

The Treasury

Solid Energy Information Release

March 2013

Release Document

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CROWN OWNERSHIP
MONITORING UNIT

Treasury Report: Solid Energy: Briefing for meeting with Chair and Deputy
Chair on 4 July 2011

Date:	30 June 2011	Report No:	T2011/1455
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	For your information	Monday 4 July 2011
Associate Minister of Finance (Hon Simon Power)	For your information	Monday 4 July 2011
Minister for State Owned Enterprises (Hon Tony Ryall)	Note contents	Monday 4 July 2011
Associate Minister of Finance (Hon Steven Joyce)	For your information	Monday 4 July 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
[4]	Analyst, Sector Monitoring	[1], [2], [3], [4], [5], [6], [7], [8], [9], [10], [11], [12], [13], [14], [15], [16], [17], [18], [19], [20], [21], [22], [23], [24], [25], [26], [27], [28], [29], [30], [31], [32], [33], [34], [35], [36], [37], [38], [39], [40], [41], [42], [43], [44], [45], [46], [47], [48], [49], [50], [51], [52], [53], [54], [55], [56], [57], [58], [59], [60], [61], [62], [63], [64], [65], [66], [67], [68], [69], [70], [71], [72], [73], [74], [75], [76], [77], [78], [79], [80], [81], [82], [83], [84], [85], [86], [87], [88], [89], [90], [91], [92], [93], [94], [95], [96], [97], [98], [99], [100]	✓
James Cunningham	Manager, Sector Monitoring	[1]	

Minister for SOEs' Office Actions (if required)

Ensure that the Minister sees this report before his meeting with Solid Energy at 4.30pm Monday 4 July 2011.

Enclosure: Yes (attached)

Treasury Report: Solid Energy: Briefing for meeting with Chair and Deputy Chair on 4 July 2011

Purpose of Report

1. You are scheduled to hold a 'meet and greet' meeting with the Chair, Mr John Palmer, and Deputy Chair, Mr John Fletcher, of Solid Energy New Zealand Limited (Solid Energy) on Monday 4 July 2011, at 4.30pm. This report provides a summary of topics that might be discussed and provides some suggested messages to give to Solid Energy.

Analysis

Background

2. COMU has sought an agenda for this meeting from the Chair. The Chair has advised that he has no formal agenda but he would like to provide you with a general briefing of the issues facing Solid Energy.
3. This briefing covers the following topics which are likely to be discussed:
 - 2010/11 financial performance;
 - progress on the 2011/12 Statement of Corporate Intent (SCI) and business plan, including shareholding Ministers' expectations and implications of the Mixed Ownership Model (MOM);
 - concerns about Solid Energy's commercial valuation;
 - the Solid Energy bid for the Pike River Coal Ltd (In Receivership) (Pike River) assets; and
 - Board fees.

2010/11 Financial Performance

4. In the second quarter of the year, Solid Energy reforecast its year-end net profit after tax (NPAT) to be \$111 million, an increase of \$45 million compared to the budgeted NPAT of \$66 million. The key contributing factors to the reforecast NPAT are:
 - continued increases in export coking coal prices;
 - sourcing more coal from lower production cost areas of Solid Energy's mines; and
 - permanent cost savings, particularly at the Stockton mine on the West Coast, from major initiatives undertaken in the past two years.
5. Solid Energy has subsequently revised its year-end NPAT forecast to \$90 million, for the reasons outlined below.
6. Although the Christchurch earthquakes have caused disruption to the Midland West Coast rail line, which transports coal to the Port of Lyttelton (PoL), this has had little impact on Solid Energy. However, damage to the coal loader and wharf at PoL has caused a reduction in the number of ships being loaded prior to 30 June. Since the 22 February earthquake, the coal loader had been working, albeit at a reduced capacity.

