



**TXU Analyst Conference
Fort Worth, Texas
May 22, 2001**

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Portfolio and Trading Risk Management

Mike McNally

Trading serves as the mechanism which converts market obligations and supply resources into claims that can be cleared in markets. Trading:

- **develops regional expertise and knowledge**
- **provides the building blocks for developing products for customers**
- **creates price discovery for commercial decisions**
- **is profitable on a net basis**
- **will mandate strict adherence to control policies**

Trading Activities

“Single Portfolio View”



- **Trading Around Assets: Marketing assets and obligations**
- **Portfolio Optimization: Mixing, decomposing, and rebundling various positions in a portfolio to create additional value**
- **Position Management: Strategies related to entering new trades to cover existing trades or reduce risk profile**
- **Opportunistic Trading: Trading to capitalize on the temporary inefficiencies of markets**

Functional Accountabilities to Support Trading



Front Office

Market Entry
Deal Origination
Negotiation
Trade Execution
Performance Management

Middle Office

Analysis and Structuring
Proprietary Models
Forward Curves
Views of the Future
Deal Capture
Risk Measurement
Trading Compliance
Credit Risk

Back Office

Accounting
Cash Management

Portfolio and Trading Risk Management

Paul Marsh

Risk - Some Basic Rules



- Assume Murphy's Law does apply - "think the unthinkable"
- Be paranoid - "the world is out to get you"
- Beware of Greeks and PhD's
- Look wider than trading

..... be worried



Risk Principles



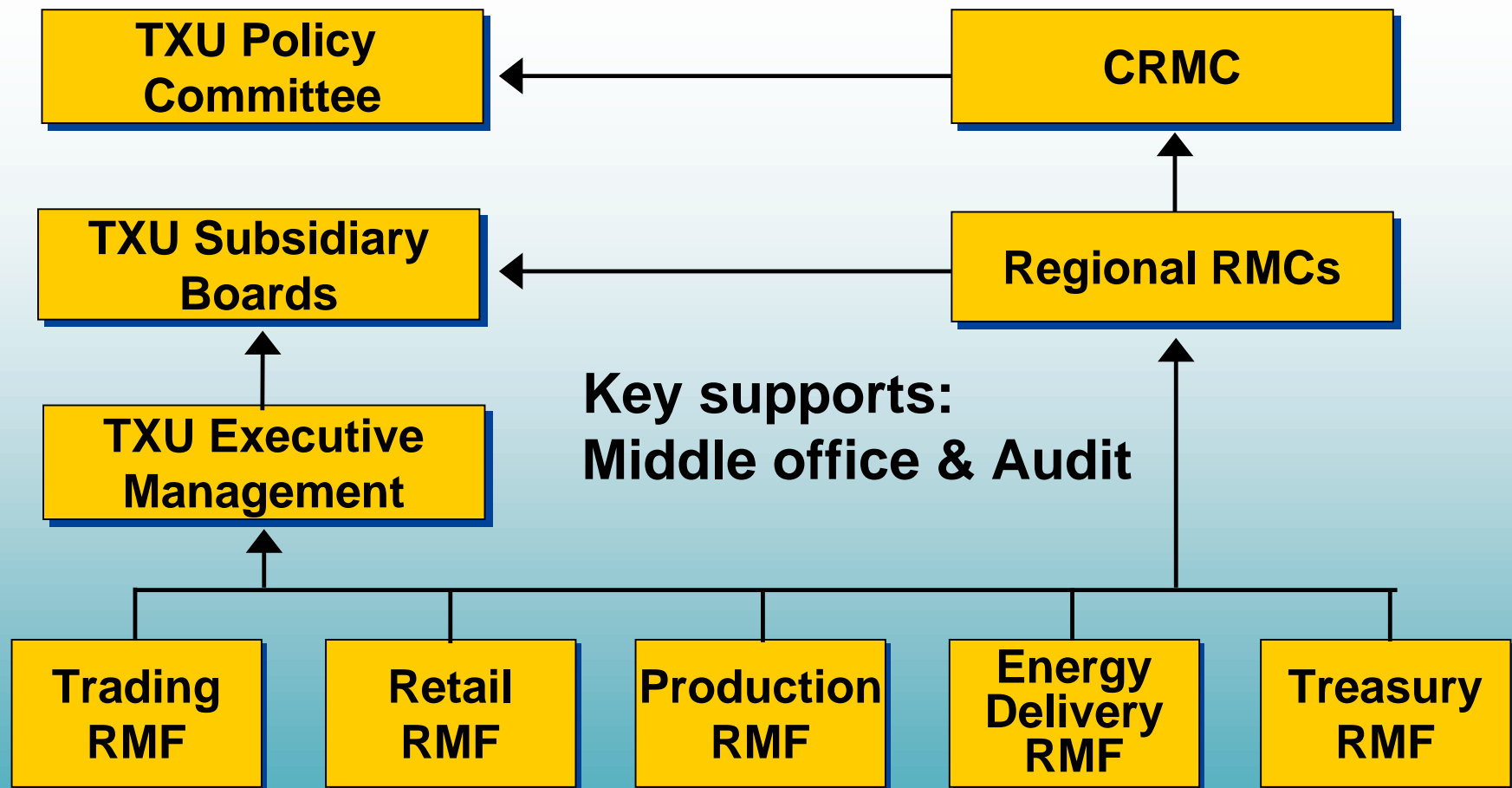
- **Business ownership**
- **Transparency and visibility**
- **Independent verification and assurance**
- **Clear authority and tolerance limits**
- **Consolidation globally**

