DYNEGY INC /IL/
Form 10-Q
November 08, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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

For the transition period from ______ to ______

Commission file number: 1-15659

DYNEGY INC.

(Exact name of registrant as specified in its charter)

Illinois	**74-2928353**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

1000 Louisiana, Suite 5800

Houston, Texas 77002

(Address of principal executive offices)

(Zip Code)

(713) 507-6400

(Registrant s telephone number, including area code)

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: Class A common stock, no par value per share, 401,197,702 shares outstanding as of November 3, 2006; Class B common stock, no par value per share, 96,891,014 shares outstanding as of November 3, 2006.

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DEFINITIONS

As used in this Form 10-Q, the abbreviations contained herein have the meanings set forth below. Additionally, the terms Dynegy, we, us, our and the Company refer to Dynegy Inc. and its subsidiaries, unless the context clearly indicates otherwise.

APB	Accounting Principles Board
APIC	Additional paid-in-capital
ARO	Asset retirement obligation
CDWR	California Department of Water Resources
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CFTC	Commodity Futures Trading Commission
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., our primary financing subsidiary
DMG	Dynegy Midwest Generation, Inc.
DMSLP	Dynegy Midstream Services Limited Partnership
DMT	Dynegy Marketing and Trade
DNE	Dynegy Northeast Generation, Inc.
DPM	Dynegy Power Marketing, Inc.
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
EITF	Emerging Issues Task Force
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
HSR	Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended
ICC	Illinois Commerce Commission
IGC	Illinova Generating Company
ISO	Independent System Operator
LNG	Liquefied natural gas
LSP	LS Power
LTIP	Long-term incentive plan
MISO	Midwest Independent Transmission System 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
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
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission

SFAS	Statement of Financial Accounting Standards
SPDES	State Pollutant Discharge Elimination System
SPN	Second Priority Senior Secured Notes
VaR	Value at Risk
VIE	Variable Interest Entity

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DYNEGY INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited) (in millions, except share data)

	September 30, 2006	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 388	$ 1,549
Restricted cash	277	397
Accounts receivable, net of allowance for doubtful accounts of $70 and $103, respectively	284	611
Accounts receivable, affiliates	1	29
Inventory	197	214
Assets from risk-management activities	343	665
Deferred income taxes	26	14
Prepayments and other current assets	99	227
Assets held for sale (Note 3)	1	
Total Current Assets	1,616	3,706
Property, Plant and Equipment	6,422	6,515
Accumulated depreciation	(1,417)	(1,192)
Property, Plant and Equipment, Net	5,005	5,323
Other Assets		
Unconsolidated investments	7	270
Restricted investments	82	85
Assets from risk-management activities	103	165
Intangible assets	362	392
Deferred income taxes	3	3
Other long-term assets	135	182
Assets held for sale (Note 3)	194	
Total Assets	$ 7,507	$ 10,126
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 215	$ 504
Accounts payable, affiliates		46
Accrued interest	91	159
Accrued liabilities and other current liabilities	194	649
Liabilities from risk-management activities	339	687
Liabilities held for sale (Note 3)	1	
Notes payable and current portion of long-term debt	48	71
Total Current Liabilities	888	2,116
Long-term debt	3,162	4,028
Long-term debt, affiliates	200	200
Long-Term Debt	3,362	4,228
Other Liabilities		

Liabilities from risk-management activities	112	255
Deferred income taxes	440	558
Other long-term liabilities	391	429
Total Liabilities	5,193	7,586
Commitments and Contingencies (Note 10)		
Redeemable Preferred Securities, redemption value of $400 at December 31, 2005		400
Stockholders Equity		
Class A Common Stock, no par value, 900,000,000 shares authorized at September 30, 2006 and December 31, 2005; 402,895,968 and 305,129,052 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	3,366	2,949
Class B Common Stock, no par value, 360,000,000 shares authorized at September 30, 2006 and December 31, 2005; 96,891,014 shares issued and outstanding at September 30, 2006 and December 31, 2005	1,006	1,006
Additional paid-in capital	37	51
Subscriptions receivable	(8)	(8)
Accumulated other comprehensive income, net of tax	59	4
Accumulated deficit	(2,077)	(1,793)
Treasury stock, at cost, 1,786,224 shares at September 30, 2006 and 1,714,026 shares at December 31, 2005	(69)	(69)
Total Stockholders Equity	2,314	2,140
Total Liabilities and Stockholders Equity	$ 7,507	$ 10,126

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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues	$ 581	$ 770	$ 1,620	$ 1,691
Cost of sales, exclusive of depreciation shown separately below	(387)	(572)	(1,103)	(1,482)
Depreciation and amortization expense	(57)	(56)	(174)	(165)
Impairment and other charges	(96)		(107)	(6)
Gain (loss) on sale of assets, net		(1)	3	(1)
General and administrative expenses	(59)	(76)	(160)	(421)
Operating income (loss)	(18)	65	79	(384)
Earnings from unconsolidated investments	4	7	6	14
Interest expense	(105)	(99)	(310)	(284)
Debt conversion costs	(2)		(249)	
Other income and expense, net	11		41	9
Loss from continuing operations before income taxes	(110)	(27)	(433)	(645)
Income tax benefit (Note 13)	39	13	154	228
Loss from continuing operations	(71)	(14)	(279)	(417)
Income from discontinued operations, net of tax benefit (expense) of $(6), $(26), $(5) and $54, respectively (Notes 3 and 13)	2	43	3	209
Income (loss) before cumulative effect of change in accounting principle	(69)	29	(276)	(208)
Cumulative effect of change in accounting principle, net of tax expense of zero			1	
Net income (loss)	(69)	29	(275)	(208)
Less: preferred stock dividends		6	9	17
Net income (loss) applicable to common stockholders	$ (69)	$ 23	$ (284)	$ (225)
Earnings (Loss) Per Share (Note 9):				
Basic earnings (loss) per share:				
Loss from continuing operations	$ (0.14)	$ (0.05)	$ (0.65)	$ (1.13)
Income from discontinued operations		0.11	0.01	0.54
Cumulative effect of change in accounting principle				
Basic earnings (loss) per share	$ (0.14)	$ 0.06	$ (0.64)	$ (0.59)
Diluted earnings (loss) per share:				
Loss from continuing operations	$ (0.14)	$ (0.05)	$ (0.65)	$ (1.13)
Income from discontinued operations		0.11	0.01	0.54
Cumulative effect of change in accounting principle				
Diluted earnings (loss) per share	$ (0.14)	$ 0.06	$ (0.64)	$ (0.59)
Basic shares outstanding	495	390	446	383

Diluted shares outstanding	497	516	512	509

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,	
	2006	**2005**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (275)	$ (208)
Adjustments to reconcile net loss to net cash flows from operating activities:		
Depreciation and amortization	206	207
Impairment and other charges	107	(1)
(Earnings) losses from unconsolidated investments, net of cash distributions	(6)	47
Risk-management activities	(70)	(11)
Gain on sale of assets, net	(3)	(9)
Deferred income taxes	(147)	(284)
Cumulative effect of change in accounting principle, net of tax (Note 1)	(1)	
Legal and settlement charges	14	110
Independence toll settlement costs		169
Sithe Subordinated Debt exchange charge	36	
Debt conversion costs	249	
Other	39	11
Changes in working capital:		
Accounts receivable	353	(199)
Inventory	12	(9)
Prepayments and other assets	119	101
Accounts payable and accrued liabilities	(817)	(113)
Changes in non-current assets	11	(4)
Changes in non-current liabilities	(7)	15
Net cash used in operating activities	(180)	(178)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(92)	(132)
Proceeds from asset sales, net	18	106
Business acquisitions, net of cash acquired		(120)
Proceeds from exchange of unconsolidated investments, net of cash acquired (Note 2 and Note 3)	165	
Decrease (increase) in restricted cash and restricted investments	125	(26)
Other investing	(3)	
Net cash provided by (used in) investing activities	213	(172)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term borrowings, net	1,071	
Repayments of long-term borrowings	(1,780)	(40)
Debt conversion costs	(249)	
Redemption of Series C Preferred (Note 8)	(400)	
Proceeds from issuance of capital stock	183	2
Dividends and other distributions, net	(17)	(22)
Other financing, net	(2)	(13)
Net cash used in financing activities	(1,194)	(73)

Net decrease in cash and cash equivalents	(1,161)	(423)
Cash and cash equivalents, beginning of period	1,549	628
Less: Cash classified as held for sale at end of period (Note 3)		(18)
Cash and cash equivalents, end of period	$ 388	$ 187
Other non-cash financing activity:		
Conversion of Convertible Subordinated Debentures due 2023 (Note 7)	$ 225	$
Sithe Subordinated Debt exchange, net (Note 7)	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,	
	2006	2005
Net income (loss)	$ (69)	$ 29
Cash flow hedging activities, net:		
Unrealized mark-to-market gains (losses) arising during period, net	38	(60)
Reclassification of mark-to-market losses to earnings, net	2	50
Changes in cash flow hedging activities, net (net of tax benefit (expense) of ($23) and $5, respectively)	40	(10)
Foreign currency translation adjustments	(1)	5
Other comprehensive income (loss), net of tax	39	(5)
Comprehensive income (loss)	$ (30)	$ 24

	Nine Months Ended September 30,	
	2006	2005
Net loss	$ (275)	$ (208)
Cash flow hedging activities, net:		
Unrealized mark-to-market gains (losses) arising during period, net	63	(81)
Reclassification of mark-to-market (gains) losses to earnings, net	(10)	61
Changes in cash flow hedging activities, net (net of tax benefit (expense) of ($31) and $12, respectively)	53	(20)
Foreign currency translation adjustments	2	5
Other comprehensive income (loss), net of tax	55	(15)
Comprehensive loss	$ (220)	$ (223)

See the notes to condensed consolidated financial statements.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Note 1 Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to interim financial reporting as prescribed by the SEC. The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. These interim financial statements should be read together with the consolidated financial statements and notes thereto included in our Form 10-K for the year ended December 31, 2005, which we refer to as our Form 10-K, and our Form 10-K for the year ended December 31, 2005, as amended on May 1, 2006, which we refer to as our Form 10-K/A.

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 (1) developing fair value assumptions, including estimates of future cash flows and discount rates, (2) analyzing tangible and intangible assets for possible impairment, (3) estimating the useful lives of our assets, (4) assessing future tax exposure and the realization of tax assets, (5) determining amounts to accrue for contingencies, guarantees and indemnifications and (6) 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.

Asset Retirement Obligations. At December 31, 2005, our ARO liabilities were $48 million for our GEN-MW segment and $8 million for our GEN-NE segment. These AROs related to activities such as ash pond and landfill capping, dismantlement of power generation facilities, closure and post-closure costs, environmental testing, remediation, monitoring and land and equipment lease obligations. We continue to follow the provisions for disclosure and accounting for these AROs under SFAS No. 143, Asset Retirement Obligations. During the three and nine months ended September 30, 2006, we recorded additional AROs of zero and $5 million, respectively, no material AROs were settled, and revisions to estimated cash flows were not material. During the three and nine months ended September 30, 2006, our accretion expenses were approximately $2 million and $5 million, respectively, which are included in cost of sales on our unaudited condensed consolidated statements of operations. During the three and nine months ended September 30, 2005, there were no material additional AROs recorded or settled, and our accretion expenses and revisions to estimated cash flows were not material. At September 30, 2006, our ARO liabilities were $52 million for our GEN-MW segment and $14 million for our GEN-NE segment.

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Accounting Principles Adopted

SFAS No. 123(R). In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation, and provides alternative methods of transition (prospective, modified prospective or retroactive) for entities that voluntarily change to the fair value-based method of accounting for stock-based employee compensation in a fiscal year beginning before December 16, 2003. SFAS No. 148 requires prominent disclosure about the effects on reported net income of an entity s accounting policy decisions with respect to stock-based employee compensation. We transitioned to a fair value-based method of accounting for stock-based compensation in the first quarter 2003 and used the prospective method of transition as described under SFAS No. 148.

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which revises SFAS No. 123. SFAS No. 123(R) requires all companies to expense the fair value of employee stock options and other forms of stock-based compensation. We adopted SFAS No. 123(R) effective January 1, 2006, using the modified prospective transition method permitted under this pronouncement. Our cumulative effect of implementing this standard, which consists entirely of a forfeiture adjustment recorded in the first quarter 2006, was less than $1 million after tax. The application of SFAS 123(R) had no material impact on the unaudited condensed consolidated statements of cash flows and basic and diluted loss per share for the three and nine months ended September 30, 2006, compared to amounts that would have been reported pursuant to our previous accounting.

In November 2005, the FASB issued FSP No. 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards. We have adopted the short-cut method to calculate the beginning balance of the APIC pool of the excess tax benefit, and to determine the subsequent impact on the APIC pool and unaudited condensed consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that were outstanding upon our adoption of FAS 123(R). Utilizing the short-cut method, we have determined that we have a Pool of Windfall tax benefits that can be utilized to offset future shortfalls that may be incurred.

Under SFAS No. 148 s prospective method of transition, all stock options granted after January 1, 2003 are accounted for on a fair value basis. Options granted prior to January 1, 2003 continue to be accounted for using the intrinsic value method. Accordingly, for options granted prior to January 1, 2003, compensation expense is not reflected for employee stock options unless they were granted at an exercise price lower than market value on the grant date. We have granted in-the-money options in the past and have recognized compensation expense over the applicable vesting periods. No in-the-money stock options have been granted since 1999.

Had compensation cost for all stock options granted prior to 2003 been determined on a fair value basis consistent with SFAS No. 123(R), our net loss and basic and diluted loss per share amounts would not have been impacted for the three and nine months ended September 30, 2006 and 2005, respectively.

Please read Note 12 Employee Compensation, Savings and Pension Plans for further discussion of our share-based compensation.

SFAS No. 154. In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The provisions of SFAS No. 154 are effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The adoption of this standard on January 1, 2006 did not have a material effect on our results of operations, financial position or cash flows.

Accounting Principles Not Yet Adopted

FIN No. 48. On July 12, 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of an income tax position taken or expected to be taken in an income tax return. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of this statement on our financial statements.

SFAS No. 157. On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements. Accordingly, SFAS No. 157 does not require any new fair value measurements; however for some entities the application of SFAS No. 157 will change current practice. 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. 158. On September 29, 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132 (R). SFAS No. 158 requires employers to recognize the overfunded or underfunded status of a defined benefit or other postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position, and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. In addition, SFAS No. 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The provisions of SFAS 158 are effective for fiscal years ending after December 15, 2006 for employers with publicly traded equity securities and retrospective application is not permitted. The disclosure and recognition provisions are required to be adopted as of December 31, 2006. We are currently evaluating the impact of this statement on our financial statements. We estimate our pre-tax cumulative effect of implementing this standard, which will be reflected as a reduction to the ending balance of accumulated other comprehensive income, will be approximately $65 million upon adoption at December 31, 2006.

