

The Treasury

Solid Energy Information Release

March 2013

Release Document

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Protecting and enhancing shareholder value

Solid Energy: Briefing for meeting with Chair and Chief Executive on Thursday, 17 August 2006

Date	15 August 2006	Priority	Urgent
Security level		Reference	SEL-032/A58274

Minister	Action sought	Deadline
Minister for State Owned Enterprises	Note recommendations.	17 August 2006

Report summary

- You are meeting with Tim Saunders, Chair and Dr Don Elder, Chief Executive of Solid Energy, on Thursday, 17 August.
- We understand Solid Energy wants to brief you on a number of key issues faced by the company, which include:
 - Spring Creek Mine
 - East Mine / New Zealand Steel
 - Ohai Mine
 - gasification / Southland lignite
 - Business Plan for 2006/07 and beyond
 - performance for the 2005/06 financial year
 - board succession.

Contacts

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Minister's comments

15 August 2006

Minister for State Owned Enterprises

Solid Energy: Briefing for Meeting with Chair and Chief Executive on Thursday, 17 August 2006

Introduction

1. You are scheduled to meet at 2:00pm on Thursday, 17 August 2006 with the Chair, Tim Saunders, and the Chief Executive, Dr Don Elder of Solid Energy.
2. We understand Solid Energy wants to brief you on a number of key issues faced by the company. Solid Energy is also expected to mention the new state-owned enterprises (SOE) policy.
3. This report discusses a range of key issues faced by Solid Energy, including those expected to be raised by Solid Energy. The issues covered by this briefing are:
 - Spring Creek Mine
 - East Mine / New Zealand Steel
 - Ohai Mine
 - gasification / Southland lignite
 - Business Plan for 2006/07 and beyond
 - performance for the 2005/06 financial year
 - board succession.

Spring Creek Mine

4. In April 2006, Solid Energy informed Ministers that the current operation at Spring Creek was no longer economically viable. The company indicated it would close the mine in January 2007 unless a current investigation of a possible niche market for specialised coal products came up with an economically viable option.

5. Spring Creek Mine was originally a joint venture between Solid Energy and Todd Energy. In 1998 the mine was opened, but by 2000 it had become obvious that opening the mine had been the wrong decision. In 2001, the mine was closed after Solid Energy and Todd Energy had jointly spent \$26 million on developing the mine. In 2002, Solid Energy bought out Todd Energy's share and reopened the mine using a different mine plan. Production was suspended in November 2004 and Solid Energy conducted a comprehensive review of the future feasibility of the mine. At the conclusion of the review viability of the mine beyond the current developed panels (to be extracted by January 2007) was in question unless significant improvements in mine productivity and market prices could be achieved. A further feasibility study was completed in April 2006.
6. The feasibility study confirmed that the mine is not economically feasible after January 2007. However, the review identified another option that may make the mine viable by investing in some specialist washing plant that will upgrade the value of the coal by producing a very low ash and sulphur product for niche international markets.
7. Solid Energy is currently investigating niche market opportunities including coal fired power stations in the US which have very stringent emissions rules, steel producers that use the PCI coal to inject directly into the blast furnace and other specialist markets. These marketing efforts have produced promising results with negotiations underway with at least two parties.
8. Solid Energy's Board expects to make a decision by October 2006 regarding the future of the mine. Prior to making a final decision Solid Energy will need to consult with affected staff, the Engineers' Union and other stakeholders.
9. Closure of Spring Creek Mine would mean job losses for up to 130 people. In contrast, there will be no personnel changes if the mine remains open. However, due to the current uncertainty, Solid Energy is losing staff to Australia, and expects to lose some staff to Pike River Mine once they start recruiting.
10. Pending on a decision to proceed, collective agreement negotiations impacting the Spring Creek work force will start in September 2006. The outcome of these negotiations will have significant impacts on the feasibility of Spring Creek Mine.