Risk Management - Key Components



- **Governance and reporting structure**
 - **Document policies and procedures**
- **Risk limit structure and tolerance**
- **Market risk measures**
- **Credit risk**
- **Processes and methodologies**
 - **Information Technology infrastructure**

Governance and Reporting Structure



CRMC - Corporate Risk Monitoring Committee
RMC - Regional Risk Monitoring Committee
RMF - Risk Management Forum

Risk Focus of RMCs and RMFs



- **Price**
- **Quantity and shape**
- **Location (“Basis”)**
- **Capacity availability**
- **Liquidity**
- **Volatility**
- **Proprietary models**
- **Credit**
- **Financing**
- **Currency and interest rates**
- **Rogue trader**
- **Physical assets**
- **Fuel delivery**

Our Risk Metrics



Two key measures are used:

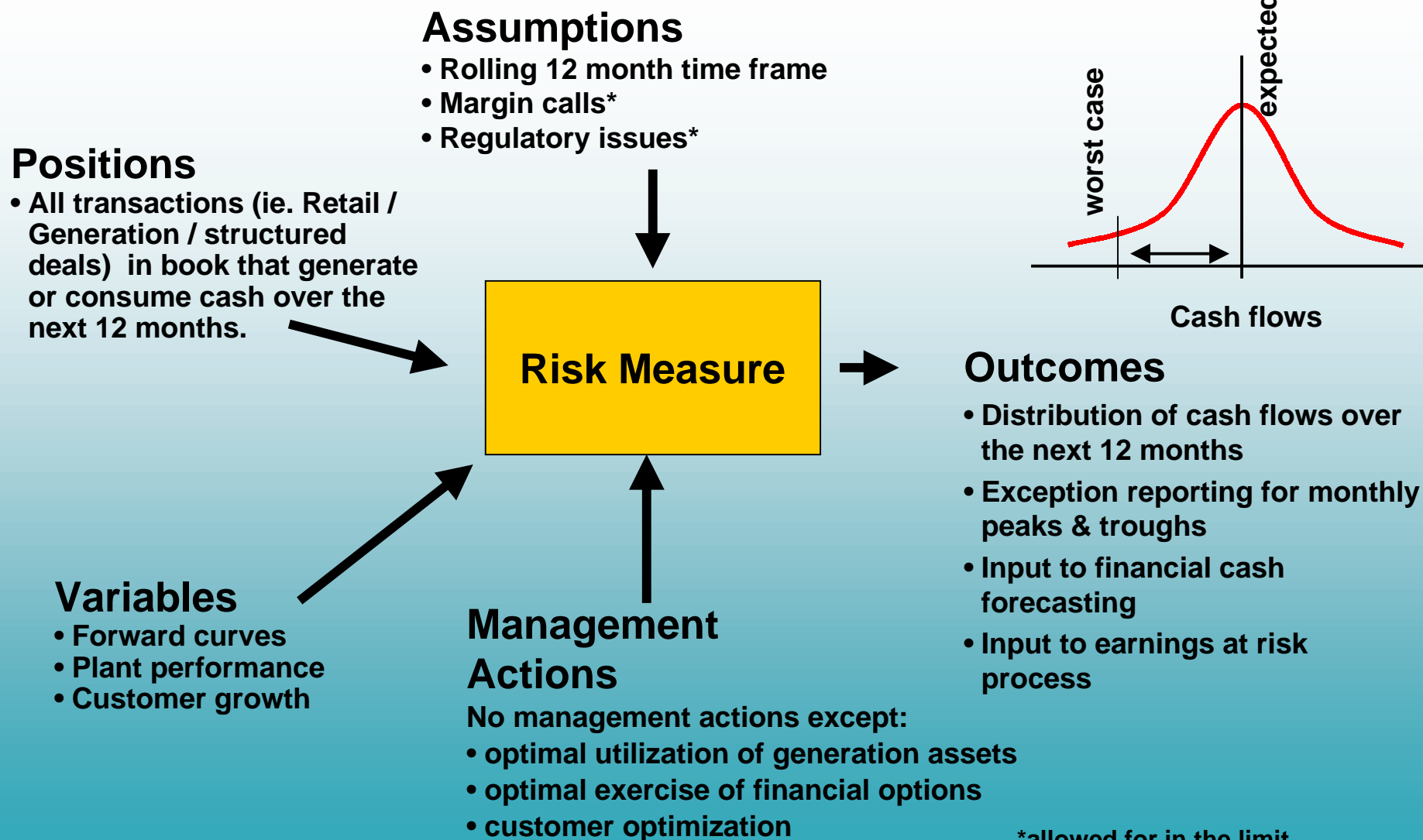
- **12-month rolling cash flow at risk**
- **Total portfolio value at risk***
- **Measures are subject to limits**