SAB 108. On September 13, 2006, the SEC released SAB 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 states that a registrant s materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure. SAB 108 also states that registrants electing not to restate prior periods should reflect the effects of initially applying SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. We do not believe the impact of this SAB will have a material effect on our results of operations, financial position or cash flows.

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Note 2 Business Combinations

LS Power. On September 14, 2006, we entered into a Plan of Merger, Contribution and Sale Agreement (the Merger Agreement) by and among Dynegy Inc., Dynegy Acquisition, Inc., a Delaware corporation (New Dynegy), Falcon Merger Sub Co., an Illinois corporation and a wholly owned subsidiary of New Dynegy (Merger Sub), LSP Gen Investors, L.P., LS Power Partners, L.P., LS Power Equity Partners PIE I, L.P., LS Power Associates, L.P., and LS Power Equity Partners, L.P. (collectively, the LS Entities), pursuant to which Merger Sub will be merged with and into us, as a result of which we and DHI will become wholly-owned subsidiaries of New Dynegy.

We will combine our current assets and operations with the LS Entities generation portfolio, and will acquire a 50 percent ownership interest in a development company that is currently controlled by the LS Entities. In the merger, each share of our Class A Common Stock and our Class B Common Stock will be converted into the right to receive one share of New Dynegy Class A Common Stock, par value $0.01 per share (New Dynegy Class A Common Stock).

In the transaction, the LS Entities will contribute certain interests in power generation assets to New Dynegy in exchange for (i) 340 million shares of New Dynegy Class B Common Stock, par value $0.01 per share (New Dynegy Class B Common Stock and, together with New Dynegy Class A Common Stock, the New Dynegy Common Stock), (ii) $100 million in cash and (iii) $275 million in aggregate principal amount of notes to be issued by New Dynegy.

Under the terms of the Merger Agreement, we and the LS Entities agreed not to (i) solicit proposals relating to alternative business combination transactions or (ii) subject to certain exceptions, enter into discussions or an agreement concerning or provide confidential information in connection with any proposals for alternative business combination transactions. The Merger Agreement provides certain termination rights to both us and the LS Entities, and further provides that, upon termination of the Merger Agreement under certain circumstances, (i) we may be required to pay the LS Entities or (ii) the LS Entities may be required to pay us, an aggregate termination fee of $100 million, as described in the Merger Agreement. The affirmative vote of two-thirds of the (i) issued and outstanding shares of our Class A Common Stock voting as a class, (ii) issued and outstanding shares of our Class B Common Stock voting as a class and (iii) issued and outstanding shares of our Common Stock voting together as a class is required to approve the merger. The consummation of the merger is subject to various other conditions, including: (i) the expiration or termination of applicable waiting periods under the HSR, (ii) approval from the FERC, (iii) registration of the shares of New Dynegy Class A Common Stock to be issued to our shareholders in the merger under the Securities Act of 1933, as amended (the Securities Act), (iv) approval from the New York State Public Service Commission and (v) satisfaction of certain other conditions. Assuming all necessary conditions are satisfied, which cannot be guaranteed, the transaction is expected to close in early 2007.

On September 14, 2006, the LS Entities and Kendall Power LLC (Kendall Power), a newly formed wholly owned subsidiary of Dynegy, entered into a Limited Liability Company Membership Interests and Stock Purchase Agreement (the Kendall Agreement) pursuant to which Kendall Power agreed to acquire all of the outstanding interests in LSP Kendall Holdings, LLC for $200 million in cash, as adjusted for certain changes in working capital. The closing of the Kendall Agreement will occur only if closing does not occur with respect to the transactions contemplated by the Merger Agreement. We have agreed to guarantee certain of Kendall Power s obligations under the Kendall Agreement. The consummation of the Kendall Agreement is subject to various conditions, including: (i) the termination of the Merger Agreement; (ii) the expiration or termination of applicable waiting periods under

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

the HSR; and (iii) satisfaction of certain other conditions. Please read Note 10 Commitments and Contingencies Guarantees and Indemnifications Kendall Guarantee for further discussion.

Rocky Road. On March 31, 2006, contemporaneous with our sale of our interest in WCP (Generation) Holdings LLC (West Coast Power) (please read Note 3 Dispositions, Contract Terminations and Discontinued Operations Dispositions and Contract Terminations West Coast Power), we completed our acquisition of NRG s 50% ownership interest in Rocky Road Power, LLC (Rocky Road), the entity that owns the Rocky Road power plant, a 364-megawatt natural gas-fired peaking facility near Chicago (of which we already owned 50%), for net proceeds of $165 million, net of cash acquired. As a result of the transaction, we became the primary beneficiary of the entity as provided under the guidance in FIN No. 46(R), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 and thus consolidated the assets and liabilities of the entity at March 31, 2006. Please read Note 6 Unconsolidated Investments Variable Interest Entities for further discussion.

Note 3 Dispositions, Contract Terminations and Discontinued Operations

Dispositions and Contract Terminations

Rockingham. On May 21, 2006, we entered into an agreement with Duke Energy Carolinas, LLC (a subsidiary of Duke Energy) for the sale of our Rockingham facility, a peaking facility in North Carolina, which is included in our GEN-SO segment, for $195 million in cash. The transaction is expected to close in the fourth quarter 2006, subject to obtaining certain regulatory approvals and satisfaction of customary closing conditions. A portion of the proceeds from the sale will be used to repay our borrowings under the $150 million Term Loan, with the remaining proceeds used as an additional source of liquidity. Please read Note 7 Debt Senior Secured Credit Facility for further discussion of the Term Loan.

Beginning in the second quarter 2006, Rockingham met the held for sale classification requirements of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and is classified as such on our unaudited condensed consolidated balance sheet. The major classes of current and long-term assets and liabilities classified as assets and liabilities held for sale at September 30, 2006 are $194 million of Property, Plant and Equipment, Net, $1 million of Inventory and $1 million of Accrued liabilities and other current liabilities.

SFAS No. 144 also requires that long-lived assets not be depreciated or amortized while they are classified as held for sale. As such, we discontinued depreciation and amortization of Rockingham's property, plant and equipment during the second quarter 2006. Depreciation and amortization expense related to Rockingham totaled zero and $2 million in the three- and nine-month periods ended September 30, 2006, compared to $1 million and $4 million in the three- and nine-month periods ended September 30, 2005. In addition, SFAS No. 144 requires a loss to be recognized if assets held for sale less liabilities held for sale are in excess of fair value less costs to sell. Accordingly, we recorded pre-tax impairments of zero and $9 million in the three and nine months ended September 30, 2006, respectively, which are included in Impairment and other charges on our unaudited condensed consolidated statements of operations.

West Coast Power. On March 31, 2006, contemporaneous with our purchase of Rocky Road (please read Note 2 Business Combinations Rocky Road), we completed our sale to NRG of our 50% ownership interest in West Coast Power, a joint venture between us and NRG which has ownership in the West Coast Power power plants in southern California totaling approximately 1,800 megawatts, for net proceeds of approximately $165 million, net of cash acquired. We did not recognize a material gain or loss on the sale. Pursuant to our divestiture of West

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Coast Power, we no longer maintain a significant variable interest in the entity as provided by the guidance in FIN No. 46(R). Please read Note 6 Unconsolidated Investments Variable Interest Entities for further discussion.

Sterlington Contract Termination. In December 2005, we entered into an agreement to terminate the Sterlington long-term wholesale power tolling contract with Quachita Power LLC (Quachita), a joint venture of GE Energy Financial Services and Cogentrix Energy, Inc. Under the terms of the agreement, we paid Quachita approximately $370 million in March 2006 to eliminate approximately $449 million in capacity payment obligations through 2012 and avoid approximately $295 million in additional capacity payment obligations that would arise if Quachita exercised its option to extend the contract through 2017. We recognized a pre-tax charge of approximately $364 million ($229 million after-tax) in the fourth quarter 2005 related to this transaction.

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. At closing, we received $2.35 billion in cash proceeds. As of September 30, 2006, we received a substantial majority of the balance of the sales proceeds from Targa, which represented our cash collateral related to DMSLP. Targa assumed responsibility for approximately $47 million in letters of credit provided by us for the benefit of DMSLP, and those letters of credit were all replaced by December 31, 2005.

Pursuant to SFAS No. 144, we are reporting the results of NGL s operations as a discontinued operation. Accordingly, the results of operations of our NGL segment have been included in discontinued operations for all periods presented. EITF Issue 87-24, Allocation of Interest to Discontinued Operations, requires that interest expense on debt that was required to be repaid upon the sale of DMSLP should be reclassified to discontinued operations. Therefore, interest expense on our former term loan and our former generation facility debt was allocated to discontinued operations, as the respective debt instruments were paid upon the sale of DMSLP. Such interest expense, inclusive of amortization of debt issuance costs, totaled zero and $15 million for the three months ended September 30, 2006 and 2005, respectively, and zero and $40 million for the nine months ended September 30, 2006 and 2005, respectively.

Additionally, results from NGL s operations include revenues and cost of sales arising from intersegment transactions, which ceased after the sale of DMSLP. NGL processed natural gas and sold this natural gas to CRM for resale to third parties. NGL also purchased natural gas from CRM and electricity from GEN. As the intersegment revenues and cost of sales included in NGL s results were reclassified to discontinued operations, the effects of these intersegment transactions eliminated in consolidation, including the ultimate third-party settlement, previously recorded in other segments, were also reclassified to discontinued operations.

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

The following table summarizes information related to all of our discontinued operations, including the NGL operations discussed above:

	U.K. CRM	DGC	NGL	Total
		(in millions)		
Three Months Ended September 30, 2006				
Income from operations before taxes	$ 6	$	$ 2	$ 8
Income (loss) from operations after taxes	(2)		4	2
Three Months Ended September 30, 2005				
Revenues	$	$	$ 1,193	$ 1,193
Income (loss) from operations before taxes	(2)		71	69
Income (loss) from operations after taxes	(4)	(2)	49	43

	U.K. CRM	DGC	NGL	Total
		(in millions)		
Nine Months Ended September 30, 2006				
Income from operations before taxes	$ 5	$	$ 3	$ 8
Income (loss) from operations after taxes	(1)		4	3
Nine Months Ended September 30, 2005				
Revenues	$	$	$ 3,172	$ 3,172
Income from operations before taxes	3		152	155
Income (loss) from operations after taxes	(1)		210	209

In the three and nine months ended September 30, 2006, we recognized approximately $6 million of pre-tax income associated with a receivable previously reserved that is now expected to be collected. In the nine months ended September 30, 2005, we recognized $3 million of pre-tax income primarily associated with U.K. CRM s receipt of a third party bankruptcy settlement.

Note 4 Restructuring and Impairment Charges

Asset Impairment. At September 30, 2006, we tested the Bluegrass generation facility for impairment based on the FERC's recent approval and Louisville Gas and Electric s (LG&E) completion of various compliance steps to allow it to withdraw from participation in the MISO market as of September 1, 2006. The Bluegrass facility has historically sold power into the MISO market through transmission provided by LG&E. This change will limit our ability or increase the cost to deliver power to the MISO market. After testing, we recorded a pre-tax impairment charge of $96 million ($61 million after-tax) in the GEN-MW segment. This charge is included in impairment and other charges in our unaudited condensed consolidated statement of operations. We determined the fair value of the facility using the expected present value technique.

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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 our Other segment, of $11 million in the fourth quarter 2005. We recognized approximately zero and $2 million of charges in the three and nine months ended September 30, 2006, respectively, when transitional services were completed by certain affected employees. These charges related entirely to severance costs.

The following is a schedule of 2006 activity for the severance liabilities recorded in connection with this restructuring (in millions):

Balance at December 31, 2005	$ 9
2006 adjustments to liability	2
Cash payments	(11)
Balance at September 30, 2006	$

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 2006 activity for the liabilities recorded in connection with this restructuring:

	Severance	Cancellation Fees and Operating Leases	Total
		(in millions)	
Balance at December 31, 2005	$ 3	$ 16	$ 19
Cash payments		(7)	(7)
Balance at September 30, 2006	$ 3	$ 9	$ 12

Including the $2 million accrual for operating leases made in connection with the sale of DMSLP (for further information, please read Note 3 Dispositions, Contract Terminations and Discontinued Operations Discontinued Operations Natural Gas Liquids), we have an aggregate accrual of $11 million as of September 30, 2006, associated with operating leases. We expect this amount to be paid by the end of 2007, when the leases expire.

Note 5 Risk Management Activities and Accumulated Other Comprehensive Income

The nature of our business 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 page F-32 of our Form 10-K/A.

Cash Flow Hedges. We enter into financial derivative instruments that qualify and are designated as cash flow hedges. Instruments related to our GEN business are entered into for purposes of hedging future fuel requirements and sales commitments and locking in commodity prices we consider favorable under the circumstances. Interest rate swaps have been used to convert floating interest-rate obligations to fixed-rate obligations.

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During the three and nine months ended September 30, 2006, we recorded $3 million and $7 million, respectively, of income related to ineffectiveness from changes in 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, 2005, we recorded $10 million and $4 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, 2006 and 2005, no amounts were reclassified to earnings in connection with forecasted transactions that were probable of not occurring.

The balance in cash flow hedging activities, net at September 30, 2006, is expected to be reclassified to future earnings, contemporaneously with the related purchases of fuel, sales of electricity and payments of interest, as applicable to each type of hedge. Of this amount, after-tax gains of approximately $34 million are currently estimated to be reclassified into earnings over the 12-month period ending September 30, 2007. The actual amounts that will be reclassified to 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 are designated 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, 2006 and 2005, 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, 2006 and 2005, 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, 2006, we had no net investment hedges in place.

Accumulated Other Comprehensive Income. Accumulated other comprehensive income, net of tax, is included in stockholders equity on our unaudited condensed consolidated balance sheets as follows:

	September 30, 2006	December 31, 2005
	(in millions)	
Cash flow hedging activities, net	$ 51	$ (2)
Foreign currency translation adjustment	26	24
Minimum pension liability	(18)	(18)
Accumulated other comprehensive income, net of tax	$ 59	$ 4

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Note 6 Unconsolidated Investments

A summary of our unconsolidated investments is as follows:

	September 30, 2006	December 31, 2005
	(in millions)	
Equity affiliates:		
GEN MW	$	$ 60
GEN SO	7	210
Total unconsolidated investments	$ 7	$ 270

Summarized aggregate financial information for unconsolidated equity investments and our equity share thereof was:

	Three Months Ended September 30, 2006		2005	
	Total	Equity Share	Total	Equity Share
	(in millions)			
Revenues	$ 16	$ 8	$ 162	$ 70
Operating income	6	3	36	16
Net income	6	3	34	16

	Nine Months Ended September 30, 2006		2005	
	Total	Equity Share	Total	Equity Share
	(in millions)			
Revenues	$ 76	$ 38	$ 510	$ 212
Operating income	16	8	64	27
Net income	13	6	63	27

Earnings from unconsolidated investments for the three months ended September 30, 2006 were $3 million. Earnings from unconsolidated investments of $16 million for the three months ended September 30, 2005 includes $1 million of earnings from NGL investments, which are included in income from discontinued operations on our unaudited condensed consolidated statements of operations. Earnings in 2005 were offset by an impairment of $8 million in our investment in West Coast Power.

