Actual Pro Forma
(in millions)

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| | | | | |
|----------|----|------|----|------|
| Revenue | \$ | 508 | \$ | 945 |
| Net loss | | (67) | | (70) |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

For the Interim Periods Ended September 30, 2007 and 2006

The following table presents unaudited pro forma information for 2007 and 2006, as if the acquisition and subsequent contribution had occurred on January 1, 2007 or 2006, respectively:

| | Nine Months Ended September 30, 2007 | | Nine Months Ended September 30, 2006 | |
|-------------------|---|-----------|---|-----------|
| | Actual | Pro Forma | Actual | Pro Forma |
| | (in millions) | | | |
| Revenue | \$ 2,379 | \$ 2,668 | \$ 1,427 | \$ 2,076 |
| Net income (loss) | 334 | 285 | (245) | (233) |

These unaudited pro forma results, based on assumptions deemed appropriate by management, have been prepared for informational purposes only and are not necessarily indicative of DHI's results if the Merger had occurred on July 1, 2006 for the three months ended September 30, 2006 or on January 1, 2007 and 2006, respectively, for the nine months ended September 30, 2007 and 2006. Pro forma adjustments to the results of operations include the effects on depreciation and amortization, interest expense, interest income and income taxes. The unaudited pro forma condensed consolidated financial statements reflect the Merger in accordance with SFAS No. 141 and SFAS No. 142. **Sithe Assets Contribution.** Also in April 2007, Dynegy Illinois contributed to DHI all of its interest in New York Holdings, together with its indirect interest in the subsidiaries of New York Holdings. New York Holdings, together with its wholly owned subsidiaries, owns various assets in the Northeast (the *Sithe Assets*). The *Sithe Assets* primarily consist of the *Sithe/Independence Power Partners, L.P.* (*Independence*), a 1,064 MW facility located in Scriba, New York, which Dynegy Illinois acquired in January 2005. This contribution was accounted for as a transaction between entities under common control. As such, the assets and liabilities of New York Holdings were recorded by DHI at Dynegy's historical cost on the date of contribution. In addition, DHI's historical financial statements have been adjusted in all periods presented to reflect the contribution as though DHI had owned New York Holdings in all periods presented. *Independence* holds a power tolling contract with DHI. As a result of the contribution, our *Independence* toll has become an intercompany agreement in our GEN-NE segment and the financial statement impact has been eliminated. The *Sithe Assets* contributed to DHI also include four hydroelectric generation facilities in Pennsylvania. Please read Note 7 *Variable Interest Entities* for further information.

Note 3 Discontinued Operations***GEN-WE Discontinued Operations***

CoGen Lyondell. On August 1, 2007, we completed our sale of our CoGen Lyondell power generation facility for approximately \$470 million to EnergyCo., LLC (*EnergyCo*), a joint venture between PNM Resources and a subsidiary of Cascade Investment, LLC. We recorded a \$210 million gain related to the sale of the asset in the third quarter 2007. The gain includes the impact of allocating approximately \$62 million of goodwill associated with the GEN-WE reporting unit to the CoGen Lyondell power generation facility. The amount of goodwill allocated to the CoGen Lyondell power generation facility was based on relative fair values of the CoGen Lyondell power generation facility and the portion of the GEN-WE reporting unit being retained.

The sale of the CoGen Lyondell power generation facility represented the sale of a significant portion of a reporting unit. As such, in accordance with SFAS No. 142, during the third quarter 2007, we tested the goodwill of the GEN-WE reporting unit for impairment. No impairment was indicated as a result of this test.

In accordance with SFAS No. 144, we discontinued depreciation and amortization of CoGen Lyondell's property, plant and equipment during the second quarter 2007. Depreciation and amortization expense related to CoGen Lyondell totaled approximately zero and \$5 million in the three- and nine-month periods ended September 30, 2007, respectively, compared to approximately \$3 million and \$8 million in the three- and nine-month periods ended September 30, 2006, respectively. Also pursuant to SFAS No. 144, we are reporting the results of CoGen Lyondell's operations in discontinued operations for all periods presented.

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Calcasieu. On January 31, 2007, we entered into an agreement to sell our interest in the Calcasieu power generation facility to Entergy Gulf States, Inc. (Entergy) for approximately \$57 million, subject to regulatory approval and other closing conditions. The transaction is expected to close in early 2008. Beginning in the first quarter 2007, Calcasieu met the held for sale classification requirements of SFAS No. 144, and is classified as such on our unaudited condensed consolidated balance sheet. The major classes of current and long-term assets classified as assets held for sale at September 30, 2007 are approximately \$57 million of property, plant and equipment, net, \$1 million of inventory, \$1 million of deferred tax liabilities, and \$1 million of accrued liabilities and other current liabilities. In accordance with SFAS No. 144, we discontinued depreciation and amortization of Calcasieu's property, plant and equipment during the first quarter 2007. Depreciation and amortization expense related to Calcasieu totaled zero and \$1 million in the three- and nine-month periods ended September 30, 2007, respectively, compared to less than \$1 million and approximately \$2 million in the three- and nine-month periods ended September 30, 2006, respectively. Also pursuant to SFAS No. 144, we are reporting the results of Calcasieu's operations in discontinued operations for all periods presented.

Other Discontinued Operations

Natural Gas Liquids. On October 31, 2005, we completed the sale of DMSLP, which comprised substantially all remaining operations of our NGL segment, to Targa Resources Inc. (Targa) and two of its subsidiaries for \$2.44 billion in cash.

Other. We sold or liquidated some of our operations during 2003, including our U.K. CRM business, which have been accounted for as discontinued operations under SFAS No. 144.

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

| | GEN-WE | CRM | NGL | Total |
|--|--------|-----|-----|-------|
| Three Months Ended September 30, 2007 | | | | |
| Revenues | \$ 14 | \$ | \$ | \$ 14 |
| Income from operations before taxes | 3 | 4 | | 7 |
| Income from operations after taxes | 7 | 3 | 4 | 14 |
| Gain on sale before taxes | 210 | | | 210 |
| Gain on sale after taxes | 110 | | | 110 |

Three Months Ended September 30, 2006

| | | | | |
|---|-------|-----|----|-------|
| Revenues | \$ 73 | \$ | \$ | \$ 73 |
| Income from operations before taxes | 2 | 6 | 2 | 10 |
| Income (loss) from operations after taxes | | (2) | 4 | 2 |

| | GEN-WE | CRM | NGL | Total |
|--|--------|-----|-----|-------|
|--|--------|-----|-----|-------|

Nine Months Ended September 30, 2007

| | | | | |
|-------------------------------------|-------|----|----|-------|
| Revenues | \$ 81 | \$ | \$ | \$ 81 |
| Income from operations before taxes | 3 | 15 | | 18 |
| Income from operations after taxes | 2 | 11 | 8 | 21 |
| Gain on sale before taxes | 210 | | | 210 |
| Gain on sale after taxes | 110 | | | 110 |

Nine Months Ended September 30, 2006

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| | | | | | | | | |
|--|----|------|----|-----|----|---|----|-----|
| Revenues | \$ | 193 | \$ | | \$ | | \$ | 193 |
| Income (loss) from operations before taxes | | (13) | | 5 | | 3 | | (5) |
| Income (loss) from operations after taxes | | (9) | | (1) | | 4 | | (6) |

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

| | GEN-WE | CRM | NGL | Total |
|--|--------|-----|-----|--------|
| Three Months Ended September 30, 2007 | | | | |
| Revenues | \$ 14 | \$ | \$ | \$ 14 |
| Income from operations before taxes | 3 | 4 | | 7 |
| Income from operations after taxes | 7 | 3 | 4 | 14 |
| Gain on sale before taxes | 210 | | | 210 |
| Gain on sale after taxes | 110 | | | 110 |
| Three Months Ended September 30, 2006 | | | | |
| Revenues | \$ 73 | \$ | \$ | \$ 73 |
| Income from operations before taxes | 2 | 6 | 2 | 10 |
| Income from operations after taxes | | 1 | 2 | 3 |
| | GEN-WE | CRM | NGL | Total |
| Nine Months Ended September 30, 2007 | | | | |
| Revenues | \$ 81 | \$ | \$ | \$ 81 |
| Income from operations before taxes | 3 | 15 | | 18 |
| Income from operations after taxes | 2 | 10 | 8 | 20 |
| Gain on sale before taxes | 210 | | | 210 |
| Gain on sale after taxes | 110 | | | 110 |
| Nine Months Ended September 30, 2006 | | | | |
| Revenues | \$ 193 | \$ | \$ | \$ 193 |
| Income (loss) from operations before taxes | (13) | 5 | 3 | (5) |
| Income (loss) from operations after taxes | (9) | 1 | 2 | (6) |

Note 4 Restructuring Charges

2005 Restructuring. In December 2005, in order to better align our corporate cost structure with a single line of business and as part of a comprehensive effort to reduce on-going operating expenses, we implemented a restructuring plan (the 2005 Restructuring Plan). The 2005 Restructuring Plan resulted in a reduction of approximately 40 positions and was complete by June 30, 2006. We recognized a pre-tax charge, primarily in Other, of \$11 million in the fourth quarter 2005. We recognized approximately \$2 million of charges in the nine months ended September 30, 2006, when transitional services were completed by certain affected employees. These charges related entirely to severance costs.

2002 Restructuring. In October 2002, we announced a restructuring plan designed to improve operational efficiencies and performance across our lines of business.

The following is a schedule of 2007 activity for the liabilities recorded in connection with this restructuring:

| Severance | Cancellation Fees and Operating Leases | Total |
|-----------|---|-------|
|-----------|---|-------|

| | (in millions) | | | | | |
|-------------------------------|----------------------|---|----|-----|----|-----|
| Balance at December 31, 2006 | \$ | 3 | \$ | 7 | \$ | 10 |
| Cash payments | | | | (5) | | (5) |
| Balance at September 30, 2007 | \$ | 3 | \$ | 2 | \$ | 5 |

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We expect the \$2 million accrual as of September 30, 2007 associated with cancellation fees and operating leases to be paid by the end of 2007, when the leases expire.

Note 5 Risk Management Activities

The nature of our business necessarily involves market and financial risks. We enter into financial instrument contracts in an attempt to mitigate or eliminate these various risks. These risks and our strategy for mitigating them are more fully described in Note 6 Risk Management Activities and Financial Instruments beginning on pages F-26 and F-21, respectively, of Dynegy's and DHI's Forms 10-K.

Cash Flow Hedges. We enter into financial derivative instruments that qualify, and that we may elect to designate, as cash flow hedges. Interest rate swaps have been used to convert floating interest rate obligations to fixed interest rate obligations. In the second quarter 2007, PPEA entered into three interest rate swap agreements with an initial aggregate notional amount of approximately \$183 million. These interest rate swap agreements convert certain of Plum Point's floating rate debt exposure (exclusive of the Tax Exempt Bonds) to a fixed interest rate of approximately 5.3%. These interest rate swap agreements expire in June 2040. For the three months ended June 30, 2007, we recorded \$27 million of mark-to-market income related to these interest rate swap agreements as an offset to interest expense. Effective July 1, 2007, we designated these agreements as cash flow hedges. Therefore, the effective portion of the changes in value after that date are reflected in Other Comprehensive Income (Loss), and subsequently reclassified to interest expense contemporaneously with the related accruals of interest expense, or depreciation expense in the event the interest was capitalized, in either case to the extent of hedge effectiveness.

Instruments related to our GEN business, which are entered into for purposes of hedging future fuel requirements and sales commitments and securing commodity prices we consider favorable under the circumstances, have also historically been designated as cash flow hedges. Beginning on April 2, 2007, we chose to cease designating such instruments related to our GEN business as cash flow hedges, and thus apply mark-to-market accounting treatment prospectively. Accordingly, as values fluctuate from period to period due to market price volatility, value changes are reflected in the Statement of Operations. Pursuant to EITF Issue 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (EITF Issue No. 02-3), all gains and losses on third party energy trading contracts, whether realized or unrealized, are presented net in the Statements of Operations. The balance in Other Comprehensive Income (Loss) at April 2, 2007 related to these instruments will be reclassified to future earnings contemporaneously with the related purchases of fuel and sales of electricity. As of September 30, 2007, this amount totaled \$5 million pre-tax.

During the three and nine months ended September 30, 2007, we recorded a \$1 million loss and \$4 million of income, respectively, related to ineffectiveness from changes in the fair value of cash flow hedge positions, and no amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and nine months ended September 30, 2006, we recorded \$3 million and \$7 million of income, respectively, related to ineffectiveness from changes in fair value of hedge positions, and no amounts were excluded from the assessment of hedge effectiveness related to the hedge of future cash flows. During the three and nine months ended September 30, 2007 and 2006, zero and \$1 million, respectively, were reclassified to earnings in connection with forecasted transactions that were no longer considered probable of occurring.

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The balance in cash flow hedging activities, net at September 30, 2007, is expected to be reclassified to future earnings when the hedged transaction occurs. Of this amount, after-tax losses of approximately \$15 million are currently estimated to be reclassified into earnings over the 12-month period ending September 30, 2008. The actual amounts that will be reclassified into earnings over this period and beyond could vary materially from this estimated amount as a result of changes in market conditions and other factors.

Fair Value Hedges. We also enter into derivative instruments that qualify, and that we designate, as fair value hedges. We use interest rate swaps to convert a portion of our non-prepayable fixed-rate debt into floating-rate debt. During the three and nine months ended September 30, 2007 and 2006, there was no ineffectiveness from changes in the fair value of hedge positions and no amounts were excluded from the assessment of hedge effectiveness. During the three and nine months ended September 30, 2007 and 2006, no amounts were recognized in relation to firm commitments that no longer qualified as fair value hedges.

Net Investment Hedges in Foreign Operations. Although we have exited a substantial amount of our foreign operations, we have remaining investments in foreign subsidiaries, the net assets of which are exposed to currency exchange-rate volatility. As of September 30, 2007, we had no net investment hedges in place.

Note 6 Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss), net of tax, is included in Dynegy's stockholders' equity and DHI's stockholders' equity on our unaudited condensed consolidated balance sheets, respectively, as follows:

| | September 30, 2007 | December 31, 2006 |
|---|--------------------------|----------------------|
| | (in millions) | |
| Cash flow hedging activities, net | \$ (14) | \$ 76 |
| Foreign currency translation adjustment | 27 | 23 |
| Unrecognized prior service cost and actuarial loss | (40) | (43) |
| Available for sale securities | 11 | 11 |
| Accumulated other comprehensive income (loss), net of tax | \$ (16) | \$ 67 |

Note 7 Variable Interest Entities

Hydroelectric Generation Facilities. On January 31, 2005, Dynegy completed the acquisition of ExRes SHC, Inc. (ExRes), the parent company of Sithe Energies, Inc. and Independence. As further discussed in Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions Sithe Assets Contribution, on April 2, 2007, Dynegy contributed its interest in the Sithe Assets to DHI. ExRes also owns through its subsidiaries four hydroelectric generation facilities in Pennsylvania. The entities owning these facilities meet the definition of VIEs. In accordance with the purchase agreement, Exelon Corporation (Exelon) has the sole and exclusive right to direct our efforts to decommission, sell, or otherwise dispose of the hydroelectric facilities owned through the VIEs. Exelon is obligated to reimburse ExRes for all costs, liabilities, and obligations of the entities owning these facilities, and to indemnify ExRes with respect to the past and present assets and operations of the entities. As a result, we are not the primary beneficiary of the entities and have not consolidated them in accordance with the provisions of FIN No. 46(R), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN No. 46(R)).

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These hydroelectric generation facilities have commitments and obligations that are off-balance sheet with respect to us that arise under operating leases for equipment and long-term power purchase agreements with local utilities. As of September 30, 2007, the equipment leases have remaining terms from one to twenty-five years and involve a maximum aggregate obligation of \$153 million over the terms of the leases. Additionally, each of these facilities is party to a long-term power purchase agreement with a local utility. Under the terms of each of these agreements, a project tracking account (the Tracking Account) was established to quantify the difference between (i) the facility's fixed price revenues under the power purchase agreement and (ii) a percentage of the respective utility's Public Utility Commission approved avoided costs associated with those power purchases plus accumulated interest on the balance. Each power purchase agreement calls for the hydroelectric facility to return to the utility the balance in the Tracking Account before the end of the facility's life through decreased pricing under the respective power purchase agreement. If the decreased pricing does not reduce the tracking account to zero, a lump sum payment for the remainder of the balance will be due. All four hydroelectric facilities are currently in the Tracking Account repayment period of the contract, whereby balances are repaid through decreased pricing. This pricing cannot be decreased below a level sufficient to allow the facilities to recover their operating costs. The aggregate balance of the Tracking Accounts as of September 30, 2007, was approximately \$345 million, and the obligations with respect to each Tracking Account are secured by the assets of the respective facility. The decreased pricing necessary to reduce the Tracking Accounts will make the continued sale of electricity from the facilities uneconomical. As discussed above, the obligations of the four hydroelectric facilities are non-recourse to us. Under the terms of the stock purchase agreement with Exelon, we are indemnified for any net cash outflow arising from ownership of these facilities.

PPEA Holding Company LLC. On April 2, 2007, in connection with the completion of the Merger Agreement, we acquired a 70% interest in PPEA Holding Company LLC (PPEA). PPEA owns and operates Plum Point Energy Associates, LLC (Plum Point). Plum Point is constructing a 665 MW coal fired power generation facility (the Project), located in Mississippi County, Arkansas, in which it owns an approximate 57% undivided interest. Plum Point is the Borrower under a \$700 million term loan facility, a \$17 million revolving credit facility, and a \$102 million letter of credit facility securing \$100 million of Tax Exempt Bonds (as discussed below in Note 8). The Project indebtedness is an obligation of Plum Point. The payment obligations of Plum Point in respect of the Bank Loan, the Revolver, and the LC Facility are unconditionally and irrevocably guaranteed by Ambac Assurance Corporation, an independent third party insurance company. Plum Point is party to credit facilities and an insurance policy, which are secured by a security interest in all of Plum Point's assets, contract rights and Plum Point's undivided tenancy in common interest in the Project and PPEA's interest in Plum Point. These assets consist primarily of \$236 million of plant construction in progress at September 30, 2007. There are no guarantees of the indebtedness by any parties, and Plum Point's creditors have no recourse against our general credit. However, as of September 30, 2007, we have posted a \$30 million letter of credit to ensure our equity contribution to the Project. See Note 8 Debt Plum Point Credit Agreement Facility for discussion of Plum Point's borrowings. PPEA meets the definition of a VIE, and we have determined we are the primary beneficiary of this entity. As such, we have consolidated it in accordance with the provisions of FIN No. 46(R).

On October 25, 2007, we entered into an agreement to sell a non-controlling ownership interest in PPEA to certain affiliates of John Hancock Life Insurance Company (Hancock) for approximately \$82 million, which is net of non-recourse project debt. The non-controlling interest to be purchased by Hancock represents approximately 125 MW of generating capacity in the Plum Point power generation facility. The transaction is subject to customary closing conditions and is expected to close in the fourth quarter 2007. Upon closing, we will own a 37% interest in PPEA, representing an equivalent of approximately 140 MW and will maintain construction and commercial control of the facility.

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DLS Power Holdings and DLS Power Development. As discussed in Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions, on April 2, 2007, in connection with the transactions consummated by the Merger Agreement, Dynegy acquired a 50% interest in DLS Power Holdings and DLS Power Development. The purpose of DLS Power Development is to provide services to DLS Power Holdings and the project subsidiaries related to power project development and to evaluate and pursue potential new development projects. DLS Power Holdings and DLS Power Development meet the definition of VIEs, as they will require additional subordinated financial support from their owners to conduct normal on-going operations. However, Dynegy is not the primary beneficiary of the entities and, in accordance with the provisions of FIN No. 46(R), has not consolidated them. Dynegy accounts for its investments in DLS Power Holdings and DLS Power Development as equity method investments pursuant to APB 18, The Equity Method of Accounting for Investments in Common Stock. We believe that Dynegy's maximum exposure to economic loss from this VIE is limited to \$61 million, which represents its equity investment in these entities at September 30, 2007.

A substantial portion of the purchase price allocated to these investments, and the equity investment at September 30, 2007, represents Dynegy's estimate of its proportionate share of the fair value of the underlying intangible assets associated with each of the development projects in excess of the equity of the underlying assets. Depending on the outcome of each development project, Dynegy could be required to record an impairment to its investment related to these intangible assets.

Sandy Creek. In connection with its acquisition of a 50% interest in DLS Power Holdings, as further discussed above, Dynegy acquired a 50% interest in Sandy Creek Holdings LLC (SCH), which owned all of Sandy Creek Energy Associates, LP (SCEA). SCEA owns the Sandy Creek Energy Station (the Project), which is a proposed 898 MW facility to be located in McLennan County, Texas. In August 2007, SCH became a stand-alone entity separate from DLS Power Holdings and its wholly owned subsidiaries, including SCEA, entered into various financing agreements to construct the Project and sold a 25% undivided interest in the Project to an unrelated third party as a result of which, SCEA currently owns a 75% interest in the Project.

Dynegy Sandy Creek Holdings, LLC (the Dynegy Member), an indirectly wholly owned subsidiary of Dynegy, and LSP Sandy Creek Member, LLC (the LSP Member) each own a 50% interest in SCH. In addition, Sandy Creek Services, LLC (SC Services) was formed to provide services to SCH. Dynegy Power Services and LSP Sandy Creek Services LLC each own a 50% interest in SC Services.

Dynegy's 50% interest in SCH, as well as a related intangible asset of approximately \$23 million, were subsequently contributed to a wholly owned subsidiary of DHI. This contribution was accounted for as a transaction between entities under common control. As such, DHI's investment in SCH, as well as the related intangible asset, were recorded by DHI at Dynegy's historical cost on the acquisition date. DHI's investment in SCH is included in GEN-WE. SCH and SC Services both meet the definition of a VIE, as they will require additional subordinated financial support to conduct their normal on-going operations. However, we are not the primary beneficiary of the entities, and, in accordance with FIN No. 46(R), do not consolidate them. We account for our investments in SCH and SC Services as equity method investments pursuant to APB 18. We believe that our maximum exposure to economic loss from these VIEs is limited to \$358 million, which represents our \$35 million equity investment in these entities at September 30, 2007 and supporting letters of credit totaling \$323 million.

The financing agreements consist of a \$200 million term loan and \$800 million in construction loans with SCEA as borrower. The SCEA debt is secured by a pledge of SCEA's assets and contract rights and SCEA's undivided tenancy in common interest in the Project.

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In addition, SCH entered into a \$200 million credit agreement with the Dynegy Member and the LSP Member, as defined below. The SCH debt is secured by a pledge of SCH's indirect ownership interests in SCEA. The Dynegy Member's 50% share of the credit agreement is supported by a letter of credit issued under DHI's primary credit facility in the amount of \$100 million. Such letter of credit may be drawn upon by the SCEA lenders if certain conditions are met. The Dynegy Member and the LS Member each agreed to make capital contributions of \$223 million to fund project costs after the SCEA and SCH loans have been utilized and otherwise upon the occurrence of certain events and milestone dates. The Dynegy Member's obligation to make such contributions is supported by a letter of credit in the amount of \$223 million issued under DHI's primary credit facility. Such letter of credit may be drawn upon by the SCEA lenders if certain conditions are met.

Upon the close of the financing agreements discussed above, SCEA sold a 25% undivided interest in the Project for approximately \$30 million plus a related portion of accumulated and future construction costs. During the third quarter 2007, we recognized our share of the gain on the sale, which approximated \$12 million, in Earnings from unconsolidated investments on the unaudited condensed consolidated statements of operations. During the third quarter 2007, SCEA received \$24 million in cash proceeds, consisting of approximately \$15 million of the purchase price and \$9 million for its share of accumulated costs. The remainder of the purchase price, plus accrued interest, is expected to be collected in 2010. SCEA will distribute the proceeds from the sale to the Dynegy Member and the LSP Member during the fourth quarter 2007.

Note 8 Debt

Notes payable and long-term debt consisted of the following:

| | September 30, 2007 | December 31, 2006 |
|---|--------------------------|----------------------|
| | (in millions) | |
| Term Loan B, due 2013 | \$ 70 | \$ |
| Term Facility, floating rate due 2013 | 850 | |
| Term Facility, floating rate due 2012 | | 200 |
| Senior Notes, 6.875% due 2011 | 496 | 493 |
| Senior Notes, 8.75% due 2012 | 493 | 488 |
| Senior Unsecured Notes, 7.5% due 2015 | 550 | |
| Senior Unsecured Notes, 8.375% due 2016 | 1,047 | 1,047 |
| Senior Debentures, 7.125% due 2018 | 173 | 173 |
| Senior Unsecured Notes, 7.75% due 2019 | 1,100 | |
| Senior Debentures, 7.625% due 2026 | 172 | 173 |
| Second Priority Senior Secured Notes, 9.875% due 2010 | | 11 |
| Subordinated Debentures payable to affiliates, 8.316%, due 2027 | 200 | 200 |
| Sithe Senior Notes, 8.5% due 2007 | | 39 |
| Sithe Senior Notes, 9.0% due 2013 | 409 | 409 |
| Plum Point Tax Exempt Bonds, floating rate due 2036 | 100 | |
| Plum Point Construction Loan, floating rate due 2010 | 263 | |
| | 5,923 | 3,233 |
| Unamortized premium on debt, net | 21 | 25 |

| | | |
|---|----------|----------|
| | 5,944 | 3,258 |
| Less: Amounts due within one year, including non-cash amortization of basis adjustments | 53 | 68 |
| Total Long-Term Debt | \$ 5,891 | \$ 3,190 |

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Aggregate debt maturities for the remainder of 2007, the next four years and thereafter of the principal amounts of all long-term indebtedness as of September 30, 2007 are as follows: 2007 \$21 million, 2008 \$50 million, 2009 \$58 million, 2010 \$63 million, 2011 \$570 million and thereafter \$5,182 million.

Fifth Amended and Restated Credit Facility. On April 2, 2007, we entered into a fifth amended and restated credit facility (the Fifth Amended and Restated Credit Facility) with Citicorp USA, Inc. and JPMorgan Chase Bank, N.A., as co-administrative agents, JPMorgan Chase Bank, N.A., as collateral agent, Citicorp USA Inc., as payment agent, J.P. Morgan Securities Inc. and Citigroup Global Markets Inc., as joint lead arrangers and joint book-runners, and the other financial institutions party thereto as lenders or letter of credit issuers.

The Fifth Amended and Restated Credit Facility amended DHI s former credit facility (the Fourth Amended and Restated Credit Facility, which was last amended on July 11, 2006) by increasing the amount of the existing \$470 million revolving credit facility (the Revolving Facility) to \$850 million, increasing the amount of the existing \$200 million term letter of credit facility (the Term L/C Facility) to \$400 million and adding a \$70 million senior secured term loan facility (Term Loan B).

Loans and letters of credit are available under the Revolving Facility and letters of credit are available under the Term L/C Facility for general corporate purposes. Letters of credit issued under DHI s former credit facility have been continued under the Fifth Amended and Restated Credit Facility. The Term Loan B was used to pay a portion of the consideration under the Merger Agreement. In connection with the completion of the transactions contemplated by the Merger Agreement, an aggregate \$275 million under the Revolving Facility, an aggregate \$400 million under the Term L/C Facility (with the proceeds placed in a collateral account to support the issuance of letters of credit), and an aggregate \$70 million under Term Loan B (representing all available borrowings under Term Loan B) were drawn. The Fifth Amended and Restated Credit Facility is secured by certain assets of DHI and is guaranteed by Dynegy, Dynegy Illinois and certain subsidiaries of DHI. In addition, the obligations under the Fifth Amended and Restated Credit Facility and certain other obligations to the lenders thereunder and their affiliates are secured by substantially all of the assets of such guarantors. The Revolving Facility matures on April 2, 2012, and the Term L/C Facility and Term Loan B each mature on April 2, 2013. The principal amount of the Term L/C Facility is due in a single payment at maturity; the principal amount of Term Loan B is due in quarterly installments of \$175,000 in arrears commencing December 31, 2007, with the unpaid balance due at maturity.

Borrowings under the Fifth Amended and Restated Credit Facility bear interest, at DHI s option, at either the base rate, which is calculated as the higher of Citibank, N.A. s publicly announced base rate and the federal funds rate in effect from time to time, or the Eurodollar rate (which is based on rates in the London interbank Eurodollar market), in each case plus an applicable margin.

The applicable margin for borrowings under the Revolving Facility depends on the Standard & Poor s Ratings Services (S&P) and Moody s Investors Service, Inc. (Moody s) credit ratings of the Revolving Facility, with higher credit ratings resulting in a lower rate. The applicable margin for such borrowings will be either 0.125% or 0.50% per annum for base rate loans and either 1.125% or 1.50% per annum for Eurodollar loans, with the lower applicable margin being payable if the ratings for the Revolving Facility by S&P and Moody s are BB+ and Ba1 or higher, respectively, and the higher applicable margin being payable if such ratings are less than BB+ and Ba1. The applicable margins for the Term L/C Facility and Term Loan B are 0.50% for base rate loans and 1.50% for Eurodollar loans.

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An unused commitment fee of either 0.25% or 0.375% is payable on the unused portion of the Revolving Facility, with the lower commitment fee being payable if the ratings for the Revolving Facility by S&P and Moody's are BB+ and Ba1 or higher, respectively, and the higher commitment fee being payable if such ratings are less than BB+ and Ba1.

The Fifth Amended and Restated Credit Facility contains mandatory prepayment provisions associated with specified asset sales and dispositions (including as a result of casualty or condemnation). The Fifth Amended and Restated Credit Facility also contains customary affirmative covenants and negative covenants and events of default. Subject to certain exceptions, DHI and its subsidiaries are subject to restrictions on incurring additional indebtedness, limitations on investments and limitations on dividends and other payments in respect of capital stock.

The Fifth Amended and Restated Credit Facility also contains certain financial covenants, including (i) a covenant (measured as of the last day of the relevant fiscal quarter as specified below) that requires DHI and certain of its subsidiaries to maintain a ratio of secured debt to adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) for DHI and its relevant subsidiaries of no greater than 2.75:1 (September 30, 2007 and thereafter through and including March 31, 2009); and 2.5:1 (June 30, 2009 and thereafter); and (ii) a covenant that requires DHI and certain of its subsidiaries to maintain a ratio of adjusted EBITDA to consolidated interest expense for DHI and its relevant subsidiaries as of the last day of the measurement periods ending September 30, 2007 and thereafter through and including December 31, 2008 of no less than 1.5:1; ending March 31, 2009 and June 30, 2009 of no less than 1.625:1; and ending September 30, 2009 and thereafter of no less than 1.75:1.

On May 24, 2007, we entered into an Amendment No. 1, dated as of May 24, 2007 (the Credit Agreement Amendment), to the Fifth Amended and Restated Credit Facility, which increased the amount of the existing \$850 million Revolving Facility to \$1.15 billion and increased the amount of the existing \$400 million Term L/C Facility to \$850 million; the Credit Agreement Amendment did not affect the Term Loan B. The Credit Agreement Amendment also amended a pro forma leverage ratio requirement in the Fifth Amended and Restated Credit Facility to allow DHI to issue the Notes (as defined and discussed below).

Plum Point Credit Agreement Facility. The Plum Point Credit Agreement Facility (Credit Agreement Facility) consists of a \$700 million construction loan (the Construction Loan), a \$700 million term loan commitment (the Bank Loan), a \$17 million revolving credit facility (the Revolver) and a \$102 million backstop letter of credit facility (the LC Facility). The LC Facility was initially utilized to back-up the \$101 million letter of credit issued under the then-existing LC Facility (the Original LC) for the benefit of the owners of the Tax Exempt Bonds described below. During the second quarter 2007, the Tax Exempt Bonds were repaid and reoffered and a new letter of credit in the amount of approximately \$101 million was issued under the LC Facility in substitution for the Original LC in connection with which the Tax Exempt Bonds were remarketed. Borrowings under the Credit Agreement Facility bear interest, at Plum Point's option, at either the base rate, which is determined as the greater of the Prime Rate or the Federal Funds Rate in effect from time to time plus 1/2 of 1%, or the Adjusted LIBOR, which is equal to the product of the applicable LIBOR and any Statutory Reserves plus an applicable margin equal to 0.35%. In addition, Plum Point pays commitment fees equal to 0.125% per annum on the undrawn Bank Loan, Revolver and LC Facility commitments. Upon completion of the construction of the Plum Point Project, the Construction Loan will terminate and the debt thereunder will be replaced by the Bank Loan. The Bank Loan matures on the thirtieth anniversary of the later of the date on which substantial completion of the facility has occurred or the first date of commercial operation under any of the power purchase agreements then in effect. The current estimated date of completion of construction is in the second quarter 2010.

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The payment obligations of Plum Point in respect of the Bank Loan, the Revolver, the LC Facility, and associated interest rate hedging agreements (discussed below) are unconditionally and irrevocably guaranteed by Ambac Assurance Corporation. Ambac Assurance Corporation also provided an unconditional commitment to issue, upon the closing of any refinancing of the Tax Exempt Bonds, a bond insurance policy insuring the Tax Exempt Bonds and a debt service reserve surety in an amount equal to the debt service reserve requirement with respect to such bonds. The credit facilities and insurance policy are secured by a mortgage and security interest (subject to permitted liens) in all of Plum Point's assets and contract rights and Plum Point's undivided tenancy in common interest in the Project and PPEA's interest in Plum Point. Plum Point pays an additional 0.38% spread for the AMBAC insurance coverage which is deemed a cost of financing and included in interest expense.

In the second quarter 2007, Plum Point entered into three interest rate swap agreements with an initial aggregate notional amount of approximately \$183 million and fixed interest rates of approximately 5.3%. These interest rate swap agreements convert Plum Point's floating rate debt exposure (exclusive of that on the Tax Exempt Bonds) to a fixed interest rate. The interest rate swap agreements expire in June 2040. For the three months ended June 30, 2007, we recorded \$27 million of mark-to-market income related to these interest rate swap agreements as an offset to our consolidated interest expense. Effective July 1, 2007, we designated these agreements as cash flow hedges. Therefore, the effective portion of the changes in value after that date are reflected in Other Comprehensive Income (Loss), and subsequently reclassified to interest expense contemporaneously with the related accruals of interest expense, or depreciation expense in the event the interest was capitalized, in either case to the extent of hedge effectiveness.

Plum Point Tax Exempt Bonds. On April 1, 2006, the City of Osceola (the City) loaned the \$100 million in proceeds of a tax exempt bond issuance (the Tax Exempt Bonds) to Plum Point. The Tax Exempt Bonds were issued pursuant to and secured by a Trust Indenture dated April 1, 2006 between the City and Regions Bank as Trustee. The purpose of the Tax Exempt Bonds is to finance certain of Plum Point's undivided interests in various sewage and solid waste collection and disposal facilities in the Plum Point facility. Interest expense on the Tax Exempt Bonds is based on a weekly variable rate and is payable monthly. The interest rate in effect at September 30, 2007 was 3.92%. The Tax Exempt Bonds mature on April 1, 2036.

