

AES CORP  
Form 10-Q  
August 07, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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## FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2006

or

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

Commission file number 0-19281

## THE AES CORPORATION

(Exact name of registrant as specified in its charter)

**Delaware**

(State or Other Jurisdiction of  
Incorporation or Organization)

**54-1163725**

(I.R.S. Employer  
Identification No.)

**4300 Wilson Boulevard, Suite 1100,  
Arlington, Virginia**

(Address of Principal Executive Offices)

**22203**

(Zip Code)

**(703) 522-1315**

(Registrant's Telephone Number, Including Area Code)

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

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. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of Registrant's Common Stock, par value \$0.01 per share, at July 28, 2006, was 661,428,135.

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THE AES CORPORATION

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

TABLE OF CONTENTS

**PART I: Financial Information (unaudited)**

Item 1. Financial Statements

Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2006 and 2005 3

Condensed Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005 4

Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005 5

Notes to Condensed Consolidated Financial Statements 6

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 28

Item 3. Quantitative and Qualitative Disclosures about Market Risk 50

Item 4. Controls and Procedures 50

**PART II: Other Information**

Item 1. Legal Proceedings 55

Item 1A. Risk Factors 63

Item 2. Unregistered Sales of Securities and Use of Proceeds 64

Item 3. Defaults Upon Senior Securities 64

Item 4. Submissions of Matters to a Vote of Security Holders 64

Item 5. Other Information 64

Item 6. Exhibits 64

Signatures 65

**PART I: FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**THE AES CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Amounts in Millions, Except Per Share Amounts)  
(Unaudited)

|  | Three Months Ended |                | Six Months Ended |                |
|--|--------------------|----------------|------------------|----------------|
|  | June 30,           | 2005           | June 30,         | 2005           |
|  | 2006               |                | 2006             |                |
| Revenues   |                    |                |                  |                |
| Regulated  | \$ 1,506           | \$ 1,376       | \$ 2,976         | \$ 2,755       |
| Non-regulated  | 1,532              | 1,273          | 3,044            | 2,537          |
| Total revenues   | 3,038              | 2,649          | 6,020            | 5,292          |
| Cost of sales  |                    |                |                  |                |
| Regulated  | (1,098 )           | (1,264 )       | (2,202 )         | (2,278 )       |
| Non-regulated  | (1,021 )           | (859 )         | (1,948 )         | (1,665 )       |
| Total cost of sales  | (2,119 )           | (2,123 )       | (4,150 )         | (3,943 )       |
| Gross margin   | 919                | 526            | 1,870            | 1,349          |
| General and administrative expenses  | (59 )              | (45 )          | (114 )           | (94 )          |
| Interest expense   | (442 )             | (475 )         | (874 )           | (941 )         |
| Interest income  | 90                 | 93             | 206              | 182            |
| Other (expense) income, net  | (49 )              | 67             | (97 )            | 52             |
| Gain on sale of investments  |                    |                | 87               |                |
| Foreign currency transaction gains (losses), net   | 1                  | (1 )           | (21 )            | (33 )          |
| Equity in earnings of affiliates   | 23                 | 21             | 59               | 46             |
| <b>INCOME BEFORE INCOME TAXES AND MINORITY INTEREST</b>  | <b>483</b>         | <b>186</b>     | <b>1,116</b>     | <b>561</b>     |
| Income tax expense   | (106 )             | (80 )          | (296 )           | (227 )         |
| Minority interest expense  | (166 )             | (19 )          | (254 )           | (125 )         |
| <b>INCOME FROM CONTINUING OPERATIONS</b>   | <b>211</b>         | <b>87</b>      | <b>566</b>       | <b>209</b>     |
| Loss from operations of discontinued businesses (net of income tax expense of \$1, \$2, \$7 and \$2, respectively) | (63 )              | (2 )           | (67 )            |                |
| Extraordinary item (net of tax of \$-)   | 21                 |                | 21               |                |
| <b>NET INCOME</b>  | <b>\$ 169</b>      | <b>\$ 85</b>   | <b>\$ 520</b>    | <b>\$ 209</b>  |
| Basic Earnings Per Share:  |                    |                |                  |                |
| Income from continuing operations  | \$ 0.32            | \$ 0.13        | \$ 0.86          | \$ 0.32        |
| Discontinued operations  | (0.09 )            |                | (0.10 )          |                |
| Extraordinary item   | 0.03               |                | 0.03             |                |
| <b>BASIC EARNINGS PER SHARE</b>  | <b>\$ 0.26</b>     | <b>\$ 0.13</b> | <b>\$ 0.79</b>   | <b>\$ 0.32</b> |
| Diluted Earnings Per Share:  |                    |                |                  |                |
| Income from continuing operations  | \$ 0.31            | \$ 0.13        | \$ 0.85          | \$ 0.31        |
| Discontinued operations  | (0.09 )            |                | (0.10 )          |                |
| Extraordinary item   | 0.03               |                | 0.03             |                |
| <b>DILUTED EARNINGS PER SHARE</b>  | <b>\$ 0.25</b>     | <b>\$ 0.13</b> | <b>\$ 0.78</b>   | <b>\$ 0.31</b> |

**THE AES CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Amounts in Millions, Except Shares and Par Value)  
(Unaudited)

|  | June 30,<br>2006 | December 31,<br>2005 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| <b>CURRENT ASSETS</b>  |                  |                      |
| Cash and cash equivalents  | \$ 1,330         | \$ 1,387             |
| Restricted cash  | 511              | 418                  |
| Short-term investments   | 420              | 199                  |
| Accounts receivable, net of reserves of \$247 and \$274, respectively  | 1,926            | 1,597                |
| Inventory  | 495              | 458                  |
| Receivable from affiliates   | 2                | 2                    |
| Deferred income taxes - current  | 243              | 266                  |
| Prepaid expenses   | 134              | 119                  |
| Other current assets   | 1,027            | 752                  |
| Current assets of held for sale and discontinued businesses  | 41               | 34                   |
| Total current assets   | 6,129            | 5,232                |
| <b>NONCURRENT ASSETS</b>   |                  |                      |
| Property, plant and equipment:   |                  |                      |
| Land   | 943              | 858                  |
| Electric generation and distribution assets  | 23,293           | 22,235               |
| Accumulated depreciation   | (6,637 )         | (6,041 )             |
| Construction in progress   | 1,577            | 1,441                |
| Property, plant and equipment, net   | 19,176           | 18,493               |
| Deferred financing costs, net of accumulated amortization of \$174 and \$222, respectively   | 307              | 293                  |
| Investment in and advances to affiliates   | 572              | 670                  |
| Debt service reserves and other deposits   | 612              | 568                  |
| Goodwill   | 1,416            | 1,406                |
| Deferred income taxes - noncurrent   | 857              | 775                  |
| Non-current assets of held for sale and discontinued businesses  | 203              | 265                  |
| Other assets   | 1,701            | 1,730                |
| Total other assets   | 5,668            | 5,707                |
| <b>TOTAL ASSETS</b>  | <b>\$ 30,973</b> | <b>\$ 29,432</b>     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                  |                      |
| <b>CURRENT LIABILITIES</b>   |                  |                      |
| Accounts payable   | \$ 1,116         | \$ 1,093             |
| Accrued interest   | 382              | 381                  |
| Accrued and other liabilities  | 2,212            | 2,101                |
| Current liabilities of held for sale and discontinued businesses   | 61               | 51                   |
| Recourse debt - current portion  |                  | 200                  |
| Non-recourse debt - current portion  | 1,416            | 1,580                |
| Total current liabilities  | 5,187            | 5,406                |
| <b>LONG-TERM LIABILITIES</b>   |                  |                      |
| Non-recourse debt  | 11,203           | 11,093               |
| Recourse debt  | 4,878            | 4,682                |
| Deferred income taxes - noncurrent   | 822              | 721                  |
| Pension liabilities and other post-retirement liabilities  | 833              | 855                  |
| Long-term liabilities of held for sale and discontinued businesses   | 131              | 136                  |
| Other long-term liabilities  | 3,212            | 3,279                |
| Total long-term liabilities  | 21,079           | 20,766               |
| Minority Interest (including discontinued operations of \$10 and \$10, respectively)   | 2,256            | 1,611                |
| Commitments and Contingent Liabilities (see Note 7)  |                  |                      |
| <b>STOCKHOLDERS' EQUITY</b>  |                  |                      |
| Common stock (\$.01 par value, 1,200,000,000 shares authorized; 660,538,275 and 655,882,836 shares issued and outstanding, respectively) | 7                | 7                    |
| Additional paid-in capital   | 6,577            | 6,517                |
| Accumulated deficit  | (694 )           | (1,214 )             |
| Accumulated other comprehensive loss   | (3,439 )         | (3,661 )             |
| Total stockholders' equity   | 2,451            | 1,649                |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 30,973</b> | <b>\$ 29,432</b>     |