Earnings from unconsolidated investments of $6 million for the nine months ended September 30, 2006, were offset by a $1 million impairment of our investment in Panama. Earnings from unconsolidated investments of $27 million for the nine months ended September 30, 2005, includes $5 million of earnings from NGL investments which are included in income from discontinued operations on our unaudited condensed consolidated statements of operations. Earnings in 2005 were offset by an impairment of $8 million in our investment in West Coast Power.

On May 15, 2006, we sold our interests in our power generating facility located in Panama. Net proceeds associated with the sale were approximately $3 million, and we did not recognize a gain or loss on the sale.

On March 31, 2006, we completed the sale to NRG of our 50% ownership interest in our unconsolidated investment in West Coast Power as well as our acquisition of NRG s ownership interest in Rocky Road. As a result

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of the transactions, we received cash proceeds of approximately $165 million, net of cash acquired, from NRG. Under the terms of this agreement, we did not recognize a material gain or loss on the sale of West Coast Power. For further discussion, please read Note 2 Business Combinations Rocky Road and Note 3 Dispositions, Contract Terminations and Discontinued Operations Dispositions and Contract Terminations West Coast Power.

Variable Interest Entities. In conjunction with our prior adoption of FIN No. 46(R), Rocky Road LLC was identified as a variable interest entity. At the time of adoption, we were not the primary beneficiary of, and therefore did not consolidate Rocky Road. We did not absorb a majority of the entity s expected losses, nor receive a majority of the expected residual returns.

On March 31, 2006, we completed our acquisition of NRG s 50% ownership interest in Rocky Road and the sale to NRG of our 50% ownership interest in West Coast Power. We paid approximately $45 million for NRG s ownership interest in Rocky Road, including $5 million of cash on hand, and received approximately $205 million for our ownership interest in West Coast Power, resulting in the receipt of proceeds of approximately $165 million, net of cash acquired, from NRG. As we now own 100% of the outstanding equity interests in Rocky Road, we are subjected to a majority of the entity s expected losses and expected residual returns, and are therefore considered the primary beneficiary of the entity. Thus, we consolidated the assets and liabilities of the entity at March 31, 2006, in accordance with the guidance provided in FIN No. 46(R), which requires that the assets and liabilities of the newly consolidated entity be measured and recorded at their fair values on the date we became the primary beneficiary. Those assets and liabilities primarily consisted of $9 million of working capital, a $29 million intangible asset related to a contract to provide capacity and energy, and $50 million of property, plant, and equipment at the facility s location.

In conjunction with acquiring the remaining outstanding equity interest in Rocky Road, we divested our interest in West Coast Power. Based on that transaction, we no longer maintain a variable interest in West Coast Power. For further discussion, please read Note 2 Business Combinations Rocky Road and Note 3 Dispositions, Contract Terminations and Discontinued Operations Dispositions and Contract Terminations West Coast Power.

On January 31, 2005, we completed the acquisition of ExRes SHC, Inc., the parent company of Sithe Energies, Inc., which we refer to as Sithe Energies, and Sithe/Independence Power Partners, L.P., which we refer to as Independence. ExRes SHC, Inc., which we refer to as ExRes, 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, which we refer to as 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 certain 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. Exelon is not required to reimburse ExRes and the entities owning these facilities for lease payments or other costs not incurred in the ordinary course of business. 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).

These hydroelectric generation facilities have commitments and obligations that are off-balance sheet with respect to Dynegy arising under operating leases for equipment and long-term power purchase agreements with local utilities. As of September 30, 2006, the equipment leases have remaining terms from one to fifteen years and involve a maximum aggregate obligation of $120 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, which we refer to as a Tracking Account, was established to quantify the

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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. Two of the 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 remaining two facilities are anticipated to begin reducing the Tracking Accounts in 2006. The aggregate balance of the Tracking Accounts as of September 30, 2006, was approximately $309 million, and the obligations with respect to each Tracking Account are secured by the assets of the respective facility. 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.

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Note 7 Debt

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

	September 30, 2006	December 31, 2005
	(in millions)	
Dynegy Holdings Inc.		
Term Loan, floating rate due 2012	$ 150	$
Term Facility, floating rate due 2012	200	
Senior Notes, 7.45% due 2006		22
Senior Notes, 6.875% due 2011	494	499
Senior Notes, 8.75% due 2012	488	491
Senior Unsecured Notes, 8.375% due 2016	1,047	
Senior Debentures, 7.125% due 2018	173	175
Senior Debentures, 7.625% due 2026	173	174
Second Priority Senior Secured Notes, floating rate due 2008		225
Second Priority Senior Secured Notes, 9.875% due 2010	11	625
Second Priority Senior Secured Notes, 10.125% due 2013		900
Subordinated Debentures payable to affiliates, 8.316%, due 2027	200	200
Sithe Energies		
Subordinated Debt, 7.0% due 2034		419
Senior Notes, 8.5% due 2007	39	57
Senior Notes, 9.0% due 2013	409	409
Dynegy Inc.		
Convertible Subordinated Debentures, 4.75% due 2023		225
	3,384	4,421
Unamortized premium (discount) on debt, net	26	(122)
	3,410	4,299
Less: Amounts due within one year, including non-cash amortization of basis adjustments	48	71
Total Long-Term Debt	$ 3,362	$ 4,228

Aggregate debt maturities for the remainder of 2006, the next four years and thereafter of the principal amounts of all long-term indebtedness as of September 30, 2006 are as follows:

	Total	2006	2007	2008	2009	2010	Thereafter
				(in millions)			

Dynegy Holdings Inc.	$ 2,929	$ 2	$	$	$	$ 11	$ 2,916
Sithe Energies	481	22	44	44	57	62	252
Total	$ 3,410	$ 24	$ 44	$ 44	$ 57	$ 73	$ 3,168

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Senior Secured Credit Facility. On April 19, 2006, we entered into a fourth amended and restated credit agreement (the Fourth Senior Secured 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, Citigroup Global Markets Inc. and JPMorgan Securities Inc., as joint lead arrangers, and the other financial institutions parties thereto as lenders. The Fourth Senior Secured Credit Facility amends our former credit facility (last amended on March 6, 2006) by increasing the amount of the existing $400 million revolving credit facility to $470 million and adding a $200 million term letter of credit facility. The revolving facility, which is currently undrawn, is available for general corporate purposes and for letters of credit. The term facility has been fully drawn and the proceeds placed in a collateral account to support the issuance of letters of credit. Letters of credit issued under the former credit facility were continued under the Fourth Senior Secured Credit Facility.

The Fourth Senior Secured Credit Facility is secured by substantially all of the assets of DHI, as borrower, and certain of its subsidiaries, as subsidiary guarantors, and certain of our assets, as parent guarantor. The revolving credit facility portion of the Fourth Senior Secured Credit Facility matures April 19, 2009 and the term letter of credit portion matures on January 31, 2012. Borrowings for both the revolving and term portions under the Fourth Senior Secured Credit Facility bear interest at the relevant Eurodollar rate plus a ratings-based margin of 175 basis points or the relevant base rate plus a ratings-based margin of 75 basis points. Letters of credit can be issued under the revolving portion of the facility at a ratings-based rate of 175 basis points. An unused commitment fee of 50 basis points is payable on the unused portion of the revolving credit facility. The margin payable for borrowing, the rate payable for letters of credit and the unused commitment fee will decrease upon meeting specified improvements in Standard and Poor s and Moody s credit ratings for the facility.

The Fourth Senior Secured Credit Facility contains mandatory prepayment provisions associated with specified asset sales and dispositions (including as a result of casualty or condemnation) and the receipt of proceeds by DHI and certain of its subsidiaries of any permitted additional non-recourse indebtedness. Commencing in 2008 with respect to the fiscal year ending December 31, 2007, each year DHI will be required to apply toward the prepayment of the loans and the permanent reduction of the commitments under the revolving credit facility (or post cash collateral in lieu thereof) a portion of its excess cash flow as calculated under the Fourth Senior Secured Credit Facility for the prior fiscal year. This portion will be 50% initially and will fall to 25% when and if DHI s leverage ratio is less than or equal to 3.50:1.00.

The Fourth Senior Secured Credit Facility 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 capital expenditures and limitations on dividends and other payments in respect of capital stock. The Fourth Senior Secured Credit Facility also contains certain financial covenants, including (1) a covenant (measured at the last day of the fiscal quarter as specified below) that requires DHI and certain of its subsidiaries to maintain a ratio of secured debt to adjusted EBITDA no greater than 3.5:1 (September 30, 2006); 3.0:1 (December 31, 2006); 2.75:1 (March 31, 2007); 2.5:1 (June 30, 2007); 2.25:1 (September 30, 2007) and 2.0:1 (December 31, 2007 and thereafter) and (2) a covenant that requires DHI and certain of its subsidiaries to maintain an interest coverage ratio as of the last day of the measurement periods ending September 30, 2006 of no less than 1.4:1; ending December 31, 2006 of no less than 1.50:1; ending March 31, June 30, September 30 and December 31, 2007 and March 31, 2008 of no less than 1.625:1, and ending June 30, 2008 and thereafter of no less than 1.75:1. We are in compliance with these covenants as of September 30, 2006.

On May 26, 2006, we closed a $150 million term loan (the Term Loan), of which $50 million was used to make a one-time cash dividend from DHI to Dynegy (the DHI Dividend) and the remainder used for working capital and general corporate purposes (please read Note 8 Related Party Transaction Series C Convertible

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Preferred Stock). The Term Loan, which will be repaid with proceeds from the sale of Rockingham, was structured as a new tranche under the Fourth Senior Secured Credit Facility. The Term Loan will mature on the earlier of five business days after the consummation of the pending sale of the Rockingham facility or January 31, 2012. Please read Note 3 Dispositions, Contract Terminations and Discontinued Operations Dispositions and Contract Terminations Rockingham for further discussion of the sale.

Second Priority Senior Secured Notes. On April 12, 2006, we completed a cash tender offer and consent solicitation (the SPN Tender Offer), in which we purchased $151 million of our $225 million Second Priority Senior Secured Floating Rate Notes due 2008 (the 2008 Notes), $614 million of our $625 million 9.875% Second Priority Senior Secured Notes due 2010 (the 2010 Notes) and all $900 million of our 10.125% Second Priority Senior Secured Notes due 2013 (the 2013 Notes and collectively with the 2008 Notes and the 2010 Notes, the Second Priority Notes). In connection with the SPN Tender Offer, we amended the indenture under which the Second Priority Notes were issued to eliminate or modify substantially all of the restrictive covenants, certain events of default and related provisions and release certain liens securing the obligations of DHI and the guarantors of the Second Priority Notes.

Total cash paid to repurchase the $1,664 million of Second Priority Notes, including consent fees and accrued interest, was $1,904 million. We recorded a charge of approximately $228 million in the second quarter 2006 associated with this transaction, of which $202 million is included in debt conversion costs and $26 million of acceleration of amortization of financing costs and write-offs of discounts and premiums is included in interest expense on our unaudited condensed consolidated statements of operations.

On July 15, 2006, we redeemed the remaining $74 million of our 2008 Notes, at a redemption price of 103% of the principal amount, plus accrued and unpaid interest to the redemption date. The interest rate on the 2008 Notes was based on three-month LIBOR plus 650 basis points. We recorded a charge of approximately $2 million in the third quarter 2006 associated with this transaction, which is included in debt conversion costs on our unaudited condensed consolidated statements of operations. The remaining outstanding 2010 Notes are redeemable at our option on or after July 15, 2007 in accordance with the terms of the indenture governing the Second Priority Notes.

Senior Unsecured Notes. On April 12, 2006, DHI issued $750 million aggregate principal amount of our 8.375% Senior Unsecured Notes due 2016 (the New Senior Notes) in a private offering (the Senior Notes Offering). The New Senior Notes are not redeemable at our option prior to maturity. The New Senior Notes are our senior unsecured obligations and rank equal in right of payment to all of our existing and future senior unsecured indebtedness, and are senior to all of our existing and any of our future subordinated indebtedness. We have not guaranteed the New Senior Notes, and the assets and operations that we own through subsidiaries other than DHI (principally our Independence plant) do not support the New Senior Notes. The proceeds from the Senior Notes Offering, together with cash on hand, were used to fund the SPN Tender Offer discussed above. On September 14, 2006, DHI exchanged the New Senior Notes for a new issue of substantially identical notes registered under the Securities Act of 1933. Please read Senior Unsecured Notes Exchange Offer below for further information.

Convertible Subordinated Debentures due 2023. On May 15, 2006, we converted all $225 million of our outstanding 4.75% Convertible Subordinated Debentures due 2023 into shares of our Class A common stock (the Convertible Debenture Exchange). In this transaction, we issued an aggregate of 54,598,369 shares of our Class A common stock and paid the debenture holders an aggregate of approximately $47 million in premiums and accrued and unpaid interest using cash on hand. We recorded a charge of approximately $44 million in the second quarter 2006 associated with this transaction, which is included in debt conversion costs on our unaudited condensed consolidated statements of operations.

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Sithe Subordinated Debt Exchange. On July 21, 2006, DHI executed and consummated an exchange agreement (the Exchange Agreement), by and among DHI and RCP Debt, LLC and RCMF Debt, LLC (together, the Reservoir Entities). Pursuant to the Exchange Agreement, the Reservoir Entities exchanged approximately $419 million principal amount of the subordinated debt of Independence, together with all claims for accrued and unpaid interest thereon and all other rights and all obligations of the Reservoir Entities under the agreement pursuant to which the subordinated debt was issued (together, the Sithe Debt), for approximately $297 million principal amount of DHI s 8.375% Senior Unsecured Notes due 2016 (the Additional Notes). The Additional Notes have terms and conditions identical to, and are fungible for trading and other purposes with, the $750 million aggregate principal amount of the New Senior Notes issued on April 12, 2006. On September 14, 2006, DHI exchanged the Additional Notes for a new issue of substantially identical notes registered under the Securities Act of 1933. We recorded a charge of approximately $36 million in the third quarter of 2006 associated with this transaction, which is included in interest expense on our unaudited condensed consolidated statements of operations. Please read Senior Unsecured Notes Exchange Offer below for further information.

Senior Unsecured Notes Exchange Offer. On September 14, 2006, pursuant to the registration rights agreements pertaining to the New Senior Notes and the Additional Notes, we completed an exchange offer of $1,047 million aggregate principal amount of DHI s 8.375% Senior Unsecured Notes due 2016 registered under the Securities Act of 1933 for all $1,047 million aggregate principal amount of DHI s outstanding 8.375% Senior Unsecured Notes due 2016.