7. The most recent earthquake (June) has been a further setback for both Solid Energy and PoL. PoL has advised that it is undertaking urgent strengthening work on the coal loading wharf's foundations. This work is expected to be completed by 3 July 2011 when coal loading should resume (although there is still some uncertainty around this date). During this time Solid Energy will continue to stockpile coal at the port. Solid Energy has advised that its inability to load coal could potentially impact production in early 2011/12, if it runs out of storage space. To date the Christchurch earthquakes have not affected production.
8. Due to the disruptions at PoL, three ships that were scheduled to be loaded this financial year will now not be loaded. We understand that a significant portion of the lost revenue is likely to be recovered in the next financial year.

2010/11 Dividends

9. Solid Energy paid an interim dividend of \$20 million on 31 March 2011. COMU has subsequently sought confirmation from the Chair that the final dividend for 2010/11 will be as per the Solid Energy dividend policy¹. The Chair advised COMU that Solid Energy will honour its dividend policy. Our expectation is that the final dividend is likely to be in the order of \$40 to \$60 million.

2012 Statement of Corporate Intent (SCI) and Business Plan

Extension to Table SCI

10. Along with the other companies being considered for the MOM, Solid Energy was provided an extension to 1 September 2011 to provide its final SCI. Providing more time will enable further analysis with respect to dividend and capital investment strategies.
11. In the context of the MOM, the Government must be careful to ensure that SOE dividends, capital investments and capital structures are optimised to maximise value at the point of sale, rather than later when the Crown's ownership interest has been reduced².

Mixed Ownership Model as it affects Solid Energy

12. Shareholding Ministers met with the Chair on 14 June 2011. No additional issues have arisen. The Commercial Transactions Group (CTG) of COMU is currently in the process of appointing the Crown advisor. Once the Crown advisor has been appointed, the next stage will be to go out to the market to select advisors to prepare scoping studies on the companies being considered for the MOM.

Expectations for the Solid Energy SCI

13. Solid Energy is yet to provide its draft business plan and SCI. However, we consider that it would be useful to reiterate shareholding Ministers' expectations, as detailed in the letter to the Chair on 15 November 2010. It would also be useful to highlight that it will be against those expectations that COMU will be assessing the draft business plan and that you expect the draft to be provided early enough to provide COMU with sufficient time to conduct a thorough assessment.

¹ The dividend policy is to distribute all funds surplus to its investment and operating requirements, subject to meeting the solvency requirements of the Companies Act 1993.

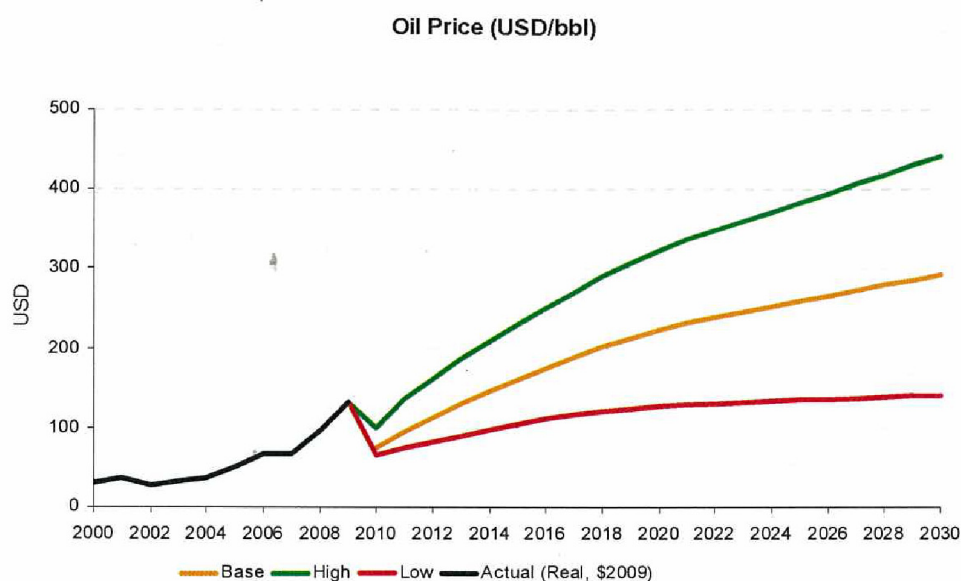
² In our view, at best, the market will value new developments or capital work-in-progress at face value. There is a risk that the market will apply a discount for project risk or fail to compensate the Crown for the opportunity cost of capital invested in new or partially completed development projects. There is also an opportunity cost associated with the SOEs building up significant cash balances or additional debt capacity.