Senior Unsecured Notes Offering. On May 24, 2007, DHI issued \$1.1 billion aggregate principal amount of its 7.75% Senior Unsecured Notes due 2019 (the 2019 Notes) and \$550 million aggregate principal amount of its 7.50% Senior Unsecured Notes due 2015 (the 2015 Notes) and, together with the 2019 Notes, the Notes) pursuant to the terms of a purchase agreement, dated as of May 17, 2007, by and among DHI and the several initial purchasers party thereto (the Purchasers). The Notes are DHI's senior unsecured obligations and rank equal in right of payment to all of DHI's existing and future senior unsecured indebtedness, and are senior to all of DHI's existing, and any of its future, subordinated indebtedness. DHI's secured debt and its other secured obligations are effectively senior to the Notes to the extent of the value of the assets securing such debt or other obligations. None of DHI's subsidiaries have guaranteed the Notes and, as a result, all of the existing and future liabilities of DHI's subsidiaries are effectively senior to the Notes. Dynegy has not guaranteed the Notes, and the assets and operations that Dynegy owns through its subsidiaries, other than DHI, do not support the Notes. In connection with the Notes, DHI entered into a registration rights agreement with the Purchasers of the Notes pursuant to which DHI agreed to offer to exchange the Notes for a new issue of substantially identical notes registered under the Securities Act of 1933. On October 15, 2007, pursuant to the registration rights agreement, DHI initiated the exchange offer, which is expected to be completed in the fourth quarter 2007.

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DHI used the net proceeds from the sale of the Notes to repay a portion of the debt assumed in the Merger Agreement. Long-term debt assumed upon completion of the Merger Agreement and repaid from the proceeds of the sale of the Notes consisted of the following as of April 2, 2007:

| | Face Value | Premium Discount (in millions) | Fair Value |
|---|---------------|--------------------------------------|---------------|
| Generation Facilities First Lien Term Loans due 2013 | \$ 919 | \$ 1 | \$ 920 |
| Generation Facilities Second Lien Term Loans due 2014 | 150 | 1 | 151 |
| Kendall First Lien Term Loan due 2013 | 396 | (5) | 391 |
| Ontelaunee First Lien Term Loan due 2009 | 100 | (1) | 99 |
| Ontelaunee Second Lien Credit Agreement due 2009 | 50 | 1 | 51 |
| Total debt repaid with proceeds from unsecured offering | \$ 1,615 | \$ (3) | \$ 1,612 |

Outstanding letters of credit under the above mentioned LC facilities were transferred to, and became outstanding letters of credit under, the Fifth Amended and Restated Credit Facility as amended by the Credit Agreement Amendment. Continuing secured obligations of Dynegy Gen Finance Co LLC include financially settled heat rate options and a collateral posting arrangement that are secured by the assets of Dynegy Gen Finance Co LLC.

Repayments and Redemptions. On both January 2, 2007 and July 2, 2007, we made principal payments of \$19 million on the Sithe Energies debt. On September 7, 2007, we completed the redemption of \$11 million of DHI's remaining outstanding 9.875% Second Priority Secured Notes due 2010 at a redemption price of 104.938% of the principal amount plus accrued and unpaid interest to the redemption date. On August 6, 2007, we repaid the aggregate \$275 million borrowed under the Revolving Facility.

Note 9 Related Party Transactions

Equity Investments. We hold three investments in joint ventures in which LS Power or its affiliates are also investors. Dynegy has a 50% ownership interest in DLS Power Holdings and DLS Power Development. DHI has a 50% ownership interest in SCEA, which was contributed to it by Dynegy in August 2007. Please see Note 7 Variable Interest Entities for further discussion.

Other. On March 30, 2007, DHI paid a dividend of \$50 million to Dynegy. In April 2007, DHI paid dividends of \$275 million and \$17 million to Dynegy.

On April 2, 2007, Dynegy contributed to Dynegy Illinois its interest in the Contributed Entities. Also in April 2007, Dynegy Illinois contributed to DHI all of its interest in New York Holdings, together with its indirect interest in the subsidiaries of New York Holdings. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion.

Note 10 Dynegy's Earnings (Loss) Per Share

Basic earnings (loss) per share represents the amount of earnings (losses) for the period available to each share of Dynegy common stock outstanding during the period. Diluted earnings (loss) per share represents the amount of earnings (losses) for the period available to each share of Dynegy 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.

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The reconciliation of basic earnings (loss) per share from continuing operations to diluted earnings (loss) per share from continuing operations is shown in the following table:

| | Three Months Ended | | Nine Months Ended | |
|--|--|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| | (in millions, except per share amounts) | | | |
| Income (loss) from continuing operations | \$ 96 | \$ (71) | \$ 179 | \$ (270) |
| Preferred stock dividends | | | | (9) |
| Income (loss) from continuing operations for basic earnings (loss) per share | 96 | (71) | 179 | (279) |
| Effect of dilutive securities: | | | | |
| Interest on convertible subordinated debentures | | | | 3 |
| Dividends on Series C Preferred | | | | 9 |
| Income (loss) from continuing operations for diluted earnings (loss) per share | \$ 96 | \$ (71) | \$ 179 | \$ (267) |
| Basic weighted-average shares | 836 | 495 | 721 | 446 |
| Effect of dilutive securities: | | | | |
| Stock options | 2 | 2 | 2 | 2 |
| Convertible subordinated debentures | | | | 27 |
| Series C Preferred | | | | 37 |
| Diluted weighted-average shares | 838 | 497 | 723 | 512 |
| Income (loss) per share from continuing operations: | | | | |
| Basic | \$ 0.11 | \$ (0.14) | \$ 0.25 | \$ (0.63) |
| Diluted (1) | \$ 0.11 | \$ (0.14) | \$ 0.25 | \$ (0.63) |

(1) When an entity has a net loss from continuing operations, SFAS No. 128, Earnings per Share, prohibits the inclusion of potential common shares in the

computation of
diluted
per-share
amounts.

Accordingly,
Dynegy has
utilized the
basic shares
outstanding
amount to
calculate both
basic and
diluted loss per
share for the
three and nine
months ended
September 30,
2006.

Note 11 Commitments and Contingencies

Set forth below is a summary of certain ongoing legal proceedings. In accordance with SFAS No. 5, Accounting for Contingencies (SFAS No. 5), we record reserves for contingencies when information available indicates that a loss is probable and the amount of the loss is reasonably estimable. In addition, we disclose matters for which management believes a material loss is at least reasonably possible. In all instances, management has assessed the matters below based on current information and made a judgment concerning their potential outcome, giving due consideration to the nature of the claim, the amount and nature of damages sought and the probability of success. Management's judgment may prove materially inaccurate and such judgment is made subject to the known uncertainty of litigation.

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In addition to the matters discussed below, we are party to numerous legal proceedings arising in the ordinary course of business or related to discontinued business operations. In management's judgment, which may prove to be materially inaccurate as indicated above, the disposition of these matters will not materially adversely affect our financial condition, results of operations or cash flows.

Gas Index Pricing Litigation. We and our former joint venture affiliate West Coast Power are named defendants in numerous lawsuits in state and federal court claiming damages resulting from alleged price manipulation and false reporting of natural gas prices to various index publications in the 2000-2002 timeframe. The cases are pending in California, Nevada and Alabama. In each of these suits, the plaintiffs allege that we, West Coast Power and other energy companies engaged in an illegal scheme to inflate natural gas prices by providing false information to natural gas index publications. All of the complaints rely heavily on prior FERC and Commodity Futures Trading Commission (CFTC) investigations into and reports concerning index manipulation in the energy industry. Except as specifically mentioned below, the parties are actively engaged in discovery.

During the previous eighteen months, several cases pending in Nevada federal court were dismissed on defendants' motions. Certain plaintiffs appealed to the Court of Appeals for the Ninth Circuit, which coordinated the cases before the same appellate panel. In September 2007, the Ninth Circuit reversed the dismissals and remanded the cases to their respective trial courts for further proceedings. We are a defendant in only one of the remanded cases. Several matters transferred to Nevada from other federal courts through the multi-district litigation process remain pending.

Pursuant to various motions, the cases pending in California state court were coordinated before a single judge in San Diego (Coordinated Gas Index Cases). In August 2006, we entered into an agreement to settle the class action claims in the Coordinated Gas Index Cases for \$30 million. In December 2006, the court granted final approval of the settlement and dismissed the class action claims. The settlement is without admission of wrongdoing, and we and West Coast Power continue to deny class plaintiffs' allegations. The settlement did not include fourteen similar claims filed by individual plaintiffs in the Coordinated Gas Index Cases (the Single Plaintiff Cases).

Also in August 2006, we entered into an agreement to settle the class action claims by California natural gas re-sellers and co-generators (to the extent they purchased natural gas to generate electricity for re-sale) pending in Nevada federal court for \$2.4 million. The court granted preliminary approval of this settlement in May 2007, which we funded shortly thereafter, and final approval in October 2007. The settlement is without admission of wrongdoing, and we and West Coast Power continue to deny class plaintiffs' allegations.

In February 2007, a Tennessee state court case was also dismissed on defendants' motion. In April 2007, the plaintiffs appealed the decision, and that appeal remains pending.

In September 2007, we and the parties to the Alabama action entered into a confidential settlement agreement to resolve the litigation. The settlement is without admission of wrongdoing, and we continue to deny plaintiffs' allegations.

In October 2007, we, on behalf of ourselves and West Coast Power, entered into a confidential memorandum of understanding to settle the Single Plaintiff Cases. The execution of a formal agreement and funding are expected to occur in the fourth quarter 2007. The settlement is without admission of wrongdoing, and we continue to deny plaintiffs' allegations.

During the three and nine months ended September 30, 2007 and 2006, we recorded legal and settlement charges of approximately \$16 million, \$16 million, \$2 million and \$25 million, respectively, as a result of the actions noted above. We continue to analyze the Gas Index Pricing Litigation and are vigorously defending the remaining individual matters as appropriate. Due to the uncertainty of litigation, we cannot predict whether we will incur any liability in connection with these lawsuits. However, given the nature of the claims, an adverse result in these proceedings could have a material adverse effect on our financial condition, results of operations and cash flows.

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California Market Litigation. We and various other power generators and marketers were defendants in numerous lawsuits alleging rate and market manipulation in California's wholesale electricity market during the California energy crisis several years ago. The complaints generally alleged unfair, unlawful and deceptive trade practices in violation of the California Unfair Business Practices Act and sought injunctive relief, restitution and unspecified actual and treble damages. All of these cases have been dismissed on grounds of federal preemption except for one remaining action that is pending and fully briefed before the Ninth Circuit Court of Appeals.

We cannot predict with certainty whether we will incur any liability in connection with the remaining pending appeal; however, given the pattern of dismissal and success on appeal of related actions, we expect a similar outcome. Nonetheless, given the nature of this claim, an adverse result could have a material adverse effect on our financial condition, results of operations and cash flows.

Nevada Power Arbitration. Through one of our indirect subsidiaries, we hold an ownership interest in Nevada Cogeneration Associates #2 (NCA#2), in which our equal partner is a CUSA subsidiary. NCA#2 has a long-term power sale agreement with Nevada Power Company (Nevada Power) that extends through April 2023. In October 2007, Nevada Power initiated an arbitration against NCA#2 seeking a declaratory judgment that (i) Nevada Power's methodology for calculating certain cumulative excess payments in the event of default or early termination by NCA#2 is correct and (ii) NCA#2 is obligated to repay to Nevada Power the full amount of any outstanding excess payments in the event of a default or early termination or upon the expiration of the agreement's term in 2023.

Currently, Nevada Power does not allege an event of default or early termination has occurred. Nonetheless, Nevada Power maintains that as of December 31, 2006, if an event of default had occurred, NCA#2 would have been required to pay approximately \$120 million in cumulative excess payments. We previously disclosed that we agreed to guarantee 50% of the NCA#2 obligation which would be approximately \$66 million, if NCA#2 had terminated the power sale agreement as of September 30, 2007. Nevada Power further alleges that the payment obligation could equal approximately \$365 million in 2023, 50% of which would be our proportionate share. While there is a question of interpretation regarding the existence of an obligation to make payments upon the scheduled termination of the agreement, management does not expect that any such payments will be required. We believe Nevada Power's claims are without merit and we intend to defend against them vigorously. However, given the amount in controversy, an adverse ruling could have a material adverse effect on our future financial condition, results of operations and cash flows. Prior to the initiation of arbitration, this matter was previously disclosed as Black Mountain in the Guarantees and Indemnification section below.

Illinois Auction Complaints. In March 2007, the Attorney General of the State of Illinois (the IAG) filed a complaint at FERC (the IAG FERC Complaint) against 16 electricity suppliers engaged in wholesale power sales, challenging the results of the Illinois reverse power procurement auction conducted in September 2006. DPM filed its motion to dismiss and answer the IAG FERC Complaint in June 2007.

In July 2007, the IAG filed a motion to suspend its complaint at FERC and legislative leaders from the State of Illinois, including the Speaker of the House and the Senate President, announced a comprehensive transitional rate relief package for electric consumers. This rate relief package and related agreements were subject to passage of certain legislation, which became law in August 2007.

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As a part of the rate relief package, we agreed to make payments of up to \$25 million over a 29-month period. These payments will be contingent on certain conditions related to the absence of future electric rate and tax legislation in Illinois. We made a payment of \$7.5 million in 2007 and anticipate making payments of \$9.0 million in 2008 and \$8.5 million in 2009. We recorded a \$25 million expense in the second quarter of 2007 related to these payments, which is included in cost of sales on our unaudited condensed consolidated statement of operations. Our payment of \$7.5 million in September 2007 is to be used for funding of the Illinois Power Agency, which is to be created as part of Illinois' comprehensive rate relief package. Our expected payments for 2008 and 2009 will be made in monthly installments so long as Illinois does not impose an electric rate freeze or an additional tax on generators prior to December 2009, as further described in the rate relief package and related agreements. The monthly payments will be paid into an escrow account established to support rate relief activities for Ameren Illinois Utilities' customers. The rate relief package and related agreements have resulted in motions to dismiss with prejudice being filed in several ongoing court and regulatory proceedings including the IAG FERC Complaint, appeals of the original orders adopting the auction process and the auction improvements case. Some of these dismissals have already been entered, including the IAG FERC Complaint, while others remain pending. The FERC complaint was dismissed in October 2007.

Shortly after the IAG FERC Complaint was filed, two civil class action complaints against 21 wholesale electricity suppliers and utilities, including DPM, were filed in Illinois state court. The complaints largely mirror the IAG's filing and seek unspecified actual and punitive damages. In April 2007, the cases were removed to federal court, and in June 2007, the defendants moved to dismiss plaintiffs' claim on grounds of the filed rate doctrine and preemption. In October 2007, at the request of the Court, the parties provided supplemental briefs on the impact of the FERC dismissal order and the Illinois rate relief package. A decision on defendants' motion to dismiss is expected in the fourth quarter 2007.

We believe that the civil plaintiffs' claims are without merit and we intend to defend against them vigorously. However, given the gravity of their claims, an adverse ruling in some or all of these proceedings could have a material adverse effect on our financial condition, results of operations and cash flows.

New York Attorney General Subpoena. On September 17, 2007, Dynegy and four other companies received a subpoena from the Office of the New York Attorney General. The subpoena seeks information and documents related to, among other things: Dynegy's evaluation, analysis and projections regarding climate change; the impact of climate change on Dynegy's operations; development opportunities through the Company's joint venture with LS Power; and alleged deficiencies in Dynegy's SEC disclosures related to the foregoing. We are reviewing the subpoena and discussing its contents with the New York Attorney General's office in anticipation of our responding as appropriate.

Illinova Arbitration. In June 2000, Dynegy's subsidiary, Illinova Generating Company (IGC), sold a minority interest it held in a Cleburne, Texas generating plant to Ponderosa Pine Energy (PPE). Brazos Electric Cooperative, Inc. (Brazos), the party to an offtake agreement from the plant, brought legal action against PPE alleging that PPE's purchase did not comply with the terms of Brazos' offtake agreement. Brazos received a favorable arbitration award against PPE, which in turn sought recovery from IGC and the other former owners of the plant for indemnification. In May 2007, the panel in PPE's arbitration action ruled that IGC and the other former owners of the plant must indemnify PPE for the Brazos arbitration award, with IGC's portion being defined as approximately \$17 million. Dynegy recognized a legal settlement charge of approximately \$17 million in the first quarter 2007 relating to this adverse ruling. In May 2007, Dynegy paid the judgment under protest. PPE recently moved to enforce the arbitration award in state district court and the defendants have filed an opposition. A hearing on the pending motions is scheduled in November 2007.

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Bridgeport RMR Agreement. The Bridgeport facility had been operating pursuant to the terms of a reliability-must-run (RMR) agreement, subject to the outcome of ongoing proceedings before the FERC to resolve the question of whether Bridgeport is eligible for an RMR agreement. On May 25, 2007, Bridgeport and the intervening parties submitted a Joint Offer of Settlement (the Settlement), which effectively terminated the RMR Agreement as of May 31, 2007. In addition, the Settlement stipulated that within 30 days of FERC approval, Bridgeport will refund ISO New England (ISO-NE) \$12.5 million and any RMR revenues received by Bridgeport from the ISO-NE under the amended RMR agreement for the calendar months April 2007 and May 2007. We recorded a reserve of \$12.5 million payable to the ISO-NE as part of the LS Power purchase price allocation, and reserved any RMR revenues received from the ISO-NE for April and May 2007. Under the Settlement, as of June 1, 2007, Bridgeport is no longer required to submit stipulated bids, which allows Bridgeport to more fully participate as a merchant generator in the ISO-NE market. The Settlement was certified as an uncontested settlement on June 29, 2007 by the Presiding Administrative Law Judge and was accepted by the FERC on August 3, 2007. Bridgeport funded the payments to ISO-NE in late August.

Danskammer State Pollutant Discharge Elimination System Permit. In January 2005, the New York State Department of Environmental Conservation (NYSDEC) issued a Draft Danskammer SPDES Permit renewal for the Danskammer plant, and an adjudicatory hearing was scheduled for the fall of 2005. Three environmental groups sought to impose a permit requirement that the Danskammer plant install a closed cycle cooling system in order to reduce the volume of water withdrawn from the Hudson River, thus reducing aquatic organism mortality. The petitioners claim that only a closed cycle cooling system meets the Clean Water Act 's requirement that the cooling water intake structures reflect best technology available (BTA) for minimizing adverse environmental impacts. A formal evidentiary hearing was held in November and December 2005. The Deputy Commissioner 's decision directing that the NYSDEC staff issue the revised Draft Danskammer SPDES Permit was issued in May 2006. In June 2006, the NYSDEC issued the revised Danskammer SPDES Permit with conditions generally favorable to us. While the revised Danskammer SPDES Permit does not require installation of a closed cycle cooling system, it does require aquatic organism mortality reductions resulting from NYSDEC 's determination of BTA requirements under its regulations. In July 2006, two of the petitioners filed suit in the Supreme Court of the State of New York seeking to vacate the Deputy Commissioner 's decision and the revised Danskammer SPDES Permit. On March 26, 2007, the Court transferred the lawsuit to the Third Department Appellate Division. The case will now proceed as a normal appeal from a final agency decision and the decision will be based on whether there is substantial evidence in the record to support the agency decision. We believe that the decision of the Deputy Commissioner is well reasoned and will be affirmed. However, in the event the decision is not affirmed and we ultimately are required to install a closed cycle cooling system, this could have a material adverse effect on our financial condition, results of operations and cash flows.

Roseton State Pollutant Discharge Elimination System Permit. In April 2005, the NYSDEC issued to DNE a draft SPDES Permit renewal for the Roseton plant. The Draft Roseton SPDES Permit requires the facility to actively manage its water intake to substantially reduce mortality of aquatic organisms.

In July 2005, a public hearing was held to receive comments on the Draft Roseton SPDES Permit. Three environmental organizations filed petitions for party status in the permit renewal proceeding. The petitioners are seeking to impose a permit requirement that the Roseton plant install a closed cycle cooling system in order to reduce the volume of water withdrawn from the Hudson River, thus reducing aquatic organism mortality. The petitioners claim that only a closed cycle cooling system meets the Clean Water Act 's requirement that the cooling water intake structures reflect the BTA for minimizing adverse environmental impacts. In September 2006, the administrative law judge issued a ruling admitting the petitioners to full party status and setting forth the issues to be adjudicated in the permit renewal hearing. Various holdings in the ruling have been appealed to the Commissioner

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of NYSDEC by DNE, NYSDEC staff, and the petitioners. We expect that the adjudicatory hearing on the Draft Roseton SPDES Permit will occur in 2007 or 2008. We believe that the petitioners' claims are without merit, and we plan to oppose those claims vigorously. Given the high cost of installing a closed-cycle cooling system, an adverse result in this proceeding could have a material adverse effect on our financial condition, results of operations and cash flows.

Moss Landing National Pollutant Discharge Elimination System Permit. The California Regional Water Quality Control Board (Water Board) issued a NPDES permit for the Moss Landing Power Plant in October 2000 in connection with modernization of the plant and the California Energy Commission's licensing of that project. A local environmental group, Voices of the Wetlands (Petitioner), sought review of the permit in Superior Court in Monterey County in July 2001 claiming that the permit was not supported by sufficient analysis of the BTA for cooling water intake structures as required under the Clean Water Act. Petitioner contends that the once-through, seawater-cooling system at Moss Landing should be replaced with a closed-cycle cooling system.

The Superior Court concluded that the Water Board's BTA analysis was insufficient and remanded the permit to the Water Board directing a comprehensive analysis and reconsideration of the NPDES permit. Following the hearing on remand, the Water Board affirmed its BTA finding. In July 2004, the Superior Court held that the Water Board had conducted a thorough and comprehensive BTA analysis on remand. This decision was appealed by Petitioner to California's Sixth Appellate District. Briefing for the appeal was completed in November 2005, and oral argument was held on September 18, 2007. A ruling from the appellate court is expected by the end of the fourth quarter 2007.

We believe that Petitioner's claims lack merit and we plan to oppose those claims vigorously. Given the high cost of installing a closed-cycle cooling system, an adverse result in this proceeding could have a material adverse effect on our financial condition, results of operation and cash flow.

Guarantees and Indemnifications

In the ordinary course of business, we routinely enter into contractual agreements that contain various representations, warranties, indemnifications and guarantees. Examples of such agreements include, but are not limited to, service agreements, equipment purchase agreements, engineering and technical service agreements, and procurement and construction contracts. Some agreements contain indemnities that cover the other party's negligence or limit the other party's liability with respect to third party claims, in which event we will effectively be indemnifying the other party. Virtually all such agreements contain representations or warranties that are covered by indemnifications against the losses incurred by the other parties in the event such representations and warranties are false. While there is always the possibility of a loss related to such representations, warranties, indemnifications and guarantees in our contractual agreements, and such loss could be significant, in most cases management considers the probability of loss to be remote.

WCP Indemnities. In connection with the sale of our 50% interest in West Coast Power to NRG on March 31, 2006, an agreement was executed to allocate responsibility for managing certain litigation and provide for certain indemnities with respect to such litigation. The agreement states that we will manage the Gas Index Pricing Litigation described above for which NRG could suffer a loss subsequent to the closing and that we would indemnify NRG for all costs or losses resulting from such litigation, as well as from other proceedings based on similar acts or omissions which formed the basis of such litigation. The agreement further states that we will manage the California Market Litigation described above for which NRG could suffer a loss subsequent to the closing, and that we and NRG would each be responsible for 50% of any costs or losses resulting from that power litigation, as well as from

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other proceedings based on similar acts or omissions which formed the basis of such litigation. The agreement provides that NRG will manage other active litigation and indemnify us for any resulting losses, subject to certain conditions. Maximum recourse under these matters is not limited by the agreement or by the passage of time with the exception of the California Department of Water Resources matter in which NRG has a specified indemnity obligation. The damages claimed by the various plaintiffs in these matters are unspecified as of September 30, 2007. **Targa Indemnities.** During 2005, as part of our sale of DMSLP, we agreed to indemnify Targa against losses it may incur under indemnifications DMSLP provided to purchasers of certain assets, properties and businesses disposed of by DMSLP prior to our sale of DMSLP. We have incurred no significant expense under these prior indemnities and deem their value to be insignificant. We have recorded an accrual in association with the cleanup of groundwater contamination at the Breckenridge Gas Processing Plant. The indemnification provided by DMSLP to the purchaser of the plant has a limit of \$5 million. We have also indemnified Targa for certain tax matters arising from periods prior to our sale of DMSLP. We have recorded a reserve associated with this indemnification.

Illinois Power Indemnities. As a condition of Dynegy's 2004 sale of Illinois Power and its interest in Electric Energy Inc.'s plant in Joppa, Illinois, Dynegy provided indemnifications to third parties regarding environmental, tax, employee and other representations. These indemnifications are limited to a maximum recourse of \$400 million. Additionally, Dynegy has indemnified third parties against losses resulting from possible adverse regulatory actions taken by the ICC that could prevent Illinois Power from recovering costs incurred in connection with purchased natural gas and investments in specified items. Although there is no limitation on Dynegy's liability under this indemnity, the amount of the indemnity is limited to 50% of any such losses. On July 27, 2005, Dynegy made a payment of \$8 million to Ameren in settlement of Ameren's indemnification claims with respect to an ICC Order disallowing items relating to one of Illinois Power's natural gas storage fields resulting in a negative revenue requirement impact to Ameren. In anticipation of similar cases, Dynegy recognized a pre-tax charge of \$12 million in 2005. As anticipated, Dynegy paid Ameren for an additional amount disallowed in a similar ICC Order in the third quarter 2006. Furthermore, in August 2007, the ICC issued its final Order in another of the related cases, which has been appealed. Dynegy has adjusted the amount reserved for the various ongoing cases in light of these and other developments in the cases. Further disallowances and other events which fall within the scope of the indemnity may still occur; however, Dynegy is not required to accrue a liability in connection with these indemnifications, as management cannot reasonably estimate a range of outcomes or at this time considers the probability of an adverse outcome as only reasonably possible. Dynegy intends to contest any proposed disallowances.

Northern Natural and Other Indemnities. During 2003, as part of our sales of Northern Natural, the Rough and Hornsea natural gas storage facilities and certain natural gas liquids assets, we provided indemnities to third parties regarding environmental, tax, employee and other representations. Maximum recourse under these indemnities is limited to \$209 million, \$857 million and \$28 million, respectively. We also entered into similar indemnifications regarding environmental, tax, employee and other representations when completing other asset sales such as, but not limited to, CoGen Lyondell, Rockingham Hackberry LNG Project, SouthStar Energy Services, various Canadian assets, Michigan Power, Oyster Creek, Hartwell, Commonwealth, Sherman, and Indian Basin. We have recorded reserves for existing environmental, tax and employee liabilities and have incurred no other expense relating to these indemnities.

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Note 12 Regulatory Issues

We are subject to regulation by various federal, state and local 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. The matters discussed below are material developments since the filing of our Forms 10-K. Please see Note 18 Regulatory Issues beginning on pages F-53 and F-40, respectively, of Dynegy's and DHI's Forms 10-K for further discussion.

Illinois Resource Procurement Auction. In January 2006, the ICC approved a reverse power procurement auction as the process by which utilities would procure power beginning in 2007. The initial auction occurred in September 2006, and we subsequently entered into two supplier forward contracts with subsidiaries of Ameren Corporation to provide capacity, energy and related services. The Illinois legislature passed legislation in 2007 as part of the Illinois rate relief package that significantly altered the power procurement process in Illinois but the contracts with the Ameren subsidiaries remain in effect. Please see Note 11 Commitments and Contingencies Illinois Auction Complaints for further discussion.

California Greenhouse Gas Regulation. The California Global Warming Solutions Act (AB 32), enacted in September 2006, became effective on January 1, 2007. This Act directs CARB to develop a greenhouse gas control program that will reduce the state's greenhouse gas emissions to their 1990 levels by 2020. CARB must establish the statewide greenhouse gas emissions cap by January 2008, finalize regulations to achieve required emission reductions by January 2011, and begin implementation and enforcement of the regulatory program by January 2012. Senate Bill No. 1368 directs the CEC and CPUC, in consultation with other state agencies, to establish greenhouse gas emission performance standards for publicly owned utilities and municipalities. These agencies have instituted proceedings to establish such performance standards restricting the rate of greenhouse gas emissions to that of combined-cycle natural gas baseload generation.

Although California's comprehensive greenhouse gas control program will likely influence the development of federal and state programs, the structure and requirements have yet to be fully developed. While we cannot reliably predict the potential impact of the California greenhouse gas program on our future financial condition, results of operations or cash flows, the program could have far-reaching and significant impacts on the energy industry and on us.

Regional Greenhouse Gas Initiative. Our Northeast assets in New York, Connecticut and Maine may become subject to a state-driven greenhouse gas program known as RGGI. RGGI is a program under development by ten New England and Mid-Atlantic states to reduce CO₂ emissions from power plants. The participating RGGI states developed a model rule for regulating greenhouse gas using a cap-and-trade program to reduce carbon emissions by at least 10 % of current emission levels by the year 2018.

The State of Maine enacted climate change legislation in June 2007 approving the state's participation in RGGI and proposed a CO₂ Budget Trading rule based on the RGGI model rule in July 2007. The proposed rule would implement a CO₂ cap-and-trade program that would cap total authorized CO₂ emissions from affected Maine power generators at 5,948,902 tons per year beginning in 2009 through 2014. Beginning in 2015, the CO₂ emission cap would be reduced each year until 2018 when emissions would be capped at 5,354,014 tons per year. The proposed rule would require that each power generator hold CO₂ allowances equal to its annual CO₂ emissions. Compliance with the allowance requirement could be achieved by reducing emissions, purchasing allowances or securing offset allowances from an approved offset project. Allowances would be distributed to power generators through a state auction with the proceeds placed in an Energy and Carbon Savings Trust fund to be used for energy efficiency and other greenhouse gas reduction projects and for ratepayer relief. The rules governing the auction have not yet been proposed.

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The State of New York issued proposed regulations on October 24, 2007 setting forth its planned CO₂ Budget Trading Program. The proposed rule would implement a cap-and-trade program that would cap total authorized CO₂ emissions from New York electric generators with capacity greater than 25MW of electrical output. The initial CO₂ emissions cap for affected New York generators would be 64,310,805 tons per year beginning in 2009 through 2014. Beginning in 2015, the cap would be reduced each year until 2018, when emissions would be capped at 57,879,725 tons per year. The program would require that each affected CO₂ budget source hold CO₂ allowances equal to the total CO₂ emissions from all of its CO₂ budget units for the control period. Compliance with the allowance requirement could be achieved by reducing emissions, purchasing allowances and/or securing offset allowances from an approved offset project. All allowances would be distributed through an auction or auctions open to participation by any individual or entity that meets prescribed minimum financial requirements. The auctions would be administered by the New York State Energy Research and Development Authority with proceeds being used to promote energy efficiency and clean energy technologies and to cover the administrative costs of the CO₂ Budget Trading Program. Rules governing the auction have not yet been proposed.

The State of Connecticut also enacted legislation in June 2007 that mandates a cap and trade program for CO₂ including a requirement that affected generators purchase 100% of the carbon credits needed to operate their facilities through an auction process. No rules governing the Connecticut auction process have yet been proposed.

The potential impact of the final RGGI program on our future financial condition, results of operations and cash flows will depend on a number of variable factors. While these impacts cannot be reliably predicted at this time, the RGGI program, including the Maine, New York and Connecticut CO₂ control programs, could have far-reaching and significant impacts on the energy industry.

Officials in other states where we have generation assets have expressed intentions to regulate greenhouse gasses and we are paying close attention to legislative and regulatory developments in those jurisdictions. However, at this time we cannot predict the potential impact of greenhouse gas regulation in these jurisdictions on our future financial condition, results of operations or cash flows.

Federal Greenhouse Gas Regulation. Despite a great deal of support in the energy industry for a comprehensive federal program, and numerous proposals in Congress, no proposal for the regulation of greenhouse gas emissions which addresses the issue of global warming has been enacted. On April 2, 2007, the U. S. Supreme Court issued its decision in *Massachusetts v. Environmental Protection Agency*, a case involving regulation of CO₂ emissions of motor vehicles. The Court ruled that CO₂ is a pollutant subject to regulation under the Clean Air Act and that the EPA has a duty to determine whether CO₂ emissions contribute to climate change. This decision, together with increasing state and federal legislative and regulatory initiatives and other related activities, may lead to federal regulation of greenhouse gas emissions. The timing of any such regulation and its impact on us and the rest of the power generation industry cannot yet be determined.

Note 13 Employee Compensation, Savings and Pension Plans

We have various defined benefit pension plans and post-retirement benefit plans in which our past and present employees participate, which are more fully described in Note 20 Employee Compensation, Savings and Pension Plans beginning on page F-61 of Dynegy's Form 10-K, and Note 18 Employee Compensation, Savings and Pension Plans beginning on page F-45 of DHI's Form 10-K.

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Components of Net Periodic Benefit Cost. The components of net periodic benefit cost were:

| | Pension Benefits | | Other Benefits | |
|---|---|-------------|-----------------------|-------------|
| | Three Months Ended September 30, | | | |
| | 2007 | 2006 | 2007 | 2006 |
| | (in millions) | | | |
| Service cost benefits earned during period | \$ 2 | \$ 2 | \$ 1 | \$ |
| Interest cost on projected benefit obligation | 3 | 2 | 1 | |
| Expected return on plan assets | (3) | (2) | | |
| Recognized net actuarial loss | 1 | 1 | | 1 |
| Net periodic benefit cost | \$ 3 | \$ 3 | \$ 2 | \$ 1 |
| Additional cost due to curtailment | | 1 | | |
| Total net periodic benefit cost | \$ 3 | \$ 4 | \$ 2 | \$ 1 |

| | Pension Benefits | | Other Benefits | |
|---|--|-------------|-----------------------|-------------|
| | Nine Months Ended September 30, | | | |
| | 2007 | 2006 | 2007 | 2006 |
| | (in millions) | | | |
| Service cost benefits earned during period | \$ 7 | \$ 7 | \$ 2 | \$ 2 |
| Interest cost on projected benefit obligation | 8 | 7 | 3 | 2 |
| Expected return on plan assets | (9) | (7) | | |
| Recognized net actuarial loss | 2 | 2 | 1 | 1 |
| Net periodic benefit cost | \$ 8 | \$ 9 | \$ 6 | \$ 5 |
| Additional cost due to curtailment | | 3 | | |
| Total net periodic benefit cost | \$ 8 | \$ 12 | \$ 6 | \$ 5 |

Exchange Transaction with Chairman and CEO. On March 17, 2006, Dynegy entered into an exchange transaction with Dynegy's Chairman and CEO. Under the terms of the transaction, the purpose of which was to address uncertainties created by proposed regulations issued in late 2005 pursuant to Section 409A of the Internal Revenue Code (the "Code"), Dynegy cancelled all of the 2,378,605 stock options then held by Dynegy's Chairman and CEO. As consideration for canceling these stock options, Dynegy granted its Chairman and CEO 967,707 stock options at an exercise price of \$4.88, which equaled the closing price of Dynegy's Class A common stock on the date of grant, and DHI made a cash payment to him of approximately \$6 million on January 15, 2007 based on the in-the-money value of the vested stock options that were cancelled.

Contributions. During the nine months ended September 30, 2007, we made approximately \$14 million in contributions to our pension plans. We expect to make contributions of approximately \$1 million to other benefit plans in the fourth quarter 2007.

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DYNEGY INC. and DYNEGY HOLDINGS INC.
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Note 14 Income Taxes

Effective Tax Rate. We compute our quarterly taxes under the effective tax rate method based on applying an anticipated annual effective rate to our year-to-date income or loss, except for significant unusual or extraordinary transactions. Income taxes for significant unusual or extraordinary transactions are computed and recorded in the period that the specific transaction occurs. Dynegy's income taxes included in continuing operations were as follows:

| | Three Months Ended September 30, 2007 | | September 30, 2006 | | Nine Months Ended September 30, 2007 | | September 30, 2006 | |
|------------------------------|--|------|-------------------------------|-----|---|------|-------------------------------|-----|
| | (in millions, except rates) | | | | | | | |
| Income tax (expense) benefit | \$ | (59) | \$ | 41 | \$ | (95) | \$ | 150 |
| Effective tax rate | | 38% | | 37% | | 35% | | 36% |

For the three months ended September 30, 2007, Dynegy's overall effective tax rate on continuing operations was different than the statutory rate of 35% due primarily to state income taxes. As a result of the Merger Agreement, our effective state tax rate increased primarily as a result of the higher state tax rates in the states in which the LS Contributed Entities' assets are located. This increase was more than offset by the impact of decreases in the New York state income tax rate, the Texas margin tax credit rate and adjustments to Dynegy's reserve for uncertain tax positions during the nine months ended September 30, 2007.

