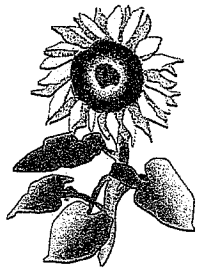

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October 14, 2011

Mary D. Nichols, Chairman
California Air Resources Board
1001 I Street
Sacramento, California 95814

Subject: Allocation of Allowances for Generators with pre-AB32 long-term contracts

Dear Chairman Nichols and Board Members:

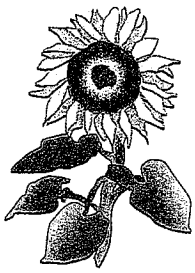
Wildflower Energy, LP ("Wildflower") is very concerned that the California Air Resources Board ("ARB") has yet to address the acknowledged predicament confronting generators with pre-AB 32 long-term power sales contracts that do not include provisions allowing the generators to recover the new greenhouse gas ("GHG") compliance costs ("pre-AB 32 contracts"). These generators have not been able to renegotiate their contracts to account for GHG compliance costs and do not have any other mechanism available for recovering their GHG compliance costs, such as near term access to wholesale markets.

Wildflower requests that the ARB either provide for direct allocation of allowances to the generators with pre-AB 32 contracts, or amend the regulations to specifically address pre-AB 32 contracts (e.g. require a beneficial holding relationship when a pre-AB 32 long-term contract is not renegotiated despite the best efforts of the generator). If the ARB does not address pre-AB 32 contracts, then Wildflower, which originally entered into long-term contracts to stabilize the California electric market in 2001, will suffer a potentially devastating penalty for its commitment to long-term contracts and stable pricing.

Unique Circumstances of Projects with Pre-AB 32 Long-Term Contracts

When the ARB first adopted the draft GHG cap-and-trade regulation in December 2010, the ARB noted the serious issues associated with the treatment of generators with pre-AB 32 long-term contracts. Similarly, the California Public Utilities Commission ("CPUC"), the California Energy Commission ("CEC"), and participants in the Market Advisory Committee also noted concerns about pre-AB 32 contracts. Examples include the following:

- The CPUC and the CEC recommended in R. 06-04-009 that generators with pre-AB 32 contracts should be addressed: *"independent power producers may have*



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contracts with utilities that extend beyond 2012 for which there is no clear provision for recovery of new GHG costs."[1]

- The ARB itself noted the need to address these pre-AB 32 contracts: *"Some generators have reported that some existing contracts do not include provisions that would allow full pass-through of cap-and-trade costs. These contracts pre-date the mid-2000s and many may be addressed through the recently announced combined heat and power settlement at the California Public Utilities Commission. Staff is evaluating this issue to determine whether some specific contracts may require special treatment on a case-by-case basis."*[2]

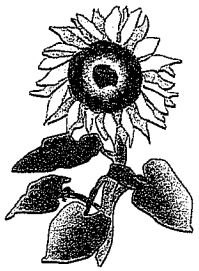
- The ARB's Board Resolution 10-42, issued on December 16, 2010 adopting the regulation, provided explicit direction on this topic: *"5. Staff will work with interested stakeholders to ensure proper treatment under the regulation of any electricity generators or combined heat and power facilities with pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse gas emissions."*[3]

It is therefore disappointing and a source of rising anxiety that the proposed regulations have not addressed this critical issue for the small group of California electric generators with pre-AB 32 contracts.

Background on Wildflower

Wildflower is the owner of Larkspur Energy and Indigo Generation, two natural gas-fired generators operating in Southern California (hereinafter "facilities"). On January 17, 2001, Governor Gray Davis proclaimed a State of Emergency to exist due to the energy shortage in the State of California. Subsequently, on February 8, 2001 and on March 7, 2001, Governor Davis issued Executive Orders D-26-01 and D-28-01, requiring the Energy Commission to invoke the emergency siting procedures in Public Resources Code section 25705 to expedite the licensing of all new renewable and peaking power plants that could be available for service no later than September 30, 2001. In these orders, Governor Davis declared that all reasonable conservation, allocation, and service restriction measures will not alleviate this energy supply emergency and that new generation was needed to avert an immediate threat to public health and safety. Larkspur was the first facility licensed under this emergency siting process and Indigo was similarly licensed under this process. At that time, the State strongly encouraged execution of

[1] See Rulemaking 06-04-009 (Filed April 13, 2006), Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies, Section 5.4.1.1.
[2] See Staff Report: Initial Statement of Reasons (Release Date: October 28, 2010), Footnote 22, Page II-32.
[3] See Resolution 10-42 Attachment B (issued on December 16, 2010), Page 8.



