

Management's Letter

DEAR FELLOW SHAREHOLDERS,

TXU is delivering excellent results on the three-year turnaround plan launched in early 2004. Our solid performance in 2005 has put us a full year ahead of schedule in transforming TXU into a high-performance company that can compete with the best industrial businesses. We are well on our way to achieving our five core business objectives for 2010:

1. Drive 3 to 5 percent annual improvement in reliability, efficiency, and service through our power, electric delivery, and retail operations.
2. Grow the Texas baseload power generation portfolio organically by 25 to 50 percent through the development of clean coal power plants.
3. Maintain our residential market share throughout Texas by profitably gaining customers outside North Texas and providing innovative products and services to customers state-wide.
4. Leverage superior baseload operations, construction expertise, and structuring skills to build a high-quality solid-fuel generation business in other competitive U.S. wholesale markets.
5. Continue to enhance our business through building strong management, ensuring that our financial risk profile is commensurate with our business risk profile, and mitigating risks that are not an inherent part of TXU's core business.

Our financial and operating performance has improved sharply relative to 2003, and we have moved from the bottom quartile to the top quartile across a variety of business dimensions. In 2005, TXU was in the top decile in the industry in total shareholder return, growth in operational earnings per share, and return on invested capital. Operating and free cash flow is also top quartile, reflecting our focus on driving operational excellence, managing the cost structure, and enhancing financial strength. We have slashed fixed costs by \$1 billion, or more than 25 percent, without negatively affecting the earnings and cash-generating power of the company.

This turnaround success has also earned us the right to pursue sensible initiatives to drive future earnings growth. While we still have a lot to do, TXU is a much stronger, more resilient, and better-performing company than it was two years ago.

IMPORTANT WORK

As we focus on the everyday process of producing, delivering, and providing electricity to our customers, we sometimes miss the big picture of what we do. If we ever needed reminding, Hurricane Katrina, followed by Rita and Wilma, made one thing powerfully clear: TXU and its employees do important work. The service we provide is essential for society to function. In the devastating aftermath of the hurricanes, restoring electricity was a prerequisite for rebuilding communities and lives.

TXU's employees went well beyond the extra mile to help those devastated by the hurricanes. In fact, Tom Baker and the TXU Electric Delivery team traveled more than 1.3 million miles to restore power to almost two-thirds of a million people in Louisiana, Florida, and Texas. At the same time, TXU employees did a great job of taking care of business back home, including welcoming thousands of displaced victims as new customers and maintaining reliable electric service. Employee response to the hurricanes was heroic and makes me even prouder to work at TXU and be part of the industry that powers America.

TURNAROUND RESULTS

TXU delivered good results in 2005 with strong financials and some terrific operational successes. But we also know we can do better, and we will. To assess our progress, we compared the results from 2003 (prior to the turnaround) to our performance through 2005. We measure our progress against

PERFORMANCE SCORECARD					
Performance Metric	Measure	2003 ¹	2005	% Improvement	Evaluation
FINANCIAL PERFORMANCE²					
Operational earnings per share	\$/share	1.01	3.33	230	Big improvement!
Normalized operating cash flow	\$ millions	1,860	2,902	56	
Normalized free cash flow	\$ millions	860	1,798	109	
Return on invested capital	percent	6.5	15.4	137	
EBITDA/interest	ratio	3.0	4.9	63	Much stronger company
OPERATIONAL EXCELLENCE					
Lignite generation	gigawatt-hours	41,311	44,005	7	Terrific!
Nuclear generation ³	gigawatt-hours	17,717	19,300	9	Great job
SAIDI ⁴	minutes	74.2	76.8	(4)	Aggressively improving
Safety ⁵	rate	0.26	0.07	73	Excellent, but can't let up
Total operating costs and SG&A expenses ⁶	\$ millions	2,773	2,206	20	Good start
Fixed costs ⁷	\$ millions	4,359	3,182	27	Excellent
MARKET LEADERSHIP					
Call answer time	seconds	268	11	96	World class!
PUC complaints	# thousands	5.4	2.3	57	Progressing
Retail bad-debt expense	\$ millions	121	53	56	Big improvement
RISK/RETURN MINDSET					
Total shareholder return (2-year)	percent	(46)	343	-	Dramatically better

¹ Based on actual 2003 financial results including subsequently discontinued operations.

² See financial definitions and Regulation G reconciliations on pages 15 and 16.

³ Nuclear generation operations refueled both units in 2005; 2005 results have been adjusted to approximate a single outage year.