DHI's income taxes included in continuing operations were as follows:

| | Three Months Ended September 30, 2007 | | September 30, 2006 | | Nine Months Ended September 30, 2007 | | September 30, 2006 | |
|------------------------------|--|------|-------------------------------|-----|---|------|-------------------------------|-----|
| | (in millions, except rates) | | | | | | | |
| Income tax (expense) benefit | \$ | (62) | \$ | 43 | \$ | (94) | \$ | 132 |
| Effective tax rate | | 39% | | 38% | | 32% | | 36% |

For the three months ended September 30, 2007, DHI's overall effective tax rate on continuing operations was different than the statutory rate of 35% due primarily to state income taxes. As a result of the Merger Agreement, our effective state tax rate increased primarily as a result of the higher state tax rates in the states in which the LS Contributed Entities' assets are located. This increase was more than offset by the impact of decreases in the New York state income tax rate, the Texas margin tax credit rate and adjustments to DHI's reserve for uncertain tax positions during the nine months ended September 30, 2007.

Dynegy and DHI recorded a \$7 million and \$13 million decrease, respectively, to their accumulated deficits as of January 1, 2007 to reflect the cumulative effect of adopting FIN No. 48. Please see Note 1 Accounting Policies Accounting Principles Adopted FIN No. 48 for further discussion.

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**DYNEGY INC. and DYNEGY HOLDINGS INC.
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Note 15 Segment Information

We report results of our power generation business in the following segments: (i) GEN-MW, (ii) GEN-WE and (iii) GEN-NE. Following the completion of the Merger Agreement in April 2007, our previously named South segment (GEN-SO) has been renamed the GEN-WE segment and the power generation facilities located in California and Arizona acquired through the Merger Agreement are included in this segment. The Kendall, Ontelaunee and Plum Point power generation facilities acquired through the Merger Agreement are included in GEN-MW, and the Casco Bay and Bridgeport power generation facilities acquired through the Merger Agreement are included in GEN-NE. We continue to separately report the results of our CRM business. Results associated with our former NGL segment are included in discontinued operations in Other and Eliminations due to the sale of this business. Our unaudited condensed consolidated financial results also reflect corporate-level expenses such as general and administrative, interest and depreciation and amortization. Because of the diversity among their respective operations, we report the results of each business as a separate segment in our unaudited condensed consolidated financial statements. Pursuant to EITF Issue 02-03, all gains and losses on third party energy trading contracts in the CRM segment, whether realized or unrealized, are presented net in the consolidated statements of operations. For the purpose of the segment data presented below, intersegment transactions between CRM and our other segments are presented net in CRM intersegment revenues but are presented gross in the intersegment revenues of our other segments, as the activities of our other segments are not subject to the net presentation requirements contained in EITF Issue 02-03. If transactions between CRM and our other segments result in a net intersegment purchase by CRM, the net intersegment purchases and sales are presented as negative revenues in CRM intersegment revenues. In addition, intersegment hedging activities are presented net pursuant to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133). In the second quarter 2007, we discontinued the use of hedge accounting for certain derivative transactions affecting the GEN-MW, GEN-NE and GEN-WE segments. The operating results presented herein reflect the changes in market values of derivative instruments entered into by each of these segments. Please see Note 5-Risk Management Activities for further discussion.

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Dynegy's Segment Data for the Three Months Ended September 30, 2007
(in millions)

Reportable segment information for Dynegy, including intercompany transactions accounted for at prevailing market rates, for the three and nine months ended September 30, 2007 and 2006 is presented below:

| | Power Generation | | | | Other and Eliminations | | Total |
|---|-------------------------|---------------|---------------|------------|-----------------------------------|-------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | | |
| Unaffiliated revenues: | | | | | | | |
| Domestic | \$ 392 | \$ 354 | \$ 264 | \$ 4 | \$ | | \$ 1,014 |
| Other | | | 32 | | | | 32 |
| Total revenues | \$ 392 | \$ 354 | \$ 296 | \$ 4 | \$ | | \$ 1,046 |
| Depreciation and amortization | \$ (51) | \$ (25) | \$ (12) | \$ | \$ | (4) | \$ (92) |
| Operating income (loss) | \$ 139 | \$ 119 | \$ 52 | \$ (12) | \$ | (51) | \$ 247 |
| Earnings (losses) from unconsolidated investments | | 12 | | | | (4) | 8 |
| Other items, net | 1 | | | (2) | | 18 | 17 |
| Interest expense | | | | | | | (117) |
| Income from continuing operations before income taxes | | | | | | | 155 |
| Income tax expense | | | | | | | (59) |
| Income from continuing operations | | | | | | | 96 |
| Income from discontinued operations, net of taxes | | | | | | | 124 |
| Net income | | | | | | | \$ 220 |
| Identifiable assets: | | | | | | | |
| Domestic | \$ 6,564 | \$ 3,411 | \$ 2,032 | \$ 294 | \$ | 1,045 | \$ 13,346 |
| Other | | 7 | 14 | 37 | | | 58 |
| Total | \$ 6,564 | \$ 3,418 | \$ 2,046 | \$ 331 | \$ | 1,045 | \$ 13,404 |
| Unconsolidated investments | \$ | \$ 35 | \$ | \$ | \$ | 61 | \$ 96 |
| | \$ (72) | \$ (5) | \$ (5) | \$ | \$ | (3) | \$ (85) |

Capital expenditures and
investments in unconsolidated
affiliates

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For the Interim Periods Ended September 30, 2007 and 2006
Dynegy's Segment Data for the Three Months Ended September 30, 2006
(in millions)

| | Power Generation | | | | Other and | |
|---|-------------------------|---------------|---------------|------------|---------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Eliminations | Total |
| Unaffiliated revenues: | | | | | | |
| Domestic | \$ 260 | \$ 24 | \$ 182 | \$ 20 | \$ | \$ 486 |
| Other | | | 18 | 4 | | 22 |
| | 260 | 24 | 200 | 24 | | 508 |
| Intersegment revenues | | | (1) | 1 | | |
| Total revenues | \$ 260 | \$ 24 | \$ 199 | \$ 25 | \$ | \$ 508 |
| Depreciation and amortization | \$ (43) | \$ (2) | \$ (6) | \$ | \$ (3) | \$ (54) |
| Impairment and other charges | (96) | | | | | (96) |
| Operating income (loss) | \$ (10) | \$ 6 | \$ 33 | \$ (9) | \$ (40) | \$ (20) |
| Earnings from unconsolidated investments | | 4 | | | | 4 |
| Other items, net | 1 | | 2 | 2 | 6 | 11 |
| Interest expense | | | | | | (107) |
| Loss from continuing operations before income taxes | | | | | | (112) |
| Income tax benefit | | | | | | 41 |
| Loss from continuing operations | | | | | | (71) |
| Income from discontinued operations, net of taxes | | | | | | 2 |
| Net loss | | | | | | \$ (69) |
| Identifiable assets: | | | | | | |
| Domestic | \$ 4,719 | \$ 747 | \$ 1,371 | \$ 364 | \$ 199 | \$ 7,400 |
| Other | | 2 | 10 | 95 | | 107 |
| Total | \$ 4,719 | \$ 749 | \$ 1,381 | \$ 459 | \$ 199 | \$ 7,507 |
| Unconsolidated investments | \$ | \$ 7 | \$ | \$ | \$ | \$ 7 |
| Capital expenditures | \$ (22) | \$ (4) | \$ (5) | \$ | \$ (2) | \$ (33) |

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Dynegy's Segment Data for the Nine Months Ended September 30, 2007
(in millions)

| | Power Generation | | | | Other and | |
|---|-------------------------|---------------|---------------|------------|---------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Eliminations | Total |
| Unaffiliated revenues: | | | | | | |
| Domestic | \$ 1,070 | \$ 499 | \$ 690 | \$ 10 | \$ | \$ 2,269 |
| Other | | | 109 | 1 | | 110 |
| Total revenues | \$ 1,070 | \$ 499 | \$ 799 | \$ 11 | \$ | \$ 2,379 |
| Depreciation and amortization | \$ (143) | \$ (49) | \$ (30) | \$ | \$ (10) | \$ (232) |
| Operating income (loss) | \$ 399 | \$ 105 | \$ 148 | \$ 17 | \$ (159) | \$ 510 |
| Earnings (losses) from unconsolidated investments | | 12 | | | (6) | 6 |
| Other items, net | (8) | | | (5) | 39 | 26 |
| Interest expense | | | | | | (268) |
| Income from continuing operations before income taxes | | | | | | 274 |
| Income tax expense | | | | | | (95) |
| Income from continuing operations | | | | | | 179 |
| Income from discontinued operations, net of taxes | | | | | | 131 |
| Net income | | | | | | \$ 310 |
| Identifiable assets: | | | | | | |
| Domestic | \$ 6,564 | \$ 3,411 | \$ 2,032 | \$ 294 | \$ 1,045 | \$ 13,346 |
| Other | | 7 | 14 | 37 | | 58 |
| Total | \$ 6,564 | \$ 3,418 | \$ 2,046 | \$ 331 | \$ 1,045 | \$ 13,404 |
| Unconsolidated investments | \$ | \$ 35 | \$ | \$ | \$ 61 | \$ 96 |
| Capital expenditures and investments in unconsolidated affiliates | \$ (187) | \$ (16) | \$ (24) | \$ | \$ (16) | \$ (243) |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
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Dynegy's Segment Data for the Nine Months Ended September 30, 2006
(in millions)

| | Power Generation | | | | | | |
|---|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|--|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other and Eliminations | Total | |
| Unaffiliated revenues: | | | | | | | |
| Domestic | \$ 744 | \$ 83 | \$ 410 | \$ 69 | \$ | \$ 1,306 | |
| Other | | | 109 | 12 | | 121 | |
| | 744 | 83 | 519 | 81 | | 1,427 | |
| Intersegment revenues | | | (3) | 3 | | | |
| Total revenues | \$ 744 | \$ 83 | \$ 516 | \$ 84 | \$ | \$ 1,427 | |
| Depreciation and amortization | \$ (126) | \$ (6) | \$ (18) | \$ | \$ (14) | \$ (164) | |
| Impairment and other charges | (96) | (9) | | | (2) | (107) | |
| Operating income (loss) | \$ 159 | \$ (2) | \$ 59 | \$ (3) | \$ (121) | \$ 92 | |
| Earnings from unconsolidated investments | | 6 | | | | 6 | |
| Other items, net | 1 | 1 | 6 | 1 | 32 | 41 | |
| Interest expense | | | | | | (559) | |
| Loss from continuing operations before income taxes | | | | | | (420) | |
| Income tax benefit | | | | | | 150 | |
| Loss from continuing operations | | | | | | (270) | |
| Loss from discontinued operations, net of taxes | | | | | | (6) | |
| Cumulative effect of change in accounting principle, net of taxes | | | | | | 1 | |
| Net loss | | | | | | \$ (275) | |
| Identifiable assets: | | | | | | | |
| Domestic | \$ 4,719 | \$ 747 | \$ 1,371 | \$ 364 | \$ 199 | \$ 7,400 | |
| Other | | 2 | 10 | 95 | | 107 | |
| Total | \$ 4,719 | \$ 749 | \$ 1,381 | \$ 459 | \$ 199 | \$ 7,507 | |
| Unconsolidated investments | \$ | \$ 7 | \$ | \$ | \$ | \$ 7 | |

| | | | | | | | | | | | | |
|----------------------|----|------|----|------|----|------|----|--|----|-----|----|------|
| Capital expenditures | \$ | (58) | \$ | (16) | \$ | (12) | \$ | | \$ | (6) | \$ | (92) |
|----------------------|----|------|----|------|----|------|----|--|----|-----|----|------|

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DYNEGY INC. and DYNEGY HOLDINGS INC.
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(Unaudited)

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Reportable segment information for DHI, including intercompany transactions accounted for at prevailing market rates, for the three and nine months ended September 30, 2007 and 2006 is presented below:

DHI's Segment Data for the Three Months Ended September 30, 2007
(in millions)

| | Power Generation | | | | Other and | | |
|---|-------------------------|---------------|---------------|------------|---------------------|--------------|-----------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Eliminations | Total | |
| Unaffiliated revenues: | | | | | | | |
| Domestic | \$ 392 | \$ 354 | \$ 264 | \$ 4 | \$ | \$ | \$ 1,014 |
| Other | | | 32 | | | | 32 |
| Total revenues | \$ 392 | \$ 354 | \$ 296 | \$ 4 | \$ | \$ | \$ 1,046 |
| Depreciation and amortization | \$ (51) | \$ (25) | \$ (12) | \$ | \$ (4) | \$ | \$ (92) |
| Operating income (loss) | \$ 139 | \$ 119 | \$ 52 | \$ (12) | \$ (51) | \$ | \$ 247 |
| Earnings from unconsolidated investments | | 12 | | | | | 12 |
| Other items, net | 1 | | | (2) | 19 | | 18 |
| Interest expense | | | | | | | (117) |
| Income from continuing operations before income taxes | | | | | | | 160 |
| Income tax expense | | | | | | | (62) |
| Income from continuing operations | | | | | | | 98 |
| Income from discontinued operations, net of taxes | | | | | | | 124 |
| Net income | | | | | | | \$ 222 |
| Identifiable assets: | | | | | | | |
| Domestic | \$ 6,564 | \$ 3,358 | \$ 2,032 | \$ 317 | \$ 1,756 | \$ | \$ 14,027 |
| Other | | | 14 | 14 | | | 28 |
| Total | \$ 6,564 | \$ 3,358 | \$ 2,046 | \$ 331 | \$ 1,756 | \$ | \$ 14,055 |
| Unconsolidated investments | \$ | \$ 35 | \$ | \$ | \$ | \$ | \$ 35 |
| Capital expenditures | \$ (72) | \$ (3) | \$ (5) | \$ | \$ (3) | \$ | \$ (83) |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
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For the Interim Periods Ended September 30, 2007 and 2006
DHI's Segment Data for the Three Months Ended September 30, 2006
(in millions)

| | Power Generation | | | | | | |
|--|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|---------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other and Eliminations | Total | |
| Unaffiliated revenues: | | | | | | | |
| Domestic | \$ 260 | \$ 24 | \$ 182 | \$ 20 | \$ | \$ 486 | |
| Other | | | 18 | 4 | | 22 | |
| | 260 | 24 | 200 | 24 | | 508 | |
| Intersegment revenues | | | (1) | 1 | | | |
| Total revenues | \$ 260 | \$ 24 | \$ 199 | \$ 25 | \$ | \$ 508 | |
| Depreciation and amortization | \$ (43) | \$ (2) | \$ (6) | \$ | \$ (3) | \$ (54) | |
| Impairment and other charges | (96) | | | | | (96) | |
| Operating income (loss) | \$ (10) | \$ 6 | \$ 33 | \$ (9) | \$ (39) | \$ (19) | |
| Earnings from unconsolidated investments | | 4 | | | | 4 | |
| Other items, net | 1 | | 2 | 2 | 4 | 9 | |
| Interest expense and debt conversion costs | | | | | | | (107) |
| Loss from continuing operations before income taxes | | | | | | | (113) |
| Income tax benefit | | | | | | | 43 |
| Loss from continuing operations | | | | | | | (70) |
| Income from discontinued operations, net of taxes | | | | | | | 3 |
| Net loss | | | | | | | \$ (67) |
| Identifiable assets: | | | | | | | |
| Domestic | \$ 4,719 | \$ 748 | \$ 1,387 | \$ 387 | \$ 744 | \$ 7,985 | |
| Other | | | 10 | 71 | | 81 | |
| Total | \$ 4,719 | \$ 748 | \$ 1,397 | \$ 458 | \$ 744 | \$ 8,066 | |
| Unconsolidated investments | \$ | \$ 7 | \$ | \$ | \$ | \$ 7 | |
| Capital expenditures | \$ (22) | \$ (4) | \$ (5) | \$ | \$ (2) | \$ (33) | |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)
For the Interim Periods Ended September 30, 2007 and 2006
DHI s Segment Data for the Nine Months Ended September 30, 2007
(in millions)

| | Power Generation | | | | | |
|---|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other and Eliminations | Total |
| Unaffiliated revenues: | | | | | | |
| Domestic | \$ 1,070 | \$ 499 | \$ 690 | \$ 10 | \$ | \$ 2,269 |
| Other | | | 109 | 1 | | 110 |
| Total revenues | \$ 1,070 | \$ 499 | \$ 799 | \$ 11 | \$ | \$ 2,379 |
| Depreciation and amortization | \$ (143) | \$ (49) | \$ (30) | \$ | \$ (10) | \$ (232) |
| Operating income (loss) | \$ 399 | \$ 105 | \$ 148 | \$ 17 | \$ (140) | \$ 529 |
| Earnings from unconsolidated investments | | 12 | | | | 12 |
| Other items, net | (8) | | | (5) | 38 | 25 |
| Interest expense | | | | | | (268) |
| Income from continuing operations before income taxes | | | | | | 298 |
| Income tax expense | | | | | | (94) |
| Income from continuing operations | | | | | | 204 |
| Income from discontinued operations, net of taxes | | | | | | 130 |
| Net income loss | | | | | | \$ 334 |
| Identifiable assets: | | | | | | |
| Domestic | \$ 6,564 | \$ 3,358 | \$ 2,032 | \$ 317 | \$ 1,756 | \$ 14,027 |
| Other | | | 14 | 14 | | 28 |
| Total | \$ 6,564 | \$ 3,358 | \$ 2,046 | \$ 331 | \$ 1,756 | \$ 14,055 |
| Unconsolidated investments | \$ | \$ 35 | \$ | \$ | \$ | \$ 35 |
| Capital expenditures | \$ (187) | \$ (14) | \$ (24) | \$ | \$ (11) | \$ (236) |

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DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)
For the Interim Periods Ended September 30, 2007 and 2006
DHI s Segment Data for the Nine Months Ended September 30, 2006
(in millions)

| | Power Generation | | | | | | |
|---|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|--|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other and Eliminations | Total | |
| Unaffiliated revenues: | | | | | | | |
| Domestic | \$ 744 | \$ 83 | \$ 410 | \$ 69 | \$ | \$ 1,306 | |
| Other | | | 109 | 12 | | 121 | |
| | 744 | 83 | 519 | 81 | | 1,427 | |
| Intersegment revenues | | | (3) | 3 | | | |
| Total revenues | \$ 744 | \$ 83 | \$ 516 | \$ 84 | \$ | \$ 1,427 | |
| Depreciation and amortization | \$ (126) | \$ (6) | \$ (18) | \$ | \$ (14) | \$ (164) | |
| Impairment and other charges | (96) | (9) | | | (2) | (107) | |
| Operating income (loss) | \$ 159 | \$ (2) | \$ 59 | \$ (3) | \$ (119) | \$ 94 | |
| Earnings from unconsolidated investments | | 6 | | | | 6 | |
| Other items, net | 1 | 1 | 6 | 1 | 27 | 36 | |
| Interest expense and debt conversion costs | | | | | | (507) | |
| Loss from continuing operations before income taxes | | | | | | (371) | |
| Income tax benefit | | | | | | 132 | |
| Loss from continuing operations | | | | | | (239) | |
| Loss from discontinued operations, net of taxes | | | | | | (6) | |
| Net loss | | | | | | \$ (245) | |
| Identifiable assets: | | | | | | | |
| Domestic | \$ 4,719 | \$ 748 | \$ 1,387 | \$ 387 | \$ 744 | \$ 7,985 | |
| Other | | | 10 | 71 | | 81 | |
| Total | \$ 4,719 | \$ 748 | \$ 1,397 | \$ 458 | \$ 744 | \$ 8,066 | |
| Unconsolidated investments | \$ | \$ 7 | \$ | \$ | \$ | \$ 7 | |
| Capital expenditures | \$ (58) | \$ (16) | \$ (12) | \$ | \$ (6) | \$ (92) | |

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**DYNEGY INC. and DYNEGY HOLDINGS INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)**

For the Interim Periods Ended September 30, 2007 and 2006

Note 16 Subsequent Events

On October 15, 2007, pursuant to a registration rights agreement pertaining to the Notes, DHI initiated an exchange offer of \$1.1 billion aggregate principal amount of DHI's 7.75% Senior Unsecured Notes due 2019 and \$550 million aggregate principal amount of its 7.50% Senior Unsecured Notes due 2015 which is expected to be completed in the fourth quarter 2007. Please see Note 8 Debt Senior Unsecured Notes Offering for further discussion.

On October 25, 2007, we entered into an agreement to sell a non-controlling ownership interest in PPEA for approximately \$82 million. Please see Note 7 Variable Interest Entities PPEA Holding Company LLC for further discussion.

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**DYNEGY INC. and DYNEGY HOLDINGS INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS**

For the Interim Periods Ended September 30, 2007 and 2006

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

The following discussion should be read together with the unaudited condensed consolidated financial statements and the notes thereto included in this report and with the audited consolidated financial statements and the notes thereto included in our Forms 10-K.

In April 2007, Dynegy contributed to DHI its interest in New York Holdings. This contribution was accounted for as a transaction between entities under common control. As such, the assets and liabilities of New York Holdings were recorded by DHI at Dynegy's historical cost on the acquisition date. This management's discussion and analysis of financial condition and results of operations included herein with respect to DHI reflects the contribution as though DHI had owned New York Holdings in all periods presented.

General

We are holding companies and conduct substantially all of our business operations through our subsidiaries. Our current business operations are focused primarily on the power generation sector of the energy industry. We report the results of our power generation business as three separate segments in our consolidated financial statements: (1) the Midwest segment (GEN-MW); (2) the West segment (GEN-WE); and (3) the Northeast segment (GEN-NE). We also separately report results of our CRM business, which primarily consists of our legacy physical gas supply contracts and gas transportation contracts and remaining legacy power and emission trading positions that remain from the third-party trading business that was substantially exited in 2002. Because of the diversity among their respective operations, we report the results of each business as a separate segment in our consolidated financial statements. Our unaudited condensed consolidated financial results also reflect corporate-level expenses such as general and administrative, interest and depreciation and amortization. In connection with the Merger Agreement discussed in Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions, our previously named South segment (GEN-SO) has been renamed GEN-WE and the power generation facilities located in California and Arizona acquired through the Merger Agreement are included in this segment. The Kendall and Ontelaunee power generation facilities acquired through the Merger Agreement are included in GEN-MW, and the Casco Bay and Bridgeport power generation facilities acquired through the Merger Agreement are included in GEN-NE.

In addition to our operating generation facilities, we own an approximate 70% interest in PPEA which in turn owns a 57% undivided interest in Plum Point, a new 665 MW coal-fired power generation facility under construction in Arkansas, which is included in GEN-MW. On October 25, 2007, we entered into an agreement to sell a non-controlling ownership interest in PPEA for approximately \$82 million. We also own a 50% interest in SCEA, which owns a 75% undivided interest in Sandy Creek, an 898 MW power generation facility under construction in McLennan County, Texas, which is included in GEN-WE. Finally, through its interest in DLS Power Holdings, Dynegy owns a 50% interest in a portfolio of greenfield development projects totaling more than 6,700 MW of generating capacity and repowering and/or expansion opportunities representing approximately 2,500 MW of generating capacity, which is included in Other.

Recent Developments

CoGen Lyondell Sale. On August 1, 2007, we completed our sale of our CoGen Lyondell power generation facility for approximately \$470 million to EnergyCo., LLC (EnergyCo.), a joint venture between PNM Resources and a subsidiary of Cascade Investment, LLC. We recorded a \$210 million gain related to the sale of the asset in the third quarter 2007.

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Illinois Rate Relief. Legislative leaders from the State of Illinois, including the Speaker of the House and the Senate President, announced a comprehensive transitional rate relief package for electric consumers on July 23, 2007. The program, which became law in August 2007, will provide approximately \$1 billion to help fund a new power procurement agency and provide assistance to utility customers in Illinois.

As a part of this rate relief package, we will make payments of up to \$25 million over a 29-month period. These payments will be contingent on certain conditions related to the absence of future electric rate and tax legislation in Illinois. We made a payment of \$7.5 million in the third quarter 2007 and anticipate making payments of \$9.0 million in 2008 and \$8.5 million in 2009. Our payment of \$7.5 million in 2007 was used as funding for the Illinois Power Agency, which was created as part of Illinois' comprehensive rate relief package. Our expected payments for 2008 and 2009 will be made in monthly installments, provided that if at any time prior to December 2009, as further described in the rate relief package and related agreements, Illinois imposes an electric rate freeze or imposes an additional tax on generators, our obligations to make the monthly payments will cease. The monthly payments will be paid into an escrow account established to support rate relief activities for Ameren Illinois Utilities' customers. The rate relief package and related agreements have resulted in motions to dismiss several ongoing court and regulatory cases surrounding the 2006 Illinois reverse power procurement auction. We recorded a second quarter 2007 pre-tax charge of \$25 million, included as a cost of sales on our unaudited condensed consolidated statements of operations. Please read Note 11 Commitments and Contingencies Illinois Auction Complaints for further discussion.

The contracts originally entered into by DPM and the Ameren Illinois Utilities as a result of the auction remain in place following the effectiveness of the rate relief package and related agreements.

Sandy Creek. In connection with its acquisition of a 50% interest in DLS Power Holdings, as further discussed above, Dynegy acquired a 50% interest in Sandy Creek Energy Associates, LP (SCEA). SCEA owns the Sandy Creek Energy Station (the Project), which is a proposed 898 MW facility to be located in McLennan County, Texas. In August 2007, Sandy Creek Holdings, LLC (SCH) became a stand-alone entity separate from DLS Power Holdings and SCH and its wholly owned subsidiaries, including SCEA, entered into various financing agreements to construct the Project and sold a 25% undivided interest in the Project to an unrelated third party.

The financing agreements consist of a \$200 million term loan and \$800 million in construction loans with SCEA as borrower. The SCEA debt is secured by a pledge of SCEA's assets, contract rights and SCEA's undivided tenancy in common interest in the Project.

In addition, SCH entered into a \$200 million credit agreement with the Dynegy Member and the LSP Member, as defined below. The SCH debt is secured by a pledge of SCH's indirect ownership interests in SCEA. To fund its obligation under the SCH Equity Agreement, SCH entered into a credit agreement with the Dynegy Member and the LSP Member. The Dynegy Member's 50% share of the credit agreement is supported by a letter of credit issued under DHI's primary credit facility in the amount of \$100 million. Such letter of credit may be drawn upon by the lenders if certain conditions are met. The Dynegy Member and the LS Member each agreed to make capital contributions of \$223 million to fund project costs after the SCEA and SCH loans have been utilized and otherwise upon the occurrence of certain events and milestone dates. The Dynegy Member's obligation to make such contributions is supported by a letter of credit in the amount of \$223 million issued under the Fifth Amended and Restated Credit Facility. Such letter of credit may be drawn upon by the SCEA lenders if certain conditions are met.

Upon the close of the financing agreements discussed above, SCEA sold a 25% undivided interest in the Project to an unaffiliated third party for approximately \$30 million plus a portion of the accumulated construction costs. During the third quarter 2007, we recognized our share of the gain on the sale, which approximated \$12 million, in Earnings from unconsolidated investments on the unaudited condensed consolidated statements of operations. During the third quarter 2007, SCEA received \$24 million in cash proceeds, consisting of approximately \$15 million of the purchase price and \$9 million for its share of accumulated costs. The remainder of the purchase price, plus accrued interest, is expected to be collected in 2010. SCEA will distribute the proceeds from the sale to the Dynegy Member and the LSP Member during the fourth quarter 2007. Please read Note 7 Variable Interest Entities Sandy Creek for further information.

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LIQUIDITY AND CAPITAL RESOURCES

Overview

In this section, we describe our liquidity and capital requirements and our internal and external liquidity and capital resources. Our liquidity and capital requirements are primarily a function of our debt maturities and debt service requirements, collateral requirements, fixed capacity payments and contractual obligations, capital expenditures, legal settlements and working capital needs. Examples of working capital needs include prepayments or cash collateral associated with purchases of commodities, particularly natural gas and coal, facility maintenance costs (including required environmental expenditures) and other costs such as payroll. Our liquidity and capital resources are primarily derived from cash flows from operations, cash on hand, borrowings under our financing agreements, asset sale proceeds and proceeds from capital market transactions to the extent we engage in these activities. Additionally, DHI may borrow money from time to time from Dynegy.

Debt Obligations

On April 2, 2007, we assumed approximately \$1.9 billion of debt upon completion of the Merger Agreement. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion.

Also on April 2, 2007, in connection with the completion of the transactions contemplated by the Merger Agreement, an aggregate \$275 million under the Revolving Facility, an aggregate \$400 million under the Term L/C Facility (with the proceeds placed in a collateral account to support the issuance of letters of credit) and an aggregate \$70 million under Term Loan B (representing all available borrowings under Term Loan B) were drawn under the Fifth Amended and Restated Credit Agreement.

On May 24, 2007, we entered into the Credit Agreement Amendment. The Credit Agreement Amendment amended the Fifth Amended and Restated Credit Facility by increasing the amount of the existing \$850 million Revolving Facility to \$1.15 billion and increasing the amount of the existing \$400 million term letter of the Term L/C Facility to \$850 million; the Credit Agreement Amendment did not affect the Term Loan B. The Credit Agreement Amendment also amended a pro forma leverage ratio requirement in the Fifth Amended and Restated Credit Facility to allow DHI to issue the Notes.

On May 24, 2007, DHI issued \$1.1 billion aggregate principal amount of its 2019 Notes and \$550 million aggregate principal amount of its 2015 Notes. DHI used the net proceeds from the sale of the Notes to repay a portion of the debt assumed in the Merger Agreement with LS Power.

On August 6, 2007, we subsequently repaid the \$275 million borrowed under the Revolving Facility. On September 7, 2007, we completed the redemption of \$11 million of DHI's remaining outstanding 9.875% Second Priority Secured Notes due 2010 at a redemption price of 104.938% of the principal amount plus accrued and unpaid interest to the redemption date. Please read Note 8 Debt for further discussion of these items.

Table of Contents**Collateral Postings**

We continue to use a significant portion of our capital resources, in the form of cash and letters of credit, to satisfy counterparty collateral demands. These counterparty collateral demands reflect our non-investment grade credit ratings and counterparties' views of our financial condition and ability to satisfy our performance obligations, as well as commodity prices and other factors. The following table summarizes our consolidated collateral postings to third parties by business at November 1, 2007, September 30, 2007 and December 31, 2006:

| | November 1, 2007 | September 30, 2007 (in millions) | December 31, 2006 |
|--------------------------|---------------------------------|---|----------------------------------|
| By Business: | | | |
| Generation | \$ 1,148 | \$ 1,169 | \$ 134 |
| Customer Risk Management | 33 | 38 | 54 |
| Other | 191 | 191 | 7 |
| Total | \$ 1,372 | \$ 1,398 | \$ 195 |
| By Type: | | | |
| Cash (1) | \$ 76 | \$ 62 | \$ 38 |
| Letters of Credit | 1,296 | 1,336 | 157 |
| Total | \$ 1,372 | \$ 1,398 | \$ 195 |

(1) Cash collateral consists of either cash deposits to cover physical deliveries or liabilities on mark-to-market positions or prepayments for commodities or services that are in advance of normal payment terms.

The majority of the increase in collateral postings from December 31, 2006 to September 30, 2007 relates to an increase of approximately \$700 million due to the completion of the Merger Agreement and incorporation of the letters of credit postings required by the LS Contributing Entities. The \$700 million is comprised of the following: approximately \$325 million relating to hedging activities; approximately \$130 million of development requirements; approximately \$100 million as required under LTSAs and EMAs; approximately \$90 million for environmental related requirements; and approximately \$50 million of collateral requirements under transport and transmission agreements. During 2007, we also issued two letters of credit totaling \$323 million in conjunction with the Sandy Creek power generation facility development and an \$83 million letter of credit to satisfy the Sithe debt service reserve fund requirements that was previously funded with restricted cash. The balance of the increase relates to price

and volume changes associated with collateral postings supporting our normal power and fuel purchases and sales. Going forward, we expect counterparties' collateral demands to continue to reflect changes in commodity prices, including seasonal changes in weather-related demand, as well as their views of our creditworthiness. We believe that we have sufficient capital resources to satisfy counterparties' collateral demands, including those for which no collateral is currently posted, for the foreseeable future.

Tax Attributes

For accounting purposes, at January 1, 2007, Dynegy's NOL deferred tax asset attributable to our previously incurred federal NOL carry-forwards was valued at approximately \$695 million. These NOL carry-forwards will begin to expire in the year 2022. As a result of the application of the provisions of Section 382 of the Internal Revenue Code, when CUSA sold its shares of Dynegy's class A common stock in the second quarter 2007, Dynegy incurred an ownership change that established an annual limitation on the usage of our NOL carry-forwards. The limitation is based in part on the market value of Dynegy's stock at the time of the ownership change and the then-prevailing interest rate and in part on certain built-in gains recognized in a particular taxable year.

The magnitude of the limitation and its effect on us is difficult to assess and may fluctuate depending on the amount of recognized built-in gains in a particular taxable year. However, we do not expect that the ownership change that occurred will have a material impact on Dynegy's tax liability, because of the application of the built-in gain provisions of Section 382. The ultimate realization of Dynegy's NOL carry-forwards will be affected, in part, by the tax law in effect at the time of realization.

Disclosure of Contractual Obligations and Contingent Financial Commitments

We have incurred various contractual obligations and financial commitments in the normal course of our operations and financing activities. Contractual obligations include future cash payments required under existing contractual arrangements, such as debt and lease agreements. These obligations may result from both general financing activities and from commercial arrangements that are directly supported by related revenue-producing activities. Contingent financial commitments represent obligations that become payable only if certain pre-defined events occur, such as financial guarantees.

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Our contractual obligations and contingent financial commitments have changed since December 31, 2006. On April 2, 2007, in conjunction with the completion of the Merger Agreement, we assumed approximately \$1 billion of contractual obligations in addition to the long-term debt assumed. These obligations primarily related to interconnection, operations and maintenance, long term service, and gas transportation agreements. Further, upon completion of the Merger Agreement, our obligations under our power tolling arrangement related to the Kendall facility became an intercompany obligation. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion. On May 24, 2007, we completed a \$1.65 billion offering of senior unsecured notes. Please also read Note 8 Debt for a discussion of these and other changes in our debt obligations. As of September 30, 2007, there were no other material changes to our contractual obligations and contingent financial commitments since December 31, 2006.

Dividends on Common Stock

Dividend payments on Dynegy's common stock are at the discretion of Dynegy's Board of Directors. Dynegy did not declare or pay a dividend on its common stock during the third quarter 2007, and does not foresee a declaration of dividends in the near term.

Internal Liquidity Sources

Our primary internal liquidity sources are cash flows from operations, cash on hand and available capacity under our Fifth Amended and Restated Credit Facility, as amended, which is scheduled to mature in April 2012.

