Dynegy Moss Landing LLC
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August 13, 2008

Ms. Mary Nichols, Chair
California Air Resources Board
1001 I Street
Sacramento, CA 95814

RE: Comments on Climate Change Draft Scoping Plan and Appendices

Dear Chairperson Nichols:

Thank you for the opportunity to comment on the Climate Change Draft Scoping Plan and the accompanying Appendices. Our comments provide the perspective of an independent power company (IPP) that owns and operates power plants throughout the United States. Dynegy's facilities are primarily located in California, Arizona, the Midwest and the Northeast. We have been involved in the GHG discussions at RGGI and in Illinois and would like to offer you our suggestions on the proposals you have put forth.

Dynegy supports the creation of a national GHG emission reduction program that allows for operation and development of a diverse portfolio of generating technologies which will provide economic and reliable power. Regulation of GHG emissions is best achieved at the national level through an economy-wide carbon tax or a cap and trade program that incorporates as many sectors of the economy as practical. A national program is preferable because it creates a uniform set of standards and rules, reduces the cost of compliance and eliminates the issues of leakage.[1]

We understand that California is proposing to establish its own GHG emission reduction program prior to the adoption of a federal program. However, we suggest that you link your program with regional programs such as the Western Climate Initiative ('WCI"). A regional GHG program is preferable to a California only program.

Our comments on the proposals in the Climate Change Draft Scoping Plan are detailed below. In brief, we support the creation of a cap and trade program that includes all sectors of the economy. Specifically, we support ARB's recommendation to create a cap and trade program that would

[1] Having a California centric policy will polarize rather than unify attempts to create a workable emissions reduction policy. If it is the objective of California to take the lead in climate change policy, it will not be achieved if it is at the expense of neighboring states or grid reliability.

include 85 percent of California's total GHG emissions under the GHG cap. We also urge the ARB to work with the California Independent System Operator (ISO) to identify electric system reliability concerns associated with proposed emissions reduction proposals. Finally, the Climate Change Plan should include flexible compliance options that have the effect of reducing GHG emissions while maintaining business operations of affected companies.

California Cap and Trade Program Linked to Western Climate Initiative

Dynegy supports the efforts to link with the WCI to create a regional cap and trade program. Although it is our position that a national program is the best approach to GHG regulation, a regional cap and trade system is preferable to a California-only program. A regional program provides greater opportunity for emissions reductions and offsets than exist in a single state, and reduces the potential that electricity and business production will migrate to non-participating states.

For a regional cap and trade system to be viable, it must require the participation of all western states and have consistent rules and requirements across all of the states. Additionally, a cap and trade system should provide flexible compliance and give impacted industries the greatest number of tools to meet the GHG emission reduction goals. These tools should include:

- early action recognition prior to 2012 – Many companies have already repowered or replaced their facilities or plan to do so before the start of the GHG program. These efforts should be encouraged.
- quantifiable and verifiable offsets – Especially in sectors where reductions are limited due to technology constraints, reliability concerns or costs. The use of offsets should not be limited. If an offset is quantifiable and verifiable, it achieves the goal of reducing GHG emissions and should count toward AB 32 compliance.
- banking of tradable allowances, offsets and credits – Sources that reduce their overall GHG emission through modernization, process changes or other technologies should be allowed to bank those credits indefinitely.
- flexible compliance periods – To allow for changes in electricity usage due to variable weather patterns and fluctuations in the availability of hydroelectricity in any given year.

Finally, electric system reliability should be a major consideration for ARB to determine how the electricity sector meets the target and timeline goals under AB 32 Targets and timelines for compliance should be closely aligned with technology developments. For example, if ARB mandates emission reductions before sufficient renewable generation can be developed or emission reduction technology can be implemented, electrical reliability could be negatively impacted. Ultimately, the final GHG program should have sufficient flexibility so that ARB can adapt the program to address changing patterns in electricity consumption and innovations in technology.

