

The Treasury

Solid Energy Information Release

March 2013

Release Document

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THE TREASURY

Kaitohutohu Kaupapa Rawa

Date: 18 April 2012

To: Minister of Finance
Associate Minister of Finance (Hon Joyce)
Minister for SOEs

Aide Memoire: DB memo on Solid Energy

Please find attached a memo from Deutsche Bank (DB) on Solid Energy's response to the UBS scoping study. The key points from the memo are:

- "Solid Energy has a very different (much higher) view of commodity prices than consensus ... Our view is that external investors under MOM (or any other ownership structure accessing public markets) will be very cautious about supplying capital to an entity that has a radically different view of price path than consensus"
- "We agree with UBS that Solid Energy's business plan should be market based – i.e. based on a commodity price path at or much closer to consensus"
- "in our view the Business Plan Update provides insufficient certainty that the pre-IPO actions identified by UBS in its scoping study will be addressed in order to prepare Solid Energy for a successful IPO under MOM"
- "assuming the Crown is committed to pursuing an IPO of Solid Energy, then we recommend the Crown engages with the Board of the Company to gain their commitment to undertake all of the UBS pre-IPO actions within their recommended scale and timeframe"

We would like to discuss the DB advice and the next steps for Solid Energy with Ministers, at the meeting scheduled for 4pm on Monday next week, 23 April.

We understand the Minister for SOEs is scheduled to meet John Palmer and John Fletcher (Deputy Chair) in two weeks time, at 5pm on Thursday 3 May.

Juston Anderson, Senior Analyst, Commercial Transactions Group, [1]

John Crawford, Deputy Secretary, Commercial Transactions Group, [1]

Attachment: [DB memo of 20 March 2012 - Solid Energy \(Treasury:2308697v1\)](#)



Memo

Subject:

Solid Energy Business Plan Update; the Response to the UBS Scoping Study on Extending the Mixed Ownership Model

To:

John Crawford, The Treasury

From:

Deutsche Bank

Pages:

9 incl. this page

20 March 2012

John

You have asked us to review *Solid Energy Business Plan Update; the response to the UBS Scoping Study* ("The Business Plan Update") received by Treasury on 23 February 2012.

As background, Treasury received the final version of the UBS Scoping Study on Extending the Mixed Ownership Model to Solid Energy in October 2011. Since October and following meetings with Treasury, Solid Energy agreed to provide to Treasury a modified business plan, taking into account the findings of the UBS Scoping Study.

The Business Plan Update from Solid Energy has four sections. Set out below are a summary and Deutsche Bank's assessment of each section.

1. Introduction

Solid Energy makes four comments in the "Introduction" section of the Response which are summarised below:

- a) the application of political and fiscal objectives for the MOM process by UBS to the partial sell down of Solid Energy has raised several issues which remain unanswered by the scoping study;
- b) the Board of Solid Energy is concerned that such a narrow focus has driven a series of recommendations that may not be in the best interest of the business nor its shareholders;
- c) the unique nature of Solid Energy means it almost certainly does not fit comfortably within the proposed MOM framework; and
- d) the Solid Energy Board is keen to work together with Treasury on delivering a capital plan that maximises value for Solid Energy while meeting the Crown's MOM fiscal and political objectives.



Deutsche Bank assessment on Introduction

- I. Solid Energy believes that UBS's "narrow focus" on capital market requirements has led to a set of recommendations that would not be in the best interests of business or shareholders. The Board believes that the "unique nature" of Solid Energy means that an alternative capital plan and ownership structure to MOM should be developed.
- II. Our view is consistent with UBS. That is, assuming that Solid Energy is part of MOM, a series of pre-IPO initiatives are required in order to IPO the Company.
- III. Our view is that the UBS actions are not inconsistent with maximising the value of the firm and being in the best interests of shareholders, in the context of an IPO.

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Response to UBS scoping study

Solid Energy makes four comments in the “Response to UBS scoping study” section which are summarised below:

1. Solid Energy’s view of price path is at significant variance to UBS and has a track record of being superior. This is a source of competitive advantage to Solid Energy and underpins its growth strategy;
2. Benchmarking Solid Energy against a conventional coal producer’ may not be appropriate as it does not take into account the boutique nature of the Company’s operations, its product mix, strategic projects and aspirations;
3. Solid Energy accepts that several of the insights of the UBS scoping study have merit and potential to generate value; and
4. Given the uniqueness of Solid Energy amongst the SOE entities subject to partial sell down, Solid Energy believes other options that fulfil the MOM objectives should be investigated.