Current Liquidity. The following table summarizes our consolidated revolver capacity and liquidity position at November 1, 2007, September 30, 2007 and December 31, 2006:

| | November 1, 2007 | September 30, 2007 (1) (in millions) | December 31, 2006 |
|--|---------------------------------|---|----------------------------------|
| Revolver capacity | \$ 1,150 | \$ 1,150 | \$ 470 |
| Borrowings against revolver capacity | | | |
| Term letter of credit capacity, net of required reserves | 825 | 825 | 194 |
| Plum Point letter of credit capacity | 101 | 101 | |
| Outstanding letters of credit | (1,296) | (1,336) | (157) |
| Unused capacity | 780 | 740 | 507 |
| Cash DHI | 503(2) | 594(2) | 243(2) |
| Total available liquidity DHI | 1,283 | 1,334 | 750 |
| Cash Dynegy | 37 | 44 | 128 |
| Total available liquidity Dynegy | \$ 1,320 | \$ 1,378 | \$ 878 |

(1) In April 2007, we amended and restated the credit facility, and in May 2007, we further amended it. Please see Note 8 Debt Fifth Amended and

Restated Credit Facility for further discussion.

- (2) The November 1, 2007, September 30, 2007 and December 31, 2006 amounts include approximately zero, \$2 million and \$46 million, respectively, of cash that remains in Europe and \$4 million, \$12 million and \$10 million, respectively, of cash that remains in Canada.

Cash Flows from Operations. Dynegy had operating cash inflows of \$366 million for the nine months ended September 30, 2007. This consisted of \$736 million in operating cash flows from our power generation business, offset by \$24 million of cash outflows relating to our customer risk management business and \$346 million of cash outflows relating to corporate-level expenses.

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DHI had operating cash inflows of \$375 million for the nine months ended September 30, 2007. This consisted of \$736 million in operating cash flows from our power generation business, offset by \$24 million of cash outflows relating to our customer risk management business and \$337 million of cash outflows relating to corporate-level expenses.

Please read **Results of Operations**, **Operating Income (Loss)** and **Cash Flow Disclosures** for further discussion of factors impacting our operating cash flows for the periods presented.

Our future operating cash flows will vary based on a number of factors, many of which are beyond our control, including the price of natural gas and its correlation to power prices, the cost of coal and fuel oil, and the value of ancillary services and capacity. Additionally, availability of our plants during peak demand periods will be required to allow us to capture attractive market prices when available. Over the longer term, our operating cash flows also will be impacted by, among other things, our ability to tightly manage our operating costs, including maintenance costs in balance with ensuring that our plants are available to operate when markets offer attractive returns.

Cash on Hand. At November 1, 2007 and September 30, 2007, Dynegy had cash on hand of \$540 million and \$638 million, respectively, as compared to \$371 million at the end of 2006. The increase in cash on hand at September 30, 2007 as compared to the end of 2006 is primarily attributable to cash provided by the operating activities of our generating business and proceeds received from the sale of our CoGen Lyondell facility offset by cash paid in connection with the Merger Agreement.

At November 1, 2007 and September 30, 2007, DHI had cash on hand of \$503 million and \$594 million, respectively, as compared to \$243 million at the end of 2006. The increase in cash on hand at September 30, 2007 as compared to the end of 2006 is primarily attributable to cash provided by the operating activities of our generation business and proceeds received from the sale of our CoGen Lyondell facility offset by dividend payments made to Dynegy.

Revolver Capacity. On April 2, 2007, DHI entered into the Fifth Amended and Restated Credit Facility, which is our primary credit facility. On May 24, 2007, DHI entered into an amendment to the Fifth Amended and Restated Credit Facility. Please read Note 8 **Debt** **Fifth Amended and Restated Credit Facility** for further discussion.

External Liquidity Sources

Our primary external liquidity sources are proceeds from asset sales and other types of capital-raising transactions, including potential debt and equity issuances.

Asset Sale Proceeds. On October 25, 2007, we entered into an agreement to sell a non-controlling ownership interest in PPEA for approximately \$82 million. Please see Note 7 **Variable Interest Entities** **PPEA Holding Company LLC** for further discussion.

On August 1, 2007, we completed our sale of our CoGen Lyondell power generation facility for approximately \$470 million. Please read Note 3 **Discontinued Operations** **GEN-WE Discontinued Operations** **Cogen Lyondell** for further discussion.

On January 31, 2007, we entered into an agreement to sell our interest in the Calcasieu power generation facility for approximately \$57 million, subject to regulatory approval. The transaction is expected to close in early 2008. Please read

Note 3 **Discontinued Operations** **GEN-WE Discontinued Operations** **Calcasieu** for further discussion.

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Consistent with industry practice, we regularly evaluate our generation fleet based primarily on geographic location, fuel supply, market structure and market recovery expectations. We consider divestitures of non-core generation assets where the balance of the above factors suggests that such assets' earnings potential is limited or that the value that can be captured through a divestiture outweighs the benefits of continuing to own and operate such assets. In connection with this review, we are considering options to potentially sell our 576 MW Bluegrass generation facility and our 539 MW Heard County generation facility. Moreover, dispositions of one or more generation facilities could occur in 2008 or beyond. Were any such sale or disposition to be consummated, the disposition could result in accounting charges related to the affected asset(s), and our future earnings and cash flows could be affected.

Capital-Raising Transactions. As part of our ongoing efforts to maintain a capital structure that is closely aligned with the cash-generating potential of our asset-based business, which is subject to cyclical changes in commodity prices, we may explore additional sources of external liquidity. The timing of any transaction may be impacted by events, such as strategic growth opportunities, development activities, legal judgments or regulatory requirements, which could require us to pursue additional capital in the near-term. The receptiveness of the capital markets to an offering of debt or equity securities cannot be assured and may be negatively impacted by, among other things, our non-investment grade credit ratings, significant debt maturities, long-term business prospects and other factors beyond our control. Any issuance of equity by Dynegy likely would have other effects as well, including stockholder dilution. Our ability to issue debt securities is limited by our financing agreements, including our Fifth Amended and Restated Credit Facility, as amended. Please read Note 8 Debt for further discussion.

In addition, we continually review and discuss opportunities to grow our company and to participate in what we believe will be continuing consolidation of the power generation industry. No such definitive transaction has been agreed to and none can be guaranteed to occur; however, we have successfully executed on similar opportunities in the past and could do so again in the future. Depending on the terms and structure of any such transaction, we could issue significant debt and/or equity securities for capital-raising purposes. We also could be required to assume substantial debt obligations and the underlying payment obligations.

Please read Uncertainty of Forward-Looking Statements and Information for additional factors that could impact our future operating results and financial condition.

RESULTS OF OPERATIONS DYNEGY INC. and DYNEGY HOLDINGS INC.

Overview. In this section, we discuss our results of operations, both on a consolidated basis and, where appropriate, by segment, for the three- and nine-month periods ended September 30, 2007 and 2006. At the end of this section, we have included our outlook for each segment.

We report results of our power generation business in the following segments: (i) GEN-MW, (ii) GEN-WE and (iii) GEN-NE. Following the completion of the Merger Agreement in April 2007, our previously named South segment has been renamed the GEN-WE segment and the power generation facilities located in California and Arizona acquired through the Merger Agreement are included in this segment. The Kendall, Ontelaunee and Plum Point power generation facilities acquired through the Merger Agreement are included in GEN-MW, and the Casco Bay and Bridgeport power generation facilities acquired through the Merger Agreement are included in GEN-NE. We also separately report results of our CRM business, which primarily consists of legacy physical gas supply contracts and gas transportation contracts and remaining legacy power and emission trading positions that remain from the third-party trading business that was substantially exited in 2002. Our unaudited condensed consolidated financial results also reflect corporate-level expenses such as general and administrative, interest and depreciation and amortization. Because of the diversity among their respective operations, we report the results of each business as a separate segment in our unaudited condensed consolidated financial statements.

Table of Contents**Three Months Ended September 30, 2007 and 2006**

Summary Financial Information. The following tables provide summary financial data regarding Dynegy's consolidated and segmented results of operations for the three-month periods ended September 30, 2007 and 2006, respectively:

Dynegy's Results of Operations for the Three Months Ended September 30, 2007

| | Power Generation | | | | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | |
| | (in millions) | | | | | |
| Revenues | \$ 392 | \$ 354 | \$ 296 | \$ 4 | \$ | \$ 1,046 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (202) | (210) | (232) | (4) | (1) | (649) |
| Depreciation and amortization expense | (51) | (25) | (12) | | (4) | (92) |
| Gain on sale of assets, net | | | | 4 | | 4 |
| General and administrative expense | | | | (16) | (46) | (62) |
| Operating income (loss) | \$ 139 | \$ 119 | \$ 52 | \$ (12) | \$ (51) | \$ 247 |
| Earnings (losses) from unconsolidated investments | | 12 | | | (4) | 8 |
| Other items, net | 1 | | | (2) | 18 | 17 |
| Interest expense | | | | | | (117) |
| Income from continuing operations before income taxes | | | | | | 155 |
| Income tax expense | | | | | | (59) |
| Income from continuing operations | | | | | | 96 |
| Income from discontinued operations, net of taxes | | | | | | 124 |
| Net income | | | | | | \$ 220 |

Dynegy's Results of Operations for the Three Months Ended September 30, 2006

| | Power Generation | | | | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | |
| | (in millions) | | | | | |
| Revenues | \$ 260 | \$ 24 | \$ 199 | \$ 25 | \$ | \$ 508 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (131) | (16) | (160) | (12) | | (319) |

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| | | | | | | |
|---|---------|------|-------|--------|---------|---------|
| Depreciation and amortization expense | (43) | (2) | (6) | (3) | (54) | |
| Impairment and other charges | (96) | | | | (96) | |
| General and administrative expense | | | | (22) | (37) | (59) |
| Operating income (loss) | \$ (10) | \$ 6 | \$ 33 | \$ (9) | \$ (40) | \$ (20) |
| Earnings from unconsolidated investments | | 4 | | | | 4 |
| Other items, net | 1 | | 2 | 2 | 6 | 11 |
| Interest expense and debt conversion costs | | | | | | (107) |
| Loss from continuing operations before income taxes | | | | | | (112) |
| Income tax benefit | | | | | | 41 |
| Loss from continuing operations | | | | | | (71) |
| Income from discontinued operations, net of taxes | | | | | | 2 |
| Net loss | | | | | | \$ (69) |

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The following tables provide summary financial data regarding DHI's consolidated and segmented results of operations for the three-month periods ended September 30, 2007 and 2006, respectively:

DHI's Results of Operations for the Three Months Ended September 30, 2007

| | Power Generation | | | | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | |
| | (in millions) | | | | | |
| Revenues | \$ 392 | \$ 354 | \$ 296 | \$ 4 | \$ | \$ 1,046 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (202) | (210) | (232) | (4) | (1) | (649) |
| Depreciation and amortization expense | (51) | (25) | (12) | | (4) | (92) |
| Gain on sale of assets, net | | | | 4 | | 4 |
| General and administrative expense | | | | (16) | (46) | (62) |
| Operating income (loss) | \$ 139 | \$ 119 | \$ 52 | \$ (12) | \$ (51) | \$ 247 |
| Earnings from unconsolidated investments | | 12 | | | | 12 |
| Other items, net | 1 | | | (2) | 19 | 18 |
| Interest expense | | | | | | (117) |
| Income from continuing operations before income taxes | | | | | | 160 |
| Income tax expense | | | | | | (62) |
| Income from continuing operations | | | | | | 98 |
| Income from discontinued operations, net of taxes | | | | | | 124 |
| Net income | | | | | | \$ 222 |

DHI's Results of Operations for the Three Months Ended September 30, 2006

| | Power Generation | | | | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | |
| | (in millions) | | | | | |
| Revenues | \$ 260 | \$ 24 | \$ 199 | \$ 25 | \$ | \$ 508 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (131) | (16) | (160) | (12) | | (319) |
| Depreciation and amortization expense | (43) | (2) | (6) | | (3) | (54) |

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| | | | | | | | | |
|---|---------|------|-------|--------|---------|---------|--|---------|
| Impairment and other charges | (96) | | | | | | | (96) |
| General and administrative expense | | | | (22) | | (36) | | (58) |
| Operating income (loss) | \$ (10) | \$ 6 | \$ 33 | \$ (9) | \$ (39) | \$ (19) | | |
| Earnings from unconsolidated investments | | 4 | | | | | | 4 |
| Other items, net | 1 | | 2 | 2 | | 4 | | 9 |
| Interest expense and debt conversion costs | | | | | | | | (107) |
| Loss from continuing operations before income taxes | | | | | | | | (113) |
| Income tax benefit | | | | | | | | 43 |
| Loss from continuing operations | | | | | | | | (70) |
| Income from discontinued operations, net of taxes | | | | | | | | 3 |
| Net loss | | | | | | | | \$ (67) |

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The following table provides summary segmented operating statistics for the three months ended September 30, 2007 and 2006, respectively:

| | Three Months Ended September 30, | |
|--|---|-------------|
| | 2007 | 2006 |
| GEN-MW | | |
| Million Megawatt Hours Generated | 7.5 | 5.7 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (1): | | |
| Cinergy (Cin Hub) | \$ 64 | \$ 58 |
| Commonwealth Edison (NI Hub) | \$ 61 | \$ 58 |
| PJM West | \$ 75 | \$ 74 |
| GEN-WE | | |
| Million Megawatt Hours Generated (2) (3) | 5.2 | 0.3 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (1): | | |
| North Path 15 (NP 15) | \$ 69 | \$ 72 |
| Palo Verde | \$ 69 | \$ 67 |
| Average Market Spark Spreads (\$/MWh): | | |
| North Path 15 (NP15) | \$ 24 | \$ 27 |
| Palo Verde | \$ 26 | \$ 24 |
| GEN-NE | | |
| Million Megawatt Hours Generated | 3.2 | 1.7 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (1): | | |
| New York Zone G | \$ 78 | \$ 84 |
| New York Zone A | \$ 64 | \$ 62 |
| Mass Hub | \$ 71 | \$ 71 |
| Average Market Spark Spreads (\$/MWh): | | |
| New York Zone A | \$ 19 | \$ 18 |
| Mass Hub | \$ 24 | \$ 24 |
| Average natural gas price Henry Hub (\$/MMBtu) (4) | \$ 6.15 | \$ 6.08 |

(1) Reflects the average of day-ahead quoted prices for the periods presented and does not necessarily reflect prices realized by the Company.

(2) Includes our ownership percentage in

the MWh generated by our GEN-WE investment in NCA#2 for the three months ended September 30, 2007 and September 30, 2006.

- (3) Excludes approximately 0.3 MWh and 0.8 MWh generated by our CoGen Lyondell facility, which we sold in August 2007, and less than 0.1 MWh and less than 0.1 MWh generated by our Calcasieu facility, which is classified as held for sale, for the three months ended September 30, 2007 and 2006, respectively.

- (4) Calculated as the average of the daily gas prices for the period.

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The following tables summarize significant items on a pre-tax basis affecting net income (loss) for the periods presented:

Three Months Ended September 30, 2007
Power Generation

| | GEN-MW | GEN-WE | GEN-NE | CRM | Other & Eliminations | Total |
|--|---------------|--------|--------|---------|-------------------------|--------|
| | (in millions) | | | | | |
| Discontinued operations (1) | \$ | \$ 213 | \$ | \$ 4 | \$ | \$ 217 |
| Legal and settlement charge | | | | (16) | | (16) |
| Gain on sale of Sandy Creek ownership interest | | 12 | | | | 12 |
| Total | \$ | \$ 225 | \$ | \$ (12) | \$ | \$ 213 |

(1) Discontinued operations for GEN-WE includes a \$210 million pre-tax gain on the sale of the CoGen Lyondell power generation facility.

Three Months Ended September 30, 2006
Power Generation

| | GEN-MW | GEN-WE | GEN-NE | CRM | Other & Eliminations | Total |
|---|---------------|--------|---------|---------|-------------------------|----------|
| | (in millions) | | | | | |
| Asset impairment | \$ (96) | \$ | \$ | \$ | \$ | \$ (96) |
| Legal and settlement charges | | | | (22) | | (22) |
| Sithe subordinated debt exchange charge | | | (36) | | | (36) |
| Discontinued operations (1) | | 2 | | 6 | 2 | 10 |
| Total | \$ (96) | \$ 2 | \$ (36) | \$ (16) | \$ 2 | \$ (144) |

Operating Income (Loss)

Operating income for Dynegy was \$247 million for the three months ended September 30, 2007, compared to an operating loss of \$20 million for the three months ended September 30, 2006. Operating income for DHI was \$247 million for the three months ended September 30, 2007, compared to an operating loss of \$19 million for the three months ended September 30, 2006.

Power Generation Midwest Segment. Operating income for GEN-MW was \$139 million for the three months ended September 30, 2007, compared to an operating loss of \$10 million for the three months ended September 30, 2006. Operating income for 2006 included a \$96 million pre-tax impairment charge related to the Bluegrass generation

facility, due to changes in the market that resulted in economic constraints on the facility.

Results for the three months ended September 30, 2007 improved by \$61 million from the three months ended September 30, 2006 as a result of higher volumes, increased market prices, improved pricing as a result of the Illinois reverse power procurement auction and the addition of the new Midwest plants acquired through the Merger, offset by mark-to market losses.

Generated volumes increased by 32%, up from 5.7 million MWh for the third quarter 2006 to 7.5 million MWh for the same period in 2007. Average actual on-peak prices in the Cin Hub pricing region increased from \$58 per MWh in the third quarter 2006 to \$64 per MWh for the third quarter 2007.

Beginning January 1, 2007, we began operating under two new energy product supply agreements with subsidiaries of Ameren Corporation through our participation in the Illinois reverse power procurement auction in 2006. Under these new agreements, we provide up to 1,400 MWh around the clock for prices of approximately \$65 per megawatt-hour.

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The Kendall and Ontelaunee plants acquired on April 2, 2007 provided results of \$25 million for the three months ended September 30, 2007, exclusive of mark-to-market results discussed below.

GEN-MW's results for the three months ended September 30, 2007 included unrealized mark-to-market losses of \$29 million related to forward sales, compared to unrealized \$11 million of mark-to-market gains for the three months ended September 30, 2006. Of the \$29 million in 2007 mark-to-market losses, \$12 million related to positions that will settle in 2007, and the remaining \$17 million related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

Depreciation expense increased from \$43 million for the third quarter 2006 to \$51 million for the third quarter 2007 primarily as a result of the new Midwest plants.

Power Generation West Segment. Operating income for GEN-WE was \$119 million for three months ended September 30, 2007, compared to income of \$6 million for the three months ended September 30, 2006. The 2006 results relate to our Heard County and Rockingham generation facilities. Results from our CoGen Lyondell and Calcasieu power generation facilities have been classified as discontinued operations for all periods presented. Results for the three months ended September 30, 2007 improved by \$136 million from the three months ended September 30, 2006 as a result of the addition of the new West plants acquired through the Merger and higher mark-to-market gains.

Generated volumes were 5.2 MWh for the third quarter 2007, up from 0.3 million MWh for the third quarter 2006.

The volume increase was primarily driven by the new West plants. The plants provided total results of \$74 million for the three months ended September 30, 2007, exclusive of mark-to-market results discussed below.

GEN-WE's results for the three months ended September 30, 2007 included unrealized mark-to-market gains of \$68 million related to heat rate call-options and forward sales agreements, compared to zero for the three months ended September 30, 2006. Of the \$68 million in 2007 mark-to-market gains, \$34 million related to positions that will settle in 2007, and the remaining \$34 million related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

Depreciation expense increased from \$2 million for the third quarter 2006 to \$25 million for the third quarter 2007 primarily as a result of the new West plants.

Power Generation Northeast Segment. Operating income for GEN-NE was \$52 million for the three months ended September 30, 2007, compared to \$33 million for the three months ended September 30, 2006.

Results for the three months ended September 30, 2007 improved by \$25 million from the three months ended September 30, 2006 as a result of the addition of the new Northeast plants acquired through the Merger offset by mark-to-market losses. Additionally, a fuel oil inventory write-down of approximately \$6 million was recorded in the three months ended September 30, 2006.

On peak market prices in New York Zone G decreased by 7% and Zone A increased by 3%. Average market spark spreads increased by 6% and zero for New York Zone A and Mass Hub, respectively.

Generated volumes increased by 88%, up from 1.7 million MWh for the third quarter 2006 to 3.2 million MWh for the same period in 2007. The volume increase was primarily driven by the new Northeast plants. The Bridgeport and Casco Bay plants provided total results of \$30 million for the three months ended September 30, 2007, exclusive of mark-to-market results discussed below.

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GEN-NE's results for the three months ended September 30, 2007 included unrealized mark-to-market losses of \$19 million related to forward sales, compared to unrealized mark-to-market losses of \$7 million for the three months ended September 30, 2006. Of the \$19 million in 2007 mark-to-market losses, \$18 million related to positions that will settle in 2007, and the remaining \$1 million loss related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

Depreciation expense increased from \$6 million for the third quarter 2006 to \$12 million for the third quarter 2007 as a result of the new Northeast plants.

CRM. Operating loss for the CRM segment was \$12 million for the three months ended September 30, 2007, compared to an operating loss of \$9 million for the three months ended September 30, 2006.

Results for 2007 and 2006 reflected legal charges of approximately \$16 million and \$22 million, respectively, resulting from additional activities during the period that negatively affected management's assessment of the probable and estimable losses associated with the applicable proceedings. The 2007 legal charges were partially offset by a \$4 million gain on the sale of NYMEX securities. The 2006 legal charges were largely offset by mark-to-market income on our legacy coal, natural gas, emissions, and power positions.

Other. Dynegy's other operating loss for the three months ended September 30, 2007 was \$51 million, compared to an operating loss of \$40 million for the three months ended September 30, 2006. Operating losses in both periods were comprised primarily of general and administrative expenses.

Dynegy's consolidated general and administrative expenses were \$62 million and \$59 million for the three months ended September 30, 2007 and 2006, respectively. General and administrative expenses for the three months ended September 30, 2007 included legal and settlement charges of \$17 million, \$16 million of which was reflected in our CRM segment. This compared with legal and settlement charges of \$22 million in the same period of 2006, all of which were reflected in our CRM segment. The remaining increase from 2006 to 2007 was primarily a result of higher salary and employee benefit costs due to the Merger.

DHI's other operating loss for the three months ended September 30, 2007 was \$51 million, compared to an operating loss of \$39 million for the three months ended September 30, 2006. Operating losses in both periods were comprised primarily of general and administrative expenses.

DHI's consolidated general and administrative expenses were \$62 million and \$58 million for the three months ended September 30, 2007 and 2006, respectively. General and administrative expenses for the three months ended September 30, 2007 included legal and settlement charges of \$17 million, \$16 million of which is reflected in our CRM segment. This compared with legal and settlement charges of \$22 million in the same period of 2006, all of which were reflected in our CRM segment. The remaining increase from 2006 to 2007 was primarily a result of higher salary and employee benefit costs due to the Merger.

Earnings from Unconsolidated Investments

Dynegy's earnings from unconsolidated investments were \$8 million for the three months ended September 30, 2007. GEN-WE recognized \$12 million of earnings related to its investment in Sandy Creek largely due to its share of the gain on SCEA's sale of a 25% undivided interest in the Project. Please see Note 7 Variable Interest Entities Sandy Creek for further information. This income was partly offset by a \$4 million loss related to Dynegy's interest in DLS Power Holdings. Earnings from unconsolidated investments for the three months ended September 30, 2006 were \$4 million, related to the GEN-WE investment in NCA#2.

DHI's earnings from unconsolidated investments of \$12 million for the three months ended September 30, 2007 related to its investment in Sandy Creek largely due to its share of the gain on SCEA's sale of a 25% undivided interest in the Project. Please see Note 7 Variable Interest Entities Sandy Creek for further information.

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Earnings from unconsolidated investments for the three months ended September 30, 2006 were \$4 million, related to the GEN-WE investment in NCA#2.

Other Items, Net

Dynegy's other items, net, totaled \$17 million of net income for the three months ended September 30, 2007, compared to \$11 million of income for the three months ended September 30, 2006. The increase was primarily associated with higher interest income due to larger restricted cash balances in 2007.

DHI's other items, net, totaled \$18 million of net income for the three months ended September 30, 2007, compared to \$9 million of income for the three months ended September 30, 2006. The increase was primarily associated with higher interest income due to larger restricted cash balances in 2007.

Interest Expense

Dynegy's and DHI's interest expense and debt conversion costs totaled \$117 million for the three months ended September 30, 2007, compared to \$107 million for the three months ended September 30, 2006. The increase was primarily attributable to additional borrowings in connection with our Fifth Amended and Restated Credit Facility and the issuance of the \$1.65 billion of Senior Unsecured Notes on May 24, 2007. This increase is partly offset by a \$36 million charge was recorded in the third quarter 2006 associated with the Sithe subordinated debt exchange.

Income Tax (Expense) Benefit

Dynegy reported an income tax expense from continuing operations of \$59 million for the three months ended September 30, 2007, compared to an income tax benefit from continuing operations of \$41 million for the three months ended September 30, 2006. The 2007 effective tax rate was 38%, compared to 37% in 2006.

DHI reported an income tax expense from continuing operations of \$62 million for the three months ended September 30, 2007, compared to an income tax benefit from continuing operations of \$43 million for the three months ended September 30, 2006. The 2007 effective tax rate was 39%, compared to 38% in 2006.

In general, differences between these effective rates and the statutory rate of 35% resulted primarily from the effect of state income taxes. As a result of the Merger Agreement, our effective state tax rate increased primarily as a result of the higher state tax rates in the states in which the LS Contributed Entities assets are located.

Discontinued Operations

Income From Discontinued Operations Before Taxes. Discontinued operations include the Calcasieu and CoGen Lyondell power generation facilities in our GEN-WE segment, DMSLP in our former NGL segment and our U.K. CRM business in our CRM segment.

During the three months ended September 30, 2007, Dynegy's pre-tax income from discontinued operations was \$217 million (\$124 million after-tax). Dynegy's GEN-WE segment included earnings of \$3 million from the operation of the CoGen Lyondell and Calcasieu power generation facilities in addition to a pre-tax gain of \$210 million associated with the completion of our sale of the CoGen Lyondell power generation facility.

During the three months ended September 30, 2006, Dynegy's pre-tax income from discontinued operations was \$10 million (\$2 million after-tax). Dynegy's GEN-WE segment included earnings of \$2 million from the operation of the CoGen Lyondell and Calcasieu generation facilities. Dynegy's U.K. CRM business included earnings of \$6 million for the three months ended September 30, 2006, associated with the settlement of an outstanding contract. Dynegy also recorded pre-tax income of \$2 million attributable to NGL.

During the three months ended September 30, 2007, DHI's pre-tax income from discontinued operations was \$217 million (\$124 million after-tax). DHI's GEN-WE segment included earnings of \$3 million from the operation of the CoGen Lyondell and Calcasieu power generation facilities in addition to a pre-tax gain of \$210 million associated with the completion of our sale of the CoGen Lyondell power generation facility.

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During the three months ended September 30, 2006, DHI's pre-tax income from discontinued operations was \$10 million (\$3 million after-tax). DHI's GEN-WE segment included earnings of \$2 million from the operation of the CoGen Lyondell and Calcasieu generation facilities. DHI's U.K. CRM business included earnings of \$6 million for the three months ended September 30, 2006, associated with the settlement of an outstanding contract. DHI also recorded pre-tax income of \$2 million attributable to NGL.

Income Tax (Expense) Benefit From Discontinued Operations.

Dynegy recorded an income tax expense from discontinued operations of \$93 million during the three months ended September 30, 2007, compared to an income tax benefit from discontinued operations of \$8 million during the three months ended September 30, 2006. The effective rates for the three months ended September 30, 2007 and 2006 were 43% and 80%, respectively. FIN No. 18, Accounting for Income Taxes in Interim Periods an interpretation of APB Opinion No. 28 requires a detailed methodology of allocating income taxes between continuing and discontinued operations. This methodology often results in an effective rate for discontinued operations significantly different from the statutory rate of 35%. The effective tax rate was also impacted by the \$62 million of goodwill allocated to the CoGen Lyondell power generation facility upon its sale. As there was no tax basis in the goodwill, there were no tax benefits associated with the allocated goodwill.

DHI recorded an income tax expense from discontinued operations of \$93 million during the three months ended September 30, 2007, compared to an income tax benefit from discontinued operations of \$7 million during the three months ended September 30, 2006. The effective rates for the three months ended September 30, 2007 and 2006 were 43% and 70%, respectively. FIN No. 18, Accounting for Income Taxes in Interim Periods an interpretation of APB Opinion No. 28 requires a detailed methodology of allocating income taxes between continuing and discontinued operations. This methodology often results in an effective rate for discontinued operations significantly different from the statutory rate of 35%. The effective tax rate was also impacted by the \$62 million of goodwill allocated to the CoGen Lyondell power generation facility upon its sale. As there was no tax basis in the goodwill, there were no tax benefits associated with the allocated goodwill.

Nine Months Ended September 30, 2007 and 2006

Summary Financial Information. The following tables provide summary financial data regarding Dynegy's consolidated and segmented results of operations for the nine-month periods ended September 30, 2007 and 2006, respectively:

Dynegy's Results of Operations for the Nine Months Ended September 30, 2007

| | Power Generation | | | | Other and Eliminations | Total |
|--|------------------|--------|--------|-------|---------------------------|----------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | | |
| | (in millions) | | | | | |
| Revenues | \$ 1,070 | \$ 499 | \$ 799 | \$ 11 | \$ | \$ 2,379 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (528) | (345) | (621) | 18 | (2) | (1,478) |
| Depreciation and amortization expense | (143) | (49) | (30) | | (10) | (232) |
| Gain on sale of assets, net | | | | 4 | | 4 |
| General and administrative expense | | | | (16) | (147) | (163) |
| Operating income (loss) | \$ 399 | \$ 105 | \$ 148 | \$ 17 | \$ (159) | \$ 510 |
| Earnings (losses) from unconsolidated investments | | 12 | | | (6) | 6 |
| Other items, net | (8) | | | (5) | 39 | 26 |

| | |
|---|--------|
| Interest expense | (268) |
| Income from continuing operations before income taxes | 274 |
| Income tax expense | (95) |
| Income from continuing operations | 179 |
| Income from discontinued operations, net of taxes | 131 |
| Net income | \$ 310 |

Table of Contents**Dynegy's Results of Operations for the Nine Months Ended September 30, 2006**

| | Power Generation | | | | Other and | Total |
|--|-------------------------|---------------|---------------|------------|---------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | CRM | Eliminations | |
| | (in millions) | | | | | |
| Revenues | \$ 744 | \$ 83 | \$ 516 | \$ 84 | \$ | \$ 1,427 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (363) | (70) | (439) | (34) | (1) | (907) |
| Depreciation and amortization expense | (126) | (6) | (18) | | (14) | (164) |
| Impairment and other charges | (96) | (9) | | | (2) | (107) |
| Gain on sale of assets, net | | | | | 3 | 3 |
| General and administrative expense | | | | (53) | (107) | (160) |
| Operating income (loss) | \$ 159 | \$ (2) | \$ 59 | \$ (3) | \$ (121) | \$ 92 |
| Earnings from unconsolidated investments | | 6 | | | | 6 |
| Other items, net | 1 | 1 | 6 | 1 | 32 | 41 |
| Interest expense and debt conversion costs | | | | | | (559) |
| Loss from continuing operations before income taxes | | | | | | (420) |
| Income tax benefit | | | | | | 150 |
| Loss from continuing operations | | | | | | (270) |
| Loss from discontinued operations, net of taxes | | | | | | (6) |
| Cumulative effect of change in accounting principle, net of taxes | | | | | | 1 |
| Net loss | | | | | | \$ (275) |

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The following tables provide summary financial data regarding DHI's consolidated and segmented results of operations for the nine-month periods ended September 30, 2007 and 2006, respectively:

DHI's Results of Operations for the Nine Months Ended September 30, 2007

| | Power Generation | | | | CRM | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|-------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | | | | |
| | (in millions) | | | | | | |
| Revenues | \$ 1,070 | \$ 499 | \$ 799 | \$ 11 | \$ | \$ | \$ 2,379 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (528) | (345) | (621) | 18 | | (2) | (1,478) |
| Depreciation and amortization expense | (143) | (49) | (30) | | | (10) | (232) |
| Gain on sale of assets, net | | | | 4 | | | 4 |
| General and administrative expense | | | | (16) | | (128) | (144) |
| Operating income (loss) | \$ 399 | \$ 105 | \$ 148 | \$ 17 | \$ | (140) | \$ 529 |
| Earnings from unconsolidated investments | | 12 | | | | | 12 |
| Other items, net | (8) | | | (5) | | 38 | 25 |
| Interest expense | | | | | | | (268) |
| Income from continuing operations before income taxes | | | | | | | 298 |
| Income tax expense | | | | | | | (94) |
| Income from continuing operations | | | | | | | 204 |
| Income from discontinued operations, net of taxes | | | | | | | 130 |
| Net income | | | | | | | \$ 334 |

DHI's Results of Operations for the Nine Months Ended September 30, 2006

| | Power Generation | | | | CRM | Other and Eliminations | Total |
|--|-------------------------|---------------|---------------|-------|------------|-----------------------------------|--------------|
| | GEN-MW | GEN-WE | GEN-NE | | | | |
| | (in millions) | | | | | | |
| Revenues | \$ 744 | \$ 83 | \$ 516 | \$ 84 | \$ | \$ | \$ 1,427 |
| Cost of sales, exclusive of depreciation and amortization expense shown separately below | (363) | (70) | (439) | (34) | | (1) | (907) |
| Depreciation and amortization expense | (126) | (6) | (18) | | | (14) | (164) |
| Impairment and other charges | (96) | (9) | | | | (2) | (107) |

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| | | | | | | | |
|---|--------|--------|-------|--------|----------|-------|-------|
| Gain on sale of assets, net | | | | | | 3 | 3 |
| General and administrative expense | | | | (53) | | (105) | (158) |
| Operating income (loss) | \$ 159 | \$ (2) | \$ 59 | \$ (3) | \$ (119) | \$ | 94 |
| Earnings from unconsolidated investments | | 6 | | | | | 6 |
| Other items, net | 1 | 1 | 6 | 1 | 27 | | 36 |
| Interest expense and debt conversion costs | | | | | | | (507) |
| Loss from continuing operations before income taxes | | | | | | | (371) |
| Income tax benefit | | | | | | | 132 |
| Loss from continuing operations | | | | | | | (239) |
| Loss from discontinued operations, net of taxes | | | | | | | (6) |
| Net loss | | | | | | \$ | (245) |

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The following table provides summary segmented operating statistics for the nine months ended September 30, 2007 and 2006, respectively:

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2007 | 2006 |
| GEN-MW | | |
| Million Megawatt Hours Generated (1) | 19.1 | 16.1 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (2): | | |
| Cinergy (Cin Hub) | \$ 62 | \$ 53 |
| Commonwealth Edison (NI Hub) | \$ 59 | \$ 54 |
| PJM West | \$ 72 | \$ 65 |
| GEN-WE | | |
| Million Megawatt Hours Generated (1) (3) | 8.0 | 0.9 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (2): | | |
| North Path 15 (NP 15) | \$ 66 | \$ 61 |
| Palo Verde | \$ 63 | \$ 59 |
| Average Market Spark Spreads (\$/MWh): | | |
| North Path 15 (NP15) | \$ 16 | \$ 14 |
| Palo Verde | \$ 15 | \$ 13 |
| GEN-NE | | |
| Million Megawatt Hours Generated | 7.0 | 3.5 |
| Average Actual On-Peak Market Power Prices (\$/MWh) (2): | | |
| New York Zone G | \$ 83 | \$ 78 |
| New York Zone A | \$ 62 | \$ 60 |
| Mass Hub | \$ 76 | \$ 71 |
| Average Actual On-Peak Market Spark Spread (\$/MWh): | | |
| New York Zone A | \$ 11 | \$ 11 |
| Mass Hub | \$ 20 | \$ 19 |
| Average natural gas price Henry Hub (\$/MMBtu) (4) | \$ 6.95 | \$ 6.79 |

(1) Includes our ownership percentage in the MWh generated by our GEN-WE investment in NCA#2 for the nine months ended September 30, 2007 and includes the MWh generated by our

GEN-WE
investments in
West Coast
Power and
NCA#2 and our
GEN-MW
investment in
Rocky Road for
the nine months
ended
September 30,
2006.

