

MEMO

Subject: Dynegy – 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 30, 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, including plans to retrofit or retire its existing coal plants; and that the Company report to shareholders by September 30, 2011, on its plans to achieve this goal. Such a report will omit proprietary information and be prepared at reasonable cost.*

Introduction

Dynegy is among the largest competitive generators¹ of wholesale electricity in the United States, with a total generation portfolio of approximately 11,800 megawatts (MW) operating in the Midwest, Northeast and West regions of the U.S.² One hundred percent of Dynegy's generating fleet is powered by fossil fuels: coal (24%), natural gas (69%), and fuel oil (7%).³ The combustion of each of these fossil fuels emits carbon dioxide (CO₂) and other heat-trapping greenhouse gases (GHGs) and pollutants into the atmosphere. It is widely expected that future legislative or regulatory policies to limit climate change will impose a cost on 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.⁴

To date, Dynegy 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, the company has not set a GHG reduction target as many of its

¹ 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.

² http://www.dynegy.com/about_dynegy/power_generation_facilities.asp

³ http://www.dynegy.com/about_dynegy/environmental_health_safety.asp

⁴ Citigroup, “Carbon Limits Are Coming” (2006); Bernstein Research, “U.S. Utilities: The Implications of Carbon Dioxide Regulation” (2007); Goldman Sachs, “Energy Carbonomics: CO₂ Still Not Fully Priced Into Power Sector” (2008); [Bernstein Research, “U.S. Utilities: Coal-Fired Generation is Squeezed in the Vice of EPA Regulation: Who Wins and Who Loses?”](#) (2010).

industry peers have done⁵ and as this shareholder proposal requests that Dynegy 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 Dynegy's generating fleet. The compliance costs associated with these regulations – the Clean Air Transport Rule (CATR), addressing sulfur dioxide (SO₂) and nitrogen oxide (NO_x), 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.⁶ This is especially bad news for competitive generators like Dynegy; 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.⁷

Bernstein goes on to name Dynegy first on a short list of unregulated generators likely to suffer the largest drop in coal-fired generation as a result of the new regulations; further, Bernstein projects that Dynegy's capital costs for complying with these regulations will be significantly higher than any of its peers. 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 Dynegy'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 Dynegy is taking timely action on this issue that is of critical importance to the company's future.**

Rationale for a Yes vote:

1. Dynegy'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 Dynegy is prepared for a low-emissions future.
2. Dynegy discloses inadequate strategies and practices for reducing GHGs and other air emissions.

1. Dynegy'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.

⁵ See subsequent discussion of electric industry peers who have set GHG reduction targets.

⁶ Bernstein Research, "U.S. Utilities: The EPA's Mercury and Air Toxics Standards Are Tougher Than They Appear," March 17, 2011.

⁷ 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 Dynegy, which unlike an electric utility cannot recover investments in pollution control technologies from captive rate-paying customers.

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

Our business is subject to extensive federal, state and local laws and regulations governing discharge of materials into the environment... The process for acquiring or maintaining permits or otherwise complying with applicable rules and regulations may create unprofitable or unfavorable operating conditions or require significant capital and operating expenditures... Changes in environmental regulations or outcomes of litigation and administrative proceedings could result in additional requirements that would necessitate increased future spending and could create adverse operating conditions. (p.14)⁸

Dynegy 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 Dynegy'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).

The latter point – the magnitude of potential capital investment required – is of particular concern to Dynegy's shareholders. As mentioned above, Bernstein Research estimates that Dynegy's compliance costs will far exceed those of its competitors, with the amount of prospective investment totaling roughly 80 percent of Dynegy's total market capitalization.⁹ This is far and away the largest forecasted capital requirement of any competitive generator and more than double Bernstein's estimates for the next most impacted company. Recent announcements that ratings agencies Standard & Poor's¹⁰ and Fitch Ratings¹¹ have downgraded Dynegy's credit ratings to near so-called "junk" status raise serious concerns about Dynegy's ability to attract needed capital to keep its fleet operational and its company in existence and profitable.

Of the prospective impact of EPA's emerging Mercury and Air Toxics standards – which are widely expected to force the closure of up to 20 percent of U.S. coal-fired generating capacity – Dynegy merely says that it "will continue to monitor the HAP¹² rulemaking process and evaluate any potential impacts the rulemaking might have on our operations."¹³ Bernstein predicts that these regulations could force Dynegy to retire approximately 8 percent of its coal-fired generating capacity.¹⁴ Because Dynegy is a merchant power generator, it would have no means to offset lost sales from closed plants.