**THE AES CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Amounts in millions)  
(Unaudited)

|   | Six months ended<br>June 30, |          |
|---|------------------------------|----------|
|   | 2006                         | 2005     |
| <b>OPERATING ACTIVITIES:</b>                                  |                              |          |
| Net cash provided by operating activities                     | \$ 977                       | \$ 845   |
| <b>INVESTING ACTIVITIES:</b>                                  |                              |          |
| Property additions  | (620 )                       | (531 )   |
| Acquisitions net of cash acquired                             | (13 )                        | (85 )    |
| Proceeds from the sale of businesses                          | 234                          |          |
| Proceeds from the sales of assets                             | 7                            | 6        |
| Sale of short-term investments                                | 758                          | 802      |
| Purchase of short-term investments                            | (942 )                       | (611 )   |
| Increase in restricted cash                                   | (95 )                        | (7 )     |
| Proceeds from the sales of emission allowances, net           | 53                           | 29       |
| (Increase) decrease in debt service reserves and other assets | (5 )                         | 73       |
| Purchase of long-term available for sale securities           | (52 )                        |          |
| Other investing   | (20 )                        | (10 )    |
| Net cash used in investing activities                         | (695 )                       | (334 )   |
| <b>FINANCING ACTIVITIES:</b>                                  |                              |          |
| Borrowings under the revolving credit facilities, net         | 143                          |          |
| Issuance of recourse debt                                     |                              | 6        |
| Issuance of non-recourse debt                                 | 1,249                        | 951      |
| Repayments of recourse debt                                   | (150 )                       | (115 )   |
| Repayments of non-recourse debt                               | (1,571 )                     | (1,248 ) |
| Payments of deferred financing costs                          | (55 )                        | (10 )    |
| Distributions to minority interests                           | (125 )                       | (47 )    |
| Contributions from minority interests                         | 117                          | 9        |
| Issuance of common stock                                      | 28                           | 16       |
| Other financing   | (3 )                         | (2 )     |
| Net cash used in financing activities                         | (367 )                       | (440 )   |
| Effect of exchange rate changes on cash                       | 28                           | 27       |
| Total (decrease) increase in cash and cash equivalents        | (57 )                        | 98       |
| Cash and cash equivalents, beginning                          | 1,387                        | 1,272    |
| Cash and cash equivalents, ending                             | \$ 1,330                     | \$ 1,370 |
| <b>SUPPLEMENTAL DISCLOSURES:</b>                              |                              |          |
| Cash payments for interest net of amounts capitalized         | \$ 856                       | \$ 849   |
| Cash payments for income taxes net of refunds                 | \$ 258                       | \$ 101   |

**THE AES CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. FINANCIAL STATEMENT PRESENTATION**

**Consolidation**

The condensed consolidated financial statements include The AES Corporation, its subsidiaries and controlled affiliates ( Company or AES ). Furthermore, variable interest entities in which the Company has an interest have been consolidated where the Company is identified as the primary beneficiary. Investments in which the Company has the ability to exercise significant influence but not control are accounted for using the equity method. Intercompany transactions and balances have been eliminated in consolidation.

**Interim Financial Presentation**

The accompanying unaudited condensed consolidated financial statements and footnotes have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and Article 10 of Regulation S-X of the Securities and Exchange Commission ( SEC ). Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles in the United States of America for annual fiscal reporting periods. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair statement of the results of operations, financial position and cash flows for the interim periods. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of results that may be expected for the year ending December 31, 2006. The accompanying condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2005 consolidated financial statements and notes thereto, which are included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the SEC on April 4, 2006.

**New Accounting Standards**

*Share-Based Payment.* In December 2004, the Financial Accounting Standards Board ( FASB ) issued a revised Statement of Financial Accounting Standard ( SFAS ) No. 123, Share-Based Payment. AES adopted SFAS No. 123R and related guidance on January 1, 2006. See Note 11 to the condensed consolidated financial statements for disclosure of the Company s employee stock-based compensation and the effect of the adoption of SFAS No. 123R.

In April 2006, the FASB issued FASB staff position ( FSP ) FIN 46(R)-6, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R) . This FSP addresses how a reporting enterprise should determine the variability to be considered in applying FIN 46(R). The guidance is to be applied to all entities with which the Company becomes involved and to all entities required to be analyzed under FIN 46(R) when a reconsideration event has occurred beginning the first day of the first reporting period after June 15, 2006. The Company is adopting the provisions of this position on July 1, 2006.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ) which is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN No. 48 on January 1, 2007 and record the cumulative effect of applying the provisions of this Interpretation as an adjustment to beginning retained earnings. FIN No. 48 applies to all tax positions accounted for in accordance with SFAS No. 109. The Company is determining the impact at this time.



In July 2006, the FASB also issued FSP SFAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*. This FSP amends FASB Statement No. 13, *Accounting for Leases*, to require a lessor in a leveraged-lease transaction to recalculate the leveraged lease for the effects of a change or projected change in the timing of cash flows relating to income taxes that are generated by the leveraged lease. The FSP is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of this FSP will be recorded as an adjustment to the balance of beginning retained earnings as of January 1, 2007. The Company is determining the impact at this time.

## 2. INVENTORY

Inventory consists of the following (in millions):

|  | June 30, 2006 | December 31, 2005 |
|--|---------------|-------------------|
| Coal, fuel oil and other raw materials     | \$ 236        | \$ 233            |
| Spare parts and supplies                   | 261           | 227               |
| Less: Inventory of discontinued operations | (2 )          | (2 )              |
| Total                                      | \$ 495        | \$ 458            |

## 3. LONG-TERM DEBT

### *Non-Recourse Debt*

#### *Debt Defaults*

Subsidiary non-recourse debt in default as of June 30, 2006 is as follows (in millions):

| Subsidiary     | Primary Nature of Default | June 30, 2006 Default | Net Assets(1) |
|----------------|---------------------------|-----------------------|---------------|
| Eden/Edes      | Payment                   | \$ 87                 | \$ (72 )      |
| Parana         | Material adverse change   | 33                    | (76 )         |
| Hefei          | Payment                   | 4                     | 25            |
| Edelap         | Payment                   | 31                    | 74            |
| Kelanitissa(2) | Covenant                  | 63                    | 41            |
|                |                           | \$ 218                |               |

- (1) Net assets are presented only for those subsidiaries with secured debt in default at June 30, 2006.
- (2) Kelanitissa is in violation of a covenant under its \$65 million credit facility because of a cross default to a material agreement for the plant. The outstanding debt balance as of June 30, 2006 was \$63 million.

None of the subsidiaries listed above that are currently in default is a material subsidiary under AES's corporate debt agreements in order for such defaults to trigger an event of default or permit acceleration under such indebtedness. However, as a result of additional dispositions of assets, other significant reductions in asset carrying values or other matters in the future that may impact our financial position and results of operations, it is possible that one or more of these subsidiaries could fall within the definition of a material subsidiary and thereby upon an acceleration trigger an event of default and possible acceleration of the indebtedness under the AES parent company's outstanding debt securities.

**Recourse Debt**

Recourse debt obligations are direct borrowings of the parent corporation.

On March 3, 2006, the Company redeemed all of its outstanding 8.875% senior subordinated debentures (the Debentures) due 2027 (approximately \$115 million aggregate principal amount). The redemption was made pursuant to the optional redemption provisions of the indenture governing the Debentures. The Debentures were redeemed at a redemption price equal to 100% of the principal amount thereof, plus a make-whole premium of \$35 million determined in accordance with the terms of the indenture, plus accrued and unpaid interest up to the redemption date.

The Company entered into a \$500 million senior unsecured credit facility agreement effective as of March 31, 2006. On May 1, 2006, the Company exercised its option to extend the total amount of the senior unsecured credit facility by an additional \$100 million to a total of \$600 million. The credit facility will be used for general corporate purposes and to provide letters of credit to support AES's investment commitment as well as the underlying funding for the equity portion of its investment in AES Maritza East 1 on an intermediate-term basis. AES Maritza East 1 is a coal-fired generation project that began construction in the second quarter of 2006. At June 30, 2006, the Company had \$100 million of outstanding borrowings and \$394 million of letters of credit outstanding under the senior unsecured credit facility.