In addition, two risk processes are followed:

- **Earnings at risk process**
- **A strategic planning risk/return assessment process**
- **Limits are not applicable**

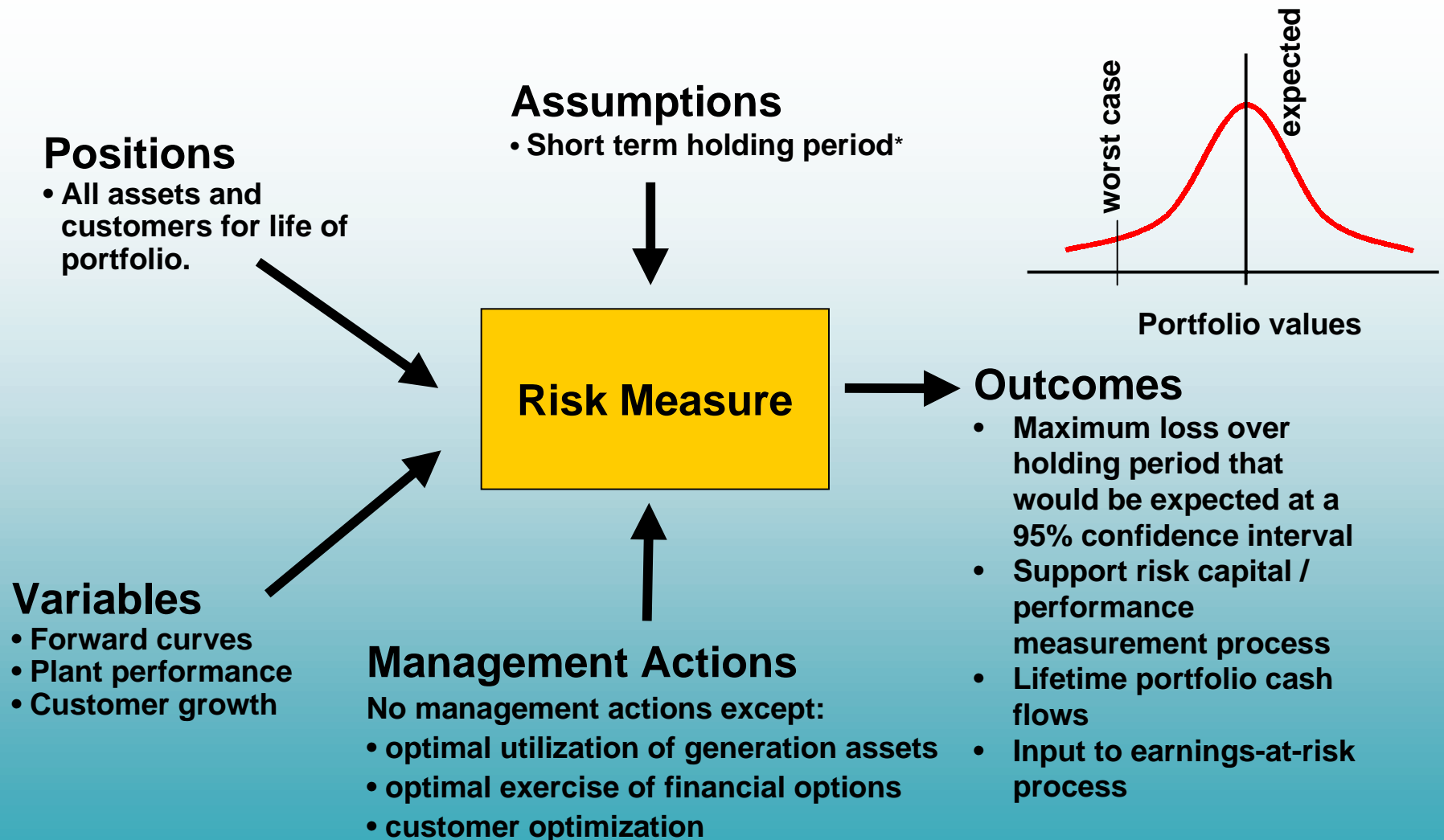
***Basis also for risk / return analysis and capital allocation**