Dynegy does acknowledge in its 2010 Form 10-K that climate change and more stringent air

⁸ Dynegy's Form 10-K is available at http://www.dynegy.com/investor_relations/investor_relations.asp

⁹ Bernstein Research, "U.S. Utilities: Coal-Fired Generation is Squeezed in the Vice of EPA Regulation; Who Wins and Who Loses?," October 2010, p. 10.

¹⁰ Dow Jones Newswires, "S&P Cuts Dynegy Two Steps From Default Rating," March 18, 2011.

¹¹ Dow Jones Newswires, "Fitch Downgrades Dynegy Two Notches After Co's Warning," March 9, 2011.

¹² "HAPs," or "hazardous air pollutants," is a collective term referring to mercury, acid gases and other air toxics that EPA is legally obligated to regulate under the emerging Mercury and Air Toxics Standards.

¹³ Dynegy 2010 Form 10-K, p. 19.

¹⁴ Bernstein Research, "U.S. Utilities: Coal-Fired Generation is Squeezed in the Vice of EPA Regulation; Who Wins and Who Loses?," October 2010, p. 39.

quality regulation is a significant issue for its business, but the company, citing uncertainty, declines to provide investors with a meaningful strategy for addressing these risks. This so-called uncertainty hasn't prevented numerous investment analysts, consultants, government agencies, and other groups from estimating how EPA's forthcoming air quality 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 CO₂ emissions prevented several of Dynegy'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 Dynegy do). See further discussion of this issue below.

2. Dynegy discloses inadequate strategies and practices for reducing GHGs and other air emissions.

Dynegy does acknowledge the significance of climate change to its business in its 2010 Form 10-K:

Existing and anticipated federal and state regulations intended to address climate change may significantly increase the cost of providing electric power, resulting in far-reaching and significant impacts on us and others in the power generation industry over time. (p. 14)

But rather than outline its strategies for reducing its GHG emissions cost-effectively, as some other electric power producers have done (see below), Dynegy focuses on the uncertainties and unknowability of future CO₂ reduction schemes, saying that the company "cannot confidently predict the final outcome of the current debate on climate change nor can we predict with confidence the ultimate requirements of proposed or anticipated federal and state legislation and regulations intended to address climate change." The company did not provide a response to the Carbon Disclosure Project in 2010, and its responses in past years were minimal.

Despite uncertainties, industry peers like Consolidated Edison, Entergy, 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.¹⁵

Shareholders have approached Dynegy about setting a greenhouse gas target before. In fall 2007, a proxy resolution led by the California State Teachers' Retirement System (CalSTRS) and the North Carolina Retirement System requested that Dynegy "address the feasibility of adopting quantitative goals, based on current and emerging technologies, for reducing carbon dioxide and

¹⁵ Xcel Energy, 2009 Corporate Responsibility Report, available at <http://www.xcelenergy.com/Minnesota/Company/AboutUs/CorporateResponsibility/Pages/CorporateResponsibilityReport.aspx>

other emissions from the company's existing and proposed power plants." Citing "numerous uncertainties," Dynegy concluded that setting a target was infeasible and declined to do so.¹⁶

By contrast, a more robust GHG reduction strategy is demonstrated by Exelon, whose *Exelon 2020* roadmap¹⁷ 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:

- Are Dynegy'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 Dynegy coal plants? How much would switching these plants cost?
- Is carbon capture and storage (CCS) an option for any of Dynegy's existing coal plants? What is the range (and most likely estimate) of costs for capturing carbon at Dynegy's existing plants?
- What role might renewable energy, such as wind, geothermal, and utility-scale solar thermal, play in Dynegy's plans to produce more energy?
- Is Dynegy conducting research and development on CCS or renewables? If not, why not?
- What impacts does Dynegy 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 CO₂, SO₂, NO_x, mercury and other air toxics and acid gases?

Conclusion

Shareholders need to know that Dynegy has a plan for remaining profitable despite significant pressures to reduce GHGs and other air emissions from its generating fleet. 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. A report detailing goals, based on current technologies for reducing total GHGs and other air emissions from products and

¹⁶ Dynegy, *2009 Report on Environmental Stewardship* (p. 10); available at http://www.dynegy.com/about_dynegy/environmental_health_safety.asp

¹⁷ Exelon 2020 is available at <http://www.exeloncorp.com/environment/Pages/overview.aspx>

operations is necessary to demonstrate to investors that Dynegy 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.