Deutsche Bank assessment on Response to UBS scoping study

- I. Solid Energy identifies the two key issues that it takes a different view than UBS:
 - Solid Energy has a very different (much higher) view of commodity prices than consensus. The Company believes it has a better track record at predicting commodity prices and so it is justified in creating a business plan and allocating capital that is consistent with this higher track.
 - Given its very heavy focus on new developments and renewables, Solid Energy sees itself as being very different from other conventional coal producers and therefore believes that it should not be benchmarked against these peers.
- II. We see these two issues as being tied. Our view is that external investors under MOM (or any other ownership structure accessing public markets) will be very cautious about supplying capital to an entity that has a radically different view of price path than consensus. Secondly, a key reason why Solid Energy has such a heavy focus on new developments and renewables is because of its view on price path. If its view on price path changed to consensus, then its focus on new developments and renewables is likely to also change – resulting in the Company appearing much closer to a conventional coal producer.
- III. We agree with UBS that Solid Energy’s business plan should be market based - ie based on a commodity price path at or much closer to consensus. The resulting change in strategic focus (including capital allocated and operating cost changes) means that the public markets are likely to benchmark the Company against conventional coal producers.
- IV. In respect to the last point raised by Solid Energy on “other options” that should be investigated. These are not specified in the response, and so we cannot comment on them [5]
[5]



3. Modifying Solid Energy's Current Business Plan



In this section of the response, Solid Energy set out 10 strategic milestones endorsed by the Board for integration into the company's current year business plan. The response notes that these milestones "are more generally applicable to a wider range of capital market options in that they focus on value uplift rather than a retail IPO in the near term".

The milestones are based on Solid Energy's analysis of UBS's recommendations contained in Appendix 2 of the Response.

Our assessment of the modifications to the business plan is based on the appendix information rather than the milestones per se – given that the appendix contains the Company's detailed analysis of each of the UBS Scoping Study conclusions and provides a corresponding business plan update and set of outcomes (that is consistent with the milestones in the main body of the document).

Below is a summary of the appendix information and an assessment of the level of alignment between the Company and UBS on each issue raised.




Assessment of Solid Energy's Response to the UBS Scoping Study

	UBS conclusions and pre-IPO actions	Solid Energy Business Plan Update & New Expected outcomes 1H2013	Deutsche Bank assessment
Level of coal reserves	Conclusion <ul style="list-style-type: none"> Ave mine life amongst Australian peers is 30+ years Pre IPO action <ul style="list-style-type: none"> Increase targeted reserve to production ratio by bringing forward exploration spending and accelerating drilling Convert resources into reserves where possible 	Business Plan Update <ul style="list-style-type: none"> [2] New expected outcomes <ul style="list-style-type: none"> Regard the current approach as relevant to NZ conditions Reviewing resource base in order to reassess value upfront/or improve value recognition Reassess the development path of Solid's coal resources and reserves Identify the value potential of different ownership or operatorship models for current reserves 	 <ul style="list-style-type: none"> ✓ Have committed to reassess coal reserves ✗ However uncertainty as to outcome of this review
Market based business plan	Conclusion <ul style="list-style-type: none"> Business plan and development projects based on market consensus price paths Pre IPO action <ul style="list-style-type: none"> Develop a modified business plan based on the current market price forecasts 	Business Plan Update <ul style="list-style-type: none"> Market consensus price paths are consistently around the p20 level Use a range of price paths in its forward planning New expected outcomes <ul style="list-style-type: none"> In addition to Solid's price path, develop a market based business plan using consensus path assumptions as part of FY13 planning Apply consensus price path ranges to internal models and valuations, including sensitivity analysis to consensus inflating the range with average consensus price path inflation over the last 5 years 	 <ul style="list-style-type: none"> ✓ Have committed to develop a business plan using consensus price path assumptions as well as Solid Energy's price path ✗ However, uncertainty as to which price path will be used to drive strategy and capital allocation

Source: Solid Energy Business Plan Update







Assessment of Solid Energy's Response to the UBS Scoping Study (con't)