Cash Flow at Risk



*allowed for in the limit

Total Portfolio Value at Risk



*Holding period dependent on local market liquidity

- **Credit Risk Definition**
 - The risk that a party to a commitment is unwilling or unable to pay
- **Credit Risk Exposure**
 - Maximum receivables exposure, plus ...
 - Cost of replacing the future position
- **Monitored via Middle Office and Treasury on a global basis via strict limit setting**

Conclusion



- **TXU's strategy for competing in today's liberalized energy markets requires leading competencies in risk management and trading**
- **Trading and risk management enhances the value and reduces the risk associated with assets, supplies, and customers**
- **Our business model demands excellence of risk awareness and control**
- **The job is never done!**

North America Middle Office

Sam Elia

Organizational Capabilities



Middle Office

**Risk
Management**

**Quantitative
Analysis**

**Risk
Control**

**Confirmations
& Contract
Administration**

Middle Office Roles



Monitor

- Position Monitoring
- Position Forecasting

Support

- Risk Review
- Risk Advice
- Risk Control

Manage

- Portfolio Optimization

Risk Management Capabilities



Advanced Risk Management

- Monte Carlo VaR
- Credit VaR
- User defined distributions
- Complex valuation models

Best in Class Risk Management

- Enterprise RM Framework
- State of the art:
 - Integrated systems
 - Knowledge and experience
 - Processes
 - Qualitative analysis

Energy Delivery Business

Jarrell Gibbs

Panel Members



- **Tom Baker - President TXU Electric & Gas**
- **Curt Seidlits - Executive Vice President Governmental Affairs**
- **Paul Plunket - Executive Vice President Regulatory Affairs**
- **Dan Farell - President Electric & Gas Distribution**
- **Mike Greene - President Transmission & Pipeline**

Energy Delivery



Transmission

Distribution

Business Functions



**Asset
Ownership**

**Asset
Management**

**Asset
Operations**

Energy Delivery Focus



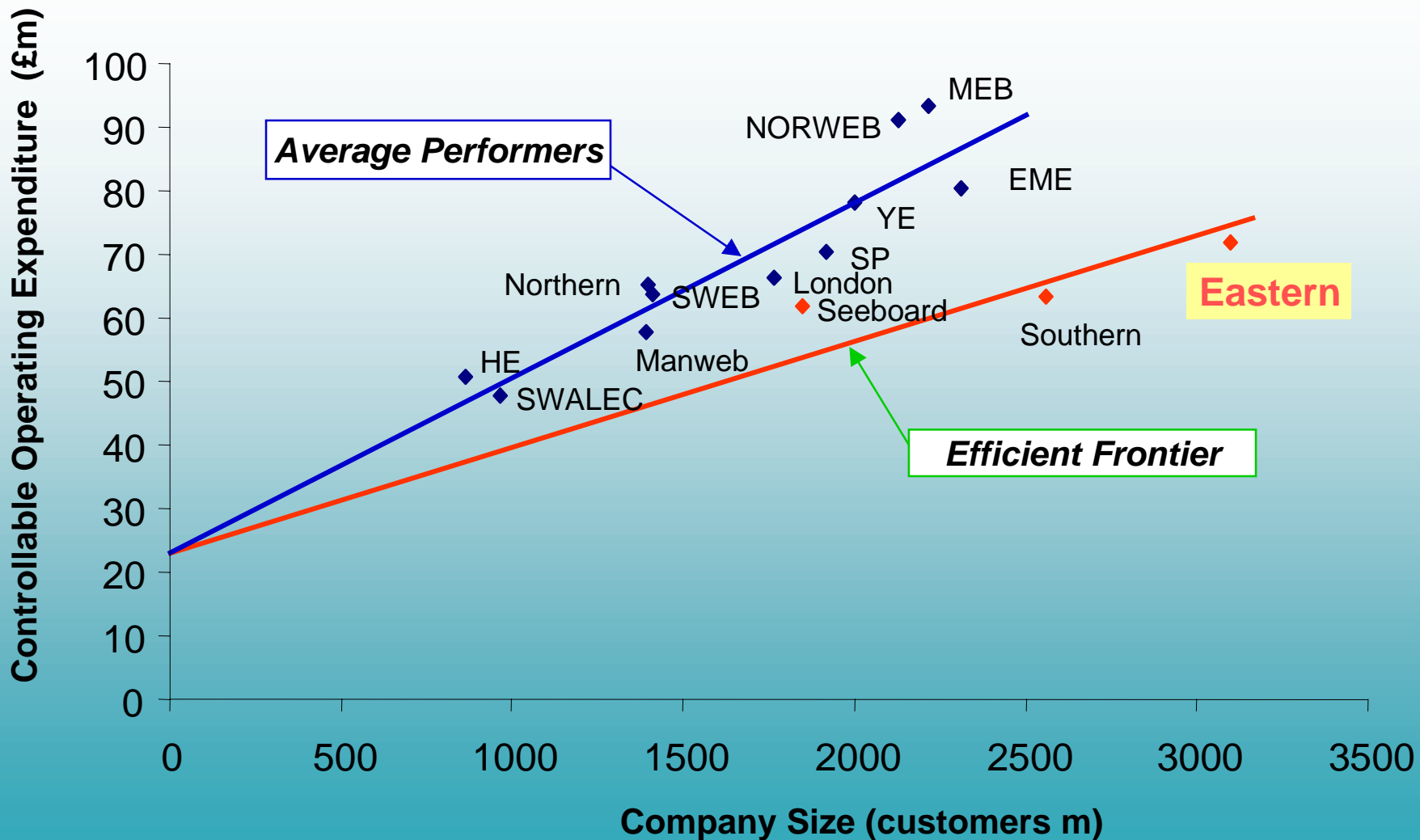
- **Service territories contain major growth corridors**
- **Reliable, cost-efficient provider**
- **Economies of scale**
- **Asset management focus over next five years**
- **Significant growth opportunities non-regulated business**