⁴ System Average Interruption Duration Index: the number of minutes an average customer's power is out during a year.

⁵ Based on Lost Time Incident Rate: the number of injuries requiring time away from the job per 200,000 employee hours worked.

⁶ 2003 amount includes \$477 million related to discontinued operations.

⁷ Includes non-variable operating costs and SG&A expenses, interest expense and related charges, and maintenance capital expenditures. All operating costs, SG&A expenses, interest expense and related charges, and capital expenditures totaled \$4,704 million in 2003 and \$4,055 million in 2005. Of this total 2003 amount, \$903 million relates to discontinued operations.

the hallmarks of successful industrial companies: operational excellence, market leadership, a strict risk/return mindset for all key business decisions, and a rigorous performance management system. We believe that executing against these elements is necessary to deliver top-quartile financial performance, shareholder return, and financial flexibility. A high-level version of the comprehensive scorecard we use to monitor our business performance

appears above. Here are some notes on how we're doing, along with my grade on an A to F scale:

Financial Performance

The improvement in most of our financial metrics over the past two years is at or near the top quartile in the industry, with outstanding free cash flow, operational earnings that have more than tripled, and substantial improvements in financial flexibility.

In a capital-intensive industry like ours, capital productivity is key. Our return on invested capital is top decile, more than doubling from 6.5 to 15.4 percent, or a 137 percent improvement. We can't find any competitor that approaches this improvement level. This progress reflects a combination of strong operational performance and strict capital discipline, with each operating division doing its part. In just two years, we have also achieved substantial efficiency gains, allowing us to reduce our workforce by over 40 percent and deliver even greater value to our customers. Overall, these improvements have boosted TXU from the bottom quartile to the top. Grade: A-

Operational Excellence

We've made very good progress toward achieving operational excellence. The improvements in our nuclear and lignite fleets are the best in the industry and a real testament to the TXU Power team, headed by Mike Greene. The new Power Optimization Center, our generation-fleet support and monitoring facility, and the TXU Operating System, our version of lean manufacturing, are really beginning to make a difference. Last year, Richard Wistrand and Steve Kopenitz led a great employee team that drove to record coal generation. Likewise, Mike Blevins, Rafael Flores, Mitch Lucas, and an exceptional group of employees at the Comanche Peak nuclear plant achieved the third-best annual production ever in spite of refueling both units during the year.

Electric reliability performance declined slightly for several reasons. Even though we have top-quartile performance in delivery reliability, I am not satisfied that our customers have to be without electricity for approximately 77 minutes per year. Our long-term goal is to reduce outages to 50 minutes per year. This is a very ambitious pursuit because no similarly situated company in the United States has achieved this performance level. I have great confidence in Tom Baker, Rob Trimble, and the TXU Electric Delivery team, and I believe we can be

the first to achieve this spectacular level of reliability. Jim Greer, supported by many others, is leading an aggressive capital expenditure and technology enhancement program over the next three years that will put TXU Electric Delivery in good position to attain this industry-leading reliability performance by the end of the decade.

While an emphasis on cost leadership has driven down non-fuel costs by 20 percent and fixed costs by 27 percent, we have an opportunity to strip out additional operating costs from all our businesses, including our nuclear and lignite operations. Cost reductions will be a big focus in 2006. Grade: A-

Market Leadership

The volatile commodity markets in 2005 created headaches for all Texas electricity providers. To guide TXU through these uncertain times, we appointed Mike McCall as chairman and CEO of TXU Wholesale to bring more experience and discipline to our wholesale and market activities.

Despite our market-leading position, our retail operation was challenged by the rising wholesale power prices and a price-to-beat transition mechanism that does not fully reflect these volatile wholesale prices. Under Jim Burke's leadership, we made a good start at improvement in 2005 by restructuring the retail organization, reducing staff, and lowering the overall cost to serve customers. We believe we have at least a 15 percent cost advantage, which allows us to pass the savings on to our customers. While customer call answer times have dropped more than 90 percent since 2003 and are now world class, customer satisfaction remains below our high expectations. The team has taken actions to improve customer service and is beginning to deliver innovative new products, like the Peace of Mind and TXU Energy Market Tracker+ programs, which allow customers to control how their rates adjust with natural gas prices. Over the next 12 months, we expect to launch dozens of new products



TXU's aim is to extract as much value as possible from its assets, including its plants, mines, land, fuel reserves, equipment, and electric infrastructure. Left to right, Chairman and CEO John Wilder with Shawn Glacken, environmental policy, and Gerald McDaniel and Brad Jones, corporate development.

and continue to differentiate our service offerings to provide more value to our customers.