Note 8 Related Party Transaction

Series C Convertible Preferred Stock. As discussed in Note 15 Redeemable Preferred Securities beginning on page F-55 of our Form 10-K/A, in August 2003, we issued to CUSA 8 million shares of our Series C Convertible Preferred Stock due 2033, which we refer to as our Series C Preferred. We accrued dividends on our Series C Preferred at a rate of 5.5% of the liquidation value per annum. We made a semi-annual dividend payment of $11 million in February 2006. On May 26, 2006, we redeemed all of the outstanding shares of our Series C Preferred, which were held by CUSA. In order to redeem the Series C Preferred, we paid CUSA $400 million in cash, plus accrued and unpaid dividends totaling approximately $6.3 million. We used approximately $178 million in net proceeds from an equity offering of 40.25 million shares of our Class A common stock that closed on the same day (includes net proceeds of $23 million from the underwriters' exercise of their option to purchase an additional 5.25 million shares), with the balance funded from cash on hand and the DHI Dividend. The redemption of the Series C Preferred eliminated the associated $22 million annual preferred dividend and reduced the number of diluted shares of our common stock outstanding.

Note 9 Loss Per Share

Basic loss per share represents the amount of losses for the period available to each share of common stock outstanding during the period. Diluted loss per share represents the amount of losses for the period available to each share of common stock outstanding during the period plus each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the period.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in millions, except per share amounts)			
Loss from continuing operations	$ (71)	$ (14)	$ (279)	$ (417)
Preferred stock dividends		(6)	(9)	(17)
Loss from continuing operations for basic loss per share	(71)	(20)	(288)	(434)
Effect of dilutive securities:				
Interest on convertible subordinated debentures		2	3	5
Dividends on Series C Preferred		6	9	17
Loss from continuing operations for diluted loss per share	$ (71)	$ (12)	$ (276)	$ (412)
Basic weighted-average shares	495	390	446	383
Effect of dilutive securities:				
Stock options	2	2	2	2
Convertible subordinated debentures		55	27	55
Series C Preferred		69	37	69
Diluted weighted-average shares	497	516	512	509
Loss per share from continuing operations:				
Basic	$ (0.14)	$ (0.05)	$ (0.65)	$ (1.13)
Diluted (1)	$ (0.14)	$ (0.05)	$ (0.65)	$ (1.13)

(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, we have 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 and 2005.

Note 10 Commitments and Contingencies

Set forth below is a description of our material legal proceedings. In addition to the matters described below, we are party to legal proceedings arising in the ordinary course of business. In management s opinion, the disposition of these ordinary course matters will not have a material adverse effect on our financial condition, results of operations or cash flows.

We record reserves for estimated losses from contingencies when information available indicates that a loss is probable and the amount of the loss is reasonably estimable under SFAS No. 5, Accounting for Contingencies. For environmental matters, we record liabilities when remedial efforts are probable and the costs can be reasonably estimated. Please read Note 2 Accounting Policies Contingencies, Commitments, Guarantees

and Indemnifications beginning on page F-17 of our Form 10-K/A for further discussion of our reserve policies. Environmental reserves do not reflect management s assessment of the insurance coverage that may be applicable to the matters at issue, whereas litigation reserves do reflect such potential coverage. We cannot make any assurances

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that the amount of any reserves or potential insurance coverage will be sufficient to cover the cash obligations we might incur as a result of litigation or regulatory proceedings, payment of which could be material.

With respect to some of the items listed below, management has determined that a loss is not probable or that any such loss, to the extent probable, is not reasonably estimable. In some cases, management is not able to predict with any degree of certainty the range of possible loss that could be incurred. Notwithstanding these facts, management has assessed these matters 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, as a result of facts arising prior to resolution of these matters or other factors, prove inaccurate and investors should be aware that such judgment is made subject to the known uncertainty of litigation.

Summary of Recent Developments. As described in greater detail below, the following significant developments involving our material legal proceedings occurred since the second quarter:

- In October 2006, we entered into a settlement agreement with Enron and certain of its subsidiaries to resolve claims arising from or relating to the entry of the Master Netting Setoff Security Agreement in 2001. DHI paid Enron $44 million to resolve such claims and retained the right to pursue amounts owed by Enron Capital and Trade Resources Limited to Dynegy UK Limited.

- In August 2006, we and our former affiliate, West Coast Power, entered into an agreement to settle class action claims by California purchasers and certain California natural gas resellers and co-generators alleging price manipulation and false reporting of natural gas trades. We agreed to pay approximately $32 million in total to settle these claims; however, the settlement does not include similar cases filed by individual plaintiffs, which we continue to defend vigorously. In September 2006, the San Diego state court granted preliminary approval of the settlement of claims by the California purchasers and we expect Plaintiffs to submit the settlement of claims by California natural gas resellers and co-generators to the Nevada federal court in the fourth quarter 2006.

The above summary of recent developments is qualified in its entirety by, and should be read in conjunction with, the more detailed summary of our significant legal proceedings set forth below.

Enron Trade Credit Litigation. On October 5, 2006, we, DHI and certain of our affiliates and subsidiaries (collectively the Dynegy Parties) entered into a Settlement Agreement and Mutual General Release (the Settlement Agreement) with Enron Corp. and certain of its subsidiaries and affiliates (collectively the Enron Parties). The Settlement Agreement provides for the settlement of all claims by either the Dynegy Parties or the Enron Parties against the others arising from or relating to the Master Netting Setoff and Security Agreement (the MNSSA) dated November 8, 2001. The MNSSA allowed certain amounts owed from the Dynegy Parties to the Enron Parties to be set off against other amounts owed from the Enron Parties to the Dynegy Parties as a result of the termination of commercial transactions between the parties.

On October 26, 2006 the settlement received final approval from the Bankruptcy Court. Under the Settlement Agreement, the Dynegy Parties and the Enron Parties agreed to the following in exchange for the final resolution and mutual release of all claims asserted by any of the parties in the adversary and arbitration proceedings and an action in Canada relating to an Enron Corp. Canadian subsidiary:

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A settlement payment by DHI of $44 million, payable on the second business day after final Bankruptcy Court approval.

Through our subsidiary Dynegy UK Limited, we retain the right to pursue claims filed against Enron Capital and Trade Resources Limited (ECTRL) in ECTRL s administration proceedings in the United Kingdom for amounts owed by ECTRL under or in connection with certain underlying commodities contracts.

In accordance with the payment terms, Dynegy funded the settlement on October 30, 2006. The Settlement Agreement further provides for a mutual release of any other claims that exist or could exist between the Dynegy Parties and the Enron Parties through the date payment is made. Neither the Dynegy Parties nor the Enron Parties admit any liability in connection with the Settlement Agreement. We recorded approximately $20 million and $28 million in pre-tax charges related to the settlement and associated legal expenses in the three and nine months ended September 30, 2006, respectively. We recognized approximately $4 million of pre-tax charges related to the settlement and associated legal expenses in the three and nine months ended September 30, 2005. These charges are recorded as general and administrative expenses on our unaudited condensed consolidated statements of operations.

Gas Index Pricing Litigation. We 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. The cases are pending in California, Nevada, Alabama and Tennessee. In each of these suits, the plaintiffs allege that we 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 CFTC investigations into and reports concerning index-reporting manipulation in the energy industry. Except as specifically mentioned below, the cases are actively engaged in discovery.

During the last year, several cases pending in Nevada federal court were dismissed on defendants motions. Certain plaintiffs have appealed to the Court of Appeals for the Ninth Circuit, which coordinated the cases before the same appellate panel. A decision from the Court of Appeals is not expected until 2007.

Pursuant to various motions, the cases pending in California state court have been 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. The settlement does not include similar claims filed by individual plaintiffs in the Coordinated Gas Index Cases, which we continue to defend vigorously. 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. In September 2006, the San Diego state court granted preliminary approval of the settlement of claims by the California purchasers. A motion to approve the re-seller and co-generator settlement is expected in the fourth quarter 2006. The settlements are without admission of wrongdoing, and Dynegy and West Coast Power continue to deny class plaintiffs allegations.

We are analyzing the remaining natural gas index cases and are vigorously defending against them. We cannot predict with certainty whether we will incur any liability in connection with these lawsuits. However, given the nature of the claims, an adverse result in any of these proceedings could have a material adverse effect on our financial condition, results of operations and cash flows. We have recorded reserves that we consider reasonable in connection with these matters.

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In connection with the sale of our interest in West Coast Power to NRG (which closed on March 31, 2006), we, NRG and NRG West Coast LLC entered into an agreement to allocate responsibility for managing certain litigation and provide for certain indemnities with respect to such litigation. Subject to conditions and limitations specified in that agreement, the parties agreed that we would manage the natural 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.

California Market Litigation. We and various other power generators and marketers are defendants in lawsuits alleging rate and market manipulation in California s wholesale electricity market during the California energy crisis several years ago. The complaints generally allege unfair, unlawful and deceptive trade practices in violation of the California Unfair Business Practices Act and seek injunctive relief, restitution and unspecified actual and treble damages. In addition, certain cases include allegations relating to the validity of the contracts between power generators, including West Coast Power, and the California Department of Water Resources (CDWR). A significant majority of these cases were dismissed on grounds of federal preemption. A motion to dismiss one remaining action on similar grounds is pending in federal court. Certain actions, however, in which plaintiffs have not exhausted the appellate process remain pending in either the California appellate court or the U.S. Court of Appeals for the Ninth Circuit.

In October 2004, an independent electric services provider in California filed suit against us and several other defendants alleging claims similar to those above and that it was forced out of business by the defendants conduct. Plaintiff seeks $5 million in compensatory damages, as well as treble damages. In June 2005, the case was removed to federal court where it remains pending.

Finally, there is a pending appeal in the Ninth Circuit Court of Appeals challenging a FERC Order affirming the validity of the former West Coast Power CDWR long term contract. We are currently awaiting a ruling on this appeal and cannot predict its outcome.

We believe that we have meritorious defenses to these claims and are vigorously defending against them. We cannot predict with certainty whether we will incur any liability in connection with these lawsuits. However, given the nature of the claims, an adverse result in any of these proceedings could have a material adverse effect on our financial condition, results of operations and cash flows.

In connection with the sale of our interest in West Coast Power to NRG on March 31, 2006, we, NRG and NRG West Coast LLC entered into an agreement to allocate responsibility for managing certain litigation and provide for certain indemnities with respect to such litigation. Subject to conditions and limitations specified in that agreement, the parties agreed that we would manage the power 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 other proceedings based on similar acts or omissions which formed the basis of such litigation. The agreement further provides that NRG will manage the CDWR appeal described above and indemnify us for any resulting losses, subject to certain conditions. Please read Guarantees and Indemnifications WCP Indemnities below.

ERISA/Illinois Power 401(k) Litigation. In January 2005, three DMG union employees who are participants in the DMG 401(k) Savings Plan for Employees Covered Under a Collective Bargaining Agreement (formerly known as the Illinois Power Company Incentive Savings Plan For Employees Covered Under a Collective Bargaining Agreement), which we refer to as the DMG 401(k) Plan, purporting to represent all DMG and Illinois

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Power employees who held Dynegy common stock through the DMG 401(k) Plan during the period from February 2000 through the present, filed a lawsuit in federal court in the Southern District of Illinois against us, Illinois Power, DMG and several individual defendants. The complaint alleges violations of ERISA in connection with the DMG 401(k) Plan that are similar to the claims made in the Dynegy Inc. ERISA litigation we settled in December 2004, including claims that certain of our former officers (who are past members of our Benefit Plans Committee) breached their fiduciary duties to plan participants and beneficiaries in connection with the plan s investment in Dynegy common stock in particular with respect to our financial statements, Project Alpha, alleged round trip trades and natural gas price index reporting. The lawsuit seeks unspecified damages for the losses to the plan, as well as attorney s fees and other costs. In March 2006, an amended complaint was filed naming additional former officers and employees as defendants and amending the fraud claims. In June 2006, the court granted our motion to dismiss plaintiffs fraud claims for failing to plead those claims with particularity. The remaining counts in the March 2006 amended complaint remain pending.

Additionally, in September 2005, two former Illinois Power salaried employees who were participants in the Dynegy Midwest Generation, Inc. 401(k) Savings Plan for salaried employees (formerly known as the Illinois Power Incentive Savings Plan), which we refer to as the DMG Salaried Plan, purporting to represent all DMG Salaried Plan participants who held Dynegy common stock through the DMG Salaried Plan during the period from January 1, 2002, through January 30, 2003, filed a lawsuit in federal court in the Southern District of Texas against us and several individual defendants. The complaint alleges violations of ERISA in connection with the DMG Salaried Plan that are similar to the claims made in the ERISA litigation referenced in the preceding paragraph. The lawsuit seeks unspecified damages for the losses to the plan, as well as attorney s fees and other costs. In December 2005, we filed a motion to dismiss the complaint, in response to which plaintiffs counsel filed a second putative class action on behalf of three alleged plan participants that is materially identical to the original action. In March 2006, the original action was dismissed by the court with prejudice based on lack of standing and lack of subject matter jurisdiction, and the plaintiffs in that matter have appealed that dismissal. The second putative class action relating to the DMG Salaried Plan remains pending at the class discovery stage.

We believe that we have meritorious defenses to plaintiffs claims in these lawsuits and are vigorously defending against them. Although it is not possible to predict with certainty whether we will incur any liability in connection with these lawsuits, we do not believe that any liability we might incur as a result of these lawsuits would have a material adverse effect on our financial condition, results of operations or cash flows.

Roseton State Pollutant Discharge Elimination System Permit. In April 2005, the NYSDEC issued to DNE a draft SPDES Permit renewal (the Draft SPDES Permit) for the Roseton plant. The Draft 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 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 best technology available for minimizing adverse environmental impacts. The requirements of the Draft SPDES Permit already exceed the best technology available requirements of the EPA regulations applicable to existing facilities. 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 of NYSDEC by DNE, NYSDEC staff, and the petitioners. We expect that the adjudicatory hearing on the Draft SPDES Permit will occur in 2007.

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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.

Danskammer State Pollutant Discharge Elimination System Permit. In January 2005, the NYSDEC issued a Draft 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 for minimizing adverse environmental impacts. The requirements of the Draft SPDES Permit already exceed the best technology available requirements of the EPA regulations applicable to existing facilities.

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 SPDES Permit was issued in May 2006. In June 2006, the NYSDEC issued the revised SPDES Permit with conditions generally favorable to us. While the revised SPDES Permit does not require installation of a closed cycle cooling system, it does require aquatic organism mortality reductions in excess of those resulting from the best technology available requirements of the EPA regulations applicable to existing facilities. In July 2006, two of the petitioners filed suit in the Supreme Court of the State of New York, Westchester County seeking to vacate the Deputy Commissioner s decision and the revised Danskammer SPDES Permit. 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.