TXU Energy Delivery



| | Australia | Europe | US |
|------------------------|---------------|----------------|----------------|
| Miles of Line | | | |
| Electric | 26,000 | 56,000 | 104,000 |
| Gas | 5,000 | - | 33,000 |
| | | | |
| Electric Meters | .5 Mil | 4.4 Mil | 2.7 Mil |
| Gas Meters | .4 Mil | - | 1.4 Mil |

The Most Efficient UK Network



source: Ofgem draft DPR Proposals October 1999



- A JV between TXU & London Electricity (EdF), managing both networks

- Successful implementation of JV in April 2000
- Delivering total savings of £50m a year
- Actively pursuing exciting new opportunities
- 24seven skills to assist TXU in continental Europe

Separation of UK Supply & Distribution



- **The Utilities Act 2000 requires clear separation**
- **Formal separation takes place 1st August 2001**
- **New Electricity Supply & Distribution license conditions will then apply to the separate subsidiaries**
- **The scheme of separation (Transfer Scheme) by which TXU's split will be defined is expected to be approved during July 2001**

Australia Network Performance



- **Successful mitigation of Regulatory Price Review, P₀ reduction of 18.8%**
- **Sale of Enetech and alliance / outsourcing of network services**
- **Out-performance regulatory OPEX and CAPEX targets (20% OPEX outperformance)**

US Energy Delivery Business

Tom Baker

Legislative Update

Curt Seidlits

Texas Legislative Update



- **Session: Jan 9 - May 28**
- **TXU Goal - Maintain Structure of SB7**
- **Challenges**
 - **Delay (HB 918)**
 - **Negative Stranded Costs (HB2107)**
 - **Validation of PUC Orders (HB2107)**
- **Results**
 - **SB 7 Maintained**



Texas, US Legislation: Backdrop



- **California debacle and backlash**
- **Other states postpone, cancel plans for deregulation**
- **Natural gas cost increases**
- **New federal and state political leadership**
- **State and federal reapportionment**

- **TXU Goal: Ensure federal public policies that allow implementation of our business plan for growth**
- **TXU Areas of Focus:**
 - **Electric Restructuring**
 - **National Energy Policy**
- **Current Activities**
 - **House Commerce Committee**
 - **Senate Energy Committee**
 - **Administration's National Energy Plan**

Regulatory Update

Paul Plunket

Unbundled Cost of Service (Wires Rates)




- **Business Separation Plan Approved**
- **11.25% ROE**
- **Major Wire Rates Revenue Requirements:**

| | | |
|-----------------------------|--------------------|----------------------|
| Requested (millions) | \$1,931 | |
| PUC Adjustments | (84) | (4.4%) |
| PUC Timing Adj. | <u>(64)</u> | <u>(3.3%)</u> |
| Total | \$1,783 | (7.7%) |

