REVIEW & OUTLOOK

The New Greenmail

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Call it greenmail for a post-Kyoto world. The private-equity firms that just agreed to buy Texas utility TXU have scored something of a PR coup by getting Environmental Defense and other climate-change activists to fall in line with their purchase plans before the deal was announced. The question is what price shareholders are paying for this act of political correctness.

In the old days, a greenmail artist like Carl Icahn would buy up a tranch of some company's stock and threaten to buy the rest unless the target paid him to go away. But 21st-century greenmail works a little differently. Judging by media accounts, the price of Environmental Defense's support was an announcement that the new owners would build only three of the 11 coal-fired power plants that TXU has had on the drawing board.

Last year, Environmental Defense had launched a "Stop TXU" campaign to oppose the new plants. But yesterday it declared "victory" and explained that its agreement had been sought by emissaries of the private-equity investors in return for mothballing the eight coal plants and an agreement to sign on to mandatory emissions caps and an overall reduction in TXU's CO_2 emissions by 2020.

TXU had painted a green bull's-eye on itself when it announced plans last year to build the 11 new plants. Never mind that the plants were to be built on the sites of existing plants, that a number of them would replace older, less-efficient plants, or that Texas is already bumping up against the limits of its ability to produce the electricity it needs for its growing population and economy. The announcement sent the environmental movement to the barricades against TXU, and may be one reason that the company's stock, after going up regularly for several years, sputtered and stalled in 2006.

That stock slide wasn't all bad for Kohlberg, Kravis Roberts, which is leading the group buying TXU for not much more than its all-time stock-price high, which it hit in the middle of last year. But then again, giving in to the pressure not to build all 11 plants may not turn out to be all bad for KKR and TXU, either.

Ercot, Texas's independent electric-grid operator, figures that peak electricity demand in the state will catch up with available capacity by 2009, if not sooner. Tight demand means higher electricity prices, which is good for TXU's profits. That squeeze will, in turn, rejuvenate calls for more capacity, which may allow TXU to dust off the plans for the new plants at a moment when the current environmental concerns weigh more

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lightly in the political scales than skyrocketing electricity bills. The private-equity crowd didn't get to be billionaires for nothing.

Texas's electricity market is bigger than all of South Korea's and nearly the size of the United Kingdom's -- which is to say, it's big. It also has limited interconnection to surrounding states, so its ability to import power on high-voltage lines to make up for any shortfall is limited. Texans learned this last April when a spring heatwave sent temperatures in parts of the state into the triple digits, catching the utilities flat-footed and producing rolling blackouts and brownouts around the state.

The people who run TXU understand all of this at least as well as anyone. They also know that starting this year and continuing in stages into 2009, the state's electricity-deregulation plan calls for the price cap on wholesale power to be raised to three times its 2006 level. The retail price cap expired at the end of last year.

These reductions in price controls would certainly have played a role in TXU's earlier decision to invest $10 billion in the 11 new plants, which was the point of decontrolling prices in the first place -- greater returns mean more investment, which is needed to supply a growing state's energy needs. So now TXU can hope to get the benefit of rising prices by restricting supply, and get environmental plaudits in the bargain. Only Texas consumers might suffer.

Which is not to say that TXU would be giving up nothing by not building the plants. Some of the plants that were to be replaced are gas-fired, and natural gas prices have been volatile and rising. TXU owns a bunch of coal deposits, so it had planned to build the coal-fired plants in part to get a better grip on its supply costs going forward. And given the projections for steadily rising electricity demand in Texas and the rather closed nature of its market, TXU runs the risk of ceding market share in electricity generation to rivals.

As for TXU's current shareholders, the agitation of the greens may have helped bring down TXU's share price last year, so the environmentalists probably did KKR and partners a favor. There may even be a trend in the making here -- environmental protesters bring down a stock, making a private-equity transaction look more attractive, and in return, the equity firm and its management partners buy off the greens with this or that environmental promise. We're not suggesting any such quid pro quo here, but if we were TXU's mom-and-pop investors or Texas energy consumers we'd certainly be asking some pointed questions.

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