Allowance Allocations

The Appendices briefly discuss the allocation process for allowances but the development of the process is left to a future ARB rulemaking process. There are several issues ARB should consider when it develops the final allocation method.

First, ARB should examine how an allocation method will impact electric system reliability. Many older generating units in California operate under Reliability Must Run requirements (RMR). These units provide critical voltage support and other system needs. As the GHG emission reduction cap declines and allowances become harder to obtain, there is the possibility that these generating units will not be able to obtain the number of allowances that are necessary to continue to operate. The ARB should understand this risk before implementing a cap and trade program and an allocation scheme. Dynegy recommends that ARB work with the Independent System Operator (ISO) to incorporate electric system reliability into the final ARB climate plan.[2]

Second, there is the potential to create competitive advantages or disadvantages for market participants by choosing different methods to allocate allowances. This is especially true in California's hybrid electric procurement system where load serving entities (LSE) such as the investor owned utilities are not only buyers of electricity, but developers of new electrical generation. Independent power producers often find themselves competing against an LSE to build new electrical generation to meet the energy and capacity needs of the LSE's customers.

If the ARB chooses to allocate free allowances to one class of participants but require another class to purchase their allowances through an auction, it creates a competitive advantage. Dynegy opposes such a system because there is no economic or other basis to differentiate between participants.

Dynegy also opposes any proposal to allocate free allowances to one participant class who would then auction them off to another class of participants. It is important for the ARB to be aware of this problem and to treat all market participants equally.

Finally, Dynegy supports allocating allowances to existing sources based on historic emissions performance and gradually transitioning into an auction of allowances. This allocation system would recognize the reliability benefits conferred by existing sources, provide funding for emission reduction investments and offset some of the loss of market value of these resources. A gradual transition to an auction-based system would allow time for new retrofit control technologies to achieve commercial standing without immediately shutting down a significant amount of the state's aging power plant capacity. A phase-in period to an auction also gives the owners of older facilities time to repower, identify ways to reduce GHG emissions or move into alternative forms of generation.

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[2] There is clearly a balancing test between reliability and CO_2 reduction. Care must be taken to insure that reliability is not sacrificed in addressing climate change.
For example, morning and evening ramping services are provided by current fossil fuel generation and not by wind or solar. The California ISO has also expressed alarm in reaction to a State Water Resources Control Board proposal to shut down power plants that utilize once-through–cooling. Coupling these prohibitions and operating realities with non flexible emission reduction policies will have a severe reliability effect on a state that is already short of power. See, e.g. Once Through Cooling: SDG&E Preliminary Results, August 11, 2008 that analyzes the impact of retiring existing generation as a result of a restriction on once-through-cooling.
http://search.caiso.com/search?q=cache:C3fT8OobiL4J:www.caiso.com/201c/201ce6071f540.pdf+once+through+cooling&access=p&output=xml_no_dtd&ie=UTF-8&client=caiso_frontend&site=default_collection&proxystylesheet=caiso_frontend&oe=UTF-8.

Auction/Safety Valve

If California decides to auction a portion of the GHG emission allowances, the market should initially be limited to entities that are required to comply with the current GHG emission reduction obligations. Dynegy is concerned that the pool of GHG emission allowances will be insufficient and may allow some auction participants to create artificial scarcity by buying, hoarding or retiring allowances. As the auctions progresses, entities will be vying for a limited number of allowances that will decline in succeeding years. If sufficient allowances are unavailable for critical generation units and alternative compliance options are limited, reliability is severely impacted. Because of these concerns, Dynegy recommends that, initially, participation in an auction should be limited to those entities that have a compliance obligation.

The risks of gaming, hoarding and other unknown economic threats are strong arguments for California to put in place a safety valve, in the form of a price cap on the cost of credits, to assure price certainty and stability. Uncertainty, volatility, and high prices for CO2 credits would adversely impact existing generation and diminish investment in new projects. If the ability to recoup these costs is limited, it could negatively impact the ability of the fossil units to continue operating when needed.