- **Excess earnings mitigation credit**
- **T&D depreciation reversal**

Fuel Recovery



| Fuel Factor | <u>¢/kwh</u> | <u>Imbedded Gas Prices</u> <u>\$/MMBTU</u> |
|--------------------------|---------------------|---|
| • Before Sept. 2000 | 1.87 | \$2.63 |
| • Increase Sept. 6, 2000 | 0.26 | |
| • Increase Jan. 11, 2001 | 0.26 | |
| • Increase May 8, 2001 | 0.69 | |
| | <u>3.08</u> |  \$5.51 |

Regulatory Assets Securitization



- **Requested \$1.65 billion**
- **PUC approved \$363 million**
- **District Court order \$1.3 billion**
- **Texas Supreme Court decision pending**

TXU Gas Distribution Rate Cases



| <u>Year</u> | <u>Approved Amount \$(Millions)</u> | <u>Cities</u> | <u>Number of Cases</u> |
|-------------|---|---------------|----------------------------|
| Year 1998 | \$ 2.5 | 19 | 5 |
| Year 1999 | 7.3 | 51 | 14 |
| Year 2000 | 19.8 | 65 | 11 |
| Year 2001* | <u>20.0</u> | 337 | 5 |
| | \$ 49.6 | | |

* Estimate

- **Commissioner Judy W. Walsh**
 - Term expired September 1, 1999
 - Resigned March 2001
 - Currently Vice President Governmental Affairs for Southwestern Bell Communications Corp.
- **Chairman Patrick H. Wood III**
 - Term expires September 1, 2001
 - FERC Commissioner Designee
 - Confirmation hearing held May 16, 2001
- **Commissioner Brett A. Perlman**
 - Term expires September 1, 2003

Strategy Going Forward

Tom Baker

Five Year Plan



- **Grow existing electric and gas delivery systems in north central Texas**
- **Initiate an unregulated asset management and associated utility services business in North America**
- **Capture attractive growth opportunities**
- **Be recognized in industry and by investment community as one of the “Top 5” providers of utility services in North America**

Business Characteristics



- **No Retail Electric Customers**
- **REP Customers - Builders / Developers**
- **Retail Service Quality Important**
- **Regulatory Management**
- **Code of Conduct / Business Separation**

Business Functions



Asset
Ownership

Asset
Management

Asset
Operations

Asset Ownership Model



- **Economically sound, growing service area**
- **Investor value - steady growth**
- **Reasonable regulation**

Earnings Enhancements



- **Investment trackers (Gas & Transmission)**
- **Bundling of gas rate cases**
- **Customer contributed capital**
- **Reasonable returns**
- **Rationalization of assets**

Business Functions



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Business Functions



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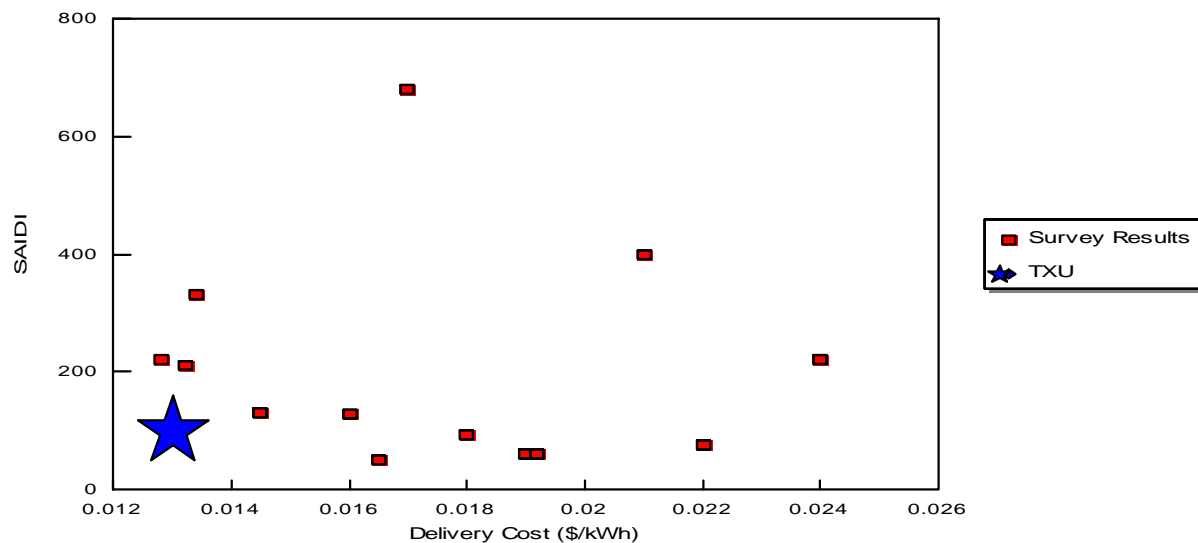
Asset
Operations

