

## MEMO

Subject: GenOn Energy (formerly RRI Energy<sup>1</sup>) – Grounds for a Yes vote on shareholder resolution requesting adoption of reduction goals for greenhouse gases (GHGs) and other air emissions and a report on plans to achieve the goals.

Date: March 23, 2011

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**RESOLVED:** *Shareholders request that the Company adopt quantitative goals for the reduction of greenhouse gas and other air emissions in anticipation of emerging EPA regulations; and that the Company report to shareholders by September 30, 2011, on its plans to achieve this goal, including plans to retrofit or retire existing coal plants. Such a report may omit proprietary information and be prepared at reasonable cost.*

### **Introduction**

GenOn is one of the largest competitive generators<sup>2</sup> of wholesale electricity in the United States, with a generation portfolio of approximately 24,600 megawatts (MW).<sup>3</sup> One hundred percent of GenOn's generating fleet is powered by fossil fuels: coal (31% of GenOn's pro forma generating capacity), natural gas (36%), dual gas/oil (27%) and oil (6%).<sup>4</sup> The combustion of each of these fossil fuels emits carbon dioxide (CO<sub>2</sub>) and other heat-trapping greenhouse gases (GHGs) into the atmosphere. It is widely expected that future legislative or regulatory policies to limit climate change will impose a cost on these GHG emissions and the companies that produce them – notably electric power companies, which collectively produce 40% of U.S. GHG emissions. In some cases, these costs could be material.<sup>5</sup>

To date, GenOn (and its antecedent companies, RRI Energy and Mirant Corp.) has done comparatively little relative to its peers to assess or respond to the financial risks that future carbon legislation or regulation could pose for the company and its shareholders. For example,

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<sup>1</sup> The Comptroller of the City of New York filed this shareholder resolution with RRI Energy on December 1, 2010, two days prior to the completion of the merger between RRI and Mirant to create GenOn Energy.

<sup>2</sup> Also known as “unregulated generators,” “merchant power generators” or “independent power producers” (IPPs); unlike an electric utility, competitive generators sell electricity into the marketplace and cannot recover capital investments from captive customers.

<sup>3</sup> <http://www.genon.com/company.aspx>

<sup>4</sup> <http://www.genon.com/company/company-plant-operations.aspx>

<sup>5</sup> Citigroup, “Carbon Limits Are Coming” (2006); Bernstein Research, “U.S. Utilities: The Implications of Carbon Dioxide Regulation” (2007); Goldman Sachs, “Energy Carbonomics: CO<sub>2</sub> Still Not Fully Priced Into Power Sector” (2008).

the company has not set a GHG reduction target as many of its industry peers have done<sup>6</sup> and as this shareholder proposal requests that GenOn do. This is discussed in more detail below.

The recent emergence of draft U.S. Environmental Protection Agency (EPA) air quality regulations puts further pressure on GenOn's generating fleet. The compliance costs associated with these regulations – the Clean Air Transport Rule (CATR), addressing sulfur dioxide (SO<sub>2</sub>) and nitrogen oxide (NO<sub>x</sub>), and the Mercury and Air Toxics Standards, addressing mercury, other toxic metals and acid gases – are expected to be substantial and could result in the retirement of approximately a fifth of the U.S. coal-fired generating fleet.<sup>7</sup> This is especially bad news for competitive generators like GenOn; as investment research firm Bernstein Research points out:

Unregulated generators, [in] contrast [to regulated utilities], enjoy no... mechanism for the recovery of environmental capex, nor any offset to the loss of generation from retired plants. These companies not only face large potential reductions in power output, reflecting the closure of power plants that are uneconomic to retrofit with emissions controls, but several of them will also incur substantial, unrecoverable capital costs to ensure the continued operation of the remainder of their coal-fired fleets.<sup>8</sup>

Bernstein goes on to name RRI Energy first on a short list of “most at risk among unregulated generators.” To date the company has not disclosed to shareholders its strategy for complying with and minimizing possible financial impacts from these EPA air quality regulations. This is discussed in more detail below.