East Mine / New Zealand Steel

11. The current contract between Solid Energy and NZ Steel for the supply of Waikato coal expires in May 2007. The coal sold to NZ Steel by Solid Energy is currently supplied from the Huntly East Mine. The expiry date on the contract coincides with the end of proven coal reserves at the Huntly East Mine.
12. The majority of the coal supplied to NZ Steel after May 2007 was expected to come from the proposed Huntly North Mine, which is a proposed extension of the Huntly East Mine. Both are underground mines. The Huntly North Mine requires substantial capital investment and will be a significantly higher cost mine to develop. Solid Energy will not proceed with the development of the mine if it is

unable to negotiate a contract with NZ Steel that fully underwrites the development costs of the mine.

13. NZ Steel has to date been unwilling to commit to a contract for the supply of Huntly North coal and is conducting trials of Indonesian coal in an effort to find an imported coal source that meets its process specification. An initial trial with a mix of greater than 15% imported coal was not successful, but further trials using different Indonesian coals are continuing. If the trials are successful, Solid Energy will purchase the coal from overseas on NZ Steel's behalf and blend it with indigenous coal to achieve a mix that meets NZ Steel's requirements.
14. Feasibility work on the Huntly North Mine continues to be progressed and good progress has been made on negotiating a new contract with NZ Steel.

Ohai Mine

15. Ohai mine is planned to close at the end of the current pit 17. The cost of mining at Ohai is at the high end of the cost curve in part due to its remote location. Solid Energy is exiting the high value residential bagged coal market by 2012, and the price required to justify the mine is expected to be prohibitive for Fonterra.
16. Solid Energy is currently negotiating its contract with Fonterra Clandeboye. The contract offer is for a two year extension beyond 2008 supplied from the Ohai pit 17. The two year extension will allow Solid Energy to complete resource exploration work, and if viable develop an industrial lignite mine to supply Clandeboye beyond 2010.
17. The current business plan assumes that lignite will be mined from the reopened Mataura Opencast Mine to replace Ohai Mine for the South Island industrial market.

Gasification / Southland lignites

18. New Zealand has 10 to 15 billion tonnes of lignite resources, mostly located in Southland. The problem with lignites is that due to the high moisture content the coal has a lower calorific value and is not as economic to transport lignites longer distances to market as with other higher grade coals.
19. Over the past two years, Solid Energy has been investigating a range of options for the use of lignites. This includes increased use of lignites by industrial markets, electricity generation, transport fuels, petrochemicals and other products. This work is at the pre-feasibility stage only.
20. In the first instance, Solid Energy is looking at the viability of reopening Mataura Mine to serve the South Island industrial market. Mataura Mine operated between 1951 and 2000, having been purchased by Solid Energy in 1996.
21. The Mataura Mine site sits on the southeastern edge of the Mataura coalfield, southwest of Mataura township (near Gore), which, with three billion tonnes of coal-in-ground, is the largest in New Zealand.

22. Solid Energy has made \$50 million of land and mineral purchases and is planning a further \$67 million to \$137 million in land and mineral purchases, in relation to lignite resource acquisition to provide options for a range of projects including the proposed coal to liquid conversion project. Solid Energy is in the process of securing properties around the Mataura Mine.
23. The investigations are in the very early stages, and the purchase of mining properties will allow Solid Energy to secure the resource to keep its options open, and progress the projects if it is deemed to be economically feasible.
24. Solid Energy's strategy to manage mine development risk is to underwrite large capital expenditure with long-term coal supply contracts. The development of the coal to fuels project represents a departure from this strategy.
25. If the feasibility study indicates a positive NPV, the upside value impact of large scale lignite mining is estimated to be \$250 million. The key economic driver of this project is the future price of oil, the industry commonly believes the oil price must remain at or above US\$40 to \$45 a barrel to be economic.
26. If the coal to liquids project proves to be viable it will require a coal to liquids plant costing more than \$6 billion. Solid Energy does not expect to be a significant equity investor in the coal to liquids plant, but expects to maintain the lead role in advancing the project through the planning stages.
27. Officials are concerned that considerable capital expenditure has occurred without any substantive prior consultation with officials or Ministers. Solid Energy's SCI requires formal consultation if any capital expenditure item exceeds 25% of shareholder funds. The land and minerals purchases to keep the options open for the project in total will significantly exceed this threshold.
28. We understand that while the coal to fuel project has been outlined briefly to Ministers, no mention was made of the intention to purchase the minerals and land. While the purchase of land is low risk and the development of the option may be reasonable, the mineral right purchase is higher risk and the lack of material consultation is unacceptable. We have noted this concern in the draft letter commenting on Solid Energy's draft SCI and Business Plan.

