

The Treasury

Solid Energy Information Release

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Release Document

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Treasury Report: Solid Energy: Briefing for Ministers' Meeting on 11 December 2006

Date:	8 December 2006	Treasury Priority:	Medium
Security Level:		Treasury Report No:	T2006/2344

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Note the attached briefing for a meeting with Solid Energy at 4.15pm on Monday 11 December Forward report to Minister of Energy	11 December 2006
Associate Minister of Finance (Hon Phil Goff)	Note	None
Associate Minister of Finance and Minister for State-Owned Enterprises (Hon Trevor Mallard)	Note the attached briefing for a meeting with Solid Energy at 4.15pm on Monday 11 December	11 December 2006
Associate Minister of Finance (Hon Clayton Cosgrove)	Note	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Matthew Morrison	Senior Analyst, Commercial Investments	[1]	✓
Jean-Pierre Andre	Senior Analyst, Commercial Investments	[1]	

Enclosure: Yes

8 December 2006

SE-2-14-0

Treasury Report: Solid Energy: Briefing for Ministers' Meeting on 11 December 2006

Purpose of Report

1. This report provides you with a briefing for a meeting with Solid Energy at 4.15pm on Monday 11 December. There are two parts of the meeting:

Part 1: 4.15-4.30 Discussion on Solid Energy's plans to commercialise Southland lignites (low grade coal). (Shareholding Ministers and the Minister of Energy);

Part 2: 4.30-5.00 Discussion on Solid Energy's strategy to secure coal resource to support all its activities, including the Southland lignites and any other outstanding business plan issues. (Shareholding Ministers)

2. Solid Energy is not expecting Ministers to make specific decisions in the meeting.

Analysis

Background

3. As at the time of its 2006 business plan, Solid Energy had made land and mineral purchases of \$50 million, and was planning a further \$67 million to \$137 million of spending, in relation to lignite resource acquisition. This was to provide it options regarding a proposed coal to liquid conversion project. Solid Energy is in the process of securing properties around the Mataura Mine, which will reopen if supported by market conditions. The coal to liquids project is in its early stages, and the purchase of mining properties will allow Solid Energy to secure the resource to keep its options open, and progress the project if it is deemed to be feasible and net present value (NPV) positive.
4. In its Business Plan the coal to liquids project is included as part of the upside scenarios only and is not included in the base plan. The base plan assumes that a small amount of lignite will be mined from Mataura mine to replace Ohai mine for the South Island industrial market, and that the bulk of the land required for the proposed coal to liquids project is eventually sold with a capital gain of 3% per annum. However, the land component is only \$80 million to \$135 million of the total projected expenditure (to date \$36 million). While it is reasonable to assume the land, as a liquid asset, can be resold at little risk, between \$37 million and \$52 million of mineral right purchases would be at risk (to date \$14 million) if a project does not eventuate and no buyer for the rights can be found.
5. 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.
6. If the feasibility study indicates a positive NPV, the upside value impact of a coal to liquids plant 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 needs to remain at or above US\$45 to \$60 a barrel to be economic.

7. The potential products produced through refining the lignite are:
 - Transport fuels (for vehicles)
 - Gas for electricity generation
 - Fertiliser (ammonia urea)
 - Methanol for export
8. If the coal to liquids project proves to be viable it could require a coal to liquids plant costing more than US\$4 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 planning stages. The very high development cost makes the probability of successful execution of this project low, and therefore the probability of write-downs for the non-land component of the project significant.
9. We understand that, while the coal to fuel project has been outlined briefly to Ministers, no mention was made of the intention to immediately purchase the minerals and land. We are concerned that considerable capital expenditure has occurred without any substantive prior consultation with officials or Ministers. Solid Energy's Statement of Corporate Intent (SCI) requires formal consultation if any capital expenditure item exceeds 25% of shareholder funds. The project in total will significantly exceed this threshold.
10. While the purchase of land is low risk and the development of the option may be reasonable, the mineral right purchase is high risk and the lack of material consultation is poor. Shareholding Ministers noted this concern and in August 2006, following this year's business planning round, wrote to Solid Energy stating:

"Accordingly, in line with our general expectation that state-owned enterprises consult on significant projects ahead of implementation, Ministers ask that, prior to further progress, Solid Energy provides us with a report by 31 October 2006 detailing:

 - *the current position of the coal to fuel project*
 - *the business case for securing the mineral resource*
 - *a broader picture of the potential coal to fuel project*
 - *any other relevant information."*
11. As a result of this letter Solid Energy has reduced the intensity of its land and mineral purchases, but has not stopped this capital expenditure entirely. It has spent approximately \$8 million more in the last 3 months.
12. To date a business case has not been received. Instead Solid Energy has arranged this meeting to introduce its plans to Ministers. It expects to provide the Business Case as part of the Business planning process early in 2007. Officials consider that this approach is satisfactory, provided no further material progress is made on the land and mineral purchases in Southland.
13. CCMAU has been consulted in the preparation of this report and Aide Memoire.