**4. EARNINGS PER SHARE**

Basic and diluted earnings per share are based on the weighted average number of shares of common stock and potential common stock outstanding during the period. Potential common stock, for purposes of determining diluted earnings per share, includes the effects of dilutive stock options, warrants, deferred compensation arrangements, and convertible securities. The effect of such potential common stock is computed using the treasury stock method or the if-converted method, as applicable.

The following table presents a reconciliation (in millions, except per share amounts) of the numerators and denominators of the basic and diluted earnings per share computation. In the table below, income represents the numerator and shares represent the denominator:

|                                       | Three Months Ended June 30,<br>2006 |            |                 | 2005         |            |                 |
|---------------------------------------|-------------------------------------|------------|-----------------|--------------|------------|-----------------|
|                                       | Income                              | Shares     | \$ per<br>Share | Income       | Shares     | \$ per<br>Share |
| <b>BASIC EARNINGS PER SHARE:</b>      |                                     |            |                 |              |            |                 |
| Income from continuing operations     | \$ 211                              | 658        | \$ 0.32         | \$ 87        | 652        | \$ 0.13         |
| <b>EFFECT OF DILUTIVE SECURITIES:</b> |                                     |            |                 |              |            |                 |
| Stock options and warrants            |                                     | 9          | (0.01 )         |              | 10         |                 |
| Restricted stock units                |                                     | 2          |                 |              | 1          |                 |
| <b>DILUTED EARNINGS PER SHARE</b>     | <b>\$ 211</b>                       | <b>669</b> | <b>\$ 0.31</b>  | <b>\$ 87</b> | <b>663</b> | <b>\$ 0.13</b>  |

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There were approximately 7,709,112 and 8,577,367 options outstanding at June 30, 2006 and 2005, respectively, that were omitted from the earnings per share calculation because they were anti-dilutive. In addition, all convertible debentures were omitted from the earnings per share calculation for the three months ended June 30, 2006 and 2005 because they were anti-dilutive.

|                                       | Six Months Ended June 30,<br>2006 |            |                 | 2005          |            |                 |
|---------------------------------------|-----------------------------------|------------|-----------------|---------------|------------|-----------------|
|                                       | Income                            | Shares     | \$ per<br>Share | Income        | Shares     | \$ per<br>Share |
| <b>BASIC EARNINGS PER SHARE:</b>      |                                   |            |                 |               |            |                 |
| Income from continuing operations     | \$ 566                            | 658        | \$ 0.86         | \$ 209        | 653        | \$ 0.32         |
| <b>EFFECT OF DILUTIVE SECURITIES:</b> |                                   |            |                 |               |            |                 |
| Convertible securities                | 11                                | 15         | (0.01 )         |               |            |                 |
| Stock options and warrants            |                                   | 10         |                 |               | 10         | (0.01 )         |
| Restricted stock units                |                                   | 1          |                 |               | 1          |                 |
| <b>DILUTED EARNINGS PER SHARE</b>     | <b>\$ 577</b>                     | <b>684</b> | <b>\$ 0.85</b>  | <b>\$ 209</b> | <b>664</b> | <b>\$ 0.31</b>  |

There were approximately 7,709,112 and 8,577,367 options outstanding at June 30, 2006 and 2005, respectively, that were omitted from the earnings per share calculation because they were anti-dilutive. For the six months ended June 30, 2006, there was one anti-dilutive convertible debenture omitted from the calculation because it was anti-dilutive and for the six months ended June 30, 2005 all convertible debentures were omitted from the earnings per share calculation because they were anti-dilutive.

### 5. SUMMARIZED INCOME STATEMENT INFORMATION OF AFFILIATES

The following table summarizes financial information (in millions) of the entities in which the Company has the ability to exercise significant influence but does not control, and that are accounted for using the equity method.

|              | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|--------------|--------------------------------|--------|------------------------------|--------|
|              | 2006                           | 2005   | 2006                         | 2005   |
| Revenues     | \$ 243                         | \$ 282 | \$ 475                       | \$ 532 |
| Gross Margin | \$ 63                          | \$ 78  | \$ 119                       | \$ 155 |
| Net Income   | \$ 48                          | \$ 48  | \$ 104                       | \$ 99  |

In accordance with Accounting Principles Board ( APB ) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, the Company discontinues the application of the equity method when an investment is reduced to zero and does not provide for additional losses when the Company does not guarantee the obligations of the investee, or is not otherwise committed to provide further financial support for the investee. The above table excludes income statement information for the Company's investments in which the Company has discontinued the application of the equity method. Furthermore, in accordance with APB No. 18, the Company's policy is to resume the application of the equity method if the investee subsequently reports net income only after the Company's share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

In March 2006, AES's wholly-owned subsidiary, AES Kingston Holdings, B.V., sold its 50% indirect ownership interest in Kingston Cogeneration Limited Partnership ( KCLP ), a 110 MW cogeneration plant located in Ontario, Canada. AES received \$110 million in net proceeds for the sale of its investment and recognized a pre-tax gain of \$87 million on the sale.

In May 2006, AES, through its wholly-owned subsidiary, AES Grand Itabo, purchased an additional 25% interest in Itabo, a power generation business located in the Dominican Republic for approximately

\$23 million. Prior to May, the Company held a 25% interest in Itabo indirectly through its Gener subsidiary in Chile and had accounted for the investment using the equity method of accounting. As a result of the transaction, AES now has a 48% economic interest in Itabo, and a majority voting interest, thus requiring consolidation. Through the purchase date in May, AES's 25% share in Itabo's net income is included in the Equity in earnings from affiliates line item on the income statement. Subsequent to the Company's purchase of the additional 25% interest, Itabo is reflected as a consolidated entity included at 100% in the financial statements, with an offsetting charge to minority interest expense for the minority shareholders' interest. The Company engaged a third-party valuation specialist to determine the purchase price allocation for the additional 25% investment. The valuation resulted in fair values of current assets and total liabilities in excess of the purchase price. Therefore, the Company recognized a \$21 million after-tax extraordinary gain on the transaction.

## 6. DISCONTINUED OPERATIONS

In May 2006, the Company reached an agreement to sell 100% of its interest in Eden, a regulated utility located in Argentina. Governmental approval of the transaction is still pending in Argentina, but the Company has determined that the sale is probable at this time. Therefore, Eden, a wholly-owned subsidiary of AES, has been classified as held for sale and reflected as such on the face of the financial statements. The Company recorded a \$66 million impairment charge to adjust the carrying value of Eden's assets to their estimated net realizable value. This impairment expense is included in the 2006 net losses for the three and six months then ended in the table below. Eden is a distribution company that is part of the Regulated Utilities segment. The sale is expected to close by the end of the year.

An agreement was reached in May 2006 in which the Company agreed to sell AES Indian Queens Power Limited and AES Indian Queens Operations Limited, (collectively IOP), which is part of the Competitive Supply segment. IOP is an Open Cycle Gas Turbine, located in the U.K. The sale is considered probable to close by the end of the year. This facility has also been classified as held for sale and reflected in the discontinued operations line items on the financial statements.

The following table summarizes the revenue and net losses for these discontinued operations for the three and six months ended June 30, 2006 and 2005 (in millions):

|            | Three Months Ended |          | Six Months Ended |       |
|------------|--------------------|----------|------------------|-------|
|            | June 30,<br>2006   | 2005     | June 30,<br>2006 | 2005  |
| Revenues   | \$ 28              | \$ 19    | \$ 58            | \$ 39 |
| Net losses | \$ (63 )           | \$ ( 2 ) | (67 )            | \$    |

## 7. CONTINGENCIES

### *Environmental*

The Company reviews its obligations as they relate to compliance with environmental laws, including site restoration and remediation. As of June 30, 2006, the Company has accrued liabilities of \$12 million for projected environmental remediation costs. Because of the uncertainties associated with environmental assessment and remediation activities, future costs of remediation could be higher or lower than the amount currently accrued. Based on currently available information and analysis, the Company believes that it is possible that costs associated with such liabilities or as yet unknown liabilities may exceed current reserves in amounts that could be material, but cannot be estimated as of June 30, 2006.

### *Financial Commitments*

At June 30, 2006, AES had provided outstanding financial and performance related guarantees or other credit support commitments for the benefit of its subsidiaries, which were limited by the terms of the

agreements to an aggregate of approximately \$594 million (excluding those collateralized by letter of credit and surety bond obligations discussed below).