Stumpf Litigation. We and two former subsidiaries are defendants in a lawsuit filed in New York by Stumpf AG and two of its affiliates stemming from the closure of our former Austrian subsidiary s Vienna telecommunications office in the spring of 2001. The plaintiffs are seeking approximately $30 million in compensatory and unspecified punitive damages, alleging breach of contract, tortious interference and other similar claims primarily relating to the termination of real property leases to which our former Austrian subsidiary was a party. These claims are based on similar lawsuits filed in Austria against our former Austrian subsidiary, which was sold to a third party in January 2003. All of these lawsuits pending in Austria have been stayed. This former subsidiary is in liquidation and one of its liquidators admitted, for purposes of the liquidation, the plaintiffs claims in the amount of approximately $30 million. In December 2004, the plaintiffs filed a motion for partial summary judgment on issues of liability which was denied by the trial court in December 2005. Plaintiffs appealed the decision to the New York Appellate Division, which affirmed the trial court s ruling in August 2006. Shortly thereafter, Plaintiffs sought re-argument from the intermediate court or permission to appeal to the New York Court of Appeals.

We continue to oppose these claims and believe we have meritorious defenses. Although it is not possible to predict with certainty whether we will incur any liability in connection with these lawsuits, we do not believe that any liability we might incur as a result of these lawsuits would have a material adverse effect on our financial condition, results of operations or cash flows. We have recorded a reserve that we consider reasonable relating to this matter.

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LS Power-Kendall Arbitration. In May 2005, DPM initiated an arbitration proceeding against LS Power-Kendall Energy, LLC. Due to the pending transaction between us and the LS Entities, the parties have agreed to dismiss the arbitration proceeding without prejudice.

Stand Energy Litigation (formerly Atlantigas Corp. Litigation). In October 2004, we were named as a defendant in a West Virginia federal court class action lawsuit alleging that interstate pipelines provided preferential storage and transportation services to their own unregulated marketing affiliates in return for a percentage of the profits. Plaintiffs contend that such conduct violated applicable FERC regulations and federal and state antitrust laws, and constituted common law tortious interference with contractual and business relations. In addition, the complaint claims the defendants conspired with the other market participants to receive preferential natural gas storage and transportation services at off-tariff prices. The complaint seeks unspecified compensatory and punitive damages. The parties are actively engaged in discovery.

We continue to analyze plaintiffs claims and intend to vigorously defend against them. We cannot predict with certainty whether we will incur any liability in connection with this lawsuit; however, we believe that any liability incurred as a result of this litigation would not have a material adverse effect on our financial condition, results of operations or cash flows.

Severance Arbitration. Our former CFO, Rob Doty, filed for arbitration pursuant to the terms of his employment/severance agreement following his departure from the Company in 2002. Mr. Doty seeks payment of up to approximately $3.4 million and additional amounts related to long-term incentive payments allegedly contemplated by his agreement. Mr. Doty s agreement is subject to interpretation, and we maintain that any amount owed is lower than the amount sought. We have recorded a severance accrual that we consider reasonable relating to this proceeding.

U.S. Attorney Texas. We are continuing to cooperate fully with the U.S. Attorney s office in Houston in its ongoing investigation of the industry s natural gas trade reporting practices.

In January 2003, one of our former natural gas traders was indicted on three counts of knowingly causing the transmission of false trade reports used to calculate the index price of natural gas and four counts of wire fraud. A second superseding indictment was returned in March 2006, recharging the original violations and adding additional charges. Following a five-week trial, in August 2006 the jury returned a verdict finding the former employee guilty on seven counts of wire fraud and not guilty on two counts of wire fraud and three counts of false reporting. The jury was unable to reach a verdict on the remaining counts, including one count of conspiracy and ten counts of false reporting. On November 3, 2006, the Court conducted a hearing on the Defendant s motion for a new trial or acquittal and took the parties arguments under advisement.

We do not believe this investigation will have a material adverse effect on our financial condition, results of operations or cash flows.

U.S. Attorney California. In November 2002, the U.S. Attorney s office in the Northern District of California issued a Grand Jury subpoena requesting information related to our activities in the California energy markets. We continue to cooperate fully with the U.S. Attorney s office in its investigation of these matters, including production of substantial documents responsive to the subpoena and other requests for information.

Department of Labor Investigation. In August 2002, the U.S. Department of Labor commenced an official investigation pursuant to Section 504 of ERISA with respect to the benefit plans we maintain and our ERISA affiliates. We cooperated with the Department of Labor throughout this investigation, which focused on a review of

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plan documentation, plan reporting and disclosure, plan record keeping, plan investments and investment options, plan fiduciaries and third party service providers, plan contributions and other operational aspects of the plans. In February 2005, we received a letter from the Department of Labor indicating that, as a result of our December 2004 settlement in the Dynegy Inc. ERISA litigation, it intended to take no further action with respect to its investigation of the Dynegy Inc. 401(k) Plan. However, its investigation is ongoing as it relates to the Illinois Power 401(k) Plans and the litigation relating to those plans described above.

Guarantees and Indemnifications

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 losses related to such representations, warranties, indemnifications and guarantees in our contractual agreements, and such losses could be significant, in most cases management considers the probability of loss to be extremely remote.

Kendall Guarantee. On September 14, 2006, the LS Entities and Kendall Power entered into the Kendall Agreement pursuant to which Kendall Power agreed to acquire all of the outstanding interests in LSP Kendall Holdings, LLC for $200 million in cash, as adjusted for certain changes in working capital. The closing of the Kendall Agreement will occur only if closing does not occur with respect to the transactions contemplated by the Merger Agreement. We have agreed to guarantee certain of Kendall Power s obligations under the Kendall Agreement. The consummation of the Kendall Agreement is subject to various conditions, including: (i) the termination of the Merger Agreement; (ii) the expiration or termination of applicable waiting periods under the HSR; and (iii) satisfaction of certain other conditions. Please read Note 2 Business Combinations LS Power for further discussion.

WCP Indemnities. In connection with our sale to NRG of our 50% ownership interest in West Coast Power (please read Note 3 Dispositions, Contract Terminations and Discontinued Operations Dispositions and Contract Terminations West Coast Power for further discussion), we entered into an agreement with NRG in which we agreed how certain litigation would be managed and allocated between the parties responsible for any loss suffered by the parties as a result of such litigation. Please read California Market Litigation and Gas Index Pricing Litigation above for further discussion.

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 Hackberry and certain other 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 also indemnified Targa for certain tax matters arising from periods prior to our sale of DMSLP. While we have incurred no expense in connection with this indemnification, we have recorded an accrual, which we deem to be the fair value of this indemnification as of September 30, 2006.

Illinois Power Indemnities. As a condition of our 2004 sale of Illinois Power and our interest in Joppa, we provided indemnifications to third parties regarding environmental, tax, employee and other representations. These

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indemnifications are limited to a maximum recourse of $400 million. Additionally, we have 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 our liability under this indemnity, the amount of our indemnity is limited to 50% of any such losses. Illinois Power had not sustained any material losses in recent years and, at the time of the sale of Illinois Power to Ameren, our management considered the probability of any material loss under this indemnity remote. Consequently, the value of the indemnification was initially deemed to be insignificant. In the second quarter 2005, however, the ICC rejected an Administrative Law Judge s proposed order and entered an order in one of the proceedings covered by the scope of this indemnification that disallowed items relating to one of Illinois Power s natural gas storage fields, resulting in a negative revenue requirement impact to Ameren. In July 2005, we made a payment of $8 million to Ameren in settlement of Ameren s indemnification claims with respect to this ICC order. Although at that time the ICC had not issued an order in any other cases, there were other cases in which it was then probable, based on this recent action by the ICC, that some loss would occur and a liability could be reasonably estimated. As a result, in the second quarter 2005, we recognized a pre-tax charge of $12 million, which is included in general and administrative expense on our condensed consolidated statements of operations. In late June 2006, the Administrative Law Judge in one of the ongoing cases issued a Proposed Order adopting the disallowances recommended by the ICC Staff in that case. In September 2006, the ICC issued an Order that adopted the findings set forth by the Administrative Law Judge in the Proposed Order. Further disallowances and other events which fall within the scope of the indemnity may still occur; however, we are not required to accrue a liability in connection with these indemnifications, as management considers the probability of an adverse outcome remote.

Constellation Guarantee. During 2004, as part of entering into a back-to-back power purchase agreement with Constellation Energy Commodities Group, Inc. (Constellation), under which Constellation effectively received our rights to purchase approximately 570 MW of capacity and energy arising under our Kendall tolling contract, we guaranteed Constellation an aggregate $4 million in reactive power revenues over the four-year term of the power purchase agreement. Upon entering into this contract, we established a liability of less than $1 million reflecting the fair value of this guarantee. During the year ended December 31, 2005, we increased the liability by approximately $1 million, as it became probable that we will be obligated to make a greater payment to Constellation under the guarantee. Based on our continued evaluation and events which have occurred to date, as of September 30, 2006, we decreased the reserve to approximately $1 million.

Northern Natural and Other Indemnities. During 2003, as part of our sale of NNG, 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 for the NNG, Rough and Hornsea natural gas storage facilities and natural gas liquids assets, 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, Hackberry LNG Project, SouthStar Energy Services, various Canadian assets, Michigan Power, Oyster Creek, Hartwell, Commonwealth, Sherman, Indian Basin and PESA. We carry reserves for existing environmental, tax and employee liabilities and have incurred no other expense relating to these indemnities.

Black Mountain Guarantee. Through one of our subsidiaries, we hold a 50% ownership interest in Black Mountain (Nevada Cogeneration) (Black Mountain), in which our partner is a Chevron subsidiary. Black Mountain owns the Black Mountain power generation facility and has a power purchase agreement with a third party that extends through April 2023. In connection with the power purchase agreement, pursuant to which Black Mountain receives payments which decrease in amount over time, we agreed to guarantee 50% of certain payments

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

that may be due to the power purchaser under a mechanism designed to protect it from early termination of the agreement. At September 30, 2006, if an event of default had occurred under the terms of the mortgage on the facility entered into in connection with the power purchase agreement, we could have been required to pay the power purchaser approximately $60 million under the guarantee. While there is a question of interpretation regarding the existence of an obligation to make payments calculated under this mechanism upon the scheduled termination of the agreement, management does not expect that any such payments would be required.

Note 11 Regulatory Issues

We are subject to regulation by various federal, state, local and foreign agencies, including extensive rules and regulations governing transportation, transmission and sale of energy commodities as well as the discharge of materials into the environment or otherwise relating to environmental protection. Compliance with these regulations requires general and administrative, capital and operating expenditures including those related to monitoring, pollution control equipment, emission fees and permitting at various operating facilities and remediation obligations. In addition, the United States Congress has before it a number of bills that could impact regulations or impose new regulations applicable to us and our subsidiaries. We cannot predict the outcome of these bills or other regulatory developments or the effects that they might have on our business.

Energy Policy Act of 2005. The Energy Policy Act of 2005 (EPACT) was signed into law on August 8, 2005. Title XII of EPACT (Electricity) deals with various matters impacting the power industry, including reliability of the bulk power system; transmission congestion, and transmission structure siting and modernization; the repeal of PUHCA; and prohibition of energy market manipulation, with enhanced FERC authority to prohibit market manipulation, including enhanced penalty authority. FERC has implemented and is considering a number of related regulations to implement EPACT that may impact, among other things, requirements for reliability, Qualified Facilities, transmission information availability, transmission congestion, security constrained dispatch, energy market transparency, energy market manipulation and behavioral rules.

Illinois Resource Procurement Auction. In January 2006, the ICC approved a resource procurement auction as the process by which utilities will procure power beginning in 2007. The 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. There continue to be challenges to the auction process. The ICC did initiate an investigation into the Hourly Auction segment and we have intervened in that proceeding.

Further, there is a possibility of political, legislative, judicial and/or regulatory actions over the next several months that could substantially alter the parties rights and obligations under or relating to the Supplier Forward Contracts. Numerous parties have appealed various aspects of the ICC Orders approving the auctions to the state intermediate appellate courts. The Illinois Attorney General has also filed for direct review by the state Supreme Court and a stay of the ICC Orders pending that review, which was denied. The appellate court cases have been consolidated and are in the briefing stage; we anticipate a ruling sometime next year, with the possibility of further review by the Illinois Supreme Court. There is also the possibility that the Illinois General Assembly will consider legislation in the fourth quarter 2006 either in its veto session or via a special session if called by the Governor.

Clean Air Mercury Rule. In March 2005, the Administrator of the EPA signed a final Clean Air Mercury Rule (CAMR) that will require mercury emission reductions to be achieved from existing coal-fired electric generating units. This rule requires all states to adopt either the EPA rule, or a state rule meeting the minimum requirements as outlined in CAMR. The Illinois EPA has proposed a state-specific rule (the Illinois Mercury Rule) that would require larger percentage reductions in mercury emissions on a significantly shorter timeframe than the

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

CAMR would require. We, along with most other owners of Illinois coal-fired electric generating units, opposed the Illinois Mercury Rule in proceedings before the Illinois Pollution Control Board (IPCB). The first hearing was held in June 2006 and the second hearing began on August 14, 2006. The Illinois EPA and Ameren filed a Joint Statement with the IPCB in late July supporting a Multi-Pollutant Alternative to the Illinois Mercury Rule that significantly extends the schedule for compliance with the proposed new mercury standard while adding new requirements for the control of sulfur dioxide and nitrogen oxides emissions. DMG filed a Joint Statement with the Illinois EPA on August 21, 2006 supporting a Multi-Pollutant alternative to the Illinois Mercury Rule. On November 2, 2006 the IPCB adopted the Illinois Mercury Rule including the Multi-Pollutant Alternative and transmitted it to the Joint Committee on Administrative Rules ("JCAR"), which will ensure the proposed rule is consistent with state law and the views of the legislature. The extended schedule for compliance will only become effective if the JCAR approves the overall Illinois Mercury Rule, including the Multi-Pollutant Alternative, which we believe will be within the next 90 days. Other industry participants are actively opposing this proposal. It is possible that the rule could pass without the Multi-Pollutant Alternative, in which case we would be subject to the schedule and mercury reductions in the original Illinois Mercury Rule.

In May 2006, the Governor of New York announced plans to regulate mercury emissions from coal-fired power plants by reducing emissions by approximately 50% by 2010 and 90% by 2015. NYSDEC issued a proposed rule in July 2006. The proposed rule would establish a 72 lb/yr mercury emission limit for the Danskammer generating units beginning in January 2010. Beginning in January 2015, the rule would impose an emission rate limit of 0.6 pounds of mercury per trillion Btu for all affected generating units. The proposed rule would not allow trading of mercury emission allowances.

Various state legislative and regulatory bodies may be considering other legislation or rules that could impact current regulations or impose new regulations applicable to us and our subsidiaries. We cannot predict the outcome of these legislative and other regulatory developments, or the effects that they might have on our business.

***FERC Market-Based Rate Authority*.** FERC-approved market-based rate authority allows those granted such authority to sell power at negotiated rates through the bilateral market or within an organized energy market, conditioned on periodic re-review. In June 2005, FERC issued an order accepting the updated market power analyses submitted by Sithe Energies and Dynegy. Accordingly, these entities have continuously had market-based rate authority. Our next triennial market power analysis is currently due in June 2008. However, FERC is considering adoption of a regional approach for the submission of triennial reviews that could alter this due date.