We Do It Well



PHB Hagler Bailly

Comparison of Distribution Delivery Cost and Reliability



ABB

"TXU's distribution engineering and planning processes are...in the upper quartile or better in industry performance"

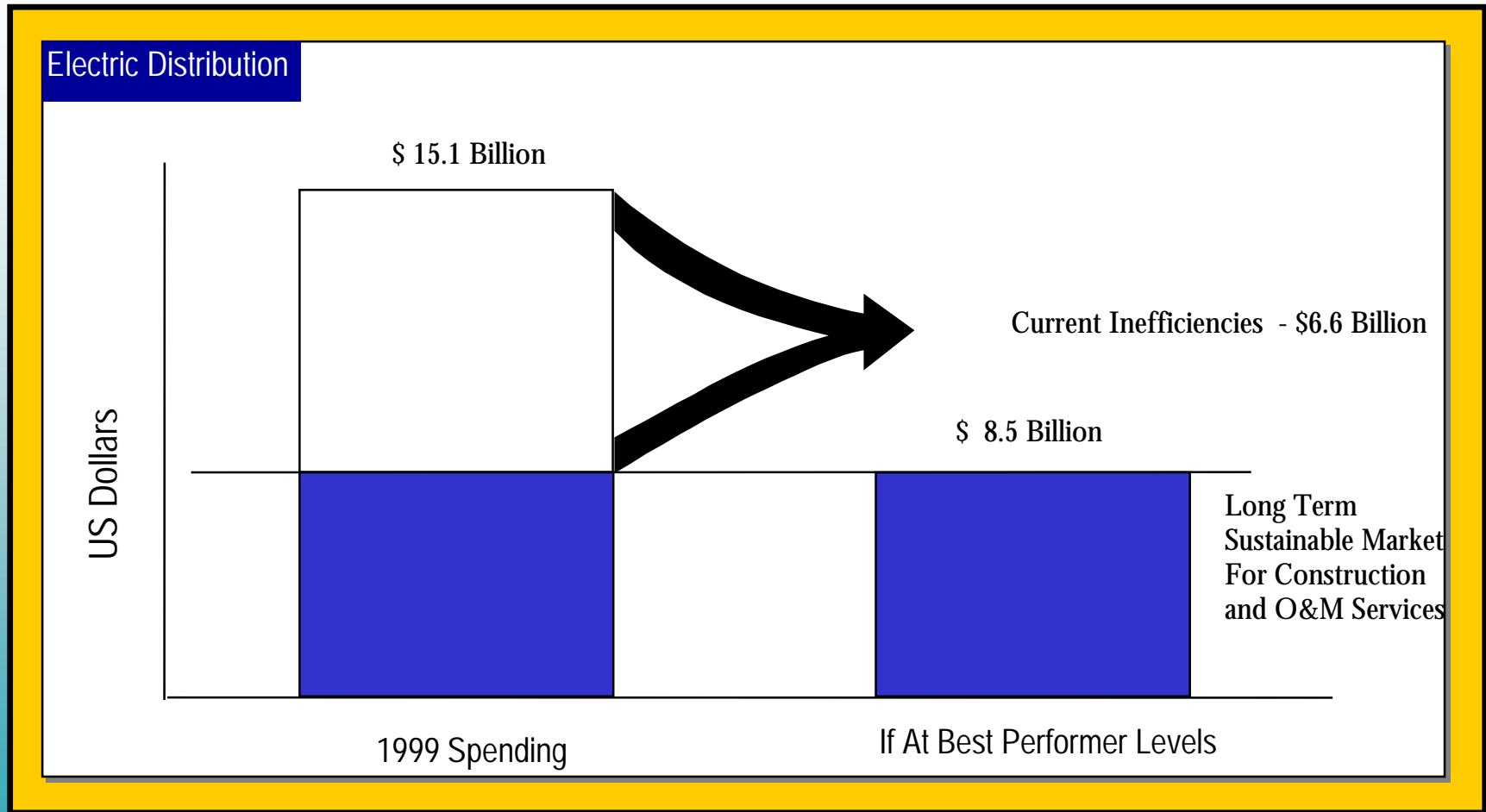
PHB Hagler Bailly

... recognized energy companies that exemplify the best in their sector and TXU Transmission was named "Best Transmission Lines Company" in the country

US Unregulated Asset Management

Dan Farrell

Market Opportunities



- **Achieves owner's financial and operational performance objectives**
- **Leverages global knowledge and capabilities**
- **Economies of scale**
- **Regulatory strategy**

Asset Management Target Markets



- **Investor-Owned Utilities**
- **Cooperatives**
- **Municipal Utilities**
- **Other**

Asset Management Value Proposition



- **Both scale economies and best practices**
- **A constructive regulatory “deal”**
- **Price reductions to consumers**
- **Upside retention for asset owners**
- **Positive margin for asset manager**
- **Incentive upside for asset services provider(s)**

A Win - Win Outcome

Q&A

Tom Baker

Financial Overview

Mike McNally

TXU Electric Restructuring



TXU Corp.