At June 30, 2006, the Company had \$583 million in letters of credit outstanding under the revolving credit facility and under the senior unsecured credit facility that operate to guarantee performance relating to certain project development activities and subsidiary operations. The Company pays a letter of credit fee ranging from 1.75% to 2.75% per annum on the outstanding amounts. In addition, the Company had \$1 million in surety bonds outstanding at June 30, 2006.

### *Litigation*

The Company is involved in certain claims, suits and legal proceedings in the normal course of business. The Company has accrued for litigation and claims where it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. The Company believes, based upon information it currently possesses and taking into account established reserves for estimated liabilities and its insurance coverage that the ultimate outcome of these proceedings and actions is unlikely to have a material adverse effect on the Company's financial statements. It is possible, however, that some matters could be decided unfavorably to the Company, and could require the Company to pay damages or make expenditures in amounts that could be material but cannot be estimated as of June 30, 2006.

In 1989, Centrais Elétricas Brasileiras S.A. (Eletrobrás) filed suit in the Fifth District Court in the State of Rio de Janeiro against Eletricidade de São Paulo S.A. (Eletropaulo) relating to the methodology for calculating monetary adjustments under the parties' financing agreement. In April 1999, the Fifth District Court found for Eletrobrás and, in September 2001, Eletrobrás initiated an execution suit in the Fifth District Court against Eletropaulo and CTEEP to collect approximately R\$615.7 million (US\$284.5 million) and R\$49.4 million (US\$ 22.8 million) from Eletropaulo and CTEEP, respectively. Eletropaulo appealed and, in September 2003, the Appellate Court of the State of Rio de Janeiro ruled that Eletropaulo was not a proper party to the litigation because its alleged liability had been transferred to CTEEP pursuant to Eletropaulo's privatization in 1998. Subsequently, both Eletrobrás and CTEEP filed separate appeals to the Superior Court of Justice. In June 2006, the Superior Court of Justice reversed the Appellate Court decision, reintroducing Eletropaulo as a defendant in the execution action, and remanded the case to the Fifth District Court for further proceedings.

In September 1999, a state appellate court in Minas Gerais, Brazil, granted a temporary injunction suspending the effectiveness of a shareholders agreement between Southern Electric Brasil Participacoes, Ltda. (SEB) and the state of Minas Gerais concerning Companhia Energetica de Minas Gerais (CEMIG), an integrated utility in Minas Gerais. The Company's investment in CEMIG is through SEB. This shareholders agreement granted SEB certain rights and powers in respect of CEMIG (Special Rights). In March 2000, a lower state court in Minas Gerais held the shareholders' agreement invalid where it purported to grant SEB the Special Rights and enjoined the exercise of Special Rights. In August 2001, the state appellate court denied an appeal of the merits decision, and extended the injunction. In October 2001, SEB filed two appeals against the decision on the merits of the state appellate court, one appeal to the Federal Superior Court and the other appeal to the Supreme Court of Justice. The state appellate court denied access of these two appeals to the higher courts, and in August 2002, SEB filed two interlocutory appeals against such decision, one directed to the Federal Superior Court and the other to the Supreme Court of Justice. In December 2004, the Federal Superior Court declined to hear SEB's appeal. However, the Supreme Court of Justice is considering whether to hear SEB's appeal. SEB intends to vigorously pursue a restoration of the value of its investment in CEMIG by all legal means; however, there can be no assurances that it will be successful in its efforts. Failure to prevail in this matter may limit SEB's influence on the daily operation of CEMIG.

In August 2000, the Federal Energy Regulatory Commission (FERC) announced an investigation into the organized California wholesale power markets in order to determine whether rates were just and reasonable. Further investigations involved alleged market manipulation. The FERC requested documents

from each of the AES Southland, LLC plants and AES Placerita, Inc. AES Southland and AES Placerita have cooperated fully with the FERC investigation. AES Southland was not subject to refund liability because it did not sell into the organized spot markets due to the nature of its tolling agreement. AES Placerita is currently subject to refund liability of \$588,000 plus interest for spot sales to the California Power Exchange for the period from October 2, 2000 to June 20, 2001 ( Refund Period ). The Ninth Circuit Court of Appeals addressed the appeal of the FERC's decision not to impose refunds for the alleged failure to file rates, including transaction specific data, for sales during 2000 and 2001. Although in its order issued on September 9, 2004 the Ninth Circuit did not order refunds, the Ninth Circuit remanded the case to the FERC for a refund proceeding to consider remedial options. On July 31, 2006, the Ninth Circuit denied rehearing of that order. Certain buyers have moved for a temporary stay of the remand to FERC so that settlement discussions may take place. In addition, on August 2, 2006 in a separate case, the Ninth Circuit heard oral arguments on the scope of refunds and the transactions subject to refunds, confirming the Refund Period but expanding the transactions subject to refunds to include multi-day transactions ( August 2 Decision ). The Ninth Circuit also expanded the potential liability of sellers to include tariff violations that may have occurred prior to the Refund Period. The Ninth Circuit ordered the matter remanded to FERC but temporarily stayed that order to facilitate settlement discussions. Placerita made sales during the time period at issue in the appeals. Both appeals may be subject to further court review. Prior to the August 2 Decision, AES Placerita's liability could have approximated \$23 million plus interest. The August 2 Decision is unclear whether AES Placerita's potential liability is less than or exceeds that amount. The Company continues to evaluate the impact of the August 2 Decision on AES Placerita's potential liability. AES Placerita believes they have meritorious defenses to the claims asserted against them and will defend themselves vigorously in this lawsuit.

In November 2000, the Company was named in a purported class action along with six other defendants, alleging unlawful manipulation of the California wholesale electricity market, allegedly resulting in inflated wholesale electricity prices throughout California. The alleged causes of action include violation of the Cartwright Act, the California Unfair Trade Practices Act and the California Consumers Legal Remedies Act. In December 2000, the case was removed from the San Diego County Superior Court to the U.S. District Court for the Southern District of California. On July 30, 2001, the Court remanded the case to San Diego Superior Court. The case was consolidated with five other lawsuits alleging similar claims against other defendants. In March 2002, the plaintiffs filed a new master complaint in the consolidated action, which reasserted the claims raised in the earlier action and names the Company, AES Redondo Beach, LLC, AES Alamitos, LLC, and AES Huntington Beach, LLC as defendants. In May 2002, the case was removed by certain cross-defendants from the San Diego County Superior Court to the U.S. District Court for the Southern District of California. The plaintiffs filed a motion to remand the case to state court, which was granted on December 13, 2002. Certain defendants appealed aspects of that decision to the United States Court of Appeals for the Ninth Circuit. On December 8, 2004, a panel of the Ninth Circuit issued an opinion affirming in part and reversing in part the decision of the District Court, and remanding the case to state court. On July 8, 2005, defendants filed a demurrer in state court seeking dismissal of the case in its entirety. On October 3, 2005, the court sustained the demurrer and entered an order of dismissal. On December 2, 2005, plaintiffs filed a notice of appeal. Plaintiffs-appellants filed their opening appeal brief on June 16, 2006. Defendants-appellees anticipate filing their responsive brief in or about mid-August 2006. The AES defendants believe that they have meritorious defenses to the allegations asserted against them and will defend themselves vigorously in this lawsuit.