	UBS conclusions and pre-IPO actions	Solid Energy Business Plan Update & New Expected outcomes 1H2013	Deutsche Bank assessment
Waikato coal	Conclusion – [2],[5],[6] – Pre IPO action – [2],[5],[6]	Business Plan Update – [2],[5],[6] – New expected outcomes – [2],[5],[6] –	 ✓ Appear to meet pre-IPO actions
West Coast coal	Conclusion – Spring creek faces operating challenges – Pike River will increase concerns over Spring Creek operations Pre IPO action – Advance options to 100% of Spring Creek – Spring Creek needs to be operational and achieving acceptable production run rates at the time of IPO	Business Plan Update – Cargill selldown announced in Feb2012 – Consideration is being given to finding a replacement partner for Cargill New expected outcomes – Resolve Spring Creek ownership issues – Implement operational improvement plan and achieve demonstrable productivity improvements – Assess the viability of proving up reserves at Spring Creek – Develop and implement a plan which maximises Solid value on the West Coast in the near term	 ✓ Appear from actions will implement improvements ? Some uncertainty as to details of plan
Value chain positioning	Conclusion – Potential confusion/concern over focus of Solid and core competencies Pre IPO action – Review New Energy projects within context of core competencies and find partners <u>subject to them being economically viable</u> . Expenditure constrained only to extent of exploration and development	Business Plan Update – Potential partnering opportunities are under investigation for all four key projects New expected outcomes – Divestment options are being pursued for Natures Flame and Bio Diesel – Partnering arrangements/considerations to be complete for CSG – Partnering for Briquettes and UGC in the short/medium term depend on technology/project circumstances – Partnering is a key workstream for CTF over the next months.	 ✓ Reviewing partnering options for New Energy projects ✗ Some projects (eg CTF) still being pursued even though not economically viable (at consensus price path)

Source: Solid Energy Business Plan Update



Assessment of Solid Energy's Response to the UBS Scoping Study (con't)

	UBS conclusions and pre-IPO actions	Solid Energy Business Plan Update & New Expected outcomes 1H2013	Deutsche Bank assessment
New Energy risks and valuation	Conclusion <ul style="list-style-type: none"> Concern over commercial viability and implications for balance sheet Management distraction from core business Pre IPO action <ul style="list-style-type: none"> Third part assessment of construction, operating costs and price path assumptions If retained, costs of New Energy projects will need to be materially reduced ahead of an IPO CTL and CTF should be put on hold unless external analysis demonstrates materially improved economics using market based prices 	Business Plan Update <ul style="list-style-type: none"> Will peer review projects at relevant stages Economic viability of projects does not rely on price paths significantly above market consensus Solid considers there is a trade off between continuing project development at minimum cost to demonstrate value and an arbitrary cost limit New expected outcomes <ul style="list-style-type: none"> CTL on hold CTF feasibility on schedule for 1Q13 completion UGC – complete light up of pilot plant Briquetting, complete commissioning by mid 2012 	 <ul style="list-style-type: none"> * CTF is not being put on hold (no external analysis completed) ? Uncertainty as to capital and operating costs being allocated to these projects
Renewable energy	Conclusion <ul style="list-style-type: none"> Difficult to identify linkages with Solid's core business Pre IPO action <ul style="list-style-type: none"> Renewables should be disposed of pre-IPO 	Business Plan Update <ul style="list-style-type: none"> Not difficult to demonstrate linkages between businesses and Solid's core competencies New expected outcomes <ul style="list-style-type: none"> The need for a transaction is agreed and under action UBS does not capture option value 	 <ul style="list-style-type: none"> ✓ Solid accepts the need for a transaction ? Uncertainty as to what the transaction looks like. Market will determine option value
Head office overhead	Conclusion <ul style="list-style-type: none"> Reflects organisation designed to deliver multiple non-traditional coal projects Significantly larger than Australian peers Pre IPO action <ul style="list-style-type: none"> Reduce Solid's overhead to a level aligned with its Australian peers 	Business Plan Update <ul style="list-style-type: none"> Coal mining component of the business very different from Australian peers Primary activity is to better and more transparently allocate this costs New expected outcomes <ul style="list-style-type: none"> Complete the allocation of overheads Reassess net head office costs and compare to peers, taking into account NZ conditions and diversity of operations Determine outcomes Undertake final stage reorganisation 	 <ul style="list-style-type: none"> * Reallocation of costs will not resolve issue * No commitment to reduce cost
Corporate governance and board structure	Conclusion <ul style="list-style-type: none"> Current board is large compared to Australian peers Less direct coal mining experience Pre IPO action <ul style="list-style-type: none"> Overall the size of the board be reduced to six Two new board members with coal expertise and oil & gas project management expertise be added 	Business Plan Update <ul style="list-style-type: none"> Board has been assembled to provide a range of capability and experience beyond straightforward coal mining New expected outcomes <ul style="list-style-type: none"> Shareholder & Chair to discuss 	 <ul style="list-style-type: none"> * Unclear as to actions