Offsets

ARB proposes limiting the use of offset projects from outside California because it could reduce the amount of reductions occurring within the state. Dynegy disagrees with this proposal.

Offsets are an important compliance tool in meeting GHG emission reduction goals. No commercially proven technologies exist today that can reduce/remove CO2 from fossil-fuel generators' exhaust gas. The only mechanism for California fossil generators to comply with CO2 reduction caps is through offsets. The availability of offsets in any cap and trade program should be maximized, at least until such point that alternative compliance approaches or technologies are available.

Additionally, limiting the use of offsets to California projects would restrict the emission reduction options that are available and increase the cost of the offsets. As long as the emission reductions associated with the offsets are quantifiable and verifiable there should not be geographic limitations on the use of the offsets. The goal of reducing GHG emissions is achieved regardless of the method of compliance.

ARB also proposes a offset limit that an individual firm can use to meet its compliance obligation. The justification is that the overall cap and trade program could be weakened. Dynegy disagrees with the proposal and the reasoning behind it. A cap and trade program will not be undermined or diluted if real emission reductions are occurring. Offsets give industries with limited GHG reductions options, a way to reduce emissions while continuing to operate. Fossil fuel generators have few alternatives to reduce their GHG emissions profile. They can reduce the operation of their

units if it is commercially viable to do so, repower their generation units if they can obtain a power purchase contract with an LSE, or shut down their generation units. No commercially proven technology exists that can reduce or remove CO2 from a fossil fuel generator's exhaust. Limiting the use of verifiable offsets requires the generation owner to make choices that negatively impact the supply of power in a supply deficient state.[3]

Carbon Fee

ARB proposes the creation of a carbon fee set at levels high enough to produce behavioral changes ($10 to $50 per metric ton of MMTCO2E) and spread across sectors of the economy responsible for a large majority of GHG emissions. ARB focuses on an upstream approach that imposes a fee on refiners and importers of gasoline and diesel, natural gas processing plants, interstate natural gas pipelines, coal imports, suppliers of high-GWP gases, and imports of electricity.

Dynegy supports the concept of an upstream carbon fee implemented on a federal level. We also would support a reasonable carbon fee for a California program. However, if California chooses to create a carbon fee, it should be in place of the creation of a cap and trade program, not an additional requirement. A carbon fee in addition to a cap and trade program would mean that Californians would pay twice for climate change when buying goods and services. We cannot support this proposal and therefore recommend that the ARB adopt either a cap and trade program or a limited carbon fee.

Use of Revenues

ARB proposes to utilize revenues from auctions or carbon fees for a variety of purposes, such as funding RD&D, mitigating price volatility in the early carbon market, supporting environmental justice goals, and training a green technology workforce. It is also proposed to create a Carbon Trust as the vehicle to distribute these revenues.

Dynegy supports the use of revenues and fees for investments in new technology retrofit programs, increased energy efficiency or additional GHG reduction programs that result in real, permanent, quantifiable, verifiable and enforceable reductions.

We also urge the ARB to be cautious in expending the revenues so as not to advantage one class of market participant over another.

Finally, we recommend that ARB provide that collected revenues will not be siphoned off to other state services during years of state budget deficits. If there is no way to ensure that fees will be spent on GHG emission reductions programs, then these fees should not be levied.

[3] See, for example, the July 28, 2008 ruling by a Los Angeles Superior Court judge restricting the sale of offsets to proposed power plants in the LA Basin and the expected impact – "blackouts and brownouts" – if the plants are not built. http://latimesblogs.latimes.com/greenspace/files/prii_order_72808.pdf

Thank you for considering Dynegy's comments on the Climate Change Draft Scoping Document and the Appendices. If you have any questions on our comments please contact me at (916) 441-6242.

Sincerely,

/s/ Audra Hartmann

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