14. The November expectations letter included the following expectations:
- entities should, over time deliver returns that meet or exceed the company's cost of capital;
 - emphasis will be placed on total shareholder returns (TSR);
 - Shareholders expect SOEs' dividends to show a degree of consistency across years, and that an appropriate balance between dividends and re-investment in the business is maintained; and
 - commercial valuation – the variation in commercial valuations will be adequately explained and independently reviewed.
15. Although COMU has not yet received a draft plan, we did recently receive forecast financials (prior to Solid Energy Board consideration). Those financials included a significant reduction in forecast capital expenditure and factor in a dividend of \$50 million for 2011/12, and \$65 million for each of 2012/13 and 2013/14. Previously an annual dividend of \$20 million was planned. Although these dividends are an improvement from the previous year's plan, COMU would want to review the entire plan before determining whether the dividends indicated are sufficient.

Concerns about Solid Energy's Commercial Valuation

16. Each SOE is required to include in its SCI the directors' estimate of the commercial value of the Crown's investment in the SOE. Shareholding Ministers have a preference for the valuation to be prepared on a discounted cash-flow (DCF) basis. For the 2011 SCI Solid Energy estimated its commercial value to be \$3.3 billion.
17. In preparing commercial valuation, key assumptions are typically made with respect to output, future prices, and costs. Figure 1 shows the oil price forecast which has been used by Solid Energy as a proxy for the price of energy-based commodities when it prepared its commercial valuation. Officials have previously advised that the price growth forecast assumed by Solid Energy is high compared with the growth path forecast by the Ministry for Economic Development and the International Energy Agency (T2010/1609 refers). In fact, the mid-point of the Solid Energy forecast is US\$250 per barrel in real terms by 2025, which is 2.5 times current prices.

Figure 1: Solid Energy Forecast Oil Price



18. While COMU accepts that Solid Energy is well-placed to make its own assumptions with respect to future coal production and operating costs, we note that the company's valuation included value attributed to future commodity price movements based on price path analysis not shared by other experts. This difference was highlighted when COMU commissioned independent commercial valuation reports³ from Macquarie Research and Forsyth Barr both of which estimated the commercial value of Solid Energy as \$1.7 billion. This compares with the Solid Energy's own valuation of \$3.3 billion. The large difference between the valuations may become problematic if a future partial sale of Solid Energy proceeds under the MOM.
19. COMU recommends that you highlight to the Chair that shareholding Ministers expect that the commercial valuations prepared by SOEs are robust. To this end, you would expect that the independent review of the Solid Energy valuation, as per shareholding Ministers' expectations, should include both the calculation of the value and the assumptions used.

Solid Energy's Bid for the Pike River Assets

20. Solid Energy lodged an indicative bid for the Pike River assets on 16 June 2011. COMU understands that the Receiver of Pike River has not yet prescribed a methodology for stage two of the bid process (post the indicative bid stage). Solid Energy is expecting the Receiver to define a process in the coming week.
21. COMU understands that if Solid Energy is successful in the bidding process, it will fund the purchase of the Pike River assets from its own balance sheet. COMU is mindful that the purchase of the assets is only the first step in the process of developing the assets, which is likely to involve significant expenditure over several years.
22. We consider that it would be useful to highlight to the Chair that shareholding Ministers expect:
 - to be consulted before any decision to invest is made by the board;
 - the consultation process should provide sufficient time for thorough consideration by the Crown as shareholder; and
 - any proposal needs to include the likely future cost of the development along with the value proposition for Solid Energy.