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long-term power purchase agreements for these emergency facilities, in order to avoid some of the spot-market fluctuations that exacerbated the energy crisis. Wildflower's facilities entered into long-term tolling contract with a third-party power marketer through 2021 which does not provide any mechanism for cost recovery of GHG compliance costs. The marketer that purchases power under this contract has declined to renegotiate to address these substantial and previously unforeseen GHG costs. Consequently, Wildflower has no ability to recoup the GHG compliance costs starting July 2012, when the first cap-and-trade auction occurs.

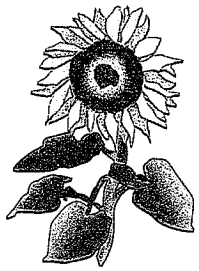
The facilities have played an important role in meeting intermittent market demands and in emergency situations such as the recent fires in San Diego. Moreover, Wildflower's long-term contractual agreement reflects a long-term commitment to California for a stable and reliable energy market. Wildflower has never sought to renegotiate the contract for added benefits when market conditions were more favorable. This long-term tolling agreement was entered into long before AB 32 was signed into law and currently does not have any mechanism available for recovery of GHG costs.

Wildflower is unique among generators operating under pre-AB 32 contracts because Wildflower's pre-AB 32 contract is a tolling agreement and the counterparty is a third-party power marketer, rather than a utility. Even though the electricity ends up serving end-use customers in California, the fact that the purchasing party is a marketer adds a layer of complexity because the marketer has full dispatch control over Wildflower's facilities. Since Wildflower cannot control how much the facilities run, the quantity of GHG emissions produced along with the quantity of allowances needed for compliance, are out of Wildflower's control. Thus, as it currently stands, Wildflower would have to bear the significant economic burden of complying with the cap-and-trade program, but has no ability to mitigate those costs.

Impact of GHG Costs

The significant unrecoverable costs of this new regulation could immediately impact debt coverage ratios and other covenants in financial documents that without assistance from CARB may result in default. Instead of being rewarded for a long-term commitment to California and helping California avoid another energy crisis, Wildflower now finds itself in a situation where unrecoverable GHG compliance costs from a pre-AB 32 long-term contract could force curtailment or cessation of operations.

The current economic climate mandates tight cost controls, particularly with respect to major capital expenditures. Leaving this issue unresolved significantly impacts the ability to make even near term plans for operation and maintenance. Wildflower cannot accurately budget these unknown regulatory costs in the 1 to 5 year business plan. Because these facilities' budgets are approved and reviewed before committing significant operational costs, there must be reasonable certainty regarding the precise scope and nature of the new requirements and its impact to the economic viability of Wildflower.



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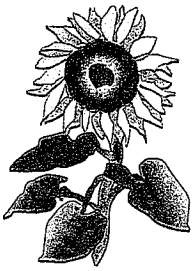
The economic impact of a potential closure of these facilities goes well beyond the direct impact to Wildflower. The operation of each of these facilities is important to the economic wellbeing of the communities where they are located. In addition to the direct benefit of providing high-paying jobs, the plants also provide second-level benefits by supporting local industrial companies and businesses, and providing significant property taxes that directly support the local communities. The potential closure of these plants will trigger long-lasting harm to communities that are already struggling with some of the highest unemployment levels in Southern California.

In addition, not only would the communities be harmed and the generator left without any ability to recover its costs, but failure to address pre-AB 32 contracts would allow the marketers to receive windfall profits resulting from the cap-and-trade. This is because the vast majority of in-state generators and power imported into the state are not subject to pre-AB 32 contracts. Consequently, these power sources would be able to pass on their GHG compliance costs at wholesale, and the market price for wholesale power will include GHG cost assumptions. Thus, a marketer would be able to sell power from a pre-AB 32 contract at a price that assumes the marketer bears GHG costs, even though this is not the case. This behavior by an off taker contradicts the State's GHG emission reduction goals because the marketer, under a pre-AB 32 contract, would realize an economic benefit by running the facility more because the costs of complying with the GHG regulations are not addressed by the marketer. The issue is exacerbated in the case of Wildflower's facilities that operate under a tolling agreement, where the marketer has full dispatch control of the facility and would be economically encouraged to maximize the dispatch of the Wildflower facilities, under the aforementioned scenario. Hence, the intent of ARB policy that GHG costs be directly considered in the economic dispatch of generating resources and for ratepayers to see the carbon price signal of generation purchased by a marketer or utility would be undermined by not addressing the pre-AB 32 contracts.