Source: Solid Energy Business Plan Update



Deutsche Bank assessment of Modifying Solid Energy's Current Business Plan

- I. Solid Energy has considered and responded to all the key issues raised in the UBS report.
- II. In respect of most of the issues, the Company has incorporated some elements of the recommended pre-IPO actions into its business plan.
- III. However, in our assessment when viewed as a whole, there is insufficient certainty around the scale of action and timing on several of the key pre-IPO actions identified by UBS to give us confidence that Solid Energy will be ready to IPO under MOM following these changes.
- IV. Examples of our uncertainty include:
 - Market based business plan. It is unclear whether consensus or its own price path will drive the Board agreed business plan;
 - New energy. It is unclear the scale of operating costs and capital will be committed to each of these projects over the next few years;
 - Head office overhead. It is unclear whether there will be significant change resulting from the review; and
 - Board size. It is unclear whether size and composition will change.



4. Valuation

Solid Energy views the^[5] enterprise value as “a market valuation based on a set of conservative assumptions and substantially explains the difference when compared to the company’s current SCI value” of \$3.0 billion cited by UBS. The Company comments that the UBS valuation “requires careful consideration as to the inherent impact of such prices in the company’s strategy and therefore value”.

In addition, Solid Energy noted four discrepancies in the valuation model:

1. Solid Energy would consider different sequencing of operations and possibly even different asset mix based on UBS’s view of the long term future price;
2. no explanation as to why our closest comparable company Bathurst is currently priced at a significant premium to Solid Energy;
3. the valuation of New Energy has been set at [2] The New Energy projects are viewed as future options for the business and their true option value needs further assessment and consideration before ascribing a point value for the purposes of valuation; and
4. the valuation of Solid Energy’s coal development assets is [2] No compelling argument for accelerating the proving and development of the coal development assets exist when this is compared to the corporate coal costs [2] and exploration costs [2] associated with these developments.

The Company concludes that the UBS approach risks sub-optimising the value of Solid Energy but that it has identified areas to reassess its milestones. The achievement of these new milestones will improve value and provide the platform “from which considered decisions can be taken as to how best to advance the MOM process as it relates to Solid Energy”.

Deutsche Bank assessment to valuation

- I. There is a massive difference between the value the Company has ascribed to itself (under SCI process) and the UBS Scoping Study valuation.
- II. They key driver to this is commodity price path - which is acknowledged by the Company
- III. We agree with the UBS market based approach for the purposes of the scoping study – which represents how external investors are likely to approach valuing the business in an IPO context
- IV. Although the UBS approach risks sub-optimising value (if prices turn out to be much higher than consensus) so also does the current business plan risk sub-optimising value (if prices turn out to be lower than the Solid Energy price path).
- V. In respect of the four discrepancies noted by UBS:
 - Sequencing and asset mix changes. We agree - optimising these for consensus could increase value to the Crown;
 - Bathurst. Bathurst is one of several comparable companies analysed by UBS. The analysis shows that Bathurst has high EV/resources and EV/reserves metrics relative to Solid Energy. Two differences mentioned by UBS in their analysis include Bathurst’s sole West Coast exposure and also that Solid Energy has higher operating costs;
 - New Energy. It is very difficult to value this business given its early stage and the range of valuation methods that can be used. [2]

**Deutsche Bank conclusion and recommendation**

- I. In our view the Business Plan Update provides insufficient certainty that that the pre-IPO actions identified by UBS in its scoping study will be addressed in order to prepare Solid Energy for a successful IPO under MOM.
- II. Assuming the Crown is committed to pursuing an IPO of Solid Energy, then we recommend the Crown engages with the Board of the Company to gain their commitment to undertake all of the UBS pre-IPO actions within their recommended scale and timeframe.