Energy Delivery

- *Transmission*
- *Distribution*

Merchant Energy

- *Trading*
- *Retail*
- *Generation*

- **Separate Retail and Generation from Transmission and Distribution**
- **Restructure capitalization at TXU Electric**
- **Finance new entity**

TXU Electric Restructuring



| | Transmission & Distribution 01-01-02 | Merchant Energy 01-01-02 |
|-----------------------------|---|---|
| Debt & Preferred | 60% | 50% |
| Equity | 40% | 50% |

- **Earnings growth*:**
 - **Merchant Energy** 11-13%
 - **Consolidated EPS** 9 - 11%
- **Position company for higher growth**
- **Credit targets:**
 - **Parent** BBB, Baa2
 - **Subsidiaries** BBB+, Baa1

*Excludes development opportunities

Summary

Erle Nye

- **Good growth prospects from existing business in Texas**
- **Top performer - efficiency and reliability**
 - ⇒ global knowledge and capabilities
- **Potential for incremental growth from unregulated asset management services**
- **Reasonable regulatory environment**

Global Merchant Energy



- **Distinctive business model**
- **Proven track record in Europe and Australia**
- **Excellent starting position in Texas; momentum in other U.S. regions**
- **World-class capabilities**
- **Capturing global synergies**
- **Maximize efficient use of capital**
- **Clear strategy and deal stream**

Enhancing Shareholder Value

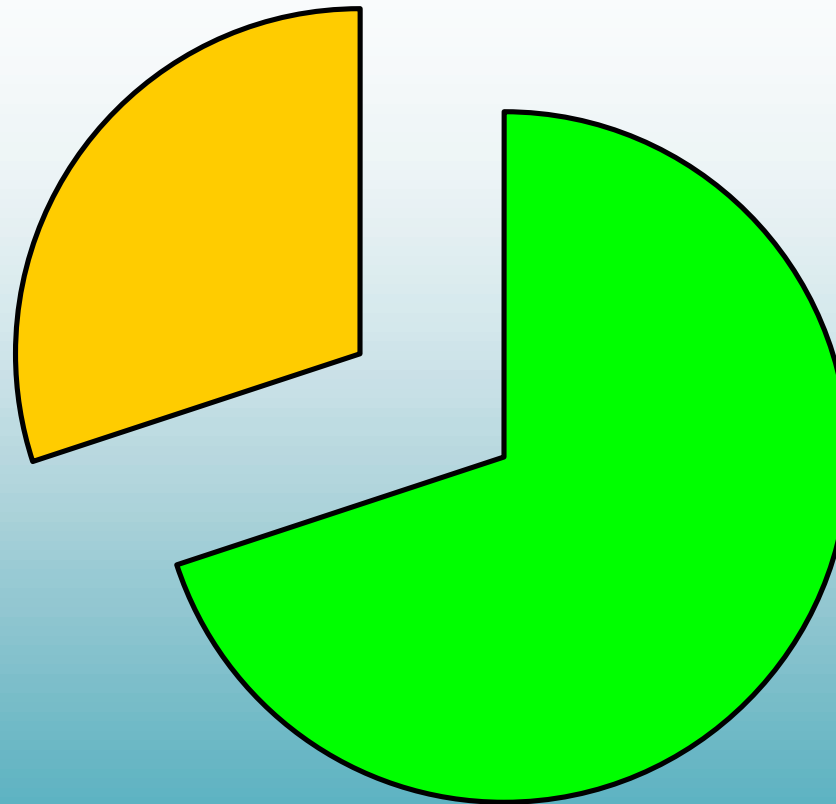


- **Deliver growth from existing businesses**
- **Create opportunity with Texas restructuring**
- **Diversify US assets outside of Texas**
- **Structurally separate merchant energy and network business**
- **Capture substantial value from global merchant energy business**
- **Strengthen credit**

Two Distinctive Businesses



EBIT - 2002



 Energy Delivery

 Merchant Energy

Q&A

Erle Nye