The retail market remains tough, but the strong retail team and the strategy established in 2005 position us well to improve the performance of this operation. The fully competitive market, which begins in 2007 after the price to beat expires, will create an environment that drives better service and product innovation for customers. As the market transitions to competition, Mike McCall's team is doing a great job in dealing with the crucial regulatory and public policy issues we face. Grade: C+

Risk/Return Mindset

Our application of a risk/return mindset to business decisions has really improved. We've whittled down the risks to those that are inherent in our core business and eliminated billions of dollars of potential future liabilities. The most important way to reduce risks is to improve the business mix and business performance, and that is where we started. We divested telecom and natural gas distribution businesses with negative cash flows,

an underperforming intrastate pipeline, and an Australian business that had cash flow we couldn't efficiently use. We restructured two parts of the retail operation that were losing \$100 million per division per year, and we substantially improved customer service to do everything we could to keep our valuable customers, who were frustrated that we wouldn't answer the phones. We very analytically benchmarked all our operations and drove our core businesses to high-performance levels.

We have been brutal in our pursuit of risk reduction. We have eliminated or mitigated risks ranging from \$1.5 billion of underwater hedges to underfunded vegetation management programs and plant maintenance. We've improved our corporate governance, restructured \$500 million of uneconomic leases and purchase power agreements, and provided for the proper regulatory recovery for almost half a billion dollars of underfunded pension and retirement medical liabilities. David Poole and the legal team have settled billions of dollars of potential litigation. We've also reduced retail bad-debt expense from \$121 million a year to \$53 million per year. A

three-year hedging strategy we executed in 2005 now mitigates virtually all our natural gas price exposure, with retail acting as a partial hedge to our generation capacity. We understand the risky nature of our businesses, and we continue to build a top management team that has a track record in managing these types of businesses.

Since we began our turnaround, cumulative total shareholder return, the most comprehensive measure of risk/return performance, dramatically exceeds that of the market indices and TXU's previous performance. Total shareholder return for the two-year period through 2005 was 343 percent, compared to minus 2 percent for the 10 years prior to the beginning of the turnaround. We are ahead of plan for improving our financial flexibility and strength. We aim to continue to improve our metrics and demonstrate that TXU is far stronger today. Grade: A-

Performance Management

Promoting an environment that champions high performance and crystal-clear accountability for each business, every manager, and all employees is among our biggest challenges. We've made a decent start and have developed scorecards of key business drivers to track progress. Our business scorecards, performance dialogue, and incentives are now aligned around the key value levers that drive to top-quartile industry performance. The senior leadership team has gone through an intensive assessment and development process, and a new performance management system is being rolled out to employees. Transforming the performance culture of a large organization like TXU takes time and a disciplined, consistent focus, but with the changes we have made and the quality and determination of TXU employees, we are well on our way.

This culture will require top-flight leadership. We have made substantial improvements in our officer group over the past two years. Over 50 percent of the officers who were part of TXU two years ago are no

longer with your company. We have recruited more than 15 high-quality executives to head up strategy, retail sales, legal, operations, supply chain, and power plant development, to name a few. We have also promoted more than half a dozen hungry managers who spend each and every day improving this company. Overall, we have grown the earnings per share by 230 percent and market capitalization by 208 percent, and we did it with 20 percent less officers. Although this is a difficult area to precisely measure, I believe our management team is at least twice as good as it was two years ago, and we hope to double its strength and quality over the next three years. Grade: B+

FOUNDATIONAL RESULTS FOR GROWTH

All in all, I'm proud of our turnaround results so far and the efforts of our employees in driving the improvements. We've moved to top-quartile performance on many measures. We're focused on areas that matter. Our success has earned us the right to pursue growth, and David Campbell and Jonathan Siegler have provided a great roadmap toward a prudent, achievable strategy. Mike Childers is focused on executing the development aspects of our new strategy as we leverage TXU's industrial skill set and strong cash flows to deliver solid earnings growth and superior returns over the next five years. We're driving continuous improvements across our business with a target of 3 to 5 percent annual productivity gains, a mandate for high performance, and top-quartile shareholder returns for you, the owners of TXU. I'm excited about the prospects ahead.

I am honored to lead this great company, and I sincerely appreciate you and your continued confidence and support.



C. JOHN WILDER
Chairman and CEO