Recommended Action

We recommend that you:

- a **note** that you are meeting with the Chair and CEO of Solid Energy on Monday 11 December at 4.15pm;
- b **note** the attached Aide Memoire for the meeting; and
- c **forward** this report and Aide Memoire to Hon David Parker, the Minister of Energy.

Agree/disagree.

Jean-Pierre Andre

Senior Analyst, Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Hon Trevor Mallard
Minister for State Owned Enterprises

AIDE MEMOIRE: MEETING WITH SOLID ENERGY, 4.15PM, MONDAY 11 DECEMBER

Attendees:

Hon Dr Michael Cullen
Hon Trevor Mallard
Hon David Parker
Tim Saunders (Chair Solid Energy)
Don Elder (CEO Solid Energy)

Purpose of meeting

There are two parts to the meeting; the Minister of Energy is only present during the first part:

4.15pm - 4.30pm (*Hons Dr Cullen, Mallard and Parker*)

Purpose: For Solid Energy to present its plan to develop options for commercial lignites in Southland; and

4.30pm - 5.00pm (*Hons Dr Cullen and Mallard*)

Purpose: For Solid Energy to present its strategy to secure coal resources across all aspects of its business and to present further detail on its plan to commercialise Southland lignites.

Questions / Discussion Points

Solid Energy will start Part 1 of the meeting with an overview of its lignite commercialisation plans, and Part 2 with the company's frustrations in securing coal resources for its core coal business, followed by discussion on these matters. Solid Energy is not asking Ministers to make specific decisions during the meeting. The following are questions/discussion points Ministers could raise regarding the coal to liquids project:

Energy / Climate Change Policy

- What benefits could this project bring to New Zealand's energy needs?
- What is your understanding of how this fits within the Government's energy policy?
- What are the likely carbon emission issues for commercial lignite options?
- Is carbon sequestration being considered, how likely is this?

Solid Energy's recent performance

- Acknowledge Solid Energy's record performance in 2005/06 in achieving a net profit of \$86 million.

Process so far

- Express disappointment that Solid Energy has commenced considerable capital expenditure, in excess of consultation thresholds, without material consultation with shareholders. But also note that much of this capital expenditure is relatively low risk, as it is land.
- Indicate that Ministers expect a comprehensive business case before Solid Energy recommence material progress on the lignite project and that Ministers are willing to wait for this to be presented as part of next year's business planning round.

Solid Energy's strategy

- What will Solid Energy's role be in the project?
- How does this fit with Solid Energy's current capability?
- Is Solid Energy big enough to take on this role?
- Who are your likely partners in this project?
- Have you sought expressions of interest from such partners, if not when do you expect to engage with them?
- What will the company do if it cannot interest a partner in this project?
- What external advice has been sought? Will be sought?
- What are the likely products produced at the end of the project?
- What comparable developments are there elsewhere in the world? How successful are they?

Financial issues

- What is the option value once the lignite resource is secured?
- What is the expected return on investment for the potential options for the lignite?
- What is the market price of oil at which the project is viable?
- What can be done to mitigate the risk if the price of oil falls below this, after the project is underway?
- How much capital expenditure does Solid Energy expect to put into this project?
- Will equity injections be required from shareholders? When? How much?

Timeline / Ministerial decisions

- What is the anticipated timeline for the project?
- What decisions do you expect to bring to Ministers during the project?

Securing coal resource

- How much lignite does Solid Energy require?
- How much has Solid Energy already secured?
- If Solid Energy chooses to abandon the project now or after all the minerals are secured, what would it do, what would be the cost to the company?

Tim Saunders retiring as Chair

- This is likely to be Tim Saunders' last meeting with shareholders as Chair and you could acknowledge his seven and a half years service as Chair of Solid Energy, during which time the company has gone from financial crisis to one of the most profitable SOEs.

Conclusion / Outcomes of Meeting

Potential concluding messages from Ministers:

- a. Ministers disappointed by the process so far;
- b. appreciate the presentation at the meeting;
- c. expect a comprehensive business case as part of next year's business planning process;
- d. until a business case is accepted by Ministers do not expect Solid Energy to undertake any material capital expenditure on the lignite project;
- e. the success of the business case will depend heavily upon its consistency with the Government's energy and climate change policies.

Solid Energy's Agenda for the meeting:

Solid Energy Meeting with Ministers

11 December 2006, 4:15 – 5:00pm

Proposed Agenda

1. Lignite gasification

- Background – reasons to consider lignite gasification
- Position in SE's current Business Plan
- Status of SE's gasification plant studies
- Status of SE's lignite resources
- Proposed approach to continuing Government liaison

2. SENZ strategic issues

- SE's strategy to secure access to coal resources (including lignites)
- SE's current secure coal resources & land access
- SE's resource & land access concerns
- SE's current resource & land access objectives

- Any other outstanding business plan issues?