Business Plan for 2006/07 and beyond

29. Solid Energy was granted an extension for the delivery of its final SCI so that officials could analyse its long-term business plan prior to giving advice on the draft SCI. The long-term plan was delayed primarily as a result of management time being diverted onto a number of business critical issues (mining of the Stockton ridgeline and related wild life permits and decisions surrounding the future of the Spring Creek mine) during the business planning period.
30. Solid Energy has once again provided a very detailed 20-year long-term Business Plan. The Business Plan provides a base case of what it sees as the most likely scenario for the next 20 years. In addition, the plan includes three upside scenarios, five downside scenarios and four Kyoto Protocol scenarios. A net

present value (NPV) of discounted cash flows for all components of its business is calculated for each scenario.

31. There are two major issues facing Solid Energy's core coal mining business; the sustainability of currently high international coal prices and the difficulties of accessing economically viable coal reserves.
32. Export prices for coking coal are currently at high levels, but have reduced from record levels in the previous year. Solid Energy projects the price to reduce gradually over the next few years, returning to historical price trends by 2010. This is a conservative assumption as it is also possible that prices continue to stay high by historic standards, consistent with worldwide energy constraints.
33. Coal prices are particularly crucial to Solid Energy because its mines are small, and its cost of mining high, in comparison to the market setting Australian mines. This is especially the case for the higher cost underground mines. Even at today's high prices some of these mines are marginal. Therefore, the company is faced with the dilemma of either keeping the underground mines open to maintain their option value if prices rise, or closing the mines because they are no longer economic if prices decline.
34. Accordingly, the company is reviewing individual mines, watching international coal prices closely and conducting thorough scenario planning. The company is also seeking to ensure each mine is underwritten by a long-term coal supply contract.
35. Beyond the term of the existing contracts, the availability of proven, accessible, economic reserves of coal is an ongoing long-term supply risk for Solid Energy. The key drivers that impede the improvement of reserve levels are, land and mineral access, the resource consenting process and the shortage of skilled labour. Solid Energy is considering supplementing its own resources by importing coal to ensure a secure supply of coal to its domestic customers.

Performance for the 2005/06 financial year

36. For the 2005/06 financial year, the company recorded NPAT of \$84.4 million which, although 13% below budget, it was a record result for the company. The previous best result was NPAT of \$56 million in 2003. Lost production from 17 days of industrial stoppages, increased costs and a higher New Zealand dollar were the main reasons why Solid Energy did not meet its budgeted profitability.

Board succession

37. [4],[5],[7]

- 38.

39. [4],[5],[7]

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Table 1. The current Board of Solid Energy:

Name	Term end
Tim Saunders (Chair)	31 December 2006 (appointed Dec 1998)
John Spencer (Deputy Chair)	30 April 2008 (appointed June 2005)
Alan Broome	30 April 2009 (appointed May 2006)
Helen Cull QC	31 October 2007 (appointed January 2005)
Michael Hawarden	30 April 2007 (Appointed Dec 1998)
John Walters	31 October 2006 (appointed August 1999)
Tony Williams	30 April 2007 (appointed November 2001)
Adrienne Young Cooper	30 April 2009 (appointed November 2002)

41. [4],[5],[7]

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[4],[5],[7]

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Consultation

49. The Treasury has been consulted and agrees with the contents of this report.

Recommendations

50. We recommend that you:

- a **note** the contents of this report, including the following key points:
 - (i) you are scheduled to meet at 2:00pm on Thursday, 17 August 2006 with Solid Energy's Chair, Tim Saunders, and the Chief Executive, Dr Don Elder
 - (ii) we understand Solid Energy wants to brief you on a number of key issues faced by the company, including:
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Hon Trevor Mallard
Minister for State Owned Enterprises