We are also subject to FERC s new regulations prohibiting market manipulation implemented pursuant to the EPACT. In 2003, FERC promulgated market behavior rules prohibiting manipulation in the wholesale electricity and natural gas markets subject to FERC s jurisdiction. The market behavior rules, which emerged from FERC s consideration of market manipulation in the Western markets, are incorporated in the tariffs of the various Dynegy entities with market based rates for wholesale power. FERC rescinded the other two market behavior rules. The new regulations apply to sales in organized and bilateral markets and spot markets, as well as long-term sales (as well as to the wholesale sale of natural gas under a blanket marketing certificate). The remedies for violating the rules could include disgorgement of unjust profits or suspension or revocation of the authority to sell at market-based rates and penalties. The extent to which these regulations will affect us is uncertain. However, we believe that we are currently in compliance.

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Note 12 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-73 of our Form 10-K/A.

Share-Based Compensation. Our share-based payments primarily consist of stock options and restricted stock awards. For stock options, we determine the fair value of each stock option at the grant date using a Black-Scholes model, with the following weighted-average assumptions used for grants for the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30,	
	2006	2005
Dividends		
Expected volatility (historical)	48.8%	84.1%
Risk-free interest rate	5.1%	4.2%
Expected option life	6 Years	10 Years

The expected volatility was calculated based on a ten-year historical volatility of our stock price in 2005 and beginning in first quarter 2006, we used a three-year historical volatility. The risk-free interest rate was calculated based upon observed interest rates appropriate for the term of our employee stock options. Currently, we calculate the expected option life using the simplified methodology suggested by SAB 107, Share-Based Payment. For restricted stock awards, we consider the fair value to be the closing price of the stock on the grant date. We recognize the fair value of our share-based payments over the vesting periods of the awards, which is typically a three-year service period.

We have nine stock option plans, all of which contain authorized shares of our Class A common stock. Each option granted is exercisable at a strike price, which ranges from $1.47 per share to $56.98 per share for options currently outstanding. A brief description of each plan is provided below:

NGC Plan. Created early in our history and revised prior to Dynegy becoming a publicly traded company in 1996, this plan contains 13,651,802 authorized shares, had a 10-year term, and expired in May 2006. All option grants are vested.

Employee Equity Plan. This plan expired in May 2002 and is the only plan in which we granted options below the fair market value of Class A common stock on the date of grant. This plan had 20,358,802 authorized shares. All option grants are vested.

Illinova Plan. Adopted by Illinova prior to the merger with Dynegy, this plan expired upon the merger date in February 2000 and had 3,000,000 authorized shares. All option grants are vested.

Extant Plan. Adopted by Extant prior to its acquisition by Dynegy, this plan expired in September 2000 and had 202,577 authorized shares. All option grants are vested.

UK Plan. This plan had 276,000 authorized shares and has been terminated. All option grants are vested.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Dynegy 1999 LTIP. This annual compensation plan has 6,900,000 authorized shares, has a 10-year term and expires in 2009. All option grants are vested.

Dynegy 2000 LTIP. This annual compensation plan, created for all employees upon the merger of Illinova and Dynegy, has 10,000,000 authorized shares, has a 10-year term and expires in February 2010. Grants from this plan vest in equal annual installments over a three-year period.

Dynegy 2001 Non-Executive LTIP. This plan is a broad-based plan and has 10,000,000 authorized shares, has a 10-year term and expires in September 2011. Grants from this plan vest in equal annual installments over a three-year period.

Dynegy 2002 LTIP. This annual compensation plan has 10,000,000 authorized shares, has a 10-year term and expires in May 2012. Grants from this plan vest in equal annual installments over a three-year period.

All of our option plans cease vesting for employees who are terminated for cause. For voluntary and involuntary termination, disability, retirement or death, continued vesting and/or an extended period in which to exercise vested options may apply, depending on the terms of the grant agreement in which a specific grant was awarded. It has been our practice to issue shares of common stock upon exercise of stock options generally from previously unissued shares.

The Merger Agreement with LS Power will result in a change in control as defined in our Severance Pay Plans, as well as the various grant agreements. Please read Note 2 Business Combinations LS Power for further discussion of the transaction. As a result, all options previously granted to employees will fully vest immediately upon the close of the LS Power transaction. This occurrence will not have a material effect on our financial condition, results of operations or cash flows.

During the first quarter 2006, we entered into an exchange transaction with our 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, we cancelled all of the 2,378,605 stock options then held by our Chairman and CEO. As consideration for canceling these stock options, we granted our Chairman and CEO 967,707 stock options at an exercise price of $4.88, which equaled the closing price of our Class A common stock on the date of grant, and agreed to make a cash payment of approximately $5.6 million based on the in-the-money value of the vested stock options that were cancelled. This cash payment, which accrues interest at 7.5% annually, will be made on January 15, 2007. The newly granted stock options have a term of 10 years, vest in three equal annual installments beginning on the first anniversary of the grant date and are subject to earlier vesting upon a constructive termination, a termination without cause or a termination resulting from a change in control. We recorded a liability to reflect the agreed upon cash payment. We were not required to record any incremental compensation expense in connection with the transaction.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Options outstanding as of September 30, 2006 are summarized below:

	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in millions)
Outstanding at December 31, 2005	9,314	$ 12.66		
Granted	3,268	$ 4.88		
Exercised	(1,423)	$ 3.46		
Forfeited or expired	(2,829)	$ 4.93		
Outstanding at September 30, 2006	8,330	$ 13.80	6.13	$ 5.0
Vested and unvested expected to vest at September 30, 2006	7,642	$ 14.63	5.8	$ 4.6
Exercisable at September 30, 2006	4,701	$ 20.78	3.7	$ 2.4

The weighted average grant-date fair value of options granted during the nine months ended September 30, 2006 and 2005 was $2.61 and $3.66, respectively. The total intrinsic value of options exercised for the nine-month periods ended September 30, 2006 and 2005 was $4 million and $1 million, respectively.

Restricted stock activity for the nine months ended September 30, 2006 was as follows:

	Number of Shares (in thousands)	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	1,239	$ 4.40
Granted	1,311	$ 4.88
Vested	(251)	$ 4.40
Forfeited	(154)	$ 4.76
Nonvested at September 30, 2006	2,145	$ 4.67

All restricted stock awards to employees vest immediately upon the occurrence of a change in control in accordance with the terms of the applicable Severance Pay Plan. The Merger Agreement with the LS Entities will result in a change in control as defined in our restricted stock agreements. Please read Note 2 Business Combinations LS Power for further discussion.

Compensation expense related to options granted and restricted stock awarded totaled $2 million and $3 million for the quarters ended September 30, 2006 and 2005, respectively, and $6 million and $7 million for the nine month periods ended September 30, 2006 and 2005 respectively. Tax benefits for compensation expense related to options granted and restricted stock awarded totaled $1 million for the quarters ended September 30, 2006 and 2005, and $2 million for both the nine months ended September 30, 2006 and 2005. We recognize compensation

expense ratably over the vesting period of the respective awards. As of September 30, 2006, $9 million of total unrecognized compensation expense related to options granted and restricted stock awarded is expected to be recognized over a weighted-average period of 2.2 years. The total fair value of shares vested was zero for the quarters ended September 30, 2006 and 2005, and $4 million and $3 million for the nine months ended September 30, 2006 and 2005, respectively. We did not capitalize or use cash to settle any share-based compensation in the nine months ended September 30, 2006.

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Cash received from option exercises for the three and nine months ended September 30, 2006 was $1 and $5 million, respectively. The tax benefit realized for the additional tax deduction from share-based payment awards totaled $1 million for the nine months ended September 30, 2006.

In the first quarter 2006, we granted stock-based compensation awards that cliff vest after three years based on our cumulative operating cash flows for 2006-2008, or sooner upon a change in control. Compensation expense recorded in the three and nine months ended September 30, 2006 related to these performance units was less than $1 million and was accrued in Other long-term liabilities in our unaudited condensed consolidated balance sheets. The Merger Agreement with the LS Entities will result in a change in control as related to these awards.

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

	Pension Benefits		Other Benefits	
	Three Months Ended September 30, 2006			
	2006	2005	2006	2005
	(in millions)			
Service cost benefits earned during period	$ 2	$ 2	$	$ 1
Interest cost on projected benefit obligation	2	3		
Expected return on plan assets	(2)	(2)		
Recognized net actuarial loss	1		1	1
Net periodic benefit cost	3	3	1	2
Additional costs due to curtailment	1			
Total net periodic benefit cost	$ 4	$ 3	$ 1	$ 2

	Pension Benefits		Other Benefits	
	Nine Months Ended September 30,			
	2006	2005	2006	2005
	(in millions)			
Service cost benefits earned during period	$ 7	$ 8	$ 2	$ 2
Interest cost on projected benefit obligation	7	7	2	2
Expected return on plan assets	(7)	(6)		
Recognized net actuarial loss	2	2	1	1
Net periodic benefit cost	9	11	5	5
Additional cost due to curtailment	3			
Total net periodic benefit cost	$ 12	$ 11	$ 5	$ 5

The curtailment charge was accrued at December 31, 2005 in other long-term liabilities on our unaudited condensed consolidated balance sheets.

Contributions. In 2006, we contributed approximately $14 million to our pension plans, $11 million of which we paid in August 2006. We expect to contribute less than $1 million to our other postretirement benefit plans in the fourth quarter 2006.

DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Note 13 Income Taxes

Effective Tax Rate. The income taxes included in continuing operations were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in millions, except rates)			
Income tax benefit	$ 39	$ 13	$ 154	$ 228
Effective tax rate	35%	48%	35%	35%

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. In general, differences between our effective rate and the statutory rate of 35% result primarily from the effect of certain foreign and state income taxes and permanent differences attributable to book-tax differences. For the nine months ended September 30, 2005, additional differences in our overall effective tax rate on continuing operations included the non deductible portion of the charge associated with the shareholder litigation settlement, off set by changes in the valuation allowances and adjustments to the effective state tax rate. For the three months ended September 30, 2005, our effective tax rate on continuing operations included an increase in the reserve for future tax liabilities.

Texas Margin Tax. In May 2006, Texas enacted a new law that substantially changes the state s tax system. The law replaces the taxable-capital and earned-surplus components of its franchise tax with a new franchise tax that is based on modified gross revenue. This new franchise tax is referred to as the Margin Tax and will significantly affect the financial reporting of a wide range of enterprises that have operations in Texas. As a result of the new law, which becomes effective January 1, 2007, we established a deferred tax liability of $2 million related to our Texas operations. The effect of the change in Texas law produced a total charge of $2 million.

Note 14 Segment Information

We report the results of our power generation business as three separate geographical segments in our consolidated financial statements: (1) the Midwest segment (GEN-MW); (2) the Northeast segment (GEN-NE); and (3) the South segment (GEN-SO). We also separately report the results of our former NGL and CRM business segments because of the diversity among their respective operations. Our consolidated financial results also reflect corporate-level expenses such as general and administrative, interest and depreciation and amortization. Certain general and administrative expenses were allocated to our reporting segments prior to January 1, 2006. Beginning January 1, 2006, all direct general and administrative expenses are included in Other and Eliminations, unless they are specifically identified with the respective segment.

Our former natural gas liquids operations comprise the NGL segment and are included in discontinued operations. Results associated with the former DGC segment are included in discontinued operations in Other and Eliminations due to the sale of our communications businesses. Reportable segment information, including intercompany transactions accounted for at prevailing market rates, for the three and nine months ended September 30, 2006 and 2005 is presented below:

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DYNEGY INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the Interim Periods Ended September 30, 2006 and 2005

Segment Data for the Three Months Ended September 30, 2006

(in millions)

		Power Generation	CRMn="left" valign="top" width="1%">
Gain on extinguishment of debt	(216,617)	—	—
Interest expense paid with Series B Preferred Stock in connection with conversion of notes payable	3,147	—	3,147
Abandoned patents	183,556	—	—
Bad debts - employee advances	255,882	—	—
Contributed technology expense	4,550,000	—	—
Consulting expense	237,836	—	—
Management unit expense	1,334,285	—	—
Expense for issuance of warrants	533,648	14,885	40,354
Expense for issuance of options	1,432,600	179,105	251,540
Amortization of deferred compensation	74,938	—	—
Penalties in connection with non-registration event	361,496	—	—
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(335,575)	52,976	46,581
Other assets	(56,393)	10,240	(23,067)
Accounts payable and accrued expenses	2,742,652	(54,264)	25,637
Accrued interest expense	1,823,103	—	—
Net cash used by operating activities	(55,808,960)	(2,211,949)	(1,942,511)
Cash flows from investing activities:			
Proceeds from sale of property and equipment	32,491	—	—
Purchases of property and equipment	(2,226,932)	(6,411)	—
Patent costs	(434,879)	(7,149)	(13,664)
Purchases of short-term investments	(393,607)	—	—
Proceeds from sale of short-term investments	393,607	199,607	—
Loan receivable	(1,632,168)	—	—
Net cash (used)/provided by investing activities	(4,261,488)	186,047	(13,664)
Cash flows from financing activities:			

Proceeds from issuance of common stock	400,490	—	—
Proceeds from issuance of preferred stock	9,579,040	—	4,894,603
Proceeds from exercise of warrants	214,010	214,010	
Equity contributions - net of fees incurred	41,711,198	—	—
Proceeds from borrowings	8,603,631	—	225,000
Proceeds from subscription receivables	499,395	—	—
Net cash provided by financing activities	61,007,764	214,010	5,119,603

See accompanying notes to consolidated financial statements.

Net change in cash and cash equivalents	937,316	(1,811,892)	3,163,428
Cash and cash equivalents - beginning of period	—	2,749,208	211,613
Cash and cash equivalents - end of period	$ 937,316	$ 937,316	$ 3,375,041
Supplemental disclosure of cash flow information:			
Cash paid during the period for interest	$ 590,189	$ —	$ —
Supplemental schedule of noncash investing and financing activities:			
Note payable principal and interest conversion to equity	$ 10,434,319	$ 57,605	$ 225,000
Issuance of member units for leasehold improvements	$ 141,635	$ —	$ —
Issuance of management units in settlement of cost of raising capital	$ 437,206	$ —	$ —
Change in fair value of management units for cost of raising capital	$ 278,087	$ —	$ —
Exchange of loan receivable for member units	$ 1,632,168	$ —	$ —
Issuance of equity in settlement of accounts payable	$ 1,609,446	$ —	$ —
Issuance of common stock in exchange for stock subscribed	$ 399,395	$ —	$ —
Costs paid from proceeds in conjunction with issuance of preferred stock	$ 768,063	$ —	$ 147,500
Preferred stock dividends	$ 2,956,193	$ 514,403	$ 735,218
Net effect of conversion of common stock to preferred stock prior to merger	$ 559	$ —	$ —

During the nine months ended September 30, 2009 and 2008, 4,407.29 and -0- Series B Preferred Shares were converted into 12,174,834 and -0- Common shares, respectively. During the nine months ended September 30, 2009 and 2008, 1,162,323 and -0- Series A Preferred Shares were converted into 10,673,236 and -0- Common shares, respectively. For the period from January 22, 1997 (date of inception) to September 30, 2009, 4,407.29 Series B Preferred Shares and 1,725,601 Series A Preferred Shares were converted into 12,174,834 and 11,296,978 Common Shares, respectively.