Bilateral Negotiations

Wildflower understands that the ARB Staff would like to see this issue resolved in bilateral negotiations between the off-taker, marketer or utility, and the generator. However, the proposed regulation does not address the circumstances when generators with pre-AB 32 contracts face counterparties unwilling to negotiate the issue of allowance allocation or GHG compensation.

In such single-issue negotiations, the marketer or utility ("off-taker") can demand significantly disproportionate concessions from the generator, since the generator has little negotiating leverage. The generator has to meet GHG compliance obligations, irrespective of any allocations or compensation form the off-taker, while the off-taker has a contractual right to require the generator to operate. Typically when parties to a power purchase agreement renegotiate their agreements, the renegotiations are major restructurings of contracts that include many more issues than just a single item like GHG compensation. Issues that have been addressed in the restructuring of agreements include the conversion of facilities from simple to



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combined cycle operation, the termination of some contracts while extending other contracts, and the assignment of agreements from one entity to another. Wildflower is not aware of any successful bilateral negotiation pertaining solely to GHG compliance costs being assumed by the off-taker in a pre-AB 32 long-term contract with a generator.

As mentioned earlier, the marketer to a pre-AB 32 contract has no motivation to agree to a re-negotiation. The marketer can simply require the generator to operate and sell that power in the market, creating a windfall profit. Without some regulatory equality, the affected generators will not be able to recover their GHG compliance costs and most will likely eventually cease operations. This is especially true for generators that face up to 10 years of meeting uncompensated GHG compliance cost, prior to the expiration of their pre-AB 32 contracts.

Recommendation

Until the ARB specifically addresses the unique situation of this small group of pre-AB 32 contracts, these generators face an untenable economic situation between the contracts they entered into for the stability of the State and the new regulatory requirements that are imposed upon them.

At the October 20th, 2011 Board Hearing, the Board should consider the attached Attachment 1 draft Resolution on pre-AB 32 contracts. There are multiple ways that the inequity created by these new regulations can be resolved by the ARB, including:

1. Directly allocate allowances to operators of projects subject to pre-AB 32 contracts like Wildflower; or

2. Under the structure currently put into play by the ARB, deem contracts like Wildflower's to be in a "beneficial holding" affiliation for the benefit of the generator with the entity that has the ultimate transactional relationship with end users of the power produced by the generator; or

3. Allow a narrowly tailored exemption for those few facilities licensed pursuant to Executive Orders D-26-01 and D-28-01(the 2001 California energy emergency orders) and still operating under pre-AB 32 contracts.

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Wildflower would be pleased to address any questions the ARB has on these matters and would appreciate the opportunity to meet with Staff to discuss this very serious situation.

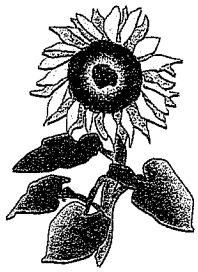
Sincerely,

Bo Buchynsky
Senior Vice President, Wildflower Energy, LP

cc:

Board Member Dr. Daniel Sperling
Board Member Dr. Ken Yeager
Board Member Dorene D'Adamo
Board Member Barbara Riordan
Board Member Dr. John R. Balmes
Board Member Lydia Kennard
Board Member Sandra Berg
Board Member Ron Roberts
Board Member Ronald O. Loveridge

Mr. Steve Cliff
Mr. Edie Chang



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ATTACHMENT 1
Wildflower Proposed Board Resolution Addressing pre-AB 32 Long-Term Contracts

WHEREAS some electricity generators and combined heat and power facilities entered into long-term contracts before the enactment of AB 32, which do not provide any mechanism for pass-through of costs associated with greenhouse gas emissions.

WHEREAS without further consideration from the CARB of these pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse gas emissions, parties that do not bare greenhouse costs compliance costs under these contracts will not have an incentive to renegotiate the contracts to provide pass-through of greenhouse gas costs.

NOW THEREFORE the CARB Staff will work with interested stakeholders to ensure proper treatment under the regulation of any electricity generators or combined heat and power facilities with pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse gas emissions.