Board membership

23. Below is the Solid Energy Board's composition as at June 2011.

Member	Service Start	Expiry of Current Term
John Palmer (Chair)	1/11/2006	31/10/2013
John Fletcher (Deputy Chair)	1/05/2007	30/04/2013
Alan Broome	1/05/2006	30/04/2012
Simon Marsters	1/05/2008	30/04/2014
John McDonald	10/03/2007	30/04/2013
David Patterson	1/05/2010	30/04/2013
Michelle Smith	1/11/2010	31/10/2013
Adrienne Young Cooper	27/11/2002	30/04/2012

³ The independent valuation reports are publicly available on the COMU website <http://www.comu.govt.nz/publications/information-releases/valuation-reports/2010/>

24. The only board activity in the recent appointment round was the reappointment of Simon Marsters for a second three-year term. The next terms to be considered will be those of Alan Broome and Adrienne Young Cooper (expiry April 2012). Mr Broome will have served two terms (six years), and Ms Young Cooper three terms (almost nine years) on the Board.
25. You will shortly receive a report recommending you approve the director fees for all of the SOEs under your portfolio responsibilities for 2011/12 financial year. As part of this process Solid Energy has requested a significant allowance for special fees related to tasks required of the directors as part of the MOM consideration. At this stage we have been non-committal, but it is likely we will recommend to you a common approach for all the potential MOM companies which would be significantly less than that requested by Solid Energy. We suggest if the issue is raised, that you defer discussion until seeing our advice which will cover the whole SOE portfolio.

Recommended Action

We recommend that you:

- a **note** that Solid Energy has been provided an extension to 1 September 2011 to provide a final SCI for tabling;
- b **note** that COMU believes that the focus of the meeting should be on encouraging Solid Energy to deliver a business plan and SCI that meets Ministers' expectations;
- c **note** COMU considers it would be useful to remind the Chair of shareholding Ministers' expectations for Solid Energy's SCI and that the draft SCI will be judged against those expectations; and
- d **note** talking points are attached including the shareholding Ministers' expectations for Solid Energy's SCI.

James Cunningham
**Manager, Sector Monitoring
for Secretary to the Treasury**

Hon Tony Ryall
Minister for State Owned Enterprises

ANNEX 1: SUGGESTED TALKING POINTS FOR YOUR MEETING WITH SOLID ENERGY

2010/11 Financial Performance of Solid Energy

- It is pleasing that even with the disruption caused by the Christchurch Earthquakes the 2010/11 year has been a good year for Solid Energy in terms of profitability.
- Given the fiscal pressure on the Crown, and the better than budget performance of Solid Energy, we expect there is scope for Solid Energy to increase its 2010/11 final dividend distribution as per your dividend policy.

Operations

- How are the repairs to the coal loader progressing? And how do you see the disruption to the coal loading impacting on production and ship loading in the new financial year?
- What alternative options does Solid Energy have if further damage to Port of Lyttelton were to occur?

Expectations for the SCI

- Although Solid Energy has been given an extension to present its final SCI (until 1 September) I would like to be clear that our expectations are that:
 - Solid Energy should, over time deliver returns that meet or exceed the company's cost of capital;
 - emphasis will be placed on total shareholder returns (TSR);
 - Shareholders expect SOEs' dividends to show a degree of consistency across years, and that an appropriate balance between dividends and re-investment in the business is maintained;
 - commercial valuation – that changes in commercial valuations will be adequately explained and independently reviewed;
 - COMU will assess the business plan and SCI against these expectations; and
 - Solid Energy needs to allow sufficient time for COMU to fully assess the business plan and SCI.

Mixed Ownership Model (MOM) Preparatory Work

- Could you please summarise what preparation is being undertaken by Solid Energy in order to effectively participate in the process?

Commercial Valuation

- I understand that there was a significant difference between Solid Energy's 2010 commercial valuation and the COMU-commissioned independent commercial valuations. When conducting this year's valuation, I encourage Solid Energy to use market-based price assumptions for the valuation process and to include in the scope of the independent review of the valuation both a review of the methodology and the validity of the assumptions used.

Solid Energy's Bid for the Pike River Assets

- As part of the bid process, Minister's would appreciate being regularly informed on the progress being made and expect:
 - to be consulted before any decision to invest is made by the Board;
 - the consultation process should provide sufficient time for consideration by the Crown, as shareholder; and
 - any proposal needs to include the likely future cost of the developing the mine along with the value proposition for Solid Energy.