- (2) Reflects the average of day-ahead quoted prices for the periods presented and does not necessarily reflect prices realized by the Company.
- (3) Excludes approximately 1.8 MWh and 2.2 MWh generated by our CoGen Lyondell facility, which we sold in August 2007, and less than 0.1 MWh and less than 0.1 MWh generated by our Calcasieu facility, which is classified as held for sale, for the nine months ended September 30, 2007 and 2006, respectively.
- (4) Calculated as the average of

the daily gas
prices for the
period.

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The following tables summarize significant items on a pre-tax basis affecting net income (loss) for the periods presented:

| Nine Months Ended September 30, 2007 | | | | | | |
|---|----------------------|---------------|---------------|------------|--------------|--------------|
| Power Generation | | | | | | |
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other | Total |
| | (in millions) | | | | | |
| Discontinued operations (1) | \$ | \$ 213 | \$ | \$ 15 | \$ | \$ 228 |
| Legal and settlement charges | | | | (16) | (2) | (18) |
| Illinois rate relief charge | (25) | | | | | (25) |
| Change in fair value of interest rate swaps, net of minority interest | (9) | | | | 39 | 30 |
| Gain on sale of Sandy Creek ownership interest | | 12 | | | | 12 |
| Settlement of Kendall toll | | | | 31 | | 31 |
| Total DHI | (34) | 225 | | 30 | 37 | 258 |
| Legal and settlement charges | | | | | (19) | (19) |
| Total Dynegy | \$ (34) | \$ 225 | \$ | \$ 30 | \$ 18 | \$ 239 |

(1) Discontinued operations for GEN-WE includes a \$210 million pre-tax gain on the sale of the CoGen Lyondell power generation facility.

| Nine Months Ended September 30, 2006 | | | | | | |
|---|----------------------|---------------|---------------|------------|--------------|--------------|
| Power Generation | | | | | | |
| | GEN-MW | GEN-WE | GEN-NE | CRM | Other | Total |
| | (in millions) | | | | | |
| Debt conversion costs | \$ | \$ | \$ | \$ | \$ (204) | \$ (204) |
| Asset impairments | (96) | (9) | | | | (105) |
| Legal and settlement charges | | | | (53) | | (53) |
| Site subordinated debt exchange charge | | | (36) | | | (36) |
| Acceleration of financing costs | | | | | (34) | (34) |
| Total DHI | (96) | (9) | (36) | (53) | (238) | (432) |
| Debt conversion costs | | | | | (45) | (45) |
| Legal and settlement charges | | | | | (2) | (2) |

| | | | | | | | | | | | | |
|--------------|----|------|----|-----|----|------|----|------|----|-------|----|-------|
| Total Dynegy | \$ | (96) | \$ | (9) | \$ | (36) | \$ | (53) | \$ | (285) | \$ | (479) |
|--------------|----|------|----|-----|----|------|----|------|----|-------|----|-------|

Operating Income

Operating income for Dynegy was \$510 million for the nine months ended September 30, 2007, compared to \$92 million for the nine months ended September 30, 2006. Operating income for DHI was \$529 million for the nine months ended September 30, 2007, compared to \$94 million for the nine months ended September 30, 2006.

Power Generation Midwest Segment. Operating income for GEN-MW was \$399 million for the nine months ended September 30, 2007, compared to \$159 million for the nine months ended September 30, 2006. Operating income for 2006 included a \$96 million pre-tax impairment charge related to the Bluegrass generation facility, due to changes in the market that resulted in economic constraints on the facility.

Results for the nine months ended September 30, 2007 improved by \$161 million from the nine months ended September 30, 2006 as a result of higher volumes, increased market prices, improved pricing as a result of the Illinois reverse power procurement auction, the addition of the new Midwest plants acquired through the Merger and higher mark-to-market gains. These items were partially offset by a \$25 million charge related to the Illinois rate relief package.

Generated volumes increased by 19%, up from 16.1 million MWh for the nine months ended September 30, 2006 to 19.1 million MWh for the same period in 2007. Average actual on-peak prices in Cin Hub pricing region increased from \$53 per MWh for the nine months ended September 30, 2006 to \$62 per MWh for the nine months ended September 30, 2007.

Beginning January 1, 2007, we began operating under two new energy product supply agreements with subsidiaries of Ameren Corporation through our participation in the Illinois reverse power procurement auction in 2006. Under these new agreements, we provide up to 1,400 MWh around the clock for prices of approximately \$64.77 per megawatt-hour.

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The Kendall and Ontelaunee plants acquired on April 2, 2007 provided results of \$44 million for the nine months ended September 30, 2007, exclusive of mark-to-market results discussed below.

GEN-MW's results for the nine months ended September 30, 2007 included unrealized mark-to-market gains of \$6 million related to forward sales, compared to \$10 million of unrealized mark-to-market gains for the nine months ended September 30, 2006. Of the \$6 million in 2007 mark-to-market gains, no losses related to positions which will settle in 2007, and the remaining \$6 million of gains related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

In July 2007, we entered into agreements with various parties to make payments of up to \$25 million to support a comprehensive rate relief package for Illinois for electric consumers. During September 2007, the governor of Illinois approved the legislation and we made an initial payment of \$7.5 million. We recorded a second quarter 2007 pre-tax charge of \$25 million, included as a cost of sales on our unaudited condensed consolidated statements of operations. Please see Note 11 Commitments and Contingencies Illinois Auction Complaints for further discussion.

Depreciation expense increased from \$126 million for the nine months ended September 30, 2006 to \$143 million for the nine months ended September 30, 2007 primarily as a result of the new Midwest plants and capital projects placed into service in 2006.

Power Generation West Segment. Operating income for GEN-WE was \$105 million for the nine months ended September 30, 2007, compared to a loss of \$2 million for the nine months ended September 30, 2006. The 2006 results relate to our Heard County and Rockingham generation facilities. Results from our CoGen Lyondell and Calcasieu power generation facilities have been classified as discontinued operations for all periods presented. Results for the nine months ended September 30, 2007 improved by \$141 million from the nine months ended September 30, 2006 as a result of the addition of the new West plants acquired through the Merger offset by mark-to-market losses described below.

Generated volumes were 8.0 million MWh for the nine months ended September 30, 2007, up from 0.9 million MWh for the nine months ended September 30, 2006. The volume increase was primarily driven by the new West plants, which provided total results of \$115 million for the nine months ended September 30, 2007, exclusive of mark-to-market results discussed below. The volume increase from the new West plants was partially offset by a reduction due to the sale of the Rockingham generation facility in late 2006.

GEN-WE's results for the nine months ended September 30, 2007 included unrealized mark-to-market gains of \$35 million related to heat rate call-options and forward sales agreements, compared to zero for the nine months ended September 30, 2006. Of the \$35 million in 2007 mark-to-market gains, \$25 million related to positions which will settle in 2007, and the remaining \$10 million related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

Depreciation expense increased from \$6 million for the nine months ended September 30, 2006 to \$49 million for the nine months ended September 30, 2007 primarily as a result of the new West plants. In addition, during the second quarter 2006, we recorded a \$9 million impairment of our Rockingham facility, resulting from the announcement of our sale of the facility.

Power Generation Northeast Segment. Operating income for GEN-NE was \$148 million for the nine months ended September 30, 2007, compared to \$59 million for the nine months ended September 30, 2006.

Results for the nine months ended September 30, 2007 improved by \$101 million from the nine months ended September 30, 2006 as a result of increased market prices and spark spreads, the addition of the new Northeast plants acquired through the Merger and higher mark-to-market gains. Additionally, a fuel oil inventory write-down of approximately \$6 million was recorded in the nine months ended September 30, 2006.

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On peak market prices in New York Zone G and Zone A increased by 7% and 4%, respectively. Spark spreads widened due to higher power prices. Average market spark spreads increased 2% and 10% for New York Zone A and Mass Hub, respectively.

Generated volumes increased by 100%, up from 3.5 million MWh for the nine months ended September 30, 2006 to 7.0 million MWh for the same period in 2007. The volume increase was partially driven by the new Northeast plants. The Bridgeport and Casco Bay plants provided total results of \$40 million for the nine months ended September 30, 2007, exclusive of mark-to-market results discussed below. The volume increase was also a result of higher spark spreads and cooler weather in the first quarter 2007, which led to greater run times than in 2006.

Results were favorably impacted by \$11 million due to an opportunistic sale of emissions credits that were not required for near-term operations of our facilities in the nine months ended September 30, 2006. Similar sales of \$7 million occurred in the nine months ended September 30, 2007.

GEN-NE's results for the nine months ended September 30, 2007 included unrealized mark-to-market gains of \$13 million related to forward sales, compared to unrealized losses of \$20 million for the nine months ended September 30, 2006. Of the \$13 million in 2007 mark-to-market gains, \$10 million related to positions which will settle in 2007, and the remaining \$3 million related to positions that will settle in 2008 and beyond. See Note 5 Risk Management Activities Cash Flow Hedges for a discussion of our decision to no longer designate derivative transactions as cash flow hedges beginning with the second quarter 2007.

Depreciation expense increased from \$18 million for the nine months ended September 30, 2006 to \$30 million for the nine months ended September 30, 2007. This was primarily due to the new Northeast plants.

CRM. Operating income for the CRM segment was \$17 million for the nine months ended September 30, 2007, compared to an operating loss of \$3 million for the nine months ended September 30, 2006. Results for 2007 include a \$31 million gain associated with the acquisition of Kendall pursuant to EITF Issue No. 04-1. Prior to the Merger, Kendall held a power tolling contract with our CRM segment. Upon completion of the Merger, this contract became an intercompany agreement, and was effectively eliminated on a consolidated basis, resulting in the \$31 million gain. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion. Results for 2007 and 2006 reflect legal charges of approximately \$16 million and \$53 million, respectively, resulting from additional activities during the period that negatively affected management's assessment of probable and estimable losses associated with the applicable proceedings. The 2007 legal charges were partially offset by a \$4 million gain on the sale of NYMEX securities. The 2006 legal charges were partially offset by mark-to-market income on our legacy coal, natural gas, emissions, and power positions.

Other. Dynegy's other operating loss for the nine months ended September 30, 2007 was \$159 million, compared to an operating loss of \$121 million for the three months ended September 30, 2006. Operating losses in both periods were comprised primarily of general and administrative expenses.

Dynegy's consolidated general and administrative expenses increased to \$163 for the nine months ended September 30, 2007 from \$160 million for the nine months ended September 30, 2006. General and administrative expenses for the nine months ended September 30, 2007 included legal and settlement charges of \$37 million, compared with legal and settlement charges of \$55 million in the same period of 2006. Additionally, general and administrative expenses for 2007 included a charge of approximately \$6 million in connection with the accelerated vesting of restricted stock and stock option awards previously granted to employees, which vested in full upon closing of the Merger Agreement. The remaining increase from 2006 to 2007 was primarily a result of higher salary and employee benefit costs due to the Merger.

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DHI's other operating loss for the nine months ended September 30, 2007 was \$140 million, compared to an operating loss of \$119 million for the nine months ended September 30, 2006. Operating losses in both periods were comprised primarily of general and administrative expense.

DHI's consolidated general and administrative expenses decreased to \$144 for the nine months ended September 30, 2007 from \$158 million for the nine months ended September 30, 2006. General and administrative expenses for the nine months ended September 30, 2007 included legal and settlement charges of \$18 million, compared with legal and settlement charges of \$53 million in the same period of 2006. The decrease in legal and settlement charges from 2006 to 2007 was partially offset by a charge of approximately \$6 million in 2007 related to the accelerated vesting of restricted stock and stock option awards previously granted to employees, which vested in full upon closing of the Merger Agreement. Additionally, salary and employee benefit costs were higher in 2007 as a result of the Merger.

Earnings from Unconsolidated Investments

Dynegy's earnings from unconsolidated investments were \$6 million for both the nine months ended September 30, 2007 and the nine months ended September 30, 2006. Earnings in 2007 included \$12 million from the GEN-WE investment in Sandy Creek largely due to its share of the gain on SECA's sale of a 25% undivided interest in the Project. Please see Note 7 Variable Interest Entities Sandy Creek for further information. This income was partially offset by losses related to Dynegy's interest in DLS Power Holdings. Earnings in 2006 related to the GEN-WE investment in NCA#2.

DHI's earnings from unconsolidated investments were \$12 million for the nine months ended September 30, 2007, compared with earnings of \$6 million the nine months ended September 30, 2006. Earnings in 2007 included \$12 million from the GEN-WE investment in Sandy Creek largely due to its share of the gain on SCEA's sale of a 25% undivided interest in the Project. Please see Note 7 Variable Interest Entities Sandy Creek for further information. Earnings in 2006 related to the GEN-WE investment in NCA#2.

Other Items, Net

Dynegy's other items, net totaled \$26 million of income for the nine months ended September 30, 2007, compared to \$41 million of income for the nine months ended September 30, 2006. The decrease was primarily associated with \$8 million of minority interest expense recorded related to the Plum Point development project as well as foreign currency losses in the nine months ended September 30, 2007. The minority interest expense was primarily due to the mark-to-market interest income recorded during the three months ended June 30, 2007 related to the interest rate swap agreements associated with the Plum Point Credit Agreement. Please see Interest Expense below for further discussion.

DHI's other items, net totaled \$25 million of income for the nine months ended September 30, 2007, compared to \$36 million of income for the nine months ended September 30, 2006. The decrease was primarily associated with \$8 million of minority interest expense recorded in 2007 related to the Plum Point development project. The minority interest expense was primarily due to the mark-to-market interest income recorded during the three months ended June 30, 2007 related to the interest rate swap agreements associated with the Plum Point Credit Agreement. Please see Interest Expense below for further discussion.

Interest Expense

Dynegy's interest expense and debt conversion costs totaled \$268 million for the nine months ended September 30, 2007, compared to \$559 million for the nine months ended September 30, 2006. The decrease was primarily attributable to debt conversion costs and acceleration of financing costs resulting from our liability management program executed in the second quarter of 2006 as well as a \$36 million charge associated with the Sithe subordinated debt exchange. Included in interest expense for the nine months ended September 30, 2007 was approximately \$27 million of mark-to-market income from interest rate swap agreements associated with the Plum Point Credit Agreement Facility. Effective July 1, 2007, these agreements were designated as cash flow hedges.

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Also included in interest expense for the nine months ended September 30, 2007 was approximately \$12 million of income from interest rate swap agreements that, prior to being terminated, were associated with the portion of the debt repaid in late May 2007. The mark-to-market income included in interest expense for 2007 was offset by net losses of approximately \$7 million in connection with the repayment of a portion of the project indebtedness assumed in connection with the Merger. These items were offset by higher interest expense incurred in 2007 due to higher 2007 debt balances resulting from the Merger Agreement.

DHI's interest expense and debt conversion costs totaled \$268 million for the nine months ended September 30, 2007, compared to \$507 million for the nine months ended September 30, 2006. The decrease was primarily attributable to debt conversion costs and acceleration of financing costs resulting from our liability management program executed in the second quarter of 2006 as well as a \$36 million charge associated with the Sithe subordinated debt exchange.

Included in interest expense for the nine months ended September 30, 2007 was approximately \$27 million of mark-to-market income from interest rate swap agreements associated with the Plum Point Credit Agreement Facility. Effective July 1, 2007, these agreements were designated as cash flow hedges. Also included in interest expense for the nine months ended September 30, 2007 was approximately \$12 million of income from interest rate swap agreements, prior to being terminated, that were associated with the portion of the debt repaid in late May 2007. The mark-to-market income included in interest expense for 2007 was offset by net losses of approximately \$7 million in connection with the repayment of a portion of the project indebtedness assumed in connection with the Merger. These items were offset by higher interest expense incurred in 2007 due to higher 2007 debt balances resulting from the Merger Agreement.

Income Tax (Expense) Benefit

Dynegy reported an income tax expense from continuing operations of \$95 million for the nine months ended September 30, 2007, compared to an income tax benefit from continuing operations of \$150 million for the nine months ended September 30, 2006. The 2007 effective tax rate was 35%, compared to 36% in 2006.

DHI reported an income tax expense from continuing operations of \$94 million for the nine months ended September 30, 2007, compared to an income tax benefit from continuing operations of \$132 million for the nine months ended September 30, 2006. The 2007 effective tax rate was 32%, compared to 36% in 2006.

In general, differences between these effective rates and the statutory rate of 35% resulted primarily from the effect of state income taxes and adjustments to our reserve for uncertain tax positions. As a result of the Merger Agreement, our effective state tax rate increased primarily as a result of the higher state tax rates in the states in which the LS assets are located. This increase was more than offset by the impact of decreases in the New York state income tax rate and the Texas margin tax credit rate during the nine months ended September 30, 2007.

Discontinued Operations

Income From Discontinued Operations Before Taxes. Discontinued operations include the Calcasieu and CoGen Lyondell power generation facilities in our GEN-WE segment, DMSLP in our former NGL segment and our U.K. CRM business in the CRM segment.

During the nine months ended September 30, 2007, Dynegy's pre-tax income from discontinued operations was \$228 million (\$131 million after-tax). Dynegy's GEN-WE segment included \$3 from the operation of the CoGen Lyondell and Calcasieu power generation facilities in addition to a pre-tax gain of \$210 million associated with the completion of our sale of the CoGen Lyondell power generation facility. Dynegy's U.K. CRM business included income of \$15 million, primarily related to a favorable settlement of a legacy receivable.

During the nine months ended September 30, 2006, Dynegy's pre-tax loss from discontinued operations was \$5 million (\$6 million after-tax). Dynegy's GEN-WE segment included losses of \$13 million from the operation of the CoGen Lyondell and Calcasieu power generation facilities. Dynegy's U.K. CRM segment included earnings of \$5 million for the nine months ended September 30, 2006, associated with the settlement of an outstanding contract. Dynegy also recorded pre-tax income of \$3 million attributable to NGL.

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During the nine months ended September 30, 2007, DHI's pre-tax income from discontinued operations was \$228 million (\$130 million after-tax). DHI's GEN-WE segment included \$3 million from the operation of the CoGen Lyondell and Calcasieu power generation facilities in addition to a pre-tax gain of \$210 million associated with the completion of our sale of the CoGen Lyondell power generation facility. DHI's U.K. CRM business included income of \$15 million, primarily related to a favorable settlement of a legacy receivable.

During the nine months ended September 30, 2006, DHI's pre-tax loss from discontinued operations was \$5 million (\$6 million after-tax). DHI's GEN-WE segment included losses of \$13 million from the operation of the CoGen Lyondell and Calcasieu power generation facilities. DHI's U.K. CRM segment included earnings of \$5 million for the nine months ended September 30, 2006, associated with the settlement of an outstanding contract. DHI also recorded pre-tax income of \$3 million attributable to NGL.

Income Tax (Expense) Benefit From Discontinued Operations.

Dynegy recorded an income tax expense from discontinued operations of \$97 million during the nine months ended September 30, 2007, compared to an income tax expense from discontinued operations of \$1 million during the nine months ended September 30, 2006. The effective rates for the nine months ended September 30, 2007 and 2006 are 43% and 20%, respectively. FIN No. 18, Accounting for Income Taxes in Interim Periods an interpretation of APB Opinion No. 28 proscribes a detailed methodology of allocating income taxes between continuing and discontinued operations. This methodology often results in an effective rate for discontinued operations significantly different from the statutory rate of 35%. The effective tax rate was also impacted by the \$62 million of goodwill allocated to the CoGen Lyondell power generation facility upon its sale. As there was no tax basis in the goodwill, there were no tax benefits associated with the allocated goodwill.

DHI recorded an income tax expense from discontinued operations of \$98 million during the nine months ended September 30, 2007, compared to an income tax expense from discontinued operations of \$1 million during the nine months ended September 30, 2006. The effective rates for the nine months ended September 30, 2007 and 2006 are 43% and 20%, respectively. FIN No. 18, Accounting for Income Taxes in Interim Periods an interpretation of APB Opinion No. 28 proscribes a detailed methodology of allocating income taxes between continuing and discontinued operations. This methodology often results in an effective rate for discontinued operations significantly different from the statutory rate of 35%. The effective tax rate was also impacted by the \$62 million of goodwill allocated to the CoGen Lyondell power generation facility upon its sale. As there was no tax basis in the goodwill, there were no tax benefits associated with the release allocated goodwill.

Outlook

Our recently completed Merger Agreement with the LS Contributing Entities represents the transition from our previous era of self-restructuring and operations of our legacy fleet to a period of expanded, more diverse operations that provides greater scale and scope in our key markets and stronger positioning for future growth opportunities.

Generally, we expect that our future financial results will continue to reflect sensitivity to fuel and emissions commodity prices, market structure and prices for electric energy, ancillary services and capacity, transportation and transmission logistics, weather conditions and IMA. Our commercial team actively manages commodity price risk associated with our unsold power production by trading in the forward markets at physical hubs that are correlated with our assets. We also participate in various regional auctions and bilateral opportunities.

Compared to the legacy Dynegy assets, a higher percentage of our forecasted generation output from the assets acquired through the Merger Agreement is contracted through physical and financial agreements extending beyond the prompt year. Including volumes committed under contracts acquired with these assets, contracts resulting from the Illinois resource procurement auction and power and steam delivery commitments from our Independence facility, a substantial portion of the output from our fleet of power generation facilities is contracted for the next twelve months. This includes RMR arrangements at our South Bay and Oakland facilities. The remaining output from our facilities is available for other forward sales opportunities to capture attractive market prices when they are available. To the extent that we choose not to enter into forward sales, the gross margin from our assets is a function of price movements in the coal, natural gas, fuel oil and power commodity markets.

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Our results will also continue to be impacted, perhaps materially, by environmental regulations and their impact on our financial condition and results of operations. In addition to the CARB, various state and federal programs on the subject of climate change have been initiated or are being discussed. It is difficult to predict with certainty the precise outcome of these various initiatives and discussions or the resulting impact on our results of operations and financial condition. If some or all of the initiatives are adopted and implemented, we and similarly situated power generators could incur significant additional costs to develop, construct and operate power generation facilities, with the magnitude of any such cost increases to be influenced by, among other things:

the structure and scope of final rules and regulations, including the level of emissions reductions required and the time period for these reductions;

the ability to recover in the marketplace any associated increases in operating and/or capital costs;

the demonstration of new technologies that make further emissions reductions a reality and any associated costs; and

the risk of litigation and related adversary proceedings, particularly with respect to development projects and associated permitting activities.

On August 21, 2007, we entered into amended and restated Contractual Service Agreements (CSAs) with General Electric, which became effective October 1, 2007, for the Casco Bay, Arlington Valley, Griffith and Moss Landing facilities. These CSAs replace the LTSA contracts for which we issued termination notices on April 2, 2007 and successfully resolved issues between the parties regarding the LTSAs.

The following summarizes our outlook for our power generation business by reportable segment.

GEN-MW. We expect our results to continue to be impacted by power prices, fuel prices, fuel availability and IMA. For the remainder of 2007, GEN-MW results will continue to be affected by the delivery obligations resulting from our participation in the Illinois resource procurement auction. The power commodity price under the auction-related agreements is higher than existed under our previous contract. The price we will receive under the auction contract in 2007 is approximately \$65/MWh. Under the auction contract, we assume increased costs and penalty risks associated with managing delivered power volumes. The price we received under the previous contract averaged approximately \$42/MWh in 2006, and was a function of the amount of power called on by IP under the previous contract. We anticipate that the revenues generated by our Midwest facilities will continue to benefit in 2007 from the implementation of contracts resulting from the auction and the sale of additional volumes into the MISO wholesale markets at prevailing market prices.

Another factor impacting our results in the Midwest will be the regulatory environment in Illinois. Recent legislation has provided more certainty with respect to the Illinois regulatory environment, at least for the near term. Please read [Recent Developments](#) and [Note 11 Commitments and Contingencies Illinois Auction Complaints](#) for further discussion. Furthermore, in October 2007, Commonwealth Edison and the Ameren Illinois Utilities filed their procurement plans for the period from June 2008 to May 2009. We are reviewing those filings and have intervened in the ICC cases. Final decisions are expected by the end of this year. We anticipate the actual procurement events will be held early next year.

In 2005, DMG entered into a comprehensive, Midwest system-wide settlement with the EPA and other parties, resolving the environmental litigation related to our Baldwin Energy Complex in Illinois. The settlement will require substantial emission reductions from our Illinois coal-fired power plants and the completion of several supplemental environmental projects in the Midwest. Through September 30, 2007, DMG had achieved all emission reductions scheduled to date under the Consent Decree and was developing plans to install additional emission control equipment to meet future Consent Decree emission limits. DMG has constructed a mercury control project at the Vermilion Power Station that began operation in June 2007. Our estimated costs associated with the Consent Decree projects, which we expect to incur through 2012, are approximately \$775 million. We expect to have spent \$115 million of this amount by December 31, 2007. Expected spending associated with the Consent Decree for the next four years and thereafter are as follows: 2008 \$150 million, 2009-\$195 million, 2010 \$175 million, 2011 \$100 million and

thereafter \$40 million.

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Through 2010, 96% of our Midwest coal requirements are contracted. For 2007 and 2008, the prices associated with these contracts are fixed. Our longer term results are sensitive to changes in coal prices to the extent that our current fixed prices are adjusted through contract re-openers or related provisions. The new prices resulting from the re-openers will become effective January 1, 2009.

Our results will continue to be affected by IMA. We use IMA to monitor fleet performance over time. This measure quantifies the percentage of generation for each of our 14 major steam units that were available when market prices were favorable for participation. Through our focus on safe and efficient operations, we seek to maximize our IMA and, as a result, our revenue generating opportunities. The IMA for our coal-fired fleet for the nine months ended September 30, 2007 was approximately 93%, compared to 89% for the comparable period of 2006. (In 2007, we modified the way we calculate IMA to better reflect the capabilities of the units due to seasonal variations. IMA for 2006 has been recalculated on a basis comparable to 2007.) We attempt to schedule maintenance and repair work to minimize downtime during peak demand periods, to the extent doing so does not compromise a safe working environment for our employees and contractors.

In connection with the Merger discussed in Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions, we acquired assets in Illinois and Pennsylvania. These assets include the 1,200 MW Kendall natural gas-fired facility in Minooka, IL and the 580 MW Ontelaunee natural gas-fired facility in Ontelaunee Township, PA. With respect to the Kendall facility, 275 MW of the facility's capacity is committed to a subsidiary of Constellation Energy (Constellation) under a power purchase agreement that extends through 2017. An additional 550 MW of capacity is committed under another agreement with Constellation, which extends through November 2008. These power purchase agreements provide us with predictable contracted revenues, and mitigate the effects of fluctuating market prices for electricity.

The Ontelaunee facility sells its energy, capacity and other ancillary services to wholesale electricity customers directly on the spot market. However, exposure to the market prices of energy has been hedged under a financially settled heat rate call-option agreement.

PJM recently implemented a forward capacity auction, the Reliability Pricing Model. The auction has resulted in a dramatic increase in the value of capacity in not only PJM, but in the neighboring MISO as well. The increase in prices indicates a projected tightening of the supply/demand balance in the near future. More immediately, we benefited from selling approximately 1,300 net MWs into the 2008-2009 planning year auction and 2,650 net MWs into the 2009-2010 auction, both of which were held earlier in 2007.

Our 576 MW Bluegrass generation facility is being considered for a potential sale. Please read Asset Sale Proceeds for further discussion.

Plum Point is currently in the construction phase, with an expected completion date of August 2010. Upon completion it will be a 665 MW coal-fired power generating facility located in Osceola, Arkansas. The City of Osceola has loaned \$100 million in proceeds of a tax exempt bond issuance to Plum Point. We are considering the possibility of refinancing the outstanding Tax Exempt Bonds, however any decision to proceed will be conditioned on seeking necessary public approvals and favorable market conditions. Please read Note 8 Debt Plum Point Tax Exempt Bonds for further discussion.

GEN-WE. In connection with the Merger discussed in Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions, we acquired a portfolio of assets in California and Arizona. These assets include six facilities located in California (Moss Landing, Morro Bay, South Bay and Oakland) and Arizona (Arlington Valley and Griffith), with a total capacity of 5,545 MW. Moss Landing, Morro Bay, and Griffith are subject to certain power purchase agreements under which the buyer pays the power generation facility a fixed monthly payment for the right to call energy, capacity and ancillary services from the power generation facility. The South Bay and Oakland facilities operate under RMR agreements with the CAISO.

Moss Landing, Arlington Valley and Griffith sell energy, capacity and/or other ancillary services to wholesale electricity customers directly in the spot market. Several financially-settled heat rate call-options are in effect that mitigate the exposure of these facilities to changes in the market price of energy.

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Our GEN-WE segment will no longer benefit from the earnings from the CoGen Lyondell facility due to the completion of the sale of this facility on August 1, 2007. For the nine months ended September 30, 2007, we recorded operating income of \$5 million related to the operation of CoGen Lyondell. This amount has been reclassified as income from discontinued operations. Additionally, our 539 MW Heard County generation facility is being considered for a potential sale. Please read *Asset Sale Proceeds* for further discussion.

In August 2007, our GEN-WE segment acquired a 50% interest in SCEA, which owns a 75% undivided interest in the Sandy Creek Energy Station, a proposed 898 MW facility to be located in McLennan County, Texas. Please see Note 7 *Variable Interest Entities Sandy Creek* for further discussion. Site work has begun on this project, and we anticipate that construction will begin in the fourth quarter 2007. We intend to pursue opportunities to enter into long-term contracts for the generation from the facility, which we anticipate will begin commercial operations in 2012.

GEN-NE. We expect our results to continue to be impacted by power prices, fuel prices, fuel availability and IMA. Spreads between the price for power and fuel costs are expected to remain volatile as both fuel and power prices change based on demand and weather. This volatility has significant impact on the run-time for the Roseton unit. All of our coal supply requirements for 2007 are contracted at a fixed price. We continue to maintain sufficient coal and oil inventories and contractual commitments intended to provide us with a stable fuel supply.

Additionally, our results could be affected by potential changes in New York, Maine and/or Connecticut state environmental regulations, as well as our ability to obtain permits necessary for the operation of our facilities. Please see Note 11 *Commitments and Contingencies Danskammer State Pollutant Discharge Elimination System Permit and Commitments and Contingencies Roseton State Pollutant Discharge Elimination System Permit*, respectively, for further discussion.

In connection with the Merger discussed in Note 2 *LS Power Business Combination and Dynegy Illinois Entity Contributions*, we acquired assets in Connecticut and Maine. These assets include the 527 MW Bridgeport natural gas-fired facility in Bridgeport, CT and the 540 MW Casco Bay natural gas-fired facility in Veazie, ME.

The Bridgeport facility had been operating pursuant to the terms of the Bridgeport RMR agreement, subject to the outcome of ongoing proceedings before the FERC to resolve the question of whether Bridgeport is eligible for an RMR agreement. On May 25, 2007, Bridgeport and the intervening parties submitted a Joint Offer of Settlement, which effectively terminated the RMR Agreement as of May 31, 2007. Under the Settlement, Bridgeport will no longer be required to submit stipulated bids as of June 1, 2007 therein allowing Bridgeport to more fully participate as a merchant generator in the ISO-NE market.

In October 2007, we terminated a heat-rate call option related to our Casco Bay facility. This option would have expired on December 31, 2010. As a result of the cancellation, we received a termination payment of \$32 million, and a letter of credit for \$35 million supporting the transaction was returned to us.

DLS Power Development. Through Dynegy's interest in DLS Power Development, Dynegy and LS Associates continue to move forward with the Long Leaf Project, which comprises development of a 600 MW scrubbed pulverized coal generating facility located in Georgia. During the second quarter 2007, this project received all necessary permits, although certain challengers are contesting the validity of these permits. Management believes the validity of the permits will be upheld, and could seek construction financing and power purchase agreements for future generation from the facility by first or second quarter of 2008.

The DLS Power Development portfolio is anticipated to be dynamic in nature, with changes in projects and priorities likely to occur based on the joint venture parties views of market prices, supply/demand balances, contract availability and the terms thereof, environmental implications and other factors that they deem relevant. Other projects in active development include renewable energy projects and natural gas-fired projects in the West.

Table of Contents**Cash Flow Disclosures**

The following table includes data from the operating section of our unaudited condensed consolidated statements of cash flows and includes cash flows from our discontinued operations, which are disclosed on a net basis in loss from discontinued operations, net of tax, in our unaudited condensed consolidated statements of operations:

| | Dynegy Inc. | | Dynegy Holdings Inc. | |
|---|--|-------------|--|-------------|
| | Nine Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| | (in millions) | | | |
| Operating cash flows from our generation businesses | \$ 736 | \$ 503 | \$ 736 | \$ 503 |
| Operating cash flows from our customer risk management business | (24) | (370) | (24) | (370) |
| Other operating cash flows | (346) | (313) | (337) | (325) |
| Net cash provided by (used) in operating activities | \$ 366 | \$ (180) | \$ 375 | \$ (192) |

Operating Cash Flow

Dynegy. Dynegy's cash flow provided by operations totaled \$366 million for the nine months ended September 30, 2007. During the nine months ended September 30, 2007, our power generation business provided positive cash flow from operations of \$736 million primarily due to positive earnings for the period. Our customer risk management business used approximately \$24 million in cash, largely as a result of cash payments associated with our legacy trading business. These payments were partially offset by the receipt of approximately \$32 million from the sale of a legacy receivable. Other and Eliminations includes a use of approximately \$346 million in cash primarily due to interest payments to service debt and general and administrative expenses, partially offset by interest income. Dynegy's cash flow used in operations totaled \$180 million for the nine months ended September 30, 2006. GEN provided cash flow from operations of \$503 million, primarily due to positive earnings for the period. Our CRM segment used cash flow of approximately \$370 million primarily due to a \$370 million termination payment on our Sterlington tolling contract. Other and Eliminations includes a use of approximately \$313 million in cash primarily due to interest payments to service debt and general and administrative expenses, partially offset by interest income on cash balances and the receipt of approximately \$20 million associated with the resolution of a legal dispute.

DHI. DHI's cash flow provided by operations totaled \$375 million for the nine months ended September 30, 2007. During the nine months ended September 30, 2007, our power generation business provided positive cash flow from operations of \$736 million primarily due to positive earnings for the period. Our customer risk management business used approximately \$24 million in cash largely as a result of cash payments associated with our legacy trading business. These payments were partially offset by the receipt of approximately \$32 million from the sale of a legacy receivable. Other and Eliminations includes a use of approximately \$337 million in cash primarily due to interest payments to service debt and general and administrative expense, partially offset by interest income. DHI's cash flow used in operations totaled \$192 million for the nine months ended September 30, 2006. GEN provided cash flow from operations of \$503 million, primarily due to positive earnings for the period. Our CRM segment used cash flow of approximately \$370 million primarily due to a \$370 million termination payment on our Sterlington tolling contract. Other and Eliminations includes a use of approximately \$325 million in cash primarily due to interest payments to service debt and general and administrative expenses, partially offset by interest income on cash balances.

Table of Contents***Capital Expenditures and Investing Activities***

Dynegy. Dynegy's cash used in investing activities during the nine months ended September 30, 2007 totaled \$503 million. Capital spending of \$236 million was primarily comprised of \$187 million, \$14 million, and \$24 million for our GEN-MW, GEN-WE, and GEN-NE segments, respectively. Capital spending for the GEN-MW segment includes \$92 million associated with the construction of the Plum Point facility, which is provided by non-recourse project financing. The remaining capital spending for the GEN-MW and GEN-WE segments primarily related to maintenance and environmental projects, while spending in the GEN-NE segment primarily related to maintenance. In addition, there was approximately \$11 million of capital expenditures in Other.