In August 2001, the Grid Corporation of Orissa, India ( Gridco ), filed a petition against the Central Electricity Supply Company of Orissa Ltd. ( CESCO ), an affiliate of the Company, with the Orissa Electricity Regulatory Commission ( OERC ), alleging that CESCO had defaulted on its obligations as an OERC-licensed distribution company, that CESCO management abandoned the management of CESCO, and asking for interim measures of protection, including the appointment of an administrator to manage CESCO. Gridco, a state-owned entity, is the sole wholesale energy provider to CESCO. Pursuant to the OERC's August 2001 order, the management of CESCO was replaced with a government administrator

who was appointed by the OERC. The OERC later held that the Company and other CESCO shareholders were not necessary or proper parties to the OERC proceeding. In August 2004, the OERC issued a notice to CESCO, the Company and others giving the recipients of the notice until November 2004 to show cause why CESCO's distribution license should not be revoked. In response, CESCO submitted a business plan to the OERC. In February 2005, the OERC issued an order rejecting the proposed business plan. The order also stated that the CESCO distribution license would be revoked if an acceptable business plan for CESCO was not submitted to, and approved by, the OERC prior to March 31, 2005. In its April 2, 2005 order, the OERC revoked the CESCO distribution license. CESCO has filed an appeal against the April 2, 2005 OERC order and that appeal remains pending in the Indian courts. In addition, Gridco asserted that a comfort letter issued by the Company in connection with the Company's indirect investment in CESCO obligates the Company to provide additional financial support to cover all of CESCO's financial obligations to Gridco. In December 2001, Gridco served a notice to arbitrate pursuant to the Indian Arbitration and Conciliation Act of 1996 on the Company, AES Orissa Distribution Private Limited (AES ODPL), and Jyoti Structures (Jyoti) pursuant to the terms of the CESCO Shareholders Agreement between Gridco, the Company, AES ODPL, Jyoti and CESCO (the CESCO arbitration). In the arbitration, Gridco appears to seek approximately \$188.5 million in damages plus undisclosed penalties and interest, but a detailed alleged damages analysis has yet to be filed by Gridco. The Company has counterclaimed against Gridco for damages. An arbitration hearing with respect to liability was conducted on August 3-9, 2005 in India. Final written arguments regarding liability were submitted by the parties to the arbitral tribunal in late October 2005. A decision on liability has not yet been issued. Moreover, a petition remains pending before the Indian Supreme Court concerning fees of the third neutral arbitrator and the venue of future hearings with respect to the CESCO arbitration. The Company believes that it has meritorious defenses to the allegations asserted against it and will defend itself vigorously in these proceedings.

In December 2001, a petition was filed by Gridco in the local India courts seeking an injunction to prohibit the Company and its subsidiaries from selling their shares in Orissa Power Generation Company Pvt. Ltd. (OPGC), an affiliate of the Company, pending the outcome of the above-mentioned CESCO arbitration. OPGC, located in Orissa, is a 420 MW coal-based electricity generation business from which Gridco is the sole off-taker of electricity. Gridco obtained a temporary injunction, but the District Court eventually dismissed Gridco's petition for an injunction in March 2002. Gridco appealed to the Orissa High Court, which in January 2005 allowed the appeal and granted the injunction. The Company has appealed the High Court's decision to the Supreme Court of India. In May 2005, the Supreme Court adjourned this matter until August 2005. In August 2005, the Supreme Court adjourned the matter again to await the award of the arbitral tribunal in the CESCO arbitration. The Company believes that it has meritorious defenses to any actions asserted against it and will defend itself vigorously against the allegations.

In early 2002, Gridco made an application to the OERC requesting that the OERC initiate proceedings regarding the terms of OPGC's existing power purchase agreement (PPA) with Gridco. In response, OPGC filed a petition in the India courts to block any such OERC proceedings. In early 2005 the Orissa High Court upheld the OERC's jurisdiction to initiate such proceedings as requested by Gridco. OPGC appealed that High Court's decision to the Supreme Court and sought stays of both the High Court's decision and the underlying OERC proceedings regarding the PPA's terms. In April 2005, the Supreme Court granted OPGC's requests and ordered stays of the High Court's decision and the OERC proceedings with respect to the PPA's terms. The matter is awaiting further hearing. Unless the Supreme Court finds in favor of OPGC's appeal or otherwise prevents the OERC's proceedings regarding the PPA terms, the OERC will likely lower the tariff payable to OPGC under the PPA, which would have an adverse impact on OPGC's financials. The Company believes that it has meritorious claims and defenses and will assert them vigorously in these proceedings.

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In April 2002, IPALCO Enterprises, Inc. ( IPALCO ) and certain former officers and directors of IPALCO were named as defendants in a purported class action filed in the United States District Court for the Southern District of Indiana. On May 28, 2002, an amended complaint was filed in the lawsuit. The amended complaint asserts that IPALCO and former members of the pension committee for the Indianapolis Power & Light Company thrift plan breached their fiduciary duties to the plaintiffs under the Employees Retirement Income Security Act by investing assets of the thrift plan in the common stock of IPALCO prior to the acquisition of IPALCO by the Company. In December 2002, plaintiffs moved to certify this case as a class action. The Court granted the motion for class certification on September 30, 2003. On October 31, 2003, the parties filed cross-motions for summary judgment on liability. On August 11, 2005, the Court issued an order denying the summary judgment motions, but striking one defense asserted by defendants. A trial addressing only the allegations of breach of fiduciary duty began on February 21, 2006 and concluded on February 28, 2006. Post-trial briefing was completed on April 20, 2006. The parties are awaiting a ruling by the Court. If the Court rules against the IPALCO defendants, one or more trials on reliance, damages, and other issues will be conducted separately. IPALCO believes it has meritorious defenses to the claims asserted against it and intends to defend itself vigorously in this lawsuit.

In November 2002, Stone & Webster, Inc. ( S&W ) filed a lawsuit against AES Wolf Hollow, L.P. ( AESWH ) and AES Frontier, L.P. ( AESF, and, collectively with AESWH, sub-subsidiaries ) in the District Court of Hood County, Texas. At the time of filing, AESWH and AESF were two indirect subsidiaries of the Company, but in December 2004 the Company finalized agreements to transfer the ownership of AESWH and AESF to a third party. S&W contracted with AESWH and AESF in March 2002 to perform the engineering, procurement and construction of the Wolf Hollow project, a gas-fired combined cycle power plant in Hood County, Texas. In its initial complaint, filed in November 2002, S&W requested a declaratory judgment that a fire that took place at the project on June 16, 2002 constituted a force majeure event, and that S&W was not required to pay rebates assessed for associated delays. As part of the initial complaint, S&W also sought to enjoin AESWH and AESF from drawing down on letters of credit provided by S&W. The Court refused to issue the injunction, and the sub-subsidiaries drew down on the letters of credit and withheld milestone payments from S&W. S&W amended its complaint five times and joined additional parties, including the Company and Parsons Energy & Chemicals Group, Inc. In addition to the claims already mentioned, the claims by S&W included claims for breach of contract, breach of warranty, wrongful liquidated damages, foreclosure of lien, fraud and negligent misrepresentation. S&W appeared to assert damages against the sub-subsidiaries and the Company in the amount of \$114 million in expert reports and sought exemplary damages. S&W filed a lien against the ownership interests of AESWH and AESF in the property, with each lien allegedly valued, after amendment on March 14, 2005, at approximately \$87 million. In January 2004, the Company filed a defamation counterclaim against S&W and its parent, the Shaw Group, Inc. ( Shaw ). AESWH and AESF filed answers and counterclaims against S&W, which were amended. The amount of AESWH and AESF's counterclaims were approximately \$215 million, according to calculations of the sub-subsidiaries and of an expert retained in connection with the litigation, minus the contract balance, not earned as of December 31, 2005, to the knowledge of the Company, in the amount of \$45.8 million. In March 2004, S&W and Shaw each filed an answer to the counterclaims. The counterclaims and answers subsequently were amended. In November 2005, the Company filed a motion for summary judgment to dismiss all claims asserted against it by S&W. In April 2006, the Court granted the Company's motion for summary judgment. In June 2006, the parties executed a confidential settlement agreement settling all of their respective claims.

In March 2003, the office of the Federal Public Prosecutor for the State of Sao Paulo, Brazil ( MPF ) notified AES Eletropaulo that it had commenced an inquiry related to the BNDES financings provided to AES Elpa and AES Transgas and the rationing loan provided to AES Eletropaulo, changes in the control of AES Eletropaulo, sales of assets by AES Eletropaulo and the quality of service provided by AES



Eletropaulo to its customers, and requested various documents from AES Eletropaulo relating to these matters. In October 2003 this inquiry was sent to the MPF for continuing investigation. Also in March 2003, the Commission for Public Works and Services of the Sao Paulo Congress requested AES Eletropaulo to appear at a hearing concerning the alleged default by AES Elpa and AES Transgas on the BNDES financings and the quality of service rendered by AES Eletropaulo. This hearing was postponed indefinitely. In addition, in April 2003, the office of the MPF notified AES Eletropaulo that it is conducting an inquiry into possible errors related to the collection by AES Eletropaulo of customers' unpaid past-due debts and requesting the company to justify its procedures. In December 2003, the Brazilian National Electric Energy Agency answered, as requested by the MPF, that the issue regarding the past-due debts are to be included in the analysis to the revision of the General Conditions for the Electric Energy Supply.