What shareholders need to know is that GenOn's managers have a plan to remain profitable despite significant pressures, both near-term and longer-term, to reduce GHGs and other air emissions from its entirely fossil-based (and consequently heavily-polluting) generating fleet. **A report detailing goals, based on current technologies for reducing total GHGs and other air emissions from products and operations is necessary to demonstrate to investors that GenOn is taking timely action on this issue that is of critical importance to the company's future.**

### **Rationale for a Yes vote:**

1. GenOn's shareholders bear significant financial and competitive risk if the company is unprepared to meet existing and impending requirements to reduce GHGs and other air emissions. Company-wide quantitative reduction goals provide the clearest signal to investors that GenOn is prepared for a low-emissions future.
2. GenOn discloses inadequate strategies and practices for reducing GHGs and other air emissions.

**1. GenOn's shareholders bear significant financial and competitive risk if the company is unprepared to meet existing and impending requirements to reduce GHGs and other air emissions.**

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<sup>6</sup> See subsequent discussion of electric industry peers who have set GHG reduction targets.

<sup>7</sup> Bernstein Research, “U.S. Utilities: The EPA's Mercury and Air Toxics Standards Are Tougher Than They Appear,” March 17, 2011.

<sup>8</sup> Bernstein Research, “U.S. Utilities: Coal-Fired Generation is Squeezed in the Vice of EPA Regulation; Who Wins and Who Loses?,” October 2010.

As mentioned above, legislative and regulatory pressures to reduce carbon and other air pollutants from electricity generation pose special risk for a competitive generator like GenOn, which unlike an electric utility cannot recover investments in pollution control technologies from captive ratepaying customers.

GenOn does include some general discussion of possible financial impacts of environmental air quality requirements in its 2010 Form 10-K:

The costs associated with more stringent environmental air quality requirements may result in coal-fired generating facilities, including some of ours, being retired. Although conditions may change, under current and forecasted market conditions, installations of additional scrubbers would not be economic at most of our unscrubbed coal-fired facilities (p.41).<sup>9</sup>

GenOn does not, however, provide an indication of 1) the extent of possible closures of coal-fired power plants (which could materially erode earnings) or 2) the magnitude of capital investment potentially required to bring GenOn's remaining plants into compliance (which, again, is risky for a competitive generator since these investments are unrecoverable in rates and increase the price of the company's electricity in the marketplace, possibly leading to reduced sales).

Prior to the merger that created GenOn, Bernstein Research named RRI Energy first on a short list of "most at risk among unregulated generators," predicting that the aforementioned EPA regulations could 1) force the closure of about a quarter of RRI's coal-fired plants and 2) require the company to raise and spend capital equivalent to about a third of its entire (pre-merger) market capitalization to bring remaining plants into compliance. To date the company has not disclosed to shareholders its strategy for complying with and minimizing possible financial impacts from these EPA air quality regulations.

Moreover, GenOn, in its 2010 Form 10-K, seems to provide investors with an overly (and perhaps unrealistically) optimistic assessment of how closures of coal-fired power plants may impact the company financially:

Any such retirements could contribute to improving supply and demand fundamentals for the remaining fleet. Any resulting increased demand for gas could increase the spread between gas and coal prices, which would also benefit the remaining coal-fired generating facilities (p. 41).

This assessment fails to acknowledge the basic point that merchant power generators like GenOn have no means to offset lost sales from closed plants. Further, it suggests an expectation that natural gas prices could rise substantially, which directly conflicts with the overwhelming balance of industry research and opinion.<sup>10</sup>

GenOn does acknowledge in its 2010 Form 10-K that "federal, state-specific or regional regulatory initiatives to stimulate CO2 emission reductions in our industry are being considered" and that "[environmental] matters could result in a material adverse effect on our results of operations," but concludes that "given the uncertainty related to these environmental matters, we cannot predict their actual outcome or ultimate effect on our business." It bears pointing out that this so-called uncertainty hasn't prevented numerous investment analysts, consultants, government agencies, and other groups from estimating how EPA's forthcoming air quality

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<sup>9</sup> GenOn's Form 10-K is available at <http://www.genon.com/investors/investors-sec-filings.aspx>

<sup>10</sup> Energy Information Administration, "Annual Energy Outlook 2011," available at <http://www.eia.doe.gov/forecasts/aeo/>

regulations will impact the U.S. generating fleet; from recognizing the types of pollution controls that will likely be required and their associated expense; or from assessing how increasingly stringent air emissions standards will impact specific companies financially.