See accompanying notes to consolidated financial statements.

MedaSorb Technologies Corporation
Notes to Consolidated Financial Statements
(UNAUDITED)
September 30, 2009

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the requirements of Form 10-Q of the Securities and Exchange Commission (the "Commission") and include the results of MedaSorb Technologies Corporation (the "Parent"), formerly known as Gilder Enterprises, Inc., and CytoSorbents, Inc. (f/k/a MedaSorb Technologies, Inc.), its wholly-owned operating subsidiary (the "Subsidiary"), collectively referred to as "the Company." Accordingly, certain information and footnote disclosures required in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. Interim statements are subject to possible adjustments in connection with the annual audit of the Company's accounts for the year ended December 31, 2009. In the opinion of the Company's management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the Company's consolidated financial position as of September 30, 2009 and the results of its operations and cash flows for the nine and three month periods ended September 30, 2009 and 2008, and for the period January 22, 1997 (date of inception) to September 30, 2009. Results for the nine and three months ended are not necessarily indicative of results that may be expected for the entire year. The unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements of the Company and the notes thereto as of and for the year ended December 31, 2008 as included in the Company's Form 10-K filed with the Commission on April 10, 2009.

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company has experienced negative cash flows from operations since inception and has a deficit accumulated during the development stage at September 30, 2009 of $78,429,038. The Company is not currently generating revenue and is dependent on the proceeds of present and future financings to fund its research, development and commercialization program. These matters raise substantial doubt about the Company's ability to continue as a going concern. The Company is continuing its fund-raising efforts. Although the Company has historically been successful in raising additional capital through equity and debt financings, there can be no assurance that the Company will be successful in raising additional capital in the future or that it will be on favorable terms. Furthermore, if the Company is successful in raising the additional financing, there can be no assurance that the amount will be sufficient to complete the Company's plans. These consolidated financial statements do not include any adjustments related to the outcome of this uncertainty.

The Company is a development stage company and has not yet generated any revenues. Since inception, the Company's expenses relate primarily to research and development, organizational activities, clinical manufacturing, regulatory compliance and operational strategic planning. Although the Company has made advances on these matters, there can be no assurance that the Company will continue to be successful regarding these issues, nor can there be any assurance that the Company will successfully implement its long-term strategic plans.

The Company has developed an intellectual property portfolio, including 26 issued and multiple pending patents, covering materials, methods of production, systems incorporating the technology and multiple medical uses.

2. PRINCIPAL BUSINESS ACTIVITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Nature of Business

The Company, through its subsidiary, is engaged in the research, development and commercialization of medical devices with its platform blood purification technology incorporating a proprietary adsorbent polymer technology. The Company is focused on developing this technology for multiple applications in the medical field, specifically to provide improved blood purification for the treatment of acute and chronic health complications associated with blood toxicity. As of September 30, 2009, the Company has not commenced commercial operations and, accordingly, is in the development stage. The Company has yet to generate any revenue and has no assurance of future revenue.

Principles of Consolidation

The consolidated financial statements include the accounts of the Parent, MedaSorb Technologies Corporation, and its wholly-owned subsidiary, CytoSorbents, Inc. All significant intercompany transactions and balances have been eliminated in consolidation.

Development Stage Corporation
The accompanying consolidated financial statements have been prepared in accordance with the provisions of accounting and reporting by development stage enterprises.

Cash and Cash Equivalents
The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Short Term Investments
Short-term investments include short-term bank certificates of deposit with original maturities of between three and twelve months. These short-term notes are classified as held to maturity and are valued at cost, which approximates fair value. These investments are considered Level 2 investments under accounting standards for fair value measurements.

Property and Equipment
Property and equipment are recorded at cost less accumulated depreciation. Depreciation of property and equipment is provided for by the straight-line method over the estimated useful lives of the related assets. Leasehold improvements are amortized over the lesser of their economic useful lives or the term of the related leases. Gains and losses on depreciable assets retired or sold are recognized in the statements of operations in the year of disposal. Repairs and maintenance expenditures are expensed as incurred.

Patents
Legal costs incurred to establish patents are capitalized. When patents are issued, capitalized costs are amortized on the straight-line method over the related patent term. In the event a patent is abandoned, the net book value of the patent is written off.

Impairment or Disposal of Long-Lived Assets
The Company assesses the impairment of patents and other long-lived assets under accounting standards for the impairment or disposal of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. For long-lived assets to be held and used, the Company recognizes an impairment loss only if its carrying amount is not recoverable through its undiscounted cash flows and measures the impairment loss based on the difference between the carrying amount and fair value.

Research and Development
All research and development costs, payments to laboratories and research consultants are expensed when incurred.

Income Taxes
Income taxes are accounted for under the asset and liability method prescribed by accounting standards for accounting for income taxes. Deferred income taxes are recorded for temporary differences between financial statement carrying amounts and the tax basis of assets and liabilities. Deferred tax assets and liabilities reflect the tax rates expected to be in effect for the years in which the differences are expected to reverse. A valuation allowance is provided if it is more likely than not that some or all of the deferred tax asset will not be realized. Under Section 382 of the Internal Revenue Code the net operating losses generated prior to the reverse merger may be limited due to the change in ownership. Additionally, net operating losses generated subsequent to the reverse merger may be limited in the event of changes in ownership.

Use of Estimates
The preparation of 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 and disclosure of contingent assets and liabilities. Actual results could differ from these estimates. Significant estimates in these financials are the valuation of options granted and the valuation of preferred shares issued as stock dividends.

Concentration of Credit Risk

The Company maintains cash balances, at times, with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation. Management monitors the soundness of these institutions in an effort to minimize its collection risk of these balances.

Financial Instruments

The carrying values of cash and cash equivalents, short-term investments, accounts payable and other debt obligations approximate their fair values due to their short-term nature.

Stock-Based Compensation

The Company accounts for its stock-based compensation under the recognition requirements of accounting standards for accounting for stock-based compensation, for employees and directors whereby each option granted is valued at fair market value on the date of grant. Under these accounting standards, the fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model.

The Company also follows the guidance of accounting standards for accounting for equity instruments that are issued to other than employees for acquiring, or in conjunction with selling, goods or services for equity instruments issued to consultants.

Net Loss Per Common Share
Basic EPS is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period. The computation of Diluted EPS does not assume conversion, exercise or contingent exercise of securities that would have an anti-dilutive effect on earnings (See Note 6).

Effects of Recent Accounting Pronouncements
In December 2007, the FASB issued an amendment to an existing accounting standard which provides guidance related to business combinations. The amendment retains its fundamental requirements that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. This amendment also establishes principles and requirements for how the acquirer: a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree; b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This amendment will apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The provisions of this amendment did not have a significant impact on the Company's statements of operations or financial position.

In March 2008, the FASB issued a new accounting standard which provides guidance related to disclosures about derivative instruments and hedging activities and amends an existing accounting standard to expand the disclosure requirements to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, the new accounting standard requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. The new accounting standard is effective for fiscal years and interim periods beginning after November 15, 2008. The provisions of the new accounting standard did not have a significant impact on the Company's statements of operations or financial position.

In May 2009, the FASB issued a new accounting standard related to subsequent events, which provides guidance on events that occur after the balance sheet date but prior to the issuance of the financial statements. The new accounting standard distinguishes events requiring recognition in the financial statements and those that may require disclosure in the financial statements. Furthermore, the new accounting standard requires disclosure of the date through which subsequent events were evaluated. The new accounting standard is effective for interim and annual periods after June 15, 2009. The Company adopted the new accounting standard for the quarter ended June 30, 2009, and have evaluated subsequent events through November 13, 2009.

In June 2009, the FASB issued a new accounting standard which provides guidance related to the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of a previously issued standard. The new accounting standard stipulates the FASB Accounting Standards Codification is the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. The new accounting standard is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The implementation of this standard did not have a material impact on the Company's statements of operations or financial position.

3. CONVERTIBLE NOTES

The Company has outstanding Promissory Notes in the aggregate principal amount of $50,000, due in September 2009, which bear interest at the rate of 10% per annum. The holder of the Promissory notes has the option to convert, on an all-or-none basis, the entire principal and outstanding interest of their Notes into the Series B Preferred Stock issued in June 2008. In addition, pursuant to the terms of such Promissory Notes, upon such conversion, each note holder will receive five-year warrants to purchase that number of shares of Common Stock equal to the quotient obtained by dividing (x) 25% of the principal amount of the Promissory Note being converted, by (y) $0.0362, the purchase price per share of Common Stock issuable upon conversion of the Series B Preferred Stock.

In September 2009 the holder of these Promissory Notes elected to convert in full principal and accrued interest totaling $57,605 into equity per the terms of these notes. Accordingly, the Company issued this investor 576.05 shares of Series B Preferred stock and a five-year warrant to purchase 397,825 shares of Common Stock with an exercise price of $0.0362 per share.

In accordance with accounting standards for convertible securities with beneficial conversion features, the Company allocates the proceeds associated with the issuance of preferred stock based on the relative fair value of the preferred stock and warrants. Additionally, the Company evaluates if the embedded conversion option results in a beneficial conversion feature by comparing the relative fair value allocated to the preferred stock to the market value of the underlying common stock subject to conversion. In connection with the preferred stock issuance per the Note conversion during September 2009, the Company recorded total proceeds of $57,605. The Company allocated the total proceeds based on the related fair value as follows: $54,253 was allocated to the preferred stock and $3,352 to the warrants. Additionally, the embedded conversion option resulted in a beneficial conversion feature in the amount of $3,352. The value assigned to the warrants resulting from the relative fair value calculation as well as the value of the beneficial conversion feature is recorded as a preferred stock dividend and is presented in the consolidated statements of operations. In addition, the Company considers the guidance of accounting standards for accounting for derivative financial instruments indexed to, and potentially settled in, a company's own common stock and derivative instruments and hedging activities and concluded that the conversion feature embedded in the preferred stock only provides for physical settlement and there are no net settlement features. Accordingly, the Company has concluded that the conversion feature is not considered a derivative.

4. STOCKHOLDERS' EQUITY (DEFICIT)

During the nine months ended September 30, 2009 the Company recorded non-cash stock dividends totaling $507,699 in connection with the issuance of 4,185.04 shares of Series B Preferred Stock and 618,232 shares of Series A Preferred Stock as a stock dividend to its preferred shareholders as of September 30, 2009. The Company has estimated the fair value of the shares issued as stock dividends based upon the last completed financing transaction involving the underlying common shares in June 2008.

During the nine months ended September 30, 2009, 4,407.29 Series B Preferred Shares were converted into 12,174,834 Common shares. During the nine months ended September 30, 2009, 1,162,323 Series A Preferred Shares were converted into 10,673,236 Common shares.

During the nine months ended September 30, 2009, the Company issued stock options to employees, consultants and directors resulting in aggregate compensation expense of $8,378, of which $584 and $7,794 is presented in research and development expenses and general and administrative expenses, respectively.

During the nine months ended September 30, 2009, the Company incurred stock-based compensation expense due to the amortization of unvested stock options. The aggregate expense for the nine months ended September 30, 2009 is $170,727, of which $73,895 and $96,832 is presented in research and development expenses and general and administrative expenses, respectively.

The summary of the stock option activity for the nine months ended September 30, 2009 is as follows:

	Shares	Weighted Average Exercise per Share	Weighted Average Remaining Life (Years)
Outstanding, January 1, 2009	18,158,846	$ 1.05	9.1
Granted	5,118,858	$ 0.123	9.2
Cancelled	—	$ —	—
Exercised	—	$ —	—
Outstanding September 30, 2009	23,277,704	$ 0.84	8.6

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The fair value of each stock option was valued using the Black Scholes pricing model which takes into account as of the grant date the exercise price (ranging from $0.084 to $0.168 per share) and expected life of the stock option (ranging from 5-10 years), the current price of the underlying stock and its expected volatility (approximately 25 percent), expected dividends (-0- percent) on the stock and the risk free interest rate (2.7 percent) for the term of the stock option.

At September 30, 2009, the aggregate intrinsic value of options outstanding and currently exercisable amounted to approximately $12,200.

The summary of the status of the Company's non-vested options for the nine months ended September 30, 2009 is as follows:

	Shares		Weighted Average Grant Date Fair Value
Non-vested, January 1, 2009	6,280,604	$	0.05
Granted	5,118,858	$	0.003
Cancelled	—		—
Vested	(4,589,075)	$	0.041
Exercised	—		—
Non-vested, September 30, 2009	6,810,387	$	.02

As of September 30, 2009, approximately $144,700 of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted average period of 0.90 years.

As of September 30, 2009, the Company has the following warrants to purchase common stock outstanding:

Number of Shares To be Purchased		Warrant Exercise Price per Share	Warrant Expiration Date
15,569	$	6.64	March 31, 2010
816,691	$	4.98	June 30, 2011
1,200,000	$	0.90	June 30, 2011
900,000	$	0.40	June 30, 2011
339,954	$	2.00	September 30, 2011
52,080	$	2.00	July 31, 2011
400,000	$	0.40	October 31, 2011
240,125	$	1.25	October 24, 2016
3,986,429	$	0.035	June 25,2013
397,825	$	0.0362	September 30, 2014

As of September 30, 2009, the Company has the following warrants to purchase Series A Preferred Stock outstanding:

Warrant
Exercise

Number of Shares to be Purchased		Price per Preferred Share	Warrant Expiration Date
525,000	$	1.00	June 30, 2011

If the holder of warrants for preferred stock exercises in full, the holder will receive additional five-year warrants to purchase a total of 210,000 shares of common stock at $0.40 per share.

In September 2009 the Company extended the expiration date of its warrants for Series B Preferred stock by 10 calendar days and offered an additional warrant for common stock as inducement for the Series B warrant holders to exercise their warrants. The additional warrant offered to participants in the exercise of Series B warrants was a twelve (12) month option to purchase one (1) dollar in Common Stock at an exercise price of $0.107 per share, for every one (1) dollar of Series B warrants they exercise. For this modification of the Series B warrant the Company recorded a non-cash charge of approximately $15,000. The warrants were granted subsequent to the close of the third quarter and accordingly, a non-cash charge of approximately $2 will be recorded in the fourth quarter of 2009.

As of September 30, 2009 Series B warrant holders had exercised warrants to purchase 2,140.1 shares of Series B which had an exercise price of $100 per share. From this exercise of these warrants the Company received net cash proceeds of $214,010.