In May 2003, there were press reports of allegations that in April 1998 Light Serviços de Eletricidade S.A. ( Light ) colluded with Enron in connection with the auction of AES Eletropaulo. Enron and Light were among three potential bidders for AES Eletropaulo. At the time of the transaction in 1998, AES owned less than 15% of the stock of Light and shared representation in Light's management and Board with three other shareholders. In June 2003, the Secretariat of Economic Law for the Brazilian Department of Economic Protection and Defense ( SDE ) issued a notice of preliminary investigation seeking information from a number of entities, including AES Brasil Energia, with respect to certain allegations arising out of the privatization of AES Eletropaulo. On August 1, 2003, AES Elpa responded on behalf of AES-affiliated companies and denied knowledge of these allegations. The SDE began a follow-up administrative proceeding as reported in a notice published on October 31, 2003. In response to the Secretary of Economic Law's official letters requesting explanations on such accusation, AES Eletropaulo filed its defense on January 19, 2004. On April 7, 2005 AES Eletropaulo responded to a SDE request for additional information. On July 11, 2005, the SDE ruled that the case was dismissed due to the passing of the statute of limitations. Subsequently, the case was sent to the Administrative Council for Economic Defense, the Brazilian antitrust authority for final review of the decision.

AES Florestal, Ltd. ( Florestal ), had been operating a pole factory and had other assets in the State of Rio Grande do Sul, Brazil (collectively, Property ). AES Florestal had been under the control of AES Sul since October 1997, when AES Sul was created pursuant to a privatization by the Government of the State of Rio Grande do Sul. After it came under the control of AES Sul, AES Florestal performed an environmental audit of the entire operational cycle at the pole factory. The audit discovered 200 barrels of solid creosote waste and other contaminants at the pole factory. The audit concluded that the prior operator of the pole factory, Companhia Estadual de Energia Elétrica (CEEE), had been using those contaminants to treat the poles that were manufactured at the factory. AES Sul and AES Florestal subsequently took the initiative of communicating with Brazilian authorities, as well as CEEE, about the adoption of containment and remediation measures. The Public Attorney's Office has initiated a civil inquiry (Civil Inquiry n. 24/05) to investigate potential civil liability and has requested that the police station of Triunfo institute a Police Investigation (IP number 1041/05) to investigate the potential criminal liability regarding the contamination at the pole factory. The environmental agency ( FEPAM ) has also started a procedure (Procedure n. 088200567/05-9) to analyze the measures that shall be taken to contain and remediate the contamination. The measures that must be taken by AES Sul and CEEE are still under discussion. In 2005, the control of AES Florestal was transferred from AES Sul to AES Guaíba II in accordance with Federal Law n. 10848/04. AES Florestal subsequently became a non-operative company. Also, in March 2000, AES Sul filed suit against CEEE in the 2nd Court of Public Treasury of Porto Alegre seeking to register in AES Sul's name the Property that it acquired through the privatization but that remained registered in CEEE's name. During those proceedings, a court-appointed expert acknowledged that AES Sul had paid for the Property but opined that the Property could not be re-registered in AES Sul's name because CEEE did not have authority to transfer the Property through the privatization. Therefore, AES waived its claim to re-register the Property and asserted a claim to recover the amounts

paid for the Property. That claim is pending. Moreover, in February 2001, CEEE and the State of Rio Grande do Sul brought suit in the 7th Court of Public Treasure of Porto Alegre against AES Sul, AES Florestal, and certain public agents that participated in the privatization. The plaintiffs alleged that the public agents unlawfully transferred assets and created debts during the privatization. In November 2005, the Court ruled that the Property must be returned to CEEE. Subsequently, AES Sul and CEEE jointly possessed the pole factory for a time, but CEEE has had sole possession of the pole factory since April 2006. The rest of the Property will be returned to CEEE after inspection by a court-appointed expert.

On January 27, 2004, the Company received notice of a Formulation of Charges filed against the Company by the Superintendence of Electricity of the Dominican Republic. In the Formulation of Charges, the Superintendence asserts that the existence of three generation companies (Empresa Generadora de Electricidad Itabo, S.A., Dominican Power Partners, and AES Andres BV) and one distribution company (Empresa Distribuidora de Electricidad del Este, S.A.) in the Dominican Republic, violates certain cross-ownership restrictions contained in the General Electricity law of the Dominican Republic. On February 10, 2004, the Company filed in the First Instance Court of the National District of the Dominican Republic ( Court ) an action seeking injunctive relief based on several constitutional due process violations contained in the Formulation of Charges ( Constitutional Injunction ). On or about February 24, 2004, the Court granted the Constitutional Injunction and ordered the immediate cessation of any effects of the Formulation of Charges, and the enactment by the Superintendence of Electricity of a special procedure to prosecute alleged antitrust complaints under the General Electricity Law. On March 1, 2004, the Superintendence of Electricity appealed the Court's decision. On or about July 12, 2004, the Company divested any interest in Empresa Distribuidora de Electricidad del Este, S.A. The Superintendence of Electricity's appeal is pending. The Company believes it has meritorious defenses to the claims asserted against it and intends to defend this lawsuit vigorously.

In July 2004, the Corporación Dominicana de Empresas Eléctricas Estatales ( CDEEE ) filed two lawsuits against Empresa Generadora de Electricidad Itabo, S.A. ( Itabo ), an affiliate of the Company, one in the First Chamber of the Civil and Commercial Court of First Instance for the National District ( First Chamber ), and the other in the Fifth Chamber of the Civil and Commercial Court of First Instance of the National District ( Fifth Chamber ). In both lawsuits, CDEEE alleges that Itabo spent more than was necessary to rehabilitate two generation units of an Itabo power plant, and, in the Fifth Chamber lawsuit, that those funds were paid to affiliates and subsidiaries of AES Gener and Coastal Itabo, Ltd. ( Coastal ) without the required approval of Itabo's board of administration. Both AES Gener and Coastal were private shareholders of Itabo at the time of the rehabilitation, which was performed from January 2000 to September 2003, but in May 2006 Coastal sold its interest in Itabo to an indirect subsidiary of the Company. In the First Chamber lawsuit, CDEEE seeks an order that Itabo provide an accounting of its transactions relating to the rehabilitation. On November 29, 2004, the First Chamber dismissed the case for lack of legal basis. On February 2, 2005, CDEEE appealed the decision to the Court of Appeals of Santo Domingo. On October 14, 2005, the Court of Appeals decided the appeal in Itabo's favor, reasoning that it lacked jurisdiction over the dispute because the parties' contracts (which were executed in conjunction with the capitalization process that created Itabo) mandated arbitration. On January 11, 2006, CDEEE appealed the Court of Appeals' decision to the Supreme Court of Justice, which is considering the appeal. In the Fifth Chamber lawsuit, which also names Itabo's former president as a defendant, CDEEE requests an order that: (1) Itabo provide an accounting of all affiliated transactions and all transactions from September 1999 to 2004; (2) Itabo pay damages in the amount of approximately \$15 million; and (3) the assets of Itabo and its former president be seized if Itabo fails to comply with the order. On October 6, 2005, the Fifth Chamber held that it lacked jurisdiction to adjudicate the dispute given the arbitration provisions in the parties' contracts. On November 6, 2005, CDEEE appealed the decision to the First Chamber of the Court of Appeal of the National District, which is considering the appeal. In a related proceeding, on May 26, 2005, Itabo filed a lawsuit in the United States District Court for the Southern

District of New York seeking to enjoin CDEEE from prosecuting its claims in the Dominican Republic Courts and to compel CDEEE to arbitrate its claims against Itabo. The petition was denied on July 18, 2005, and Itabo appealed that decision to the United States Court of Appeal for the Second Circuit on September 6, 2005. The appeal is pending. In another related proceeding, on February 9, 2005, Itabo initiated arbitration against CDEEE and the Fondo Patrimonial de las Empresas Reformadas ( FONPER ) in the Arbitral Court of the ICC seeking, among other relief, to enforce the arbitration provisions in parties' contracts. On March 28, 2006, Itabo and FONPER executed an agreement resolving all of their respective claims in the arbitration. The settlement agreement has been approved by the ICC. On May 28 through 31, 2006, Itabo and CDEEE attended an evidentiary hearing before the arbitral tribunal. A ruling on the arbitration is pending. Itabo believes it has meritorious claims and defenses and will assert them vigorously in these proceedings.

