

The Treasury

Solid Energy Information Release

March 2013

Release Document

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Solid Energy NZ Ltd: Briefing for Business Planning Meeting

To	Minister for State Owned Enterprises	Priority	Urgent
cc	Minister of Finance Associate Minister of Finance (Hon Steven Joyce)		
Date	17 August 2009	Deadline	18 August 2009

Purpose

You are scheduled to meet with the Chair (John Palmer) of Solid Energy on Tuesday, 18 August 2009. The meeting is to discuss progress on Solid Energy's Statement of Corporate Intent (SCI), and in particular changes to the dividend policy following its recently completed capital structure review.

Background

In recent years, Solid Energy has had a poor record of returning profits to the Crown and has maintained extremely conservative debt levels. At your last meeting with Solid Energy, on 9 June 2009, you requested a larger and more consistent share of profits be paid to the Crown and that the Board take on a higher level of debt (excluding its rehabilitation liability).

The Chair confirmed a capital structure review was underway to address these expectations, but also noted their view that dividends were likely to remain restricted due to upcoming capital projects which were considered a priority.

The Board was also reviewing its methodology for calculating Solid Energy's valuation.

Latest Draft SCI and Business Plan

Solid Energy has now completed its capital structure review (which included an assessment undertaken by PricewaterhouseCoopers (PWC)) and has updated its draft SCI and business plan.

Solid Energy's initial draft dividend policy was for 50% of net profit after tax. However, its dividend forecasts did not reflect this policy, with profits largely being retained for capital projects (rather than paid out as dividends). Forecast dividends for the first two years were nil and \$60 million for the third year. Gearing was forecast to range between 20 - 26%.

The updated dividend policy is based solely on achieving a gearing target of 35% (excluding rehabilitation¹) and removes any link to profit or cash flow. Although gearing targets have been increased by ~10%, they remain conservative compared with

¹ The Board has now accepted that it should not include its long-term mine rehabilitation liability in the gearing target, as it does not have the same characteristics as bank debt.

the PWC assessment that Solid Energy could support increasing its gearing ratio to 40% over two years or more.

Despite now forecasting higher debt levels, instead of returning the available funds to the Crown, Solid Energy plans to use them to fund higher stock levels, mine stripping work and long-term investments. Although forecast dividends have been brought forward (\$24m for FY10, \$10m for FY11 and \$28m for FY12) total forecast dividends for the planning period have increased only marginally (ie. \$62 million over the three years, compared with \$60 million initially).

Solid Energy's view

Solid Energy's profit has been volatile in recent years, due to movements in international coal prices, foreign exchange rates and increasing mine operating costs. Given this volatility, which significantly exceeds other SOEs, the Board is strongly of the view that it does not want to increase gearing to 40%, preferring to stay at 35% over the short-to-medium term.

The Board's rationale for basing the dividend policy solely on gearing, is that such a policy provides the company with the necessary flexibility and control it needs to proceed with capital intensive projects such as the Millerton and Cypress Mines, coal seam gas and underground coal gasification.

Officials' comment

Over the business planning period, Solid Energy's return on equity is forecast to remain reasonable, at between 10 – 15%. Longer-term coal prices are expected to continue to rise, suggesting reinvestment in the business is a sound objective.

However, the Solid Energy Board continues to place capital investment ahead of returning dividends to the Crown, and believes dividends should be treated as a residual only (ie. after all capital requirements have been met).

This view is at odds with shareholding Ministers' expectations that a larger, more consistent share of profits be returned to the Crown. Although the Board has acknowledged shareholding Ministers' expectations, and made some attempt to address them, it is clear that it sees reinvestment as a priority over paying dividends.

Officials believe removing the linkage between profit and dividends gives the Board too much ability to manipulate dividends based on the investment decisions of the Board and management. Given shareholding Ministers' expectations, we believe the dividend policy should aim to return a larger share of profits to the Crown, whilst also considering the company's optimal capital structure.

Officials have attached a draft letter to the Chair requesting a formal response as to why Solid Energy cannot return larger dividends to the Crown, based on a percentage of profit. We consider the Board should provide a thorough response to shareholding Ministers expectations regarding dividend policy and gearing and the priority of dividends against capital expenditure.

Commercial Valuation

In last year's SCI, the Board took an aggressive valuation approach and applied a discounted cash flow valuation to all parts of the business, including those which were some time from commercialisation.

The Board has changed its approach this year, maintaining a discounted cash flow approach, but discounting future projects by between 5% and 95% depending on current progress with the project. As a result, the valuation has fallen from \$3.0 billion to \$2.5 billion. Officials believe this is a more appropriate method, and that it has been sufficiently explained in the draft SCI.

Officials do not have any other concerns with the latest draft SCI.

Other Issues

Solid Energy has requested shareholding Ministers' approval of the proposed Stockton Mine Alliance agreement with Downer EDI, which represents a major transaction. CCMAU and Treasury have engaged with Solid Energy and are supportive of the proposal. We will provide a report to shareholding Ministers this week.

From Monday 17 August 2009, Solid Energy is to widen its current random drug-testing policy to all of its sites, including offices and locations without major employee safety issues. Solid Energy believes it will be the first company to introduce such a policy so widely, and recognises that some staff resentment is highly likely.

[4],[5]

Consultation

The Treasury has been consulted on this report, and agrees with its content.

Chris Jones
**Manager - Energy, Land &
Environment, CCMAU**
[1]

Hon Simon Power
Minister for State Owned Enterprises

Attachment: Proposed questions

The following are some questions you may like to ask Solid Energy:

- Is the Board willing to link its dividend policy to a percentage of net profit or operating cash flow, while retaining a specific gearing ratio target? If not, why not?
- Is the Board willing to increase gearing from 35% to 40% over the medium term, as was suggested by the PricewaterhouseCoopers capital review? If not, why not?
- Does the Board retain the view that capital investments should be the priority over returning a significant share of profits to the shareholder, despite shareholding Ministers' expectations that a larger and more consistent share of profits be returned to the Crown?
- Despite the increase in gearing from the initial business plan, total forecast dividends over the next three years have not increased significantly. To what use is Solid Energy putting these funds, rather than returning them to the Crown as a special dividend?

Summary Table of Financial Performance

	2008/09 (Draft)	2009/10 (Forecast)	2010/11 (Forecast)	2011/12 (Forecast)
NPAT (\$m)	\$108	\$43	\$70	\$89
Dividends (\$m)	\$26*	\$24	\$10	\$28
Gearing (%)	12%	35%	35%	35%
Return on Equity (%)	27%	10%	15%	15%

* excludes \$34.4 million dividend payment relating to the 2008 financial year