Net proceeds from the sale of assets totaled \$466 million, which included \$462 million from the sale of the CoGen Lyondell power generation facility.

Cash used in connection with the completion of the Merger Agreement, net of cash acquired, was \$128 million. Please see Note 2 LS Power Business Combination and Dynegy Illinois Entity Contributions for further discussion.

The increase in restricted cash of \$598 million related primarily to a \$650 million deposit associated with our cash collateralized facility, partially offset by the release of Independence restricted cash due to the posting of a letter of credit.

Dynegy's cash provided by investing activities during the nine months ended September 30, 2006 totaled \$213 million. Capital spending of \$92 million was primarily comprised of \$58 million, \$16 million, and \$12 million in the GEN-MW, GEN-WE, and GEN-NE segments, respectively. The capital spending for each segment primarily related to maintenance and environmental capital projects. In addition, there was approximately \$6 million of capital expenditures in Other.

Proceeds from assets sales, net totaled \$18 million and primarily consisted of proceeds from the sale of a gas turbine not in use.

Net proceeds from the sale and acquisition of unconsolidated investments, net of cash acquired totaled \$165 million. This included net cash proceeds of \$205 million from the sale of our 50% ownership interest in West Coast Power to NRG. This was partially offset by a payment of \$45 million for our acquisition of NRG's 50% ownership interest in Rocky Road, which included \$5 million of cash on hand.

The decrease in restricted cash of \$125 million related primarily to the return of our \$335 million deposit associated with our former cash collateralized facility, offset by a \$200 million deposit associated with our cash collateralized facility and a \$10 million increase in the Independence restricted cash balance.

DHI. DHI's cash used in investing activities during the nine months ended September 30, 2007 totaled \$363 million. Capital spending of \$236 million was primarily comprised of \$187 million, \$14 million, and \$24 million for our GEN-MW, GEN-WE, and GEN-NE segments, respectively. Capital spending for the GEN-MW segment includes \$92 million associated with the construction of the Plum Point facility. The remaining capital spending for the GEN-MW and GEN-WE segments primarily related to maintenance and environmental projects, while spending in the GEN-NE segment primarily related to maintenance. In addition, there was approximately \$11 million of capital expenditures in Other.

Net proceeds from the sale of assets totaled \$466 million, which included \$462 million from the sale of the CoGen Lyondell power generation facility.

The increase in restricted cash of \$598 million related primarily to a \$650 million deposit associated with our cash collateralized facility, partially offset by the release of Independence restricted cash due to the posting of a letter of credit.

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DHI's cash provided by investing activities during the nine months ended September 30, 2006 totaled \$212 million. Capital spending of \$92 million was primarily comprised of \$58 million, \$16 million, and \$12 million in the GEN-MW, GEN-WE, and GEN-NE segments, respectively. The capital spending for each segment primarily related to maintenance and environmental capital projects. In addition, there was approximately \$6 million of capital expenditures in Other.

Proceeds from assets sales, net totaled \$15 million and primarily consisted of proceeds from the sale of a gas turbine not in use.

Net proceeds from the sale and acquisition of unconsolidated investments, net of cash acquired totaled \$165 million. This included net cash proceeds of \$205 million from the sale of our 50% ownership interest in West Coast Power to NRG. This was partially offset by a payment of \$45 million for our acquisition of NRG's 50% ownership interest in Rocky Road, which included \$5 million of cash on hand.

The decrease in restricted cash of \$125 million related primarily to the return of our \$335 million deposit associated with our former cash collateralized facility, offset by a \$200 million deposit associated with our cash collateralized facility and a \$10 million increase in the Independence restricted cash balance.

Financing Activities

Dynegy. Dynegy's cash provided by financing activities during the nine months ended September 30, 2007 totaled \$404 million. During the nine months ended September 30, 2007, Dynegy received proceeds from long-term borrowings from the following sources, net of approximately \$33 million of debt issuance costs:

\$1,650 million in aggregate principal amount from our Senior Unsecured Notes due 2015 and 2019;

\$665 million in aggregate principal amount on our letter of credit facilities;

\$275 million in aggregate principal amount on our revolver due 2012;

\$70 million senior secured term loan facility due 2013; and

\$78 million in aggregate principal amount on our Plum Point Credit Agreement Facility.

These borrowings were partially offset by \$2,300 million of payments:

\$396 million in aggregate principal amount on our Kendall Senior Secured Term Loan Facility;

\$150 million in aggregate principal amount on our Ontelaunee term loan due 2009;

\$919 million in aggregate principal amount on our Gen Finance First Lien Term Loan;

\$150 million in aggregate principal amount on our Gen Finance Second Lien Term Loan;

\$275 million promissory note to LS Associates;

\$275 million in aggregate principal amount on our Revolving Facility;

\$70 million in aggregate principal amount on our Griffith debt;

\$39 million in aggregate principal amount on our 8.50% secured bonds due 2007;

\$15 million in aggregate principal amount on our letter of credit facilities; and

\$11 million in aggregate principal amount on our Second Priority Senior Secured Notes.

Dynegy's cash used in financing activities during the nine months ended September 30, 2006 totaled \$1,194 million. Repayments of long-term debt totaled \$1,780 million for the nine months ended September 30, 2006 and consisted of

the following payments:

\$900 million in aggregate principal amount on our 10.125% Second Priority Senior Secured Notes due 2013;

\$614 million in aggregate principal amount on our 9.875% Second Priority Senior Secured Notes due 2010;

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\$225 million in aggregate principal amount on our Second Priority Senior Secured Floating Rate Notes due 2008;

\$23 million in aggregate principal amount on our 7.45% Senior Notes due 2006; and

\$18 million in aggregate principal amount on our 8.50% secured bonds due 2007.

In addition to the above repayments during the nine months ended September 30, 2006, we redeemed all of the outstanding shares of our Series C Preferred for \$400 million.

Debt conversion costs of \$249 million consisted of the following payments:

\$204 million to redeem the Second Priority Senior Secured Notes mentioned above, including approximately \$3 million of transaction costs;

\$44 million aggregate premium to induce conversion of our \$225 million 4.75% Convertible Subordinated Debentures due 2023; and

\$1 million in transaction costs associated with the redemption of our Series C Preferred.

The repayments were partially offset by \$1,071 million of proceeds from the following sources, net of approximately \$29 million of debt issuance costs:

\$750 million aggregate principal amount from a private offering of our 8.375% Senior Unsecured Notes due 2016;

\$200 million, LIBOR + 1.75% letter of credit facility due 2012; and

\$150 million, LIBOR + 1.75% term loan due 2012.

Proceeds from the issuance of common stock during the nine months ended September 30, 2006 consisted primarily of approximately \$178 million in proceeds from a common stock offering of 40.25 million shares of Dynegy's Class A common stock at \$4.60 per share, net of underwriting fees. Dividend payments totaling \$17 million were also made on Dynegy's Series C Preferred prior to its redemption.

DHI. DHI's cash provided by financing activities during the nine months ended September 30, 2007 totaled \$339 million. During the nine months ended September 30, 2007, DHI received proceeds from long-term borrowings from the following sources, net of approximately \$33 million of debt issuance costs:

\$1,650 million in aggregate principal amount from our Senior Unsecured Notes due 2015 and 2019;

\$665 million in aggregate principal amount on our letter of credit facilities;

\$275 million in aggregate principal amount on our revolver due 2012;

\$70 million in aggregate principal amount on our senior secured term loan facility due 2013; and

\$78 million in aggregate principal amount on our Plum Point Credit Agreement Facility.

These borrowings were partially offset by \$2,025 million of payments:

\$396 million in aggregate principal amount on our Kendall Senior Secured Term Loan Facility;

\$150 million in aggregate principal amount on our Ontelaunee term loan due 2009;

\$919 million in aggregate principal amount on our Gen Finance First Lien Term Loan;

\$150 million in aggregate principal amount on our Gen Finance Second Lien Term Loan;

\$275 million in aggregate principal amount on our Revolving Facility;

\$70 million in aggregate principal amount on our Griffith debt;

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\$39 million in aggregate principal amount on our 8.50% secured bonds due 2007;

\$15 million in aggregate principal amount on our letter of credit facilities; and

\$11 million in aggregate principal amount on our Second Priority Senior Secured Notes.

Cash used in financing activities for the nine months ended September 30, 2007 also includes dividend payments to Dynegy totaling \$342 million.

DHI's cash used in financing activities during the nine months ended September 30, 2006 totaled \$1,083 million.

Repayments of long-term debt totaled \$1,780 million for the nine months ended September 30, 2006 and consisted of the following payments:

\$900 million in aggregate principal amount on our Second Priority Senior Secured Notes due 2013;

\$614 million in aggregate principal amount on our Second Priority Senior Secured Notes due 2010;

\$225 million in aggregate principal amount on our Second Priority Senior Secured Notes due 2008;

\$23 million in aggregate principal amount on our 7.45% Senior Notes due 2006; and

\$18 million in aggregate principal amount on our 8.50% secured bonds due 2007.

Debt conversion costs of \$203 million consisted of payments to redeem the Second Priority Senior Secured Notes mentioned above, including approximately \$3 million of transaction costs.

The repayments were partially offset by \$1,071 million of proceeds from the following sources, net of approximately \$29 million of debt issuance costs:

\$750 million aggregate principal amount from our Senior Unsecured Notes due 2016;

\$200 million, LIBOR + 1.75% letter of credit facility due 2012; and

\$150 million, LIBOR + 1.75% term loan due 2012.

Cash used in financing activities for the nine months ended September 30, 2006 also includes \$170 million in payments to Dynegy, which consists of repayments of borrowings of \$120 million and a dividend payment of \$50 million.

RISK-MANAGEMENT DISCLOSURES

The following table provides a reconciliation of the risk-management data on the unaudited condensed consolidated balance sheets:

| | As of and for the Nine Months Ended September 30, 2007 (in millions) |
|--|---|
| Balance Sheet Risk-Management Accounts | |
| Fair value of portfolio at January 1, 2007 | \$ 53 |
| Risk-management gains recognized through the income statement in the period, net | 126 |
| Cash received related to risk-management contracts settled in the period, net | (13) |
| Changes in fair value as a result of a change in valuation technique (1) | |
| Non-cash adjustments and other (2) | (149) |
| Fair value of portfolio at September 30, 2007 | \$ 17 |

- (1) Our modeling methodology has been consistently applied.
- (2) This amount consists of \$38 million in net risk management liabilities acquired in connection with the Merger Agreement as well as changes in value associated with cash flow hedges on forward power sales and fair value and cash flow hedges on debt.

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The net risk management asset of \$17 million is the aggregate of the following line items on our condensed consolidated balance sheets: Current Assets Assets from risk-management activities, Other Assets Assets from risk-management activities, Current Liabilities Liabilities from risk-management activities and Other Liabilities Liabilities from risk-management activities.

Risk-Management Asset and Liability Disclosures. The following tables depict the mark-to-market value and cash flow components of our net risk-management assets and liabilities at September 30, 2007 and December 31, 2006. As opportunities arise to monetize positions that we believe will result in an economic benefit to us, we may receive or pay cash in periods other than those depicted below:

Mark-to-Market Value of Net Risk-Management Assets (1)

| | Total | 2007 (2) | 2008 | 2009 | 2010 | 2011 | Thereafter |
|-------------------------|---------------|----------|--------|--------|--------|------|------------|
| | (in millions) | | | | | | |
| September 30, 2007 | \$ 29 | \$ 39 | \$ (5) | \$ (8) | \$ (2) | \$ 1 | \$ 4 |
| December 31, 2006 | (44) | (45) | (3) | | | 1 | 3 |
| Increase (decrease) (3) | \$ 73 | \$ 84 | \$ (2) | \$ (8) | \$ (2) | \$ | \$ 1 |

(1) The table reflects the fair value of our risk-management asset position, which considers 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 asset at September 30, 2007 of \$17 million on the unaudited condensed consolidated balance sheets include the \$29 million herein as well as

hedging instruments. Cash flows have been segregated between periods based on the delivery date required in the individual contracts.

- (2) Amounts represent October 1 to December 31, 2007 values in the September 30, 2007 row and January 1 to December 31, 2007 values in the December 31, 2006 row.
- (3) Increase since December 31, 2007 primarily due to the settlement of a large portion of risk-management liabilities outstanding at December 31, 2006 during 2007 and mark-to-market gains recognized in 2007, partially offset by \$38 million in net risk-management liabilities acquired in connection with the Merger Agreement.

Cash Flow Components of Net Risk-Management Asset

**Nine
Months Three Months**

| | Ended September 30, 2007 | Ended December 31, 2007 | Total 2007 | 2008 | 2009 | 2010 | 2011 | Thereafter |
|---------------------------|---|--|-----------------------|---------------|-------------|-------------|-------------|-------------------|
| | | | | (in millions) | | | | |
| September 30, 2007 (1) | \$ 19 | \$ 53 | \$ 72 | \$ 6 | \$ (14) | \$ (4) | \$ 2 | \$ 6 |
| December 31, 2006 | | | (45) | (4) | | | 1 | 5 |
| Increase (decrease) | | | \$ 117 | \$ 10 | \$ (14) | \$ (4) | \$ 1 | \$ 1 |

(1) The cash flow values for 2007 reflect realized cash flows for the nine months ended September 30, 2007 and anticipated undiscounted cash inflows and outflows by contract based on the tenor of individual contract position for the remaining periods. These anticipated undiscounted cash flows have not been adjusted for counterparty credit or other reserves. These amounts exclude the cash flows associated with certain derivative instruments designated as hedges.

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The following table provides an assessment of net contract values by year as of September 30, 2007, based on our valuation methodology:

Net Fair Value of Risk-Management Portfolio

| | Total | 2007 | 2008 | 2009 | 2010 | 2011 | Thereafter |
|-------------------------|--------------|--------------|---------------|----------------------|---------------|-------------|-------------------|
| | | | | (in millions) | | | |
| Market Quotations (1) | \$ 25 | \$ 17 | \$ (1) | \$ 3 | \$ 1 | \$ 1 | \$ 4 |
| Prices Based on Models. | 4 | 22 | (4) | (11) | (3) | | |
| Total | \$ 29 | \$ 39 | \$ (5) | \$ (8) | \$ (2) | \$ 1 | \$ 4 |

(1) 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.

UNCERTAINTY OF FORWARD-LOOKING STATEMENTS AND INFORMATION

This Form 10-Q includes statements reflecting assumptions, expectations, projections, intentions or beliefs about future events that are intended as forward-looking statements by both Dynegy and DHI. All statements included or incorporated by reference in this quarterly report, other than statements of historical fact, that address activities, events or developments that we or our management expect, believe or anticipate will or may occur in the future are forward-looking statements. These statements represent our reasonable judgment on the future based on various factors and using numerous assumptions and are subject to known and unknown risks, uncertainties and other factors that could cause our actual results and financial position to differ materially from those contemplated by the statements. 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, plan, may, will, should, expect and other similar meaning. In particular, these include, but are not limited to, statements relating to the following:

anticipated benefits of diversifying our operations, including the merger with the LS Contributing Entities;

beliefs and expectations regarding financing, development and timing of any and all joint venture projects;

projected operating or financial results, including anticipated cash flows from operations, revenues and profitability;

expectations regarding capital expenditures, interest expense and other payments;

beliefs and assumptions about economic conditions and the demand for electricity;

beliefs about commodity pricing and generation volumes;

our focus on safety and our ability to efficiently operate our assets so as to maximize our revenue generating opportunities;

strategies to capture opportunities presented by rising commodity prices and strategies to manage our exposure to energy price volatility;

beliefs and assumptions relating to liquidity;

statements related to the effects of changing to mark-to-market accounting including any related to gains and losses in earnings or value changes related to market price volatility;

strategies to address our substantial leverage, or to access the capital markets;

measures to compete effectively with industry participants;

beliefs and assumptions about market competition, fuel supply, generation capacity and regional supply and demand characteristics of the wholesale power generation market;

sufficiency of coal, fuel oil and natural gas inventories and transportation, including strategies to deploy coal supplies;

beliefs about the outcome of legal, regulatory and administrative matters;

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expectations regarding environmental matters, including costs of compliance, availability and adequacy of emission credits, and the impact of ongoing proceedings and potential regulations, including those relating to global warming;

the disposition and resolution of settlements, complaints, and suits related to the Illinois Power Auction and impacts that these may have;

expectations and estimates regarding the DMG consent decree and the associated costs; and

efforts to position our power generation business for future growth and pursuing and executing acquisition, disposition or combination opportunities.

Any or all of our forward-looking statements may turn out to be wrong. They can be affected by inaccurate assumptions or by known or unknown risks, uncertainties and other factors, many of which are beyond our control, including those set forth under Part II-Other Information, Item 1A-Risk Factors.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1 Accounting Policies to the unaudited condensed consolidated financial statements for a discussion of recently issued accounting pronouncements affecting us.

CRITICAL ACCOUNTING POLICIES

Please read Note 1 Accounting Policies Goodwill and Other Intangible Assets for further discussion of our policy with respect to goodwill and other intangible assets. Please read Critical Accounting Policies beginning on pages 74 and 62, respectively, of Dynegy's and DHI's Forms 10-K for a complete description of our critical accounting policies, with respect to which there have been no other material changes since the filing of such Forms 10-K.

Item 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK DYNEGY INC. AND DYNEGY HOLDINGS INC.

Please read Item 7A. Quantitative and Qualitative Disclosures About Market Risk beginning on pages 81 and 68, respectively, of Dynegy's and DHI's Forms 10-K for a discussion of our exposure to commodity price variability and other market risks related to our net non-trading derivative assets and liabilities, including foreign currency exchange rate risk. Following is a discussion of the more material of these risks and our relative exposures as of September 30, 2007.

Value at Risk (VaR). The following table sets forth the aggregate daily VaR of the mark-to-market portion of our risk-management portfolio primarily associated with the GEN segments and the CRM business. The VaR calculation does not include market risks associated with the accrual portion of the risk-management portfolio that is designated as a cash flow hedge or a normal purchase normal sale, nor does it include expected future production from our generating assets. Another limitation to our calculation of VaR is our use of the JP Morgan RiskMetrics™ approach, which calculates option values using a linear approximation. With the acquisition of several financially-settled heat rate call-option agreements in the LS Power business combination, the actual change in the fair value of these instruments may differ significantly from the calculated VaR.

There is a significant increase in VaR from December 31, 2006 to September 30, 2007 due to the above mentioned financially-settled heat rate call-options and our decision to cease designating certain derivative transactions as cash flow hedges, beginning on April 2, 2007.

Table of Contents**Daily and Average VaR for Risk-Management Portfolios**

| | September 30, 2007 | December 31, 2006 |
|--|-----------------------------------|------------------------------|
| | (in millions) | |
| One Day VaR 95% Confidence Level | \$ 22 | \$ 1 |
| One Day VaR 99% Confidence Level | \$ 31 | \$ 1 |
| Average VaR for the Year-to-Date Period 95% Confidence Level | \$ 17 | \$ 3 |

Credit Risk. The following table represents our credit exposure at September 30, 2007 associated with the mark-to-market portion of our risk-management portfolio, on a net basis.

Credit Exposure Summary

| | Investment Grade Quality (in millions) |
|------------------------------|---|
| Type of Business: | |
| Financial Institutions | \$ 435 |
| Utility and Power Generators | 37 |
| Total | \$ 472 |

Interest Rate Risk. We are exposed to fluctuating interest rates related to variable rate financial obligations. As of September 30, 2007, our fixed rate debt instruments, as a percentage of total debt instruments, were approximately 78%. Adjusted for interest rate swaps, net notional fixed rate debt as a percentage of total debt was approximately 74%. Based on sensitivity analysis of the variable rate financial obligations in our debt portfolio as of September 30, 2007, it is estimated that a one percentage point interest rate movement in the average market interest rates (either higher or lower) over the 12 months ended September 30, 2008 would either decrease or increase interest expense by approximately \$15 million. Over time, we may seek to reduce or increase the percentage of fixed rate financial obligations in our debt portfolio through the use of swaps or other financial instruments.

Derivative Contracts. The notional financial contract amounts associated with our interest rate contracts were as follows at September 30, 2007 and December 31, 2006, respectively:

Absolute Notional Contract Amounts

| | September 30, 2007 | December 31, 2006 |
|--|-------------------------------|------------------------------|
| Net Cash Flow Hedge Interest Rate Swaps (In Millions of U.S. Dollars) | \$ 263 | \$ |
| Fixed Interest Rate Paid (Percent) | 5.32 | |
| Net Fair Value Hedge Interest Rate Swaps (In Millions of U.S. Dollars) | \$ 525 | \$ 525 |
| Fixed Interest Rate Received on Swaps (Percent) | 4.33 | 4.33 |
| Interest Rate Risk-Management Contract (In Millions of U.S. Dollars) | \$ 231 | \$ 306 |
| Fixed Interest Rate Paid (Percent) | 5.35 | 5.29 |
| Interest Rate Risk-Management Contract (In Millions of U.S. Dollars) | \$ 206 | \$ 281 |
| Fixed Interest Rate Received (Percent) | 5.28 | 5.23 |

Item 4 CONTROLS AND PROCEDURES DYNEGY INC. AND DYNEGY HOLDINGS INC.

DHI is not subject to the disclosure requirements promulgated under Section 404 of the Sarbanes-Oxley Act of 2002 with respect to its internal control over financial reporting until DHI files its 2007 Form 10-K. Nevertheless, because DHI comprises a significant part of Dynegy as a consolidated enterprise, DHI's internal control over financial reporting has been reviewed in connection with Dynegy's compliance with Section 404 of the Sarbanes-Oxley Act.

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Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of Dynegy's and DHI's management, including their Chief Executive Officer and their Chief Financial Officer, of the effectiveness of the design and operation of the consolidated enterprise's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). This evaluation included consideration of the various processes carried out under the direction of Dynegy's disclosure committee in an effort to ensure that information required to be disclosed in the consolidated enterprise's SEC reports is recorded, processed, summarized and reported within the time periods specified by the SEC. This evaluation also considered the work completed as of the end of the third quarter 2007 relating to Dynegy's compliance with Section 404 of the Sarbanes-Oxley Act of 2002. Based on this evaluation, Dynegy's and DHI's CEO and CFO concluded that Dynegy's and DHI's disclosure controls and procedures were effective as of September 30, 2007.

Changes in Internal Controls Over Financial Reporting

There were no changes in the consolidated enterprise's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the consolidated enterprise's internal control over financial reporting during the third quarter 2007.

Table of Contents**DYNEGY INC. and DYNEGY HOLDINGS INC.****PART II. OTHER INFORMATION****Item 1 LEGAL PROCEEDINGS DYNEGY INC. AND DYNEGY HOLDINGS INC.**

See Note 11 Commitments and Contingencies to the accompanying unaudited condensed consolidated financial statements for discussion of the legal proceedings that we believe could be material to us.

Item 1A RISK FACTORS DYNEGY INC. AND DYNEGY HOLDINGS INC.

See Item 1A Risk Factors on pages F-22 and F-18, respectively, of Dynegy's and DHI's Forms 10-K as updated in their respective Forms 10-Q for the quarters ended March 31 and June 30, 2007 for factors, risks and uncertainties that may affect future results.

Item 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS DYNEGY INC.

Upon vesting of restricted stock awarded by the Company to employees, shares are withheld to cover the employees withholding taxes. Information on the Company's purchases of equity securities during the quarter follows:

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|-----------|--|---|---|---|
| July | | | | N/A |
| August | 2,394 | 8.91 | | N/A |
| September | | | | N/A |
| Total | 2,394 | 8.91 | | N/A |

These were the only repurchases of equity securities made by us during the three months ended September 30, 2007. Dynegy does not have a stock repurchase program.

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

Our 2007 annual meeting of stockholders was held on July 18, 2007. The purpose of the annual meeting was to consider and vote upon the following proposals:

1. To elect eight Class A common stock directors and three Class B common stock directors to serve until the 2008 annual meeting of stockholders;
2. To act upon a proposal to ratify the appointment of Ernst & Young LLP as our independent auditors commencing with the review of the unaudited financial statements for the second quarter ending June 30, 2007 through the remainder of the fiscal year ending December 31, 2007; and
3. To act upon a stockholder proposal regarding pay-for-superior-performance.

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Our current Board of Directors is comprised of eleven members. At the annual meeting, each of the following individuals was elected to serve as one of our directors: James T. Bartlett, David W. Biegler, Thomas D. Clark, Jr., Victor J. Grijalva, Patricia A. Hammick, Frank E. Hardenbergh, George L. Mazanec, Robert C. Oelkers, Mikhail Segal, William L. Trubeck and Bruce A. Williamson. The votes cast for each nominee and the votes withheld were as follows:

Class A Directors

| | FOR | WITHHELD |
|-------------------------|-------------|------------|
| 1. David W. Biegler | 442,454,325 | 12,362,799 |
| 2. Thomas D. Clark, Jr. | 450,035,665 | 4,781,459 |
| 3. Victor J. Grijalva | 441,378,492 | 13,438,632 |
| 4. Patricia A. Hammick | 450,019,133 | 4,797,991 |
| 5. George L. Mazanec | 433,932,288 | 20,884,836 |
| 6. Robert C. Oelkers | 434,074,048 | 20,743,076 |
| 7. William L. Trubeck | 434,004,791 | 20,812,333 |
| 8. Bruce A. Williamson | 447,354,233 | 7,462,891 |

Class B Directors

| | FOR | WITHHELD |
|-------------------------|-------------|----------|
| 1. James T. Bartlett | 340,000,000 | 0 |
| 2. Frank E. Hardenbergh | 340,000,000 | 0 |
| 3. Mikhail Segal | 340,000,000 | 0 |

The following votes were cast with respect to the proposal to ratify the selection of Ernst & Young LLP as our independent auditors commencing with the review of the unaudited financial statements for the second quarter ending June 30, 2007 through the remainder of the fiscal year ending December 31, 2007, which passed. There were no broker non-votes.

| FOR | AGAINST | ABSTAIN |
|-------------|-----------|-----------|
| 791,900,986 | 1,801,951 | 1,114,185 |

The following votes were cast with respect to the stockholder proposal regarding pay-for-superior-performance, which failed to pass. There were 91,719,360 broker non-votes.

| FOR | AGAINST | ABSTAIN |
|-------------|-------------|-----------|
| 121,029,989 | 613,373,998 | 4,692,277 |

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Item 6 EXHIBITS DYNEGY INC. AND DYNEGY HOLDINGS INC.

The following documents are included as exhibits to this Form 10-Q:

| Exhibit Number | Description |
|---------------------------|--|
| 10.1 | Fourth Amendment to October 18, 2002 Employment Agreement between Bruce A. Williamson and Dynegy Inc. dated August 23, 2007 (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Dynegy Inc. filed on August 24, 2007, File No. 001-33443). |
| 10.2 | Equity Commitment Agreement among Sandy Creek Energy Associates, L.P., Dynegy Sandy Creek Holdings, LLC and Credit Suisse dated August 29, 2007 (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Dynegy Inc. filed on September 5, 2007, File No. 001-33443). |
| 10.3 | Equity Commitment Agreement among Sandy Creek Energy Associates, L.P., Sandy Creek Holdings, LLC and Credit Suisse dated August 29, 2007 (incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K of Dynegy Inc. filed on September 5, 2007, File No. 001-33443). |
| **31.1 | Chief Executive Officer Certification Pursuant to Rule 13a-14(a) and 15d-14(a), As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| **31.1(a) | Chief Executive Officer Certification Pursuant to Rule 13a-14(a) and 15d-14(a), As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| **31.2 | Chief Financial Officer Certification Pursuant to Rule 13a-14(a) and 15d-14(a), As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| **31.2(a) | Chief Financial Officer Certification Pursuant to Rule 13a-14(a) and 15d-14(a), As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Chief Executive Officer Certification Pursuant to 18 United States Code Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.1(a) | Chief Executive Officer Certification Pursuant to 18 United States Code Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Chief Financial Officer Certification Pursuant to 18 United States Code Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2(a) | Chief Financial Officer Certification Pursuant to 18 United States Code Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

** Filed herewith.

Pursuant to
Securities and
Exchange
Commission
Release
No. 33-8238,

this certification
will be treated
as
 accompanying
this report 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.

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**DYNEGY INC. and DYNEGY HOLDINGS INC.
SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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: November 8, 2007

By: /s/ Holli C. Nichols

**Holli C. Nichols
Executive Vice President and Chief
Financial Officer (Duly Authorized
Officer and Principal Financial
Officer)**

DYNEGY HOLDINGS INC.

Date: November 8, 2007

By: /s/ Holli C. Nichols

**Holli C. Nichols
Executive Vice President and Chief
Financial Officer (Duly Authorized
Officer and Principal Financial
Officer)**

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EXHIBIT INDEX

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** Filed herewith.

Pursuant to
Securities and
Exchange
Commission
Release
No. 33-8238,

this certification will be treated as accompanying this report 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.

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Provisions for impairment of long-lived assets

11,249 5,657 320

Deferred income taxes

19,671 (5,263) (10,833)

Share-based compensation

1,914 1,469 1,164

Provision for doubtful accounts

2,661 421 466

Interest income from imputed interest

(4,281) (4,308) (2,559)

Changes in operating assets and liabilities:

Accounts receivable

(95) (1,987) (4,190)

Inventory

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5,174 4,178 (2)
 Deferred contract costs
 (828) (998) —
 Prepaid expenses and other
 (872) 76 (2,743)
 Federal and state income tax payable/receivable
 (4,081) (4,904) 319
 Notes receivable
 2,372 (8,402) (335)
 Accounts payable and accrued expenses
 (2,370) 7,227 (9,650)
 Other long-term liabilities
 (278) 263 (96)
 Deferred revenue
 (4,058) 8,307 (762)
NET CASH PROVIDED BY OPERATING ACTIVITIES
 48,665 58,923 34,110
CASH FLOWS FROM INVESTING ACTIVITIES:

Acquisitions of property and equipment
 and leased gaming equipment
 (40,580) (45,997) (59,212)
 Proceeds from disposal of assets
 — 340 1,599
 Acquisition of intangible assets
 (3,011) (4,845) (3,850)
 Advances under development agreements
 (9,600) (41,660) (28,492)
 Repayments under development agreements
 20,271 27,273 43,629
 Proceeds from development agreement floor space buyback
 — — 12,731
NET CASH USED IN INVESTING ACTIVITIES
 (32,920) (64,889) (33,595)
CASH FLOWS FROM FINANCING ACTIVITIES:

Proceeds from exercise of stock options,
 warrants and related tax benefit
 1,333 329 4,834
 Proceeds from shares issued
 — 1,170 —
 Proceeds from long-term debt
 8,730 4,574 75,047
 Principal payments of long-term debt and capital leases
 (15,970) (11,633) (5,124)
 Proceeds from revolving lines of credit
 17,000 31,418 23,777
 Payments on revolving lines of credit
 (21,000) (19,418) (72,791)
 Purchase of treasury stock
 — — (25,387)

NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES

(9,907) 6,440 356

EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS

328 10 (5)

Net increase in cash and cash equivalents

6,166 484 866

Cash and cash equivalents, beginning of year

6,289 5,805 4,939

Cash and cash equivalents, end of year

\$12,455 \$6,289 \$5,805

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

For the Years Ended September 30, 2009, 2008 and 2007

(In thousands)

| | 2009 | 2008 | 2007 |
|--|-----------|------------|---------|
| SUPPLEMENTAL CASH FLOW DATA: | | | |
| Interest paid | \$5,695 | \$7,564 | \$4,805 |
| Income tax paid (refunded), net | \$(1,395) |) \$10,852 | \$7,629 |
| NONCASH TRANSACTIONS: | | | |
| Contract rights resulting from imputed interest on development agreement notes receivables | \$(399) |) \$6,380 | \$6,290 |
| Transfer of leased gaming equipment to inventory | \$3,506 | \$3,021 | \$— |

The accompanying notes are an integral part of the consolidated financial statements.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Operations – Multimedia Games, Inc. and its subsidiaries (the Company) designs, manufactures and supplies innovative standalone and networked gaming systems. Our standalone player terminals, server-based systems, video lottery terminals, electronic scratch ticket systems, electronic instant lottery systems, back-office systems and bingo systems are used by Native American and commercial casino operators as well as state lottery operators in North America and in certain international markets. We have long been a leading provider of server-based gaming systems known as central determinant and downloadable systems. These systems are used by our Native American gaming operator customers in both Class II and Class III settings, by our commercial casino customers, by operators of charity and commercial bingo gaming facilities, and by lottery jurisdictions for operation of their video lottery systems.

We derive the majority of our gaming revenues from participation, or revenue share, agreements. Under our participation agreements, we place player terminals and systems, along with our proprietary and other licensed game content, at a customer's facility in return for a share of the revenues that these terminals and systems generate. To a lesser extent, we generate revenues from the sale of gaming units and systems though we are seeking to expand our use of for-sale revenues as we expand into additional gaming jurisdictions and into other segments of the gaming market. We also generate revenues from our provision of the central determinant system for video lottery terminals installed at racetracks in the State of New York and operated by the New York State Division of the Lottery. The Company offers content for its gaming systems that has been designed and developed by the Company, as well as game themes the Company has licensed from others. The Company currently operates in one business segment.

Consolidation Principles – The Company's consolidated financial statements include the accounts of Multimedia Games, Inc. and its wholly-owned subsidiaries: Megabingo, Inc., MGAM Systems, Inc., Innovative Sweepstakes Systems, Inc., MGAM Services, LLC, MGAM Systems International, Inc., Megabingo International, LLC, Multimedia Games de Mexico 1, S. de R.L. de C.V., and Servicios de Wild Basin S. de R.L. de C.V. Intercompany balances and transactions have been eliminated.

Accounting Estimates – The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Examples include share-based compensation, provisions for doubtful accounts and contract losses, estimated useful lives of property and equipment and intangible assets, impairment of property and equipment and intangible assets, deferred income taxes, and the provision for and disclosure of litigation and loss contingencies. Actual results may differ materially from these estimates in the future.

Revenue Recognition – In accordance with the provision of Accounting Standards Codification (ASC) Topic 605, "Revenue Recognition" (formerly Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition"), the Company recognizes revenue when all of the following have been satisfied:

- § Persuasive evidence of an arrangement exists;
- § Delivery has occurred;
- § Price to the buyer is fixed or determinable; and
- § Collectability is probable.

Gaming Revenue - The Company derives Gaming Revenue from the following sources:

- § Oklahoma Compact – Participation revenue generated from its games placed by the Company under the Oklahoma Compact
- § Class II – Participation revenue generated from the Company’s Native American Class II product
- § Charity – Participation revenue generated from its charity bingo product
- § All Other – Participation revenue from Class III back-office systems, New York Lottery system, Mexico bingo market, and certain other participation based markets

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The majority of the Company's gaming revenue is of a recurring nature, and is generated under lease participation arrangements when the Company provides its customers with player terminals, player terminal-content licenses and back-office equipment, collectively referred to as gaming equipment. Under these arrangements, the Company retains ownership of the gaming equipment installed at customer facilities, and the Company receives revenue based on a percentage of the net win per day generated by the gaming equipment. Revenue from lease participation arrangements are considered both realizable and earned at the end of each gaming day.

Gaming Revenue generated by player terminals deployed at sites under development agreements is reduced by the accretion of contract rights from those development agreements. Contract rights are amounts allocated to intangible assets for dedicated floor space resulting from development agreements, described under "Development Agreements." The related amortization expense, or accretion of contract rights, is netted against its respective revenue category in the consolidated statements of operations.