On February 18, 2004, AES Gener S.A. ( Gener ), a subsidiary of the Company, filed a lawsuit against Coastal in the Federal District Court for the Southern District of New York. Coastal was Gener's co-venturer in Itabo at the time the lawsuit was filed, however, Coastal sold its stake in Itabo to an indirect subsidiary of the Company in May 2006. The lawsuit sought to enjoin the efforts initiated by Coastal to hire an alleged independent expert, purportedly pursuant to the shareholders' agreement between the parties, to perform a valuation of Gener's aggregate interests in Itabo. Coastal asserted that Gener had committed a material breach under the parties' Shareholders Agreement, and therefore, Gener was required if requested by Coastal to sell its aggregate interests in Itabo to Coastal at a price equal to 75% of the independent expert's valuation. Coastal claimed a breach occurred based on alleged violations by Gener of purported antitrust laws of the Dominican Republic and breaches of fiduciary duty. Gener disputed that any default had occurred. On March 11, 2004, upon motion by Gener, the court enjoined disclosure of the valuation performed by the expert and ordered the parties to arbitration. On March 11, 2004, Gener commenced arbitration proceedings in the International Chamber of Commerce ( ICC ) seeking, among other things, a declaration that it had not breached the Shareholders Agreement. Coastal then filed a counterclaim alleging that Gener had breached the Shareholders Agreement. On January 4, 2006, Coastal filed a Withdrawal of Counterclaim with a Withdrawal of Notice of Defaults withdrawing with prejudice its allegations that Gener SA had violated the Shareholders Agreement. On June 2, 2006, Gener and Coastal jointly requested that the arbitration tribunal issue a final award dismissing Gener's claims without prejudice, dismissing Coastal's claims with prejudice, and requiring the parties to bear their own litigation expenses. The arbitration tribunal granted the request on July 4, 2006, and the ICC approved the tribunal's decision on July 11, 2006.

Pursuant to the pesification established by the Public Emergency Law and related decrees in Argentina, since the beginning of 2002, the Company's subsidiary TermoAndes has converted its obligations under its gas supply and gas transportation contracts into Argentine pesos. In accordance with the Argentine regulations, payments were made in Argentine pesos at a 1:1 exchange rate. Certain gas suppliers (Tecpetrol, Ledesma, Mobil and Compañía General de Combustibles S.A.), which represented 50% of the gas supply contracts, have objected to the payment in pesos. On January 30, 2004, such gas suppliers filed for arbitration with the ICC requesting the re-dollarization of gas prices. TermoAndes replied on March 10, 2004 with a counter-lawsuit related to: (i) the default of suppliers regarding the most favored nation clause; (ii) the unilateral modification of the point of gas injection by the suppliers; (iii) the obligations to supply the contracted quantities; and (iv) the ability of TermoAndes to resell the gas not consumed. On January 26, 2006, the parties resolved all outstanding disputes including the pending arbitration proceeding before the ICC. A final award consistent with the parties' settlement agreement was issued on April 18, 2006. Additionally, the contract between the parties was adapted to TermoAndes requirements and market conditions, including the termination of the contractual relationship with Ledesma.

On or about October 27, 2004, Raytheon Company ( Raytheon ) filed a lawsuit against AES Red Oak LLC ( Red Oak ) in the Supreme Court of the State of New York, County of New York. The complaint purports to allege claims for breach of contract, fraud, interference with contractual rights and equitable relief concerning alleged issues related to the construction and/or performance of the Red Oak project, an 800 MW combined cycle power plant in Sayreville, New Jersey. The complaint seeks the return from Red Oak of approximately \$30 million that was drawn by Red Oak under a letter of credit that was posted by Raytheon related to the construction and/or performance of the Red Oak project. Raytheon also seeks \$110 million in purported additional expenses allegedly incurred by Raytheon in connection with the guaranty and construction agreements entered with Red Oak. In December 2004, Red Oak answered the complaint and filed breach of contract and fraud counterclaims against Raytheon. In January 2005, Raytheon moved for dismissal of Red Oak's fraud counterclaims and requests for consequential damages. In March 2005, the motion to dismiss was withdrawn and a partial motion for summary judgment was filed by Raytheon seeking return of approximately \$16 million of the letter of credit draw, which sum allegedly represented the amount of the draw that had yet to be utilized for the performance/construction issues. Red Oak submitted its opposition to the partial motion for summary judgment in April 2005. Meanwhile, Raytheon re-filed its motion to dismiss the fraud counterclaims. In late April 2005, Red Oak filed its response opposing the renewed motion to dismiss. In December 2005, the Court granted a dismissal of Red Oak's fraud counterclaims. The Court also ordered Red Oak to pay Raytheon approximately \$16.3 million plus interest. On April 21, 2006, Red Oak paid Raytheon approximately \$16.3 million plus approximately \$1.8 million in interest. Pursuant to a joint stipulation, on May 30, 2006, Raytheon posted a new credit in the amount of approximately \$16.3 million. On July 6, 2006, Red Oak appealed the dismissal of its fraud claims to the Appellate Division of the Supreme Court. The parties are conducting discovery. The discovery cut-off is December 15, 2006. Raytheon also filed a related action against Red Oak in the Superior Court of Middlesex County, New Jersey, on May 27, 2005, seeking to foreclose on a construction lien filed against property allegedly owned by Red Oak, in the amount of \$31 million. Red Oak was served with the Complaint in September of 2005, and filed its answer, affirmative defenses, and counterclaim in October of 2005. Raytheon has stated that it wishes to stay the New Jersey action pending the outcome of the New York action. Red Oak has not decided whether it wishes to oppose the lien or consent to a stay. Red Oak believes it has meritorious defenses to the claims asserted against it and expects to defend itself vigorously in the lawsuits.

On January 26, 2005, the City of Redondo Beach ( City ), California, sent Williams Power Co., Inc., ( Williams ) and AES Redondo Beach, LLC ( AES Redondo ), an indirect subsidiary of the Company, a notice of assessment for allegedly overdue utility users' tax ( UUT ) for the period of May 1998 through September 2004, taxing the natural gas used at AES Redondo's plant to generate electricity during that period. The original assessment included alleged amounts owing of \$32.8 million for gas usage and \$38.9 million in interest and penalties. The City lowered the total assessment to \$56.7 million on July 13, 2005, based on an admitted calculation error. An administrative hearing before the City Tax Administrator was held on July 18-21, 2005, to hear Williams' and AES Redondo's respective objections to the assessment. On September 23, 2005, the Tax Administrator issued a decision holding AES Redondo and Williams jointly and severally liable for approximately \$56.7 million, over \$20 million of which constituted interest and penalties ( September 23 Decision ). On October 7, 2005, AES Redondo and Williams filed an appeal of that decision with the City Manager of Redondo Beach, who appointed a hearing officer to decide the appeal. Those proceedings are ongoing, although a schedule has not been established for a hearing or decision. In addition, in July 2005, AES Redondo filed a lawsuit in Los Angeles Superior Court seeking a refund of UUT that was paid from February 2005 through final judgment in that case, and an order that the City cannot charge AES Redondo UUT going forward ( July 2005 Lawsuit ). At a February 6, 2006 status conference, the Superior Court stayed AES Redondo's July 2005 lawsuit until May 22, 2006. At a May 22, 2006 status conference, the Superior Court partially lifted the stay to allow AES Redondo to amend its complaint and the City to challenge that amended complaint with a demurrer. On May 26, 2006,

AES Redondo filed an amended complaint that, among other things, added a claim for the City's breach of a December 1998 memorandum of understanding ( MOU ). Pursuant to the MOU, AES Redondo agreed to redevelop certain parts of its property and the City agreed, among other things, to withdraw a ballot initiative that would have, if approved by the voters of the City of Redondo Beach, allowed the City to collect UUT from AES Redondo. On June 29, 2006, the City filed a demurrer to AES Redondo's amended complaint. At an August 1, 2006 hearing, the Superior Court addressed whether AES Redondo must prepay to the City any UUT allegedly owed prior to judicially challenging the UUT and ordered further briefing on that issue and continued the hearing for issuance of a decision until September 14, 2006. Furthermore, on December 13, 2005, January 21, 2006, and June 20, 2006, the Tax Administrator issued assessments against AES Redondo and Williams totaling approximately \$3.3 million for allegedly overdue UUT on the gas used at the facility from October 2004 through March 2006 (collectively, New UUT Assessments ). AES Redondo has objected to those and any future UUT assessments. A hearing has not been scheduled on those objections, but the Tax Administrator has rejected as moot AES Redondo's objections to the December 13, 2005 UUT assessment based on the findings of his September 23 Decision, which, as noted above, is on appeal. If there is a hearing on the New UUT assessments, the Tax Administrator has indicated that he will only address the amount of those assessments, but not the merits of them. On January 24, 2006, AES Redondo filed an administrative complaint seeking damages for the City's breach of the MOU. On March 1, 2006, the City's claims processor returned the administrative complaint on the basis that the complaint was filed out of time. AES Redondo appealed that decision on May 26, 2006, when it filed an amended complaint in the July 2005 Lawsuit, which as noted above added a claim for the City's breach of the MOU. AES Redondo believes that it has meritorious claims and defenses and intends to assert them vigorously in these proceedings.

