The Treasury

Solid Energy Information Release

March 2013

Release Document

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CROWN OWNERSHIP
MONITORING UNIT

Treasury Report: Solid Energy - Comment on Commerce Select Committee review for the year ended 30 June 2009

Date:	21 April 2010	**Report No:**	T2010/659

Action Sought

	Action Sought	Deadline
Minister for State Owned Enterprises (Hon Simon Power)	Note contents	N/A

Contact for Telephone Discussion (if required)

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Minister for State Owned Enterprises' Office Actions (if required)

None.

Enclosure: **No**

21 April 2010

Treasury Report: Solid Energy - Comment on Commerce Select Committee review for the year ended 30 June 2009

Executive Summary

The Commerce Select Committee's 2008/09 financial review of Solid Energy included the comment that "Solid Energy acknowledges it got it wrong last year" in regards to its foreign currency hedging policy. This was in response to the company's 2009 annual report which disclosed it recorded losses on cash flow hedges of $102.4 million for the year.

This report provides background to the losses which were not so much a failure of treasury policy or operations, but due to the rapid fall in the New Zealand dollar in the second half of 2008 and the global financial crisis which lead to an abrupt halt in sales, which left Solid Energy in an over-covered position for a period.

Recommended Action

We recommend that you **note** the contents of this report.

Andrew Blazey
Manager, Sector Monitoring
for Secretary to the Treasury

Hon Simon Power
Minister for State Owned Enterprises

Background

1. On 26 March 2010, the Commerce Select Committee released its 2008/09 financial review of Solid Energy New Zealand Limited. The review highlights the record post-tax profit for the year, the unacceptable health and safety performance, lost revenue due to the global downturn, development of the Southland lignite resource and environmental issues.
2. This report focuses on the committee's comments regarding Solid Energy's hedging policy, which were:

   "Solid Energy acknowledges it "got it wrong" last year, but maintains that it is now robust. This policy is based on hedging mainly during the year in which prices have been set rather than over a longer time period. Re-setting of commodity prices as the dollar fluctuates also provides a natural ledge for commodity prices."

Analysis

3. The Commerce Select Committee's comments regarding Solid Energy's hedging policy and performance were not consistent with officials' understanding of the factors that created the cash flow hedge losses. We therefore discussed the report, officials' understanding of the situation, and the company's performance in further detail with Solid Energy's Chief Financial Officer.
4. In summary, Solid Energy's foreign currency hedging policy is to:
   - for the next six months, cover between 60% and 90% of forecast revenue; and
   - for seven to twelve months out, cover between 30% and 70% of forecast revenue.
5. The intention of the policy is to provide greater certainty in earnings for the upcoming months, not to try and beat the market. However, the range of cover percentage that is available to management gives it the ability to adjust cover levels in times of extreme variation in the New Zealand dollar. The Board receives a report from Solid Energy's treasury group each month, ensuring the company's position is governed.
6. As a guide to how Solid Energy's management uses the flexibility of the policy, when the New Zealand dollar is high (eg NZ$=US.75 as in early to mid 2008) coverage is generally at the lower end of the policy range, and when the dollar is low (e.g. NZ$=US.55 as in early 2009) coverage is increased.
7. Solid Energy's overall hedge position can move significantly during the year due to factors such as the timing of coal production and/or revenue (which is not necessarily smooth), export price changes (which are reset around April each year) and the price and volume of spot sales (as opposed to annual contracted sales).
8. The reasons for Solid Energy's foreign currency hedge losses during 2008/09 were essentially two-fold:
   - the rapid fall in the value of the New Zealand dollar against the United States dollar from ~0.76c in mid 2008 to ~0.52c in early 2009; and
   - from November 2008 onward customers from around the world cancelled orders as a result of the global financial crisis, leaving Solid Energy with hedge cover for USD revenue it was no longer going to receive.

9. The first reason, the rapid fall in the NZD, resulted in a loss of ~$80 million during the year. In mid-2008 due to the high NZD, Solid Energy had reduced its cover toward the lower end of company policy. This was on the expectation the dollar would begin to fall from the then current highs and it did not want to be locked into a high exchange rate resulting in lower NZD revenue. As the dollar fell, Solid Energy's reduced cover position was justified (if the cover had been higher the losses would have been higher), but the cover that was held still resulted in losses due to the very rapid fall of the dollar.

10. The second reason was a result of the global financial crisis, which from mid-November 2008 and into the first half of 2009, resulted in customers cancelling orders overnight. In December 2008, every contracted shipment was cancelled.

11. With the reduced USD revenue, Solid Energy had to purchase USD at the spot rate to cover its hedge contracts resulting in a ~$20 million loss.

Official's comment

12. COMU considers that the objective of Solid Energy's hedging policy, to provide greater certainty in earnings, is reasonable, and that the flexibility given to management in implementing the policy has been appropriately used. The policy does not attempt to remove the potential for foreign currency losses, but rather smooth the volatility of New Zealand dollar movements while trying to manage for a degree of upside.

13. Foreign currency losses incurred as a result of cancelled export orders were an unfortunate result, which was out of management's control and reasonable ability to forecast. The financial impact could just as easily have been positive, but still out of management's control.

14. Solid Energy has not changed its hedging policy in recent times as implied by the committee's report. The current level of cover differs from that of mid-to-late 2008, but the management and Board continue to manage the company's position within the policy, its objectives, and its governance rules.

15. Although Solid Energy's foreign currency hedge policy gives management a significant range to operate within, we are comfortable that it is reasonable for the operations of business and that the policy's objective and governance procedures appear appropriate. We would have concerns if Solid Energy had changed its policy to try and beat the market.