The Company also generates gaming revenues from back-office fees with certain customers. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its gaming equipment, as well as the cost of related software updates. Back-office fees are considered both realizable and earned at the end of each gaming day.

Gaming equipment and system sales - The Company periodically sells gaming equipment and gaming systems under independent sales contracts through normal credit terms or may grant extended credit terms under contracts secured by the related equipment, with interest recognized at market rates.

For sales arrangements with multiple deliverables, the Company applies the guidance from ASC Topic 985, "Software" and ASC Topic 605, "Revenue Recognition" (formerly Statement of Position, or SOP 97-2, "Software Revenue Recognition," as amended, and Emerging Issues Task Force, or EITF 00-21, "Revenue Arrangements with Multiple Deliverables"). Deliverables are divided into separate units of accounting if: (i) each item has value to the customer on a stand-alone basis; (ii) there is objective and reliable evidence of the fair value of the undelivered items; and (iii) delivery of the undelivered item is considered probable and substantially in the Company's control.

The majority of the Company's multiple element sales contracts are for some combination of gaming equipment, player terminals, content, system software, license fees and maintenance. For multiple element contracts considered a single unit of accounting, the Company recognizes revenues based on the method appropriate for the last delivered item.

The Company allocates revenue to each accounting unit based upon its fair value as determined by Vendor Specific Objective Evidence, or VSOE. VSOE of fair value for all elements of an arrangement is based upon the normal pricing and discounting practices for those products and services when sold individually. The Company recognizes revenue when the product is physically delivered to a customer controlled location or over the period in which the service is performed and defers revenue for any undelivered elements.

§ In those situations where each element is not essential to the function of the other, the "multiple deliverables" are bifurcated into accounting units based on their relative fair market value against the total contract value and revenue recognition on those deliverables are recorded when all requirements of revenue recognition have been met.

§ If any element is determined to be essential to the function of the other, revenues are generally recognized over the term of the services that are rendered.

In those situations where VSOE does not exist for any undelivered elements of a multiple element arrangement, then the aggregate value of the arrangement, including the value of products and services delivered or performed, is initially deferred until all hardware and software is delivered, and then the entire amount of the arrangement is recognized ratably over the period of the last deliverable, generally the remaining service period of the contract. Depending upon the elements and the terms of the arrangement, the Company recognizes certain revenues under the residual method. Under the residual method, revenue is recognized when VSOE of fair value exists for all of the undelivered elements in the arrangement, but does not exist for one or more of the delivered elements in the arrangement. Under the residual method, the Company defers the fair value of undelivered elements, and the remainder of the arrangement fee is then allocated to the delivered elements and is recognized as revenue, assuming the other revenue recognition criteria are met.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Costs and Billings on Uncompleted Contract - During fiscal 2008 and continuing during fiscal 2009, the Company entered into a fixed-price contract with a customer, pursuant to which it will deliver an electronic bingo system. Revenues from this fixed-price contract is being recognized on the completed-contract method in accordance with ASC Subtopic 605-35, "Construction-Type and Production-Type Contracts" (formerly American Institute of Certified Public Accountants Statement of Position 81-1).

Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies and tools. General and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

Costs incurred in excess of amounts billed are classified as current assets under "Deferred contract costs."

At September 30, 2009 and 2008, the following amounts were recorded in the Company's consolidated financial statements (in thousands):

| | September 30, | |
|---|---------------|----------|
| | 2009 | 2008 |
| Costs incurred on uncompleted contracts | \$ 3,697 | \$ 1,350 |
| Billings on uncompleted contracts | (1,871) | (352) |
| Deferred contract costs, net | \$ 1,826 | \$ 998 |

The contract is expected to be completed during the first half of fiscal 2010, the Company does not anticipate a loss on the contract at this time.

Cash and Cash Equivalents – The Company considers all highly liquid investments (i.e., investments which, when purchased, have original maturities of three months or less) to be cash equivalents.

Restricted Cash and Long-Term Investments – Restricted cash and long-term investments at September 30, 2009 and 2008 were \$804,000 and \$868,000, respectively, representing the fair value of investments held by the Company's prize fulfillment firm related to outstanding MegaBingo® jackpot prizes.

Allowance for Doubtful Accounts – The Company maintains an allowance for doubtful accounts related to its accounts receivable and notes receivable that have been deemed to have a risk of collectibility. Management reviews its accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. Management analyzes historical collection trends and changes in its customer payment patterns, customer concentration, and creditworthiness when evaluating the adequacy of its allowance for doubtful accounts. In its overall allowance for doubtful accounts, the Company includes any receivable balances where uncertainty exists as to whether the account balance has become uncollectible. Based on the information available, management believes the allowance for doubtful accounts is adequate; however, actual write-offs might exceed the recorded allowance.

Inventory – The Company's inventory consists primarily of completed player terminals, related component parts and back-office computer equipment expected to be sold over the next twelve months. Inventories are stated at the lower of cost (first in, first out) or market.

Development Agreements – The Company enters into development agreements to provide financing for new gaming facilities or for the expansion of existing facilities. In return, the facility dedicates a percentage of its floor space to placement of the Company's player terminals, and the Company receives a fixed percentage of those player terminals'

hold per day over the term of the agreement which is generally for 83 months. Certain of the agreements contain player terminal performance standards that could allow the facility to reduce a portion of the Company's guaranteed floor space. In addition, certain development agreements allow the facilities to buy out floor space after advances that are subject to repayment have been repaid. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the operating profits of the facility to be used to repay some or all of the advances recorded as notes receivable. Amounts advanced in excess of those to be reimbursed by the customer for real property and land improvements are allocated to intangible assets and are generally amortized over the term of the contract, which is recorded as a reduction of revenue generated from the gaming facility. In the past and in the future, the Company may by mutual agreement and for consideration, amend these contracts to reduce its floor space at the facilities. Any proceeds received for the reduction of floor space is first applied against the intangible asset recovered for that particular development agreement, if any and the remaining net book value of the intangible asset is prospectively amortized on a straight-line method over the remaining estimated useful life.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

At September 30, 2009 and 2008, the following net amounts related to advances made under development agreements were recorded in the following balance sheet captions:

| | 2009 | September 30, 2008 (In thousands) |
|--|-----------|---|
| Included in: | | |
| Notes receivable, net of discount(1) | \$ 50,288 | \$ 61,750 |
| Intangible assets – contract rights, net of accumulated amortization | 28,175 | 29,368 |

(1) The Company collected approximately \$21.3 million on development agreement notes receivable during 2009.

Notes receivable from development agreements are generated from reimbursable amounts advanced under development agreements. The Company has entered into development agreements with customers under which approximately \$57.6 million has been advanced and is outstanding at September 30, 2009, and for which we impute interest on these interest-free loans discounting the balances to \$50.3 million. During both fiscal 2009 and 2008, the Company recorded imputed interest of \$4.3 million relating to development agreements with an imputed interest rate range of 5.75% to 9.00%.

Property and Equipment and Leased Gaming Equipment – Property and equipment and leased gaming equipment are stated at cost. The cost of property and equipment and leased gaming equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and regulatory acceptable methods for income tax reporting purposes. Player terminals placed with customers under participation arrangements are included in leased gaming equipment. Leased gaming equipment includes a “pool” of rental terminals, i.e., the “rental pool.” Rental pool units are those units that have previously been placed in the field under participation arrangements, but are currently back with the Company, being refurbished and/or awaiting redeployment. Routine maintenance of property and equipment and leased gaming equipment is expensed in the period incurred, while major component upgrades are capitalized and depreciated over the estimated remaining useful life of the component. Sales and retirements of depreciable property are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in the Company’s results of operations.

Management reviews long-lived asset classes for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to its fair value, which considers the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs of disposal. During the years ended September 30, 2009 and 2008, the Company charged operations by recording reserves or writing off \$9.4 million and \$5.9 million, respectively, of property and equipment and leased gaming equipment (See Note 2, “Property and Equipment and Leased Gaming Equipment.”)

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deferred Revenue – Deferred revenue represents amounts from the sale of gaming equipment and systems that have been billed, or for which notes receivable have been executed, but which transaction has not met the Company’s revenue recognition criteria. The cost of the related gaming equipment and systems has been offset against deferred revenue. Amounts are classified between current and long-term liabilities, based upon the expected period in which the revenue will be recognized.

Other Income - Other income was \$74,000, \$3.1 million and \$3.1 million for the years ended September 30, 2009, 2008 and 2007, respectively. Other income consisted of distributions from a partnership interest, accounted for on the cost basis, of \$3.1 million in 2008 and \$1.7 million in 2007. Also in 2007, other income consisted of \$1.4 million resulting from the extinguishment of a liability resulting from the settlement with the Company’s former Chief Executive Officer.

Research and Development Costs - For the years ended September 30, 2009, 2008 and 2007 research and development costs were \$10.3 million, \$16.2 million and \$18.1 million, respectively.

Other Long-Term Liabilities – Other long-term liabilities at September 30, 2009 and 2008 include the present value of investments held by the Company’s prize-fulfillment firm related to outstanding MegaBingo jackpot-prize-winner annuities of \$800,000 and \$868,000, respectively

Fair Value of Financial Instruments – The carrying value of financial instruments reported in the accompanying consolidated balance sheets for cash, accounts and notes receivable, accounts payable, and accrued expenses payable and other liabilities, approximate fair value due to the immediate or short-term nature or maturity of these financial instruments. The carrying amount for our credit facility approximates fair value due to the fact that the underlying instrument includes provisions to adjust interest rates to approximate fair value.

Segment and Related Information – Although the Company has a number of operating divisions, separate segment data has not been presented as they meet the criteria for aggregation as permitted by ASC Topic 280, “Segment Reporting” (formerly Statement of Financial Accounting Standards (SFAS) No. 131, “Disclosures About Segments of an Enterprise and Related Information”).

Costs of Computer Software – Software development costs have been accounted for in accordance with ASC Topic 985, “Software” (formerly SFAS No. 86, “Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed”). Under ASC Topic 985, capitalization of software development costs begins upon the establishment of technological feasibility and prior to the availability of the product for general release to customers. We capitalized software development costs of approximately \$2.5 million during 2009, \$3.7 million during 2008, and \$2.8 million during 2007. Software development costs primarily consist of personnel costs. We begin to amortize capitalized costs when a product is available for general release to customers. Amortization expense is determined on a product-by-product basis at a rate not less than straight-line basis over the product’s remaining estimated economic life, but not to exceed five years. Amortization of software development costs was approximately \$3.8 million in 2009, \$3.3 million in 2008, and \$4.3 million in 2007, and is included in amortization and depreciation in the accompanying consolidated statements of operations.

Income Taxes – The Company accounts for income taxes using the asset and liability method and applies the provisions of ASC Topic 740, “Income Taxes” (formerly SFAS, No. 109, “Accounting for Income Taxes”). Under ASC Topic 740, deferred tax liabilities or assets arise from differences between the tax basis of liabilities or assets and their bases for financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which

those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not. Additionally, in accordance with ASC Topic 740, (formerly FIN 48, “Accounting for Uncertainty in Income Taxes”), we are required to determine whether it is more likely than not (a likelihood of more than 50 percent) that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position in order to record any financial statement benefit. If that step is satisfied, then we must measure the tax position to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Treasury Stock – The Company utilizes the cost method for accounting for its treasury stock acquisitions and dispositions.

Earnings (Loss) per Common Share – Earnings per common share is computed in accordance with ASC Topic 260, “Earnings Per Share” (formerly SFAS No. 128, “Earnings per Share”). Presented below is a reconciliation of net income (loss) available to common stockholders and the differences between weighted average common shares outstanding, which are used in computing basic earnings (loss) per share, and weighted average common and potential shares outstanding, which are used in computing diluted earnings (loss) per share.

| | For the Year Ended September 30, | | |
|--|--|------------|------------|
| | (In thousands, except share and per-share amounts) | | |
| | 2009 | 2008 | 2007 |
| Income (loss) available to common stockholders | \$(44,778) | \$378 | \$(744) |
| Weighted average common shares outstanding | 26,758,873 | 26,291,968 | 27,388,921 |
| Effect of dilutive securities: | | | |
| Options | — | 909,462 | — |
| Weighted average common and potential shares outstanding | 26,758,873 | 27,201,430 | 27,388,921 |
| Basic earnings (loss) per share | \$(1.67) | \$0.01 | \$(0.03) |
| Diluted earnings (loss) per share | \$(1.67) | \$0.01 | \$(0.03) |

Stock Options - At September 30, 2009, options to purchase approximately 6.8 million shares of common stock, with exercise prices ranging from \$1.00 to \$18.71 per share were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect, of which 6.0 million were not included due to their respective share price and the balance due to the loss generated during the current year.

At September 30, 2008, options to purchase approximately 2.9 million shares of common stock, with exercise prices ranging from \$4.68 to \$21.53 per share were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect.

At September 30, 2007, options to purchase approximately 1.7 million shares of common stock, with exercise prices ranging from \$7.61 to \$21.53 per share, were not included in the computation of diluted earnings per share due to the antidilutive effect, and approximately 1.8 million equivalent shares were not included due to the loss generated during fiscal 2007.

The Company adopted the provisions of ASC Topic 718, “Compensation – Stock Compensation” (formerly SFAS No. 123(R), “Share-Based Payment”). Among other items, ASC Topic 718 requires the Company to recognize in the financial statements, the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards. To measure the fair value of stock options granted to employees, the Company currently utilizes the Black-Scholes-Merton option-pricing model. The Company applied the “modified prospective” method, under which compensation cost is recognized in the financial statements beginning with the adoption date for all share-based payments granted after that date, and for all unvested awards granted prior to the adoption date. Expense is recognized over the required service period, which is generally the vesting period of the options.

The Black-Scholes-Merton model incorporates various assumptions, including expected volatility, expected life, and risk-free interest rates. The expected volatility is based on the historical volatility of the Company’s common stock

over the most recent period commensurate with the estimated expected life of the Company's stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

There were option grants to purchase 1.7 million, 2.7 million and 160,000 common shares during the years ended September 30, 2009, 2008 and 2007, respectively. The assumptions used for the years ended September 30, 2009, 2008 and 2007, and the resulting estimates of weighted-average fair value per share of options granted during these periods are as follows:

| | 2009 | 2008 | 2007 |
|--|------------|-------------|------------|
| Weighted expected life | 4.97 years | 4.98 years | 4.63 years |
| Risk-free interest rate | 1.5 - 2.9% | 3.0% - 4.1% | 4.10% |
| Expected volatility | 58.28% | 50.23% | 62.00% |
| Expected dividend yields | None | None | None |
| Weighted-average fair value of options granted during the period | \$1.81 | \$2.14 | \$5.88 |
| Expected annual forfeiture rate | 5.31% | 5.31% | 5.31% |

In accordance with ASC Topic 718, “Compensation – Stock Compensation (Formerly SFAS No. 123 (R), “Share-Based Payments”), the share-based compensation has been recorded by the Company for the years ended 2009, 2008 and 2007 in the amounts of \$1.8 million, \$1.5 million and \$1.2 million, respectively. The total income tax benefit recognized in the statement of operations for share-based compensation arrangements was \$0 (due to a current year valuation allowance), \$234,000 and \$162,000 for the years ended September 30, 2009, 2008 and 2007, respectively.

Foreign Currency Translation. The Company accounts for currency translation in accordance with ASC Topic 830, “Foreign Currency Matters” (formerly SFAS No. 52, “Foreign Currency Translation”). Balance sheet accounts are translated at the exchange rate in effect at each balance sheet date. Income statement accounts are translated at the average rate of exchange prevailing during the period. Translation adjustments resulting from this process are charged or credited to other comprehensive income (loss) a component of stockholders’ equity, in accordance with ASC Topic 220, “Comprehensive Income” (formerly SFAS 130, “Reporting Comprehensive Income”). Transactional currency gains and losses arising from transactions in currencies other than the Company’s local functional currency are included in the consolidated statement of operations in accordance with ASC Topic 830.

Recently Issued Accounting Pronouncements – In June 2009, the FASB issued SFAS No. 168, “The FASB Accounting Standards Codification and Hierarchy of Generally Accepted Accounting Principles (a replacement of SFAS No. 162).” FASB Accounting Standards Codification (ASC) has become the source of authoritative generally accepted accounting principles GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this statement, the codification will supersede all then-existing non-SEC accounting and reporting standards; and all non-grandfathered, non-SEC accounting literature not included in the codification will be superseded and deemed non-authoritative. The new codification standards have been adopted by the Company in its annual report on Form 10-K as of September 30, 2009. Reference to the new ASC topic, subtopic, or section will be provided along with the superceded historical accounting literature. The adoption of codification standards did not impact our consolidated financial position, results of operation or cash flows.

In October 2009, FASB issued ASU No. 2009-13, “Revenue Recognition(Topic 605), Multiple-Deliverable Revenue Arrangements” and ASU No. 2009-14, “Software(Topic 985), Certain Revenue Arrangements that Include Software Elements,” both consensus of the FASB Emerging Issues Task Force. ASU No. 2009-13 establishes the accounting and reporting guidance for arrangements under which the vendor will perform multiple revenue-generating activities; specifically, how to separate deliverables and how to measure and allocate arrangement consideration to one or more

units of accounting. ASU No. 2009-14 affects vendors that sell or lease tangible products in an arrangement that contains software that is more than incidental to the tangible product as a whole and clarifying what guidance should be used in allocating and measuring revenue. Upon adoption of these standards, a company can recognize revenue on delivered elements within a multiple elements arrangement based upon estimated selling prices, which is a departure from previous guidance. These standards are required to be implemented by October 1, 2010, but we are currently evaluating the impact of implementation in the first quarter of 2010, as early adoption is permitted.

In May 2009, the FASB issued ASC Topic 855, “Subsequent Events” (formerly SFAS No. 165, “Subsequent Events”), which establishes the accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date; that is, whether that date represents the date the financial statements were issued or were available to be issued. Consistent with ASC Topic 855 requirements for public entities, we evaluate subsequent events through the date the financial statements are issued. ASC Topic 855 should not result in significant changes in the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. ASC Topic 855 was adopted as of June 30, 2009. The adoption of ASC Topic 855 did not impact our consolidated financial position, results of operations or cash flows.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In March 2008, the FASB issued ASC Topic 815, “Derivatives and Hedging” (formerly SFAS No 161, “Disclosures about Derivative Instruments and Hedging Activities—An Amendment of FASB Statement No. 133”). ASC Topic 815 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted, and (c) derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. ASC Topic 815 is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2008, though earlier application is encouraged. Accordingly, the Company expects to adopt ASC Topic 815 beginning in fiscal 2010. The Company expects that ASC Topic 815 will have an impact on accounting for derivative instruments and hedging activities once adopted, but the significance of the effect is dependent upon entering into these related transactions, if any, at that time.

Effective October 1, 2008, the Company adopted ASC Topic 820, “Fair Value Measurements and Disclosures” (formerly SFAS No. 157, “Fair Value Measurements”), for its financial assets and financial liabilities, but it has not yet adopted ASC Topic 820 as it relates to nonfinancial assets and liabilities as ASC Topic 820 permits a one-year deferral of the its application for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of ASC Topic 820 as it pertains to financial assets and liabilities did not have a material impact on the Company’s results of operations, financial position or liquidity. The Company will adopt ASC Topic 820 for non-financial assets and non-financial liabilities on October 1, 2009, and the Company is currently evaluating the effect, if any, the adoption may have on its financial position, results of operations or cash flows.

In December 2007, the FASB issued ASC Topic 805, “Business Combinations” (formerly SFAS No. 141 (revised), “Business Combinations”). ASC Topic 805 changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for preacquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer’s income tax valuation allowance. ASC Topic 805 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company is required to adopt ASC Topic 805 effective October 1, 2009, and the Company is currently evaluating the effect, if any, the adoption may have on its financial position or the results of its operations.

In December 2007, the FASB issued ASC Topic 810, “Consolidation” (formerly SFAS No. 160, “Non Controlling Interests in Consolidated Financial Statements,” an amendment of Accounting Research Bulletin, or ARB No. 51, “Consolidated Financial Statements”). ASC Topic 810 changes the accounting for non controlling (minority) interests in consolidated financial statements, including the requirement to classify non controlling interests as a component of consolidated stockholders’ equity, and the elimination of “minority interest” accounting in results of operations with earnings attributable to non controlling interests reported as part of consolidated earnings. Additionally, ASC Topic 810 revises the accounting for both increases and decreases in a parent’s controlling ownership interest. ASC Topic 810 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company is required to adopt ASC Topic 810 effective October 1, 2009, and the Company is currently evaluating the effect, if any, the adoption may have on its results of operations or financial position.

In February 2007, the FASB issued ASC Topic 825, “Financial Instruments” (formerly SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 “Accounting for Certain Investments in Debt and Equity Securities”), which permits entities to choose to measure many financial instruments and certain other items at fair value with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge

accounting provisions. This Statement became effective for the Company beginning in October 2008. The implementation of ASC Topic 825, effective October 1, 2008, did not have a material effect on the consolidated financial statements in the year ended September 30, 2009.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2. Property and Equipment and Leased Gaming Equipment

At September 30, 2009 and 2008, the Company's property and equipment and leased gaming equipment consisted of the following:

| | 2009 | 2008 | Estimated Useful Lives |
|--|----------------|------------|------------------------------|
| | (In thousands) | | |
| Gaming equipment and third-party gaming content licenses available for deployment(1) | \$ 6,449 | \$ 30,252 | |
| Deployed gaming equipment | 99,522 | 96,584 | 3-5 years |
| Deployed third-party gaming content licenses | 39,512 | 34,444 | 1.5-3 years |
| Tribal gaming facilities and portable buildings | 3,563 | 4,720 | 5-7 years |
| Third-party software costs | 7,720 | 7,732 | 3-5 years |
| Vehicles | 3,065 | 3,502 | 3-10 years |
| Other | 2,991 | 3,191 | 3-7 years |
| Total property and equipment | 162,822 | 180,425 | |
| Less accumulated depreciation and amortization | (127,774) | (113,096) | |
| Total property and equipment, net | \$ 35,048 | \$ 67,329 | |
| Leased gaming equipment | \$ 156,474 | \$ 165,903 | 3 years |
| Less accumulated depreciation | (122,472) | (129,879) | |
| Total leased gaming equipment, net | \$ 34,002 | \$ 36,024 | |

(1) Gaming equipment and third-party gaming content licenses will begin depreciating when they are placed in service.

During 2009, the Company sold, disposed of, or wrote off \$5.4 million of net book value related to third-party gaming content licenses, installation costs, tribal gaming facilities and portable buildings, and other equipment. Of this \$5.4 million, \$3.3 million related to the sale of previously deployed units.

Leased gaming equipment includes player terminals placed under participation arrangements that are either at customer facilities or in the rental pool.

In accordance with ASC Topic 360, "Property, Plant, and Equipment" (formerly SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"), the Company i) recognizes an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows; and (ii) measures an impairment loss as the difference between the carrying amount and fair value of the asset.

During the year ended September 30, 2009, the Company hired a new management team. The management team conducted a thorough review of the Company's business in an effort to determine the proper go-forward strategy for the Company. As part of this analysis, the Company's revised marketing efforts and a more standardized product mix, management considered whether the future benefits expected from certain long-lived assets exceeded the assets carrying value. As a result of this analysis, it was determined that certain assets should be written-off or reserved for as of September 30, 2009. The charges include the write-off of property and equipment included in the Company's rental pool and obsolete component parts of \$5.6 million, the write-off of certain licenses used for game development of \$2.0 million and a the reserve for slow-moving component parts of \$1.8 million. The Company considered the

potential salvage value of the assets and determined that such an amount would be negligible. Therefore, classification of these assets as 'held for sale' is not necessary.

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

3. Development Agreements

The Company enters into participation, or revenue share, agreements. Under our participation agreements, we place player terminals and systems, along with our proprietary and other licensed game content, at a customer's facility in return for a share of the revenues that these terminals and systems generate. Often our participation agreements are in the form of development agreements, which the Company enters into in order to provide financing for new gaming facilities or for the expansion of existing facilities. In return, the facility dedicates a percentage of its floor space to placement of the Company's player terminals, and the Company receives a fixed percentage of those player terminals' hold per day over the term of the agreement. The agreements typically provide for some or all of the advances to be repaid by the customer to the Company. Amounts advanced in excess of those to be reimbursed by the customer are allocated to intangible assets and are generally amortized over the life of the contract, which is recorded as a reduction of revenue generated from the gaming facility. Certain of the agreements contain player terminal performance standards that could allow the facility to reduce a portion of the Company's floor space. In the past and in the future, the Company may by mutual agreement and for consideration, amend these contracts to reduce its floor space at the facilities. Any proceeds received for the reduction of floor space is first applied as a recovery against the intangible asset or property and development for that particular development agreement, if any. In the second quarter of fiscal 2008, the Company modified a development agreement by agreeing to reduce the number of player terminals at a development site. In return, the Company received a complete payoff of a note receivable in the amount of \$4.5 million.

In 2008, the Company fulfilled a commitment to a significant, existing tribal customer to provide approximately 43.8%, or \$65.6 million, of the total funding for a facility expansion. Because of our commitment to fund the expansion, the Company secured the right to place an additional 1,400 gaming units in the expanded facility in southern Oklahoma. The Company recorded all advances as a note receivable and imputed interest on the interest free loan. The discount (imputed interest) was recorded as contract rights and will be amortized over the life of the agreement. The repayment period of the note will be based on the performance of the facility. As of September 30, 2009, the Company had installed the additional 1,400 units in the expanded facility. During 2009, the tribal customer repaid \$13.1 million of the balance; thus the balance as of September 30, 2009 was \$52.5 million.

In addition, the Company funded two additional facilities in 2009 in the amount of \$5.1 million. These funded amounts are expected to be repaid to the Company from excess sales proceeds after giving effect to the revenue share arrangements.

Management reviews intangible assets related to development agreements for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. There were no events or changes in circumstance during fiscal 2009 that would require an impairment charge to the assets' carrying value.

The following net amounts related to advances made under development agreements and were recorded in the following balance sheet captions:

| | 2009 | September 30, 2008 |
|--|----------------|-----------------------|
| | (In thousands) | |
| Included in: | | |
| Notes receivable, net | \$ 50,288 | \$ 61,750 |
| Intangible assets – contract rights, net of accumulated amortization | 28,175 | 29,368 |

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

4. Intangible Assets

At September 30, 2009 and 2008, the Company's intangible assets consisted of the following:

| | September 30, 2009 | 2008 | Estimated Useful Lives |
|--|-----------------------|-----------|------------------------------|
| (In thousands) | | | |
| Contract rights under development agreements | \$ 46,319 | \$ 41,325 | 5-7 years |
| Internally developed gaming software | 28,388 | 26,473 | 1-5 years |
| Patents and trademarks | 8,226 | 8,464 | 1-5 years |
| Other | 961 | 1,054 | 3-5 years |
| Total intangible assets | 83,894 | 77,316 | |
| Less accumulated amortization – all other | (50,533) | (39,960) | |
| Total intangible assets, net | \$ 33,361 | \$ 37,356 | |

Contract rights are amounts allocated to intangible assets for dedicated floor space resulting from development agreements, described under "Development Agreements." The related amortization expense, or accretion of contract rights, is netted against its respective revenue category in the consolidated statements of operations.

Internally-developed gaming software is accounted for under the provisions of ASC Topic 985, "Software" (formerly SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed") and is stated at cost, which is amortized over the estimated useful life of the software, generally using the straight-line method. The Company amortizes internally-developed games over a twelve-month period, gaming engines over an eighteen-month period, gaming systems over a three-year period and its central management systems over a five-year period. Software development costs are capitalized once technological feasibility has been established, and are amortized when the software is placed into service. Any subsequent software maintenance costs, such as bug fixes and subsequent testing, are expensed as incurred. Discontinued software development costs are expensed when the determination to discontinue is made. For the years ended September 30, 2009, 2008, and 2007, amortization expense related to internally-developed gaming software was \$3.8 million, \$3.3 million and \$4.3 million, respectively. During fiscal 2009, 2008, and 2007, the Company wrote off \$571,000, \$531,000 and \$300,000, respectively, related to internally-developed gaming software that the Company chose to abandon.

Management reviews intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An analysis of intangible assets at September 30, 2008 indicated there was an impairment to goodwill which resulted in a \$335,277 reserve being recorded.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Amortization expense, inclusive of accretion of contract rights, totaled \$11.0 million, \$8.8 million and \$11.9 million for the years ended September 30, 2009, 2008 and 2007, respectively. Annual estimated amortization expense for each of the five succeeding fiscal years is as follows:

| Year | Amount (In thousands) |
|-------|--------------------------|
| 2010 | \$ 9,253 |
| 2011 | 6,854 |
| 2012 | 5,695 |
| 2013 | 4,928 |
| 2014 | 2,923 |
| Total | \$ 29,653 |

5. Notes Receivable

At September 30, 2009 and 2008, the Company's notes receivable consisted of the following:

| | 2009 | September 30, 2008 |
|--|----------------|-----------------------|
| | (In thousands) | |
| Notes receivable from development agreements | \$ 57,558 | \$ 72,706 |
| Less imputed interest discount reclassified to contract rights | (7,270) | (10,956) |
| Notes receivable from equipment sales and other | 5,616 | 8,012 |
| Notes receivable, net | 55,904 | 69,762 |
| Less current portion | (15,780) | (23,072) |
| Notes receivable – noncurrent | \$ 40,124 | \$ 46,690 |

Notes receivable from development agreements are generated from reimbursable amounts advanced under development agreements.

Notes receivable from equipment sales outstanding as of September 30, 2009 consist of financial instruments issued by customers for the purchase of player terminals and licenses, and bear interest at 5.75%. All of the Company's notes receivable from equipment sales are collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the note receivable outstanding.

6. Accounts Payable and Accrued Expenses

At September 30, 2009 and 2008, the Company's accounts payable and accrued expenses consisted of the following:

| | September 30, 2009 | September 30, 2008 |
|---|-----------------------|-----------------------|
| | (In thousands) | |
| Trade accounts payable and accrued expenses | \$ 18,955 | \$ 23,022 |
| Accrued bonus and salaries | 4,196 | 2,474 |
| Other | 3,727 | 3,785 |
| Accounts payable and accrued expenses | \$ 26,878 | \$ 29,281 |

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

7. Credit Facility, Long-Term Debt

At September 30, 2009 and 2008, the Company's Credit Facility, long-term debt and capital leases consisted of the following:

| | September 30, 2009 | 2008 |
|--------------------------------------|-----------------------|-----------|
| | (In thousands) | |
| Long-term revolving lines of credit | \$ 15,000 | \$ 19,000 |
| Term loan facility | \$ 60,748 | \$ 67,988 |
| Less current portion | (2,073) | (1,544) |
| Long-term debt, less current portion | \$ 58,675 | \$ 66,444 |

Credit Facility. On April 27, 2007, the Company entered into a \$150 million Credit Facility which replaced its previous credit facility in its entirety. On October 26, 2007, the Company amended the Credit Facility, transferring \$75 million of the revolving credit commitment to a fully funded \$75 million term loan due April 27, 2012. The Term Loan is amortized at an annual amount of 1% per year, payable in equal quarterly installments beginning January 1, 2008, with the remaining amount due on the maturity date. The Company entered into a second amendment to the Credit Facility on December 20, 2007 which (i) extended the hedging arrangement date related to a portion of the term loan to June 1, 2008; and (ii) modified the interest rate margin applicable to the Revolving Credit Facility and the term loan.

The Credit Facility provides the Company with the ability to finance development agreements and acquisitions and working capital for general corporate purposes. Amounts under the \$65 million revolving credit commitment and the \$60 million term loan mature on April 27, 2012, and advances under the term loan and revolving credit commitment bear interest at the Eurodollar rate plus the applicable spread, tied to various levels of interest pricing determined by total debt to EBITDA (EBITDA is defined as earnings before interest, taxes, amortization, depreciation, and accretion of contract rights). As of September 30, 2009, the \$15.0 million drawn under the revolving credit commitment bore interest at 5.75% and the \$60.0 million under the term loan bore interest at 6.5%. Also included in the September 30, 2009 and 2008 balances are approximately \$748,000 and \$680,000, respectively, of accrued interest.

On July 22, 2009, the Company entered into a third amendment to the Credit Facility. Under the terms of the amended credit agreement, the calculation of consolidated Adjusted EBITDA (EBITDA, plus certain add-backs as agreed upon by our lenders) for the purposes of evaluating compliance with the specified covenants will now reflect the add-back of several items including: i) legal costs and settlement fees incurred in the trailing four-quarter period related to litigation with Diamond Game Enterprises, Inc., or Diamond Game, which was settled on May 1, 2009; ii) all non-cash stock-based compensation expenses; and, iii) up to \$10 million, in aggregate, of additional non-cash asset impairment charges that the Company may incur in future periods. In conjunction with the third amendment, the Company reduced the total borrowing capacity of the credit facility to \$125 million from the previous total borrowing capacity of \$150 million and agreed to a LIBOR floor of 2%, which would have increased the interest rate paid as of June 30, 2009 by approximately 1.7%. On July 23, 2009, the Company paid a one-time fee of 25 basis points of the total borrowing capacity of \$125 million as well as other customary fees associated with the amendment.

The Credit Facility is collateralized by substantially all of the Company's assets, and also contains financial covenants as defined in the agreement. These covenants include (i) a minimum fixed-charge coverage-ratio of not less than 1.50 : 1.00; (ii) a maximum total debt to Adjusted EBITDA ratio of not more than 2.25 : 1.00 through

June 30, 2008, and 1.75 : 1.00 from September 30, 2008 thereafter; and (iii) a minimum trailing twelve-month Adjusted EBITDA of not less than \$60.0 million for the quarter. As of September 30, 2009, the Company is in compliance with its loan covenants. The Credit Facility requires certain mandatory prepayments be made on the term loan from the net cash proceeds of certain asset sales and condemnation proceedings (in each case to the extent not reinvested, within certain specified time periods, in the replacement or acquisition of property to be used in its businesses). In the second quarter of 2008, the Company made a mandatory prepayment of the term loan in the amount of \$4.5 million due to an early prepayment of a development agreement note receivable. As of September 30, 2009, the Credit Facility had availability of \$50.0 million, subject to covenant restrictions.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Credit Facility also required that the Company enter into hedging arrangements covering at least \$50 million of the term loan for a three-year period by June 1, 2008; therefore, on May 29, 2008, the Company purchased, for \$390,000, an interest rate cap (5% cap rate) covering \$50 million of the term loan. The Company accounts for this hedge in accordance with ASC Topic 815, “Derivatives and Hedging” (formerly FASB Statement No. 133, “Accounting for Derivative Instruments and Hedging Activities”) which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet, at their respective fair values. The Company records, on a mark-to-market basis, changes to the fair value of the interest rate cap on a quarterly basis. These changes in fair value are recorded in interest expense in the consolidated statement of operations.

Long-term debt at September 30, 2009 and 2008, includes the Credit Facility’s term loan.

A schedule for each of the fiscal years ending after September 30, 2009, representing the maturities of long-term debt is as follows:

| Year | Long-Term Debt | Revolving Lines of Credit |
|----------------|-------------------|---------------------------------|
| (In thousands) | | |
| 2010 | \$ 2,073 | \$ — |
| 2011 | 750 | — |
| 2012 | 57,925 | 15,000 |
| Total | \$ 60,748 | \$ 15,000 |

8. Leases

The Company leases its corporate offices, warehouses and certain office equipment under noncancelable operating leases. In addition, the Company leases certain equipment used in its operations under capital lease arrangements.