In March 2006, the Government of the Dominican Republic and Secretariat of State of the Environment and Natural Resources of the Dominican Republic (collectively, Government of the Dominican Republic ) filed a complaint in the United States District Court for the Eastern District of Virginia against The AES Corporation, AES Aggregate Services, Ltd., AES Atlantis, Inc., and AES Puerto Rico, LP (collectively, AES Defendants ), and unrelated third parties, Silver Spot Enterprises and Roger Charles Fina. In June 2006, the Government of the Dominican Republic filed a substantially similar amended complaint against the defendants, alleging that the defendants improperly disposed of coal ash waste in the Dominican Republic, and that the alleged waste was generated at AES Puerto Rico's power plant in Guyama, Puerto Rico. Based on these allegations, the amended complaint asserts seven claims against the defendants: violation of 18 U.S.C. §§ 1961-68, the Racketeer Influenced and Corrupt Organizations Act ( RICO Act ); conspiracy to violate section 1962(c) of the RICO Act; civil conspiracy to violate the Foreign Corrupt Practices Act ( FCPA ) and other unspecified laws concerning bribery and waste disposal; aiding and abetting the violation of the FCPA and other unspecified laws concerning bribery and waste disposal; violation of unspecified nuisance law; violation of unspecified product liability law; and violation of 28 U.S.C. § 1350, the Alien Tort Statute. The amended complaint also generally alleges that the defendants are liable for compensatory damages for alleged physical, mental, economic, and environmental injuries in the Dominican Republic, punitive damages, treble damages under the RICO Act, and attorneys' fees and costs. While the amended complaint does not specify the amount of alleged damages that the Government of the Dominican Republic is seeking from the defendants, the Government of the Dominican Republic and its attorneys have stated in press reports that it is seeking to recover at least \$80 million. The AES Defendants believe that they have meritorious defenses to the claims asserted against them and will defend themselves vigorously in the lawsuit.

In February 2006, the local Kazakhstan tax commission imposed an environmental fine of approximately \$2.5 million (including interest) on Maikuben West mine, for alleged unauthorized disposal of overburden in the mine during 2003 and 2004. The commission also imposed a fine of approximately \$54,000 for alleged unauthorized drain water discharge during 2004. Maikuben West is currently disputing both fines.

AES Eastern Energy voluntarily disclosed to the New York State Department of Environmental Conservation ( NYSDEC ) and the U.S. Environmental Protection Agency ( EPA ) on November 27, 2002 that nitrogen oxide ( NOx ) exceedances appear to have occurred on October 30 and 31, and November 1-8 and 10 of 2002. The exceedances were discovered through an audit by plant personnel of the Plant's NOx Reasonably Available Control Technology ( RACT ) tracking system. Immediately upon the discovery of the exceedances, the selective catalytic reduction ( SCR ) at the Somerset plant was activated to reduce NOx emissions. AES Eastern Energy learned of a notice of violation (the NOV ) issued by the NYSDEC for the NOx RACT exceedances through a review of the November 2004 release of the EPA's Enforcement and Compliance History ( ECHO ) database. However, AES Eastern Energy has not yet seen the NOV from the NYSDEC. AES Eastern Energy is currently negotiating with NYSDEC concerning this matter.

#### *Tax Examinations*

The Company and certain of its subsidiaries are under examination by the relevant taxing authorities for various tax years. The Company regularly assesses the potential outcome of these examinations in each of the taxing jurisdictions when determining the adequacy of the provision for income taxes. Tax reserves have been established, which the Company believes to be adequate in relation to the potential for additional assessments. Once established, reserves are adjusted only when there is more information available or when an event occurs necessitating a change to the reserves. While the Company believes that the amount of the tax estimates is reasonable, it is possible that the ultimate outcome of current or future examinations may exceed current reserves in amounts that could be material but cannot be estimated as of June 30, 2006.

#### *Other*

In exchange for the termination of \$863 million of outstanding Brasileira Energia debt and accrued interest during 2004, the Brazilian National Development Bank ( BNDES ) received \$90 million in cash, 53.85% ownership of Brasileira Energia and a one-year call option ( Sul Option ) to acquire a 53.85% ownership interest of Sul. The Sul Option, which would require the Company to contribute its equity interest in Sul to Brasileira Energia, became exercisable on December 22, 2005. In the event BNDES exercises its option, 100% of the Company's ownership in Sul would be transferred to Brasileira Energia and the Company would be required to recognize a non-cash loss on its investment in Sul estimated at approximately \$566 million as of June 30, 2006. This amount primarily includes the recognition of currency translation losses and recording minority interest for BNDES's share of Sul offset by the estimated fair value of the Sul Option accrued as of June 30, 2006. If the Company's ownership in Sul is transferred to Brasileira Energia, the Company's ownership share would be reduced from approximately 100% to approximately 46%. In June 2006, BNDES and AES reached an agreement to terminate the Sul Option in exchange for the transfer of another wholly owned AES subsidiary, AES Infoenergy Ltda., to Brasileira Energia and \$15 million in cash. The closing of the agreement is pending finalization of the delivery of certain legal documentation and has not been executed as of June 30, 2006. As a result, the Sul Option remains outstanding until the consummation of the agreement; however, we believe it is unlikely that BNDES will exercise the Sul Option.

## 8. COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income for the three and six months ended June 30, 2006 and 2005 are as follows (in millions):

|   | Three Months Ended |        | Six Months Ended |        |
|---|--------------------|--------|------------------|--------|
|   | June 30,<br>2006   | 2005   | June 30,<br>2006 | 2005   |
| Net income  | \$ 169             | \$ 85  | \$ 520           | \$ 209 |
| Change in fair value of available for sale securities<br>(net of income taxes of \$ )                                   | 1                  |        | 1                |        |
| Foreign currency translation adjustments (net of income taxes of \$ )   | 17                 | 91     | 85               | 82     |
| Cash flow hedging activity:   |                    |        |                  |        |
| Reclassification to earnings (net of income tax benefit of<br>\$2, \$12, \$4 and \$21, respectively)                    | 8                  | 42     | 14               | 61     |
| Change in derivative fair value (net of income tax expense (benefit) of<br>\$24, (\$13), \$64 and (\$39), respectively) | 37                 | (102 ) | 122              | (145 ) |
| Change in fair value of derivatives   | 45                 | (60 )  | 136              | (84 )  |
| Comprehensive income  | \$ 232             | \$ 116 | \$ 742           | \$ 207 |

Accumulated other comprehensive loss is as follows (in millions) at June 30, 2006:

|  |             |
|--|-------------|
| Accumulated other comprehensive loss December 31, 2005 | \$ (3,661 ) |
| Change in fair value of available for sale securities  | 1           |
| Total foreign currency translation adjustments         | 85          |
| Change in fair value of derivatives                    | 136         |
| Accumulated other comprehensive loss June 30, 2006     | \$ (3,439 ) |

## 9. SEGMENTS

AES reports its financial results in three business segments of the electricity industry: regulated utilities, contract generation and competitive supply. Although the product, electricity, is the same in all three segments, the segments are differentiated by the nature of the customers, operational differences, cost structure, regulatory environment and risk exposure.

- The regulated utilities segment primarily consists of 14 distribution companies in 7 countries that maintain a franchise within a defined service area.
- The contract generation segment consists of 76 power generation facilities in 19 countries that have contractually limited their exposure to electricity price volatility by entering into long-term (five years or longer) power sales agreements for 75% or more of their output capacity. Exposure to fuel supply risks is also limited through long-term fuel supply contracts or through tolling arrangements. These contractual agreements generally reduce exposure to fuel commodity and electricity price volatility, and thereby increase the predictability of their cash flows and earnings.
- The competitive supply segment consists primarily of 24 power plants selling electricity to wholesale customers in seven countries through competitive markets, and as a result, the cash flows and earnings of such businesses are more sensitive to fluctuations in the market price of electricity, natural gas, coal, oil and other fuels.

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Information about the Company's operations by segment for the three and six months ended June 30, 2006 and 2005, respectively, is as follows (in millions):