Nor has the uncertainty concerning climate policies to limit CO<sub>2</sub> emissions prevented several of GenOn's industry peers from developing viable strategies and practices to address and avoid risks associated with climate change, such as establishing a GHG reduction target (which this proposal requests that GenOn do). See further discussion of this issue below.

## **2. GenOn discloses inadequate strategies and practices for reducing GHGs and other air emissions.**

While GenOn does acknowledge in its 2010 Form 10-K that "costs of compliance with such [climate change and air emissions] efforts could affect our ability to compete in the markets in which we operate, especially with our coal-fired generating facilities"<sup>11</sup> and RRI Energy (pre-merger) provided a response to the Carbon Disclosure Project,<sup>12</sup> the quality and extent of disclosure is limited, focusing on the uncertainties and unknowability of future CO<sub>2</sub> reduction schemes rather than providing an analysis of how a range of carbon costs could impact the company and steps the company could take to minimize those costs.

Despite uncertainties, industry peers like Consolidated Edison, Duke Energy, Exelon, National Grid and Xcel Energy have set absolute GHG reduction targets, while others, such as CMS Energy, PSEG, NiSource and Pinnacle West, have set GHG intensity targets. Xcel Energy, a midwestern electric utility that relies on coal-fired power plants for about half of its generating capacity, explains its strategy to proactively reduce GHG emissions this way:

Rather than waiting for regulation, we are reducing GHGs today. Our customers, communities, shareholders and employees expect us to take action. We also know through past experience that taking early action and voluntarily reducing emissions is a better way to manage costs, which ultimately benefits everyone.<sup>13</sup>

RRI's (pre-merger) Carbon Disclosure Project response suggests that the entirety of the company's strategy to address GHG emissions consisted of 1) exploring reforestation projects for carbon sequestration credits, and 2) purchasing emissions permits. By contrast, a more complete GHG reduction strategy is demonstrated by Exelon, whose *Exelon 2020* roadmap<sup>14</sup> partly consists of the following:

- Energy-efficiency programs... in Exelon's own operations, including cutting energy use at company facilities by 23%
- Investments in clean energy, including purchasing a 735 MW wind operation from John Deere, for approximately \$900 million, and building a 10 MW solar plant on Chicago's South Side
- Retiring four inefficient, carbon-intensive fossil units in Pennsylvania for a total of 933 MW

Further questions that might need answering include:

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<sup>11</sup> GenOn's 2010 Form 10-K (p. 10-11).

<sup>12</sup> Available at [www.cdproject.net](http://www.cdproject.net)

<sup>13</sup> Xcel Energy, 2009 Corporate Responsibility Report, available at <http://www.xcelenergy.com/Minnesota/Company/AboutUs/CorporateResponsibility/Pages/CorporateResponsibilityReport.aspx>

<sup>14</sup> Exelon 2020 is available at <http://www.exeloncorp.com/environment/Pages/overview.aspx>

- Are GenOn's coal plants viable under a high cost of carbon emissions scenario, or will they become too expensive to operate? What about at medium and low costs of carbon emissions scenarios?
- Is fuel switching to natural gas an option at any GenOn coal plants? How much would switching these plants cost?
- Is carbon capture and storage (CCS) an option for any of GenOn's existing coal plants? What is the range (and most likely estimate) of costs for capturing carbon at GenOn's existing plants?
- What role might renewable energy, such as wind, geothermal, and utility-scale solar thermal, play in GenOn's plans to produce more energy?
- Is GenOn conducting research and development on CCS or renewables? If not, why not?
- What impacts does GenOn anticipate from compliance with EPA's draft Clean Air Transport Rule and draft Mercury and Air Toxics Standards in terms of:
  - Closures of coal-fired power plants (expressed in total MW of generating capacity retired and as a percentage of total fleet-wide generating capacity);
  - Capital expenditure required to bring remaining plants into compliance;
  - Electricity sales;
  - Air emissions of CO<sub>2</sub>, SO<sub>2</sub>, NO<sub>x</sub>, mercury and other air toxics and acid gases?

## **Conclusion**

Shareholders need to know that GenOn has a plan for remaining profitable despite significant pressures to reduce GHGs and other air emissions from its generating fleet. A report detailing goals, based on current technologies for reducing total GHGs and other air emissions from products and operations is necessary to demonstrate to investors that GenOn is taking timely action on this issue that is of critical importance to the company's future. We urge shareholders to vote in support of this proposal.