A schedule of future minimum rental payments required under noncancelable operating leases is as follows:

| Year | Operating (In thousands) |
|---------------------------------------|--------------------------------|
| 2010 | \$ 2,134 |
| 2011 | 199 |
| 2012 | 36 |
| 2013 | 36 |
| 2014 | 36 |
| Total Minimum Lease Payments | \$ 2,441 |

Rental expense during 2009, 2008, and 2007 amounted to \$2.8 million, \$2.7 million and \$2.5 million, respectively.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

9. Income Taxes

The provision for income tax expense (benefit) consisted of the following for the years ended September 30, 2009, 2008 and 2007:

| | 2009 (In thousands) | 2008 | 2007 |
|-------------------------------------|------------------------|---------------|--------------------|
| Current: | | | |
| Federal | \$ (6,271) | \$ 4,223 | \$ 8,784 |
| State | 41 | 828 | 638 |
| Foreign | 692 | 514 | 274 |
| | (5,538) | 5,565 | 9,696 |
| Deferred: | | | |
| Federal | 18,185 | (4,673) | (10,489) |
| State | 1,351 | (590) | (386) |
| Foreign | — | — | — |
| | 19,536 | (5,263) | (10,875) |
| Income tax expense (benefit) | \$ 13,998 | \$ 302 | \$ (1,179) |

The effective income tax rates differ from the statutory U.S. federal income tax rates as follows for the years ended September 30, 2009, 2008, and 2007:

| | 2009 | 2008 | 2007 |
|--|----------|----------|----------|
| Federal income tax expense (benefit) at statutory rate | (35.0 %) | 35.0 % | (35.0 %) |
| State income tax expense, net of federal benefit | (2.6 %) | 7.8 % | 8.5 % |
| Foreign income tax expense, net of federal benefit | 1.1 % | 47.7 % | 9.3 % |
| Change in valuation allowance | 81.2 % | — | — |
| Other, net | 0.7 % | (46.1 %) | (44.7 %) |
| Provision (benefit) for income taxes | 45.4 % | 44.4 % | (61.9 %) |

The “other, net” category above captures the impact of several tax expense items, the three largest of which, are all favorable to the Company in the fiscal years 2008 and 2007, and included an unrecorded federal refund, an over-accrual of state income tax expense, and the true-up of the Company’s income tax accounts.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Differences between the book value and the tax basis of the Company's assets and liabilities at September 30, 2009 and 2008 result in deferred tax assets and liabilities as follows:

| | 2009 | 2008 |
|---|----------------|-----------|
| | (In thousands) | |
| Deferred tax asset – current: | | |
| Allowance for doubtful accounts | \$ 1,383 | \$ 455 |
| Inventory reserve | 1,038 | 1,526 |
| Accruals not currently deductible for tax purposes | 3,345 | 1,764 |
| Deferred revenue | 2,307 | 3,131 |
| Current deferred tax asset | 8,073 | 6,876 |
| Valuation allowance | (6,935) | - |
| Current deferred tax asset, net | 1,138 | 6,876 |
| Noncurrent deferred tax asset: | | |
| Property and equipment, leased gaming equipment and intangible assets, due principally to depreciation and amortization differences | 19,560 | 15,916 |
| Non-qualified stock compensation expense | 1,261 | 986 |
| Net Operating Losses and credits | 250 | - |
| Noncurrent deferred tax asset, net | 21,071 | 16,902 |
| Valuation allowance | (18,102) | - |
| Noncurrent deferred tax asset, net | 2,969 | 16,902 |
| Deferred tax asset | \$ 4,107 | \$ 23,778 |

As of September 30, 2009, the Company had state net operating loss carryforwards of approximately \$4.0 million and a federal alternative minimum tax credit carryforward of approximately \$147,000. The state net operating losses will begin to expire in varying amounts in 2024 if not utilized.

For 2009, 2008, and 2007, the Company recorded reductions of \$221,000, \$112,000 and \$1.4 million respectively, of its federal and state income tax liability due to the effects of stock compensation.

During the year ended September 30, 2009, the Company hired a new management team. The management team conducted a thorough review of the Company's business in an effort to determine the proper go-forward strategy for the Company. In conjunction with this analysis, management also considered the likelihood of realizing the future benefits associated with the Company's existing deductible temporary differences and carryforwards. As a result of this analysis and based on the current year loss and a cumulative loss in the prior three fiscal years, management determined that it is not more likely than not that the future benefit associated with all of the Company's existing deductible temporary differences and carryforwards in the U.S. and Mexico will be realized. As a result, the Company recorded a valuation allowance against its deferred tax assets to the extent that its gross deferred tax assets exceed the Company's carryback potential. Accordingly, for the year ended September 30, 2009, the valuation allowance increased by approximately \$25.0 million. The Company maintains a valuation allowance when management believes it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in a valuation allowance from period to period are included in the tax provision in the period of change. Management evaluates the recoverability of our deferred income tax assets by assessing the need for a valuation allowance on a quarterly basis. If we determine that it is more likely than not that our deferred tax assets will be recovered, the valuation allowance will be reduced.

The Company paid income taxes, net of refunds received of (\$1.4) million, \$10.9 million and \$7.6 million in 2009, 2008 and 2007, respectively.

In fiscal 2009, the Company conducted operations in Mexico through a subsidiary treated as a disregarded entity for U.S. income tax purposes. Accordingly, income or losses are taxed or benefited, as appropriate, in the Company's U.S. tax provision. At present, Company management determined that it is more likely than not that the Mexican operations can not benefit from past losses, from a Mexican tax perspective. Accordingly, a full valuation allowance has been recorded against the deferred tax asset related to the Mexican net operating loss. The effect on the total income tax expense is deemed immaterial.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On November 6, 2009, the President signed H.R. 3548, which included a provision that will allow most business taxpayers with losses to benefit from an increased carryback period for net operating losses incurred in 2008 or 2009. The effects of changes in tax law are taken into account during the interim period in which the law is enacted. The Company is still evaluating whether the passage of H.R. 3548 will have a material impact on its financial statements.

The Company adopted the provisions of ASC 740-10-25 effective September 30, 2007. ASC 740-10-25 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all the relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. ASC 740-10-25 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest, and penalties. Upon adoption and implementation of ASC 740-10-25, the Company recognized a decrease of \$295,000 to the October 1, 2007 balance of retained earnings.

The following is a tabular reconciliation of the total amounts of unrecognized tax benefits for the years ended September 30,:

| | 2009 | 2008 |
|---|------------|------------|
| Unrecognized tax benefit – October 1, | \$ 311,000 | \$ 295,000 |
| Gross increases – tax positions in prior period | 23,000 | 16,000 |
| Gross decreases – tax positions in prior period | - | - |
| Gross increases – tax positions in current period | - | - |
| Settlements | - | - |
| Lapse of statute of limitations | - | - |
| Unrecognized tax benefit – September 30, | \$ 334,000 | \$ 311,000 |

Included in the balance of unrecognized tax benefits at September 30, 2009 and 2008, are \$334,000 and \$311,000, respectively, of tax benefits that, if recognized, would affect the effective tax rate.

The Company recognizes interest accrued related to unrecognized tax benefits and penalties as income tax expense. Related to the unrecognized tax benefits noted above, the Company accrued interest and penalties of \$39,000 and \$16,000 as of September 30, 2009 and 2008, respectively.

The Internal Revenue Service has concluded the examination and appeals phase for the tax year ended September 30, 2003 and 2004. The Company continues to be under examination for the tax year ended September 30, 2005. We expect to conclude the examination phase of this audit during 2010.

The Company is subject to taxation in the US, including various states jurisdictions, and Mexico. With few exceptions, the Company is no longer subject to U.S. federal and state examinations for tax years prior to September 30, 2006, and September 30, 2005, respectively.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

10. Stockholders' Equity

Preferred Stock

During fiscal 1995, the Company amended its articles of incorporation to provide for the issuance of up to 2,000,000 shares of Preferred Stock in such series and with such rights and preferences as may be approved by the Board of Directors. In January 1995, the Board of Directors approved a Series A Preferred Stock, which is cumulative, voting and convertible. In October 1998 the Board of Directors approved a Series B Junior Participating Preferred Stock, which is cumulative and voting. As of September 30, 2009 and 2008, there were no shares of Series A Preferred Stock or Series B Junior Participating Preferred Stock outstanding.

Treasury Stock

During July 2007, the Company completed a modified "Dutch Auction" Tender Offer and purchased \$25.0 million of its common stock and the associated preferred share purchase rights. The Company accepted, for purchase, an aggregate of 1,992,032 shares of its common stock at a net purchase price of \$12.74 per share, to record an aggregate share repurchase of approximately \$25.0 million and incurred transaction costs of \$387,457 related to the Tender Offer that was recorded in treasury stock.

During fiscal 2009 and 2008, the Company did not repurchase any shares of its Common Stock. During fiscal 2007, the Company repurchased with cash 1,992,000 shares of its Common Stock at an average cost of \$12.74.

Director Compensation Plan

The Company maintains a plan to compensate the members of its Board of Directors for their services as directors, including serving on committees of the board. Under the Director Compensation Plan, each of the Company's directors, will receive \$37,500 per year, except for the Chairman of the Board, who will receive \$75,000 per year. In addition, each director will receive \$500 for each board meeting attended in person, \$250 for each board meeting attended by telephone, \$400 for each committee meeting attended in person and \$200 for each committee meeting attended by telephone. Each member of the Audit Committee will also receive an additional \$15,000 per year for serving on the Audit Committee, except for the Chairman of the Audit Committee who will receive \$25,000 per year for serving on the Audit Committee as its Chairman. The members of the Nominating and Governance Committee each receive an additional \$7,500 per year for serving on the Nominating and Governance Committee, except for the Chairman of the Nominating and Governance Committee, who receives \$15,000 per year. The members of the Compensation Committee each receive an additional \$15,000 per year for serving on the Compensation Committee, except for the Chairman of the Compensation Committee, who receives \$25,000 per year. In general, each sitting director will receive an option grant on an annual basis for 10,000 shares of Common Stock that will vest six months from the date of grant, subject to restrictions which prevent the sale of such shares. These restrictions on the sale of the underlying shares lapse with respect to 25% of the shares annually.

Stock Option Plans

Nonqualified stock options have been granted to the Company's directors under its nonemployee director stock plans. Nonqualified and incentive stock options have been granted to the Company's officers and employees under its employee stock plans. Options granted to its officers and employees generally vest over four years and expire seven years from the date of grant. The Company expects to continue to issue stock options to new employees as they are hired, as well as to current employees as incentives from time to time.

The Company issues new shares to satisfy stock option exercises under the plans.

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

At September 30, 2009, there were stock options available for grant under the following plans:

| | Approved by Shareholders | Options available for grant as of September 30, 2009 |
|---|--------------------------------|--|
| 2000 Stock Option Plan | May 2001 | 16,015 |
| 2001 Stock Option Plan | May 2002 | 185,873 |
| 2002 Stock Option Plan | February 2003 | 172,914 |
| 2003 Outside Director Stock Option Plan | February 2004 | 712,500 |
| 2008 Employment Inducement Plan | | 94,986 |
| Total | | 1,182,288 |

For the year ended September 30, 2009, the activity relating to stock option issuances under the stock option plans is as follows:

| | Number of Options | Weighted- Average Exercise Price per Share | Weighted- Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|---|-------------------------|--|--|---------------------------------|
| Stock Options Outstanding October 1, 2008 | 6,689,508 | \$ 6.14 | | |
| Granted | 1,719,433 | 3.54 | | |
| Exercised | (609,349) | 2.05 | | |
| Forfeited | (963,344) | 7.75 | | |
| Stock Options Outstanding September 30, 2009 | 6,836,248 | \$ 5.63 | 5.31 | \$ 5,996,719 |
| Stock Options Exercisable September 30, 2009 | 3,519,540 | \$ 7.09 | 3.71 | \$ 2,461,461 |

For the years ended September 30, 2009, 2008 and 2007, other information pertaining to stock options was as follows:

| | 2009 | 2008 | 2007 |
|---|---------|---------|---------|
| Weighted-average grant-date fair value of stock options granted | \$ 1.81 | \$ 2.14 | \$ 5.88 |
| Total intrinsic value of options exercised (in millions) | 0.8 | 0.5 | 4.8 |
| Total grant-date fair value of stock options vested during the year (in millions) | 2.1 | 1.7 | 2.4 |

A summary of the status of the Company's nonvested options as of September 30, 2009 and changes during the year then ended is as follows:

| Nonvested Options | Number of Options | Weighted- Average Grant-Date |
|-------------------|-------------------------|------------------------------------|
|-------------------|-------------------------|------------------------------------|

| | | Fair Value |
|---------------------------------|------------|------------|
| Nonvested at October 1, 2008 | 2,842,375 | \$ 2.25 |
| Granted | 1,719,433 | 1.81 |
| Vested | (281,756) | 7.33 |
| Forfeited | (963,344) | 7.75 |
| Nonvested at September 30, 2009 | 3,316,708 | 2.09 |

Cash received from option exercise under all share-based payment arrangements for the years ended September 30, 2009, 2008 and 2007 was \$1.3 million, \$218,000, and \$3.4 million. For September 2009, 2008, and 2007, the Company recorded reductions of \$221,000, \$328,000, and \$1.4 million, respectively, of its federal and state income tax liability, with an offsetting credit to additional paid-in capital resulting from the tax benefits of stock options.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

As of September 30, 2009, there was \$6.0 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over a weighted-average period of 3.08 years. This estimate is subject to change based upon a variety of future events which include, but are not limited to, changes in estimated forfeiture rates, cancellations and the issuance of new options.

Employee Benefit Plans

The Company has established a employee savings plan pursuant to Section 401(k) of the Internal Revenue Code. The plan provides for the employees to make tax-deferred deposits into the plan up to the maximum of \$22,000 for 2009. The Company has historically matched employees' contributions. Such Company contributions amounted to \$688,000, \$694,000, and \$730,000 for the years ended September 30, 2009, 2008, and 2007, respectively.

11. Commitments and Contingencies

Litigation and Regulatory Proceedings

The Company is subject to the possibility of loss contingencies arising in its business and such contingencies are accounted for in accordance with ASC Topic 450, "Contingencies" (formerly SFAS No. 5, "Accounting for Contingencies"). In determining loss contingencies, the Company considers the possibility of a loss as well as the ability to reasonably estimate the amount of such loss or liability. An estimated loss is recorded when it is considered probable that a liability has been incurred and when the amount of loss can be reasonably estimated.

International Gamco. International Gamco, Inc., or Gamco, claiming certain rights in U.S. Patent No. 5,324,035, or the '035 Patent, brought suit against the Company on May 25, 2004 in the U.S. District Court for the Southern District of California alleging that the Company's central determinant system, as operated by the New York State Lottery, infringes the '035 Patent. Gamco claims to have acquired ownership of the '035 Patent from Oasis Technologies, Inc., or Oasis, a previous owner of the '035 Patent. In February 2003, Gamco assigned the '035 Patent to International Game Technology, or IGT. Gamco claims to have received a license back from IGT for the New York State Lottery. The lawsuit claims that the Company infringed the '035 Patent after the date on which Gamco assigned the '035 Patent to IGT.

The Company has made a number of challenges to Gamco's standing to sue for infringement of the '035 Patent. On October 15, 2007, pursuant to an interlocutory appeal, the federal circuit court reversed the district court's order when it held that Gamco did not have sufficient rights in the '035 Patent to sue the Company without the involvement of the patent owner, IGT.

On December 4, 2007, Gamco and IGT entered into an Amended and Restated Exclusive License Agreement whereby IGT granted to Gamco exclusive rights to the '035 Patent in the state of New York and the right to sue for past infringement of the same. On January 9, 2008, Gamco filed its third amended complaint for infringement of the '035 Patent against the Company. On January 28, 2008, the Company filed an answer to the complaint denying liability. The Company also filed a third amended counterclaim against Oasis, Gamco and certain officers of Gamco, for fraud, promise without intent to perform, negligent misrepresentation, breach of contract, specific performance and reformation of contract with regard to the Company's rights under the Sublicense Agreement for the '035 Patent, as well as for non-infringement and invalidity of the '035 Patent. These parties have filed a motion to dismiss and a motion for summary judgment as to these claims. On August 11, 2009, the Court issued an order denying the motion to dismiss and granting in part and denying in part the motion for summary judgment. The Court entered judgment against the Company on its claims for fraud, promise without intent to perform and negligent

misrepresentation. However, the Court held that Gamco was not entitled to judgment as a matter of law on the Company's claims for breach of contract, reformation and specific performance. The Company's affirmative motion for partial summary judgment was denied. The court issued a claim construction ruling in this case on April 20, 2009. The Company will be filing motions for summary judgment of non-infringement of the '035 Patent and to invalidate the '035 Patent in light of the Court's claim construction ruling.

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On August 28, 2009, the court held a telephonic conference, issued pre-trial deadlines and set the Final Pre-Trial Conference date for September 9, 2010. A trial date will be scheduled during the Final Pre-Trial Conference on September 9, 2010.

The Company continues to vigorously defend this matter. Given the inherent uncertainties in this litigation, the Company is unable to make any prediction as to the ultimate outcome.

Cory Investments Ltd. On September 2, 2009, we entered into a comprehensive settlement agreement with Cory Investments, LTD., or Cory Investments, to resolve all claims arising from a May 7, 2008 lawsuit filed by Cory against us and several of our former officers, including Clifton Lind, Robert Lannert and Gordon Graves, in the State Court in Oklahoma City, Oklahoma. Litigation expenses and settlement charges have been reflected in the Company's consolidated statement of operations as of September 30, 2009. The case asserted that we offered allegedly illegal Class III games on the MegaNanza and Reel Time Bingo gaming systems to Native American tribes in Oklahoma which had a severe negative impact on Cory Investments' market for its legal Class II games. Cory Investments also alleged that the defendants conspired to drive it and other Class II competitors out of the Class II market in Oklahoma and other states. In addition to the conspiracy allegations, Cory Investments alleged six causes of action: (i) deceptive trade practices; (ii) common law unfair competition; (iii) wrongful interference with business; (iv) malicious wrong / prima facie tort; (v) intentional interference with contract; and (vi) unreasonable restraint of trade. Cory Investments was seeking unspecified actual and punitive damages and equitable relief. The settlement agreement was reached while the parties were engaged in mediation and we did not admit any wrongdoing as a result of this settlement agreement.

Diamond Game Enterprises, Inc. On May 1, 2009, the Company entered into a comprehensive settlement agreement with Diamond Game Enterprises, Inc., or Diamond Game, to resolve all claims arising from a November, 2004 lawsuit filed by Diamond Game against the Company and several former officers, including Clifton Lind, Robert Lannert and Gordon Graves. This settlement agreement was reached while the parties were engaged in federal mediation and the Company did not admit any wrongdoing in relation to the underlying litigation. During fiscal 2009, the Company incurred \$7.7 million in legal fees and settlement costs, net of insurance proceeds.

Other. In addition to the threat of litigation relating to the Class II or Class III status of the Company's games and equipment, the Company is the subject of various pending and threatened claims arising out of the ordinary course of business. The Company believes that any liability resulting from these various other claims will not have a material adverse effect on its results of operations or financial condition or cash flows. During its ordinary course of business, the Company enters into obligations to defend, indemnify and/or hold harmless various customers, officers, directors, employees and other third parties. These contractual obligations could give rise additional litigation cost and involvement in court proceedings.

Governmental Regulation. The Company is not aware of any pending litigation or sanctions related to violations of government regulations at this time. Existing federal and state regulations may impose civil and criminal sanctions for various activities prohibited in connection with gaming operations, including but not limited to: (i) false statements on applications; (ii) failure or refusal to obtain required licenses; and / or (iii) the placement of gaming devices, terminals, player stations, and / or units.

The Company may become subject to litigation related to its charity bingo business in Alabama. On November 13, 2009, the Supreme Court of Alabama, in a 6-3 decision, reversed and remanded a trial court's preliminary injunction in favor of a charity operating bingo in the Town of White Hall, Lowndes County, Alabama, referred to herein as the White Hall decision. The appeal arose out of a raid conducted by the Governor's Task Force on Illegal Gambling on

March 19, 2009. The Governor's Task Force on Illegal Gambling seized server-based bingo gaming systems, computers, servers, and cash. Included with the equipment seized were approximately 34 of the Company's games and certain of the Company's charity bingo equipment located in Alabama. In the White Hall decision, the Supreme Court of Alabama established a definition of "bingo" that included a set of standards that apply to the operation of charity bingo in Alabama. The charity that operates White Hall filed an application for rehearing with the Supreme Court of Alabama. The Supreme Court has not ruled on this application. The White Hall decision will become final if and when the Supreme Court denies the application. Additionally, the Governor's Task Force on Illegal Gambling filed a forfeiture action against all of the equipment seized at White Hall. The forfeiture action remains pending in the trial court. It is possible that further proceedings will be initiated in the future.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Further, three recent lower court decisions by both State and federal trial courts ruled or implied that electronic bingo was illegal under the particular constitutional amendments examined by those courts. There may be other cases pending or threatened involving electronic bingo that might have an impact upon our operations in Alabama.

Off Balance Sheet Arrangements

As of September 30, 2009, the Company had no off balance sheet arrangements.

Employment Agreements

We have employment agreements with each of our executive officers with positions of Senior Vice President or above. These employment agreements generally provide for an initial rate of pay and other general employment terms. If there is a change in control of the Company, each of our executives are entitled to certain severance benefits, which vary depending on the length of the executive officer's employ with the Company upon the change in control or the termination without cause or termination of employment for good reason (each as defined within the employment agreement). The employment agreements include post-employment non-compete provisions and the terms of the severance benefits generally range from twelve-to twenty-four month's salary continuation with similar non compete periods.

License Agreements

In June 2004, the Company entered into an agreement with WMS Gaming, Inc. to purchase WMS cabinets and games for placement in various Class II and Class III jurisdictions in North America. The agreement has been amended several times, most recently in June 2009 to add additional purchase commitments and to alter the method of Class II game theme license renewals. WMS and the Company agreed to additional Class III cabinet purchases and agreed to extend the term of the agreement until June 30, 2010 for certain jurisdictions, with limited sell-off rights extending thereafter. The Company has satisfied all required cabinet and game-theme purchases.

On November 27, 2006 the Company entered into a letter agreement with Aristocrat Technologies, Inc. in which the Company is granted the right to purchase, as well as the exclusive right to place Aristocrat Class III cabinets and attendant game themes to certain Native American tribes within the State of Oklahoma. The initial term of the agreement is three years from delivery of the first order of Aristocrat cabinets, with a two-year extension by mutual agreement. In October 2008, Aristocrat and the Company agreed to additional Class III cabinet purchases and agreed to extend the term of the agreement until December 15, 2010.

In April 2001, the Company entered into a license agreement with Bally Technologies, Inc. to use and distribute Bally's games themes and cabinets in the Washington State Class III native American market. In September 2001, Bally extended the license agreement to provide the Company access to Bally's catalog of game themes for use in Class II bingo games for deployment in certain Class II jurisdictions. The authorized market was expanded in 2004 to include charitable bingo in Alabama and Native American lottery in California. The agreement expired in September of 2005. The Company retains the right to deploy in the authorized markets the licensed games that it has purchased..

Certain of the Company's license agreements require it to pay royalty fees based on a fixed percentage of the hold per day generated by a player terminal.

12. Concentrations of Credit Risk

The Company maintains its cash in bank deposit accounts which at times may exceed the federal depository insurance limits. At September 30, 2009, the Company had concentrations of cash in two banks totaling approximately \$8.2 million and \$3.9 million. The Company has not experienced any losses on such accounts in the past.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Accounts receivable represent short-term credit granted to customers for which collateral is generally not required. As of September 30, 2009 and 2008, approximately 59% and 44%, respectively, of the Company's accounts receivable were from Native American tribes or their gaming enterprises.

In addition, a large percentage of these tribes have their reservations and gaming operations in the state of Oklahoma. Despite the industry and geographic concentrations related to the Company's customers, due to the historical experience of the Company on receivable collections, management considers credit risk to be minimal with respect to accounts receivable. At September 30, 2009 and 2008, the following concentrations existed in the Company's accounts receivable, as a percentage of total accounts receivable:

| | 2009 | 2008 |
|----------|------|------|
| Customer | | |
| A | 33% | 17% |
| Customer | | |
| B | 10% | 13% |

For the years ended September 30, 2009, 2008 and 2007, the following customers accounted for more than 10% of the Company's total revenues:

| | 2009 | 2008 | 2007 |
|----------|------|------|------|
| Customer | | | |
| A | 42% | 39% | 42% |
| Customer | | | |
| B | 7% | 10% | 4% |
| Customer | | | |
| C | 4% | 7% | 10% |

Approximately 64% and 58% of the Company's total revenues for the years ended September 30, 2009 and 2008, respectively, were from tribes located in Oklahoma.

While the Company believes that its relationships with all of its customers are good, the loss of any of these customers would have a material and adverse effect upon its financial condition and results of operations and cash flows.

Notes receivable consist of financial instruments issued by customers for the purchase of player terminals and licenses, and amounts generated from reimbursable amounts advanced under development agreements, generally at prevailing interest rates. Substantially all of the Company's notes receivable are from Native American tribes or their gaming enterprises. At September 30, 2009, two customers represented approximately 85% and 10% of the notes receivable.

13. Related Party Transactions

During fiscal 2009, the Company paid approximately \$293,000 and \$136,000 to two former Chief Executive Officers for consulting services.

During fiscal 2008, the Company paid approximately \$48,000 to a former Chairman of the Board for consulting services and approximately \$150,000 to the former Chief Executive Officer for consulting services.

During fiscal 2007, in connection with executing a content license agreement, the Company paid \$25,000 to a family member of the former Chairman of the Board.

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MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

14. Supplemental Consolidated Quarterly Financial Data (Unaudited)

| | Year Ended September 30, 2009 | | | |
|--|--|-------------------|------------------|-----------------------|
| | Quarters Ended | | | |
| | December 31, 2008 | March 31, 2009 | June 30, 2009 | September 30, 2009 |
| | (In thousands, except per-share amounts) | | | |
| Total revenues | \$28,576 | \$33,870 | \$32,129 | \$32,577 |
| Operating income (loss) | (8,400) | (4,569) | (1,239) | (14,805) |
| Income (loss) before taxes | (9,171) | (5,214) | (1,473) | (14,947) |
| Net income (loss) | (5,924) | (3,394) | (1,160) | (34,300) |
| Diluted earnings (loss) per share | (0.22) | (0.13) | (0.04) | (1.28) |
| Weighted average common shares outstanding, diluted | 26,624 | 26,643 | 26,693 | 27,073 |

| | Year Ended September 30, 2008 | | | |
|--|--|-------------------|------------------|-----------------------|
| | Quarters Ended | | | |
| | December 31, 2007 | March 31, 2008 | June 30, 2008 | September 30, 2008 |
| | (In thousands, except per-share amounts) | | | |
| Total revenues | \$30,235 | \$32,202 | \$30,252 | \$38,443 |
| Operating income (loss) | 821 | 2,722 | 209 | (2,517) |
| Income (loss) before taxes | 153 | 2,239 | 348 | (2,060) |
| Net income (loss) | 399 | 1,258 | 164 | (1,443) |
| Diluted earnings (loss) per share | 0.01 | 0.05 | 0.01 | (0.06) |
| Weighted average common shares outstanding, diluted | 27,380 | 27,243 | 27,153 | 26,595 |

In accordance with ASC Topic 360, the Company (i) recognizes an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows; and (ii) measures an impairment loss as the difference between the carrying amount and fair value of the asset.

During the year ended September 30, 2009, the Company hired a new management team. The management team conducted a thorough review of the Company's business in an effort to determine the proper go-forward strategy for the Company. As part of this analysis, management considered whether the future benefits expected from certain long-lived assets exceeded the assets carrying value; as well as the likelihood of realizing the future benefits associated with the Company's existing deductible temporary differences and carryforwards. As a result of this analysis, it was determined that certain assets should be written-off or reserved for as of September 30, 2009. The charges include a valuation allowance on deferred tax assets of \$25.0 million, the write-off of property and equipment included in the Company's rental pool and obsolete component parts of \$5.6 million, the write-off of certain licenses used for game development of \$2.0 million and a the reserve for slow-moving component parts of \$1.8 million. The Company considered the potential salvage value of the assets and determined that such an amount would be negligible. Therefore, classification of these assets as 'held for sale' is not necessary.

MULTIMEDIA GAMES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

15. Subsequent Events

The Company has evaluated subsequent events through December 14, 2009, which is the date the financial statements were issued, and determined that no events have occurred subsequent to September 30, 2009 that warrant additional disclosure.

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MULTIMEDIA GAMES, INC.

Schedule II – Valuation and Qualifying Accounts

Allowance for Doubtful Accounts

| | Balance at Beginning of Period | (Recoveries)/ Additions | Deductions | Balance at End of Period |
|---------|--------------------------------------|----------------------------|------------|--------------------------------|
| | (In thousands) | | | |
| FY 2009 | \$ 1,209 | \$ 2,661 | \$ 194 | \$ 3,676 |
| FY 2008 | \$ 854 | \$ 421 | \$ 66 | \$ 1,209 |
| FY 2007 | \$ 1,007 | \$ 466 | \$ 619 | \$ 854 |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MULTIMEDIA GAMES, INC.

Dated: December 14, 2009

By: /s/ Adam D. Chibib
Adam D. Chibib
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|--|---|-------------------|
| /s/ ANTHONY M. SANFILIPPO Anthony M. Sanfilippo | Chief Executive Officer and Director (Principal Executive Officer) | December 14, 2009 |
| /s/ ADAM D. CHIBIB Adam D. Chibib | Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | December 14, 2009 |
| /s/ MICHAEL J. MAPLES Michael J. Maples | Chairman of the Board and Director | December 14, 2009 |
| /s/ ROBERT D. REPASS Robert D. Repass | Director | December 14, 2009 |
| /s/ EMANUEL R. PEARLMAN Emanuel Pearlman | Director | December 14, 2009 |
| /s/ NEIL E. JENKINS Neil E. Jenkins | Director | December 14, 2009 |
| /s/ STEPHEN J. GREATHOUSE Stephen J. Greathouse | Director | December 14, 2009 |
| /s/ JUSTIN A. ORLANDO Justin A. Orlando | Director | December 14, 2009 |

EXHIBIT INDEX

| EXHIBIT NO. | TITLE | LOCATION |
|-------------|--|----------|
| 3.1 | Amended and Restated Articles of Incorporation | (1) |
| 3.2 | Amendment to Articles of Incorporation | (2) |
| 3.3 | Second Amended and Restated Bylaws, as Amended | (3) |
| 10.1 | 1996 Stock Incentive Plan, as Amended | (4) |
| 10.2 | 2000 Stock Option Plan | (4) |
| 10.3 | 2001 Stock Option Plan | (5) |
| 10.4 | 2002 Stock Option Plan | (6) |
| 10.5 | 2003 Outside Director Stock Option Plan | (7) |
| 10.6 | Ad Hoc Option Plan | (8) |
| 10.7 | 2008 Employment Inducement Award Plan | (3) |
| 10.8 | Form of Indemnification Agreement | (9) |
| 10.9 | Employment Agreement, dated as of June 15, 2008, between the Company and Anthony M. Sanfilippo | (10) |
| 10.10 | Stock Purchase Agreement, dated as of June 15, 2008, between the Company and Anthony M. Sanfilippo | (10) |
| 10.11 | First Amendment to Executive Employment Agreement, dated as of December 31, 2008, between the Company and Anthony Sanfilippo | (11) |
| 10.12 | Employment Agreement, dated as of July 28, 2008, between the Company and Virginia E. Shanks | (*) |
| 10.13 | First Amendment to Executive Employment Agreement, dated as of December 31, 2008, between the Company and Virginia E. Shanks | (11) |
| 10.14 | Employment Agreement, dated as of August 16, 2008, between the Company and Uri L. Clinton | (*) |
| 10.15 | First Amendment to Executive Employment Agreement, dated as of December 31, 2008, between the Company and Uri L. Clinton | (11) |
| 10.16 | Employment Agreement, dated as of September 14, 2008, between the Company and Patrick J. Ramsey | (12) |
| 10.17 | First Amendment to Executive Employment Agreement, dated as of December 31, 2008, between the Company and Patrick J. Ramsey | (11) |
| 10.18 | Employment Agreement, dated as of February 10, 2009, between the Company and Adam D. Chibib | (13) |
| 10.19 | Revolving Credit Agreement, dated as of April 27, 2007, by and among MegaBingo, Inc. and MGAM Systems, Inc. and those Banks listed therein with Comerica Bank, as Agent | (14) |
| 10.20 | Amendment to Credit Agreement, dated as of October 26, 2007, by and among MGAM Systems, Inc., Megabingo, Inc., Comerica Bank, CIT Lending Services Corporation and the Banks party to Credit Agreement | (15) |
| 10.21 | Second Amendment to Credit Agreement, dated as of December 20, 2007, by and among MGAM Systems, Inc., Megabingo, Inc. and Comerica Bank | (16) |
| 10.22 | Third Amendment to Credit Agreement, dated as of July 22, 2009, by and among MGAM Systems, Inc., Megabingo, Inc. and Comerica Bank | (17) |
| 10.23 | Settlement Agreement, effective as of May 1, 2009, by and among the Company, Diamond Game Enterprises, Inc., and those parties listed therein | (18) |
| 21.1 | Subsidiaries of registrant | (*) |
| 23.1 | Consent of BDO Seidman, LLP | (*) |
| 31.1 | Certification of the Principle Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | (*) |

| | | |
|------|--|-----|
| 31.2 | Certification of the Principle Accounting Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | (*) |
| 32.1 | Certification of the Chief Executive Officer and Chief Financial Officer, Pursuant to U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | (*) |

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- (1) Incorporated by reference to our Form 10-QSB for the quarter ended March 31, 1997, as filed with the Securities and Exchange Commission, or SEC, on May 15, 1997.
 - (2) Incorporated by reference to our Form 10-Q for the quarter ended December 31, 2003, as filed with the SEC on February 17, 2004.
 - (3) Incorporated by reference to our Form 10-K for the fiscal year ended September 30, 2008, as filed with the SEC on December 15, 2008.
 - (4) Incorporated by reference to our Registration Statement on Form S-8, as filed with the SEC on December 1, 2000.
 - (5) Incorporated by reference to our Registration Statement on Form S-8, as filed with the SEC on October 18, 2002.
 - (6) Incorporated by reference to our Form 10-Q for the quarter ended March 31, 2003, as filed with the SEC on May 15, 2003.
 - (7) Incorporated by reference to Appendix B of our Definitive Proxy Statement on Schedule 14A, as filed with the SEC on January 6, 2004.
 - (8) Incorporated by reference to our Registration Statement on Form S-8, as filed with the SEC on October 18, 2002.
 - (9) Incorporated by reference to our Form 8-K, as filed with the SEC on June 4, 2008.
 - (10) Incorporated by reference to our Form 8-K, as filed with the SEC on June 18, 2008.
 - (11) Incorporated by reference to our Form 10-Q for the quarter ended December 31, 2009, as filed with the SEC on February 9, 2009.
 - (12) Incorporated by reference to our Form 8-K, as filed with the SEC on September 17, 2008.
 - (13) Incorporated by reference to our Form 8-K, as filed with the SEC on February 2, 2009.
 - (14) Incorporated by reference to our Form 8-K, as filed with the SEC on May 3, 2007.
 - (15) Incorporated by reference to our Form 8-K, as filed with the SEC on November 1, 2007.
 - (16) Incorporated by reference to our Form 8-K, as filed with the SEC on December 27, 2007.
 - (17) Incorporated by reference to our Form 8-K, as filed with the SEC on July 23, 2009, and as amended by our Form 8-K/A as filed with the SEC on September 29, 2009.
 - (18) Incorporated by reference to our Form 10-Q/A for the fiscal quarter ended June 30, 2009, as filed with the SEC on September 29, 2009.
 - (*) Filed herewith.