As of September 30, 2009, the Company has the following warrants to purchase Series B Preferred Stock outstanding:

Number of Shares to be Purchased		Warrant Exercise Price per Preferred Share	Warrant Expiration Date
12,859.9	$	100.00	October 5, 2009

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5. COMMITMENTS AND CONTINGENCIES

Employment Agreements

The Company has employment agreements with certain key executives through December 2009. The agreements provide for annual base salaries of varying amounts.

Litigation

The Company is currently not involved, but may at times be involved in various claims and legal actions. Management is currently of the opinion that these claims and legal actions would have no merit, and any ultimate outcome will not have a material adverse impact on the consolidated financial position of the Company and/or the results of its operations.

Royalty Agreements

Pursuant to an agreement dated August 11, 2003, an existing investor agreed to make a $4 million equity investment in the Company. These amounts were received by the Company in 2003. In connection with this agreement, the Company granted the investor a future royalty of 3% on all gross revenues received by the Company from the sale of its CytoSorb device. The Company has not generated any revenue from this product and has not incurred any royalty costs through September 30, 2009. The amount of future revenue subject to the royalty agreement could not be reasonably estimated nor has a liability been incurred, therefore, an accrual for royalty payments has not been included in the consolidated financial statements.

License Agreements

In an agreement dated September 1, 2006, the Company entered into a license agreement which provides the Company the exclusive right to use its patented technology and proprietary know how relating to adsorbent polymers for a period of 18 years. Under the terms of the agreement, MedaSorb has agreed to pay royalties of 2.5% to 5% on the sale of certain of its products if and when those products are sold commercially for a term not greater than 18 years commencing with the first sale of such product. The Company has not generated any revenue from its products and has not incurred any royalty costs through September 30, 2009. The amount of future revenue subject to the license agreement could not be reasonably estimated nor has a liability been incurred, therefore, an accrual for royalty payments has not been included in the consolidated financial statements.

Warrant agreement

As inducement to invest additional funds in the private placement of Series B Preferred Stock, additional consideration was granted to the participants of the Series B Preferred Stock offering in the event that litigation is commenced against Medasorb prior to June 30, 2018, claiming patent infringement on certain of the Company's issued patents. In the event this litigation arises the Company may be required to issue warrants to purchase in the aggregate up to a maximum of ten million shares of Common Stock subject to certain adjustments. Through September 30, 2009 no such litigation has arisen and due to the deemed low probability of this potential outcome; the Company has not booked a contingent liability for this agreement.

6. NET LOSS PER SHARE

Basic loss per share and diluted loss per share for the nine and three month periods ended September 30, 2009 and 2008 have been computed by dividing the net loss for each respective period by the weighted average number of

shares outstanding during that period. All outstanding warrants and options representing 31,626,377 and 25,073,756 incremental shares at September 30, 2009 and 2008, respectively, as well as shares issuable upon conversion of Series A and Series B Preferred Stock and Preferred Stock Warrants representing 232,547,948 and 182,285,696 incremental shares at September 30, 2009 and 2008, respectively, have been excluded from the computation of diluted loss per share as they are anti-dilutive.

7. SUBSEQUENT EVENTS

The Company has evaluated subsequent events occurring after the balance sheet through the date of November 13, 2009, which is the date the financial statements were issued.

In October 2009 investors exercised warrants to purchase an additional 11,217.42 shares of Series B Preferred Stock. From this exercise of warrants the Company received net cash proceeds of $1,096,742.

In October 2009, in connection with the total exercise of Series B warrants, the Company granted twelve (12) month warrants to purchase a total of 12,483,665 shares of Common Stock with an exercise price of $0.107 per share. This Common Stock warrant issuance was part of an inducement for Series B warrant holders to exercise their warrants (See Note 4).

During October and November 2009 a total of 1,603,630 shares of Series A Preferred Stock were converted into 6,518,152 shares of Common Stock, and a total of 2,221.26 shares of Series B Preferred Stock were converted into 6,136,077 shares of Common Stock.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

These unaudited condensed consolidated financial statements and management’s discussion should be read in conjunction with the audited financial statements of the Company and the notes thereto as of and for the year ended December 31, 2008 as included in the Company’s Form 10-K filed with the Securities and Exchange Commission (the “Commission”) on April 10, 2009.

Forward-looking statements

Statements contained in this Quarterly Report on Form 10-Q, other than the historical financial information, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All such forward-looking statements involve known and unknown risks, uncertainties or other factors which may cause actual results, performance or achievement of the Company to be materially different from any future results, performance or achievement expressed or implied by such forward-looking statements. Primary risk factors include, but are not limited to: ability to successfully develop commercial operations; the ability to obtain adequate financing in the future when needed; dependence on key personnel; acceptance of the Company's medical devices in the marketplace; obtaining government approvals, including required FDA approvals; compliance with governmental regulations; reliance on research and testing facilities of various universities and institutions; product liability risks; limited manufacturing experience; limited marketing, sales and distribution experience; market acceptance of the Company's products; competition; unexpected changes in technologies and technological advances; and other factors detailed in the Company's Current Report on Form 10-K filed with the Commission on April 10, 2009.

Plan of Operations

We are a development stage company and expect to remain so for at least the next several quarters. We have not generated revenues to date and do not expect to do so until we commercialize and receive the necessary regulatory approvals to sell our proposed products. We will seek to commercialize a blood purification technology that efficiently removes middle molecular weight toxins from circulating blood and physiologic fluids.

We are focusing our efforts on the commercialization of our CytoSorb™ product. The first indication for CytoSorb™ will be in the adjunctive treatment of sepsis (bacterial infection of the blood), which causes systematic inflammatory response syndrome. CytoSorb™ has been designed to prevent or reduce the accumulation of high concentrates of cytokines in the bloodstream associated with sepsis. It is intended for short term use as an adjunctive device to the standard treatment of sepsis. To date, we have manufactured the CytoSorb™ device on a limited basis for testing purposes, including for use in clinical studies. We believe that current state of the art blood purification technology (such as dialysis) is incapable of effectively clearing the toxins intended to be adsorbed by our CytoSorb™ device.

Following the sepsis indication, we intend to continue our research in other acute conditions where CytoSorb™ has indicated potential in preliminary studies to prevent or reduce the accumulation of cytokines in the bloodstream. These conditions include the prevention of post-operative complications of cardiac surgery (cardiopulmonary bypass surgery) and damage to organs donated for transplant prior to organ harvest. We are also exploring the potential benefits the CytoSorb™ device may have in removing drugs from blood.

In December 2006, we submitted a proposed pilot study for approval to the FDA with respect to our CytoSorb™ device. In the first quarter of 2007, we received approval from the FDA to conduct a limited study of five patients in the adjunctive treatment of sepsis. Based on management’s belief that proceeding with the approved limited study would add at least one year to the approval process for the United States, we made a determination to focus our efforts on obtaining regulatory approval in Europe before proceeding with the FDA.

We estimate that the market potential in Europe for our products is substantially equivalent to that in the U.S. Given the opportunity to conduct a much larger clinical study in Europe, and management's belief that the path to a CE Mark should be faster than FDA approval, we decided to target Europe as the introductory market for our CytoSorb™ product. To accomplish the European introduction, in July 2007 we prepared and filed a request for a clinical trial with a German Central Ethics Committee. We received approval of the final study design in October of 2007.

We are currently approved by the German Ethics Committee to conduct a clinical study of up to 100 patients with acute respiratory distress syndrome or acute lung injury in the setting of sepsis. By December 31, 2008 we had initiated and opened for enrollment seven (7) hospital units to participate in our clinical study and had identified an additional six (6) sites that may be added to our study to accelerate enrollment. As of November 2009 the number of hospital units participating in our study has increased to twelve (12).

To date patient enrollment has been slower than originally anticipated. The Company has taken a number of steps to improve recruitment, the most significant of which is the increase in the number of our clinical trial sites. With more sites actively seeking to enroll patients, we expect the patient enrollment rate to increase going forward. Concurrent with the clinical study, we have commenced preparation for the CE Mark submission process. Assuming a successful outcome of the study, the Company intends to apply for CE Mark approval.

The primary endpoint of our clinical trial is cytokine reduction and is the basis of a planned CE Mark application to approve our device for clinical use in Europe. After reviewing the initial cytokine data from the first 22 patients enrolled in the protocol, our medical advisors recommended revisions to our protocol to minimize non-device related artifacts that may potentially arise if the samples are not processed or handled appropriately. The revisions to the protocol also include a provision for testing of our targeted endpoints in plasma instead of serum and changes in cytokine processing and analysis. These changes are intended to optimize the accuracy of our cytokine data for CE Mark submission. The proposed protocol changes and rationale for change were submitted to the German Ethics Committee and approved. Given these changes, cytokine data will not be statistically comparable between these 22 patients and those enrolled subsequently in the study. While the company will continue to review all patient data in the aggregate, including secondary and exploratory endpoints, the primary use of the data from the first 22 patients will be used to support the planned CE Mark application from a safety perspective. Cytokine data from all patients enrolled subsequent to these 22 patients, as well as safety data on all patients enrolled in the study, will be used for submission to the CE Mark authority. The Company has recruited thirty nine (39) patients in the clinical study to date. Management continues to anticipate that a total of approximately 80 patients, including these 22 initial patients, will be required to complete our study. The Company has the flexibility to enroll up to a total of 100 patients.

The clinical protocol for our European clinical study has been designed to allow us to gather information to support future U.S. studies. In the event we receive the CE Mark and are able to successfully commercialize our products in the European market, we will review our plans for the United States to determine whether to conduct clinical trials in support of a 510K or PMA registration. No assurance can be given that our proposed CytoSorb™ product will work as intended or that we will be able to obtain CE Mark (or FDA) approval to sell CytoSorb™. Even if we ultimately obtain CE Mark approval, because we cannot control the timing of responses from regulators to our submissions, there can be no assurance as to when such approval will be obtained.

Our research and development costs were, $1,602,636 and $1,376,921, for the nine months ended September 30, 2009 and 2008 respectively and $532,705 and $594,358 for the three months ended September 30, 2009 and 2008, respectively. We have experienced substantial operating losses since inception. As of September 30, 2009, we had an accumulated deficit of $78,429,038 which included losses of $841,058 and $2,453,154 for the three and nine month periods ended September 30, 2009. In comparison, we had losses of $862,751 and $2,364,478 for the three and nine month periods ended September 30, 2008. Historically, our losses have resulted principally from costs incurred in the research and development of our polymer technology, and general and administrative expenses, which together were $740,107 and $2,231,227 for the three and nine month periods ended September 30, 2009 and $755,021 and $2,055,468 for three and nine month periods ended September 30, 2008.

Off-balance Sheet Arrangements

We have no off-balance sheet arrangements.

Liquidity and Capital Resources

Since inception, our operations have been financed through the private placement of our debt and equity securities. At December 31, 2008 we had cash of $2,749,208. As of September 30, 2009 we had cash on hand of $937,316, and current liabilities of $915,835. In October 2009 an additional $1,096,742 was received by the Company from investors exercising warrants to purchase Series B Preferred Stock.

We believe that we have sufficient cash to fund our operations into the second quarter of 2010, following which we will need additional funding before we can complete our clinical studies and commercialize our products. We will continue to seek funding for the long term needs of the Company. There can be no assurance that financing will be available on acceptable terms or at all. If adequate funds are unavailable, we may have to suspend, delay or eliminate one or more of our research and development programs or product launches or marketing efforts or cease operations.

Our Annual Report dated December 31, 2008 was prepared assuming we will continue as a going concern, and the auditors' report on those financial statements expresses substantial doubt about our ability to continue as a going concern.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Not applicable to smaller reporting companies.

Item 4(T). Controls and Procedures.

Management's annual report on internal control over financial reporting

Management of Medasorb is responsible for establishing and maintaining adequate internal control over financial reporting under the supervision of the President and Chief Executive Officer and the Chief Financial Officer. Internal

control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Management evaluated the design and operation of our internal control over financial reporting as of September 30, 2009, based on the framework and criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and has concluded that such internal control over financial reporting is effective. There are no material weaknesses that have been identified by management.

An evaluation was performed, under the supervision of, and with the participation of, our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-(e) to the Securities and Exchange Act of 1934). Based on that evaluation, the Company's management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were adequate and effective, as of September 30, 2009, to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, is recorded, processed, summarized, and reported within the time periods specified in the Commission's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

We do not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the system are met and cannot detect all deviations. Because of the inherent limitations in all control systems, no evaluation of control can provide absolute assurance that all control issues and instances of fraud or deviations, if any, within the Company have been detected.

This report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this report.

Changes in internal control over financial reporting

There were no significant changes in our internal controls over financial reporting that occurred subsequent to our evaluation of our internal control over financial reporting for the nine months ended September 30, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In February 2008, Alkermes, Inc. commenced an action against us in the United States District Court for the District of Massachusetts, alleging that our use of the name MedaSorb infringes on Alkermes' registered trademark "MEDISORB." In the action, Alkermes sought an injunction against our further use of the name MedaSorb. Pursuant to a Settlement Agreement dated June 18, 2008, the Company will continue to use the name MedaSorb Technologies Corporation for the near term, but its wholly-owned subsidiary, through which the Company conducts all of its operational activities, has ceased using the "MedaSorb" name to avoid any potential confusion with Alkermes' similarly named product. The operating subsidiary has been renamed CytoSorbents, Inc. as of November 2008.

Item 1A. Risk Factors

Not required to be provided by smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

In February 2009, our Series B Preferred Shareholders voted to approve to waive any Event of Default and liability due upon an Event of Default pursuant to Section 6(ix) of the Certificate of Designation of Series B Preferred Shares that shall arise from or in connection with the occurrence of a Non-Registration Event as provided in Section 11.4 of the Series B Subscription Agreement. The Registration Statement has been filed but it has not been declared effective as of the date of this filing. A copy of the Resolution of the Series B Preferred Shareholders to Waive the Registration Penalty is attached as Exhibit 10.1 hereto.

Item 5. Other Information

None.

Item 6. Exhibits.

Number	Description
31.1	Certification of Phillip Chan, Chief Executive Officer of the Registrant, pursuant to Rules 13a-14(a) and 15(d)-14(a) of the Securities Exchange Act of 1934
31.2	Certification of David Lamadrid, Chief Financial Officer of the Registrant, pursuant to Rules 13a-14(a) and 15(d)-14(a) of the Securities Exchange Act of 1934

32.1	Certification of Phillip Chan, Chief Executive Officer of the Registrant, pursuant to Rules 13a-14(B) and 15(d)-14(b) of the Securities Exchange Act of 1934
32.2	Certification of David Lamadrid, Chief Financial Officer of the Registrant, pursuant to Rules 13a-14(B) and 15(d)-14(b) of the Securities Exchange Act of 1934

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SIGNATURES

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

MEDASORB TECHNOLOGIES
CORPORATION

Dated: November 13, 2009	By:	/s/ David Lamadrid
		Name: David Lamadrid
		Title: Chief Financial Officer

(On behalf of the registrant and as
principal accounting officer)