The Treasury

Solid Energy Information Release

March 2013

Release Document

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Solid Energy - Move to Intensive Monitoring

Date:	5 June 2012	**Report No:**	T2012/1081

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the contents of this report	None
Associate Minister of Finance (Hon Steven Joyce)	**Note** the contents of this report	None
Minister for State Owned Enterprises (Hon Tony Ryall)	**Agree** to move Solid Energy into an intensive monitoring regime **Agree** to extend the deadline for Solid Energy Limited to finalise its SCI and Business Plan to 31 August 2012 **Sign** the attached letter to John Palmer, chair of Solid Energy	Friday 8 June 2012

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[4]	Analyst, Commercial Transactions Group	[1]		✓
Andrew Blazey	Manager, Commercial Transactions Group	[1]		

Minister of Finance's Office Actions (if required)

None.

Enclosure: **Yes (attached)**

(Letter to John Palmer on move to intensive monitoring:2354703)

Treasury Report: Solid Energy - Move to Intensive Monitoring

Executive Summary

This paper updates you on the situation at Solid Energy Limited and recommends that you move the company to intensive monitoring status.

Solid Energy's performance has deteriorated sharply over the last few months as a result of a significant fall in international coal prices. This fall has put the company in a position that if it does not take significant action it will be in a loss making position in the next financial year.

Management has proposed a series of actions to address the situation and ensure that the company remains profitable. These actions are cost control, reductions in capital expenditure, sell additional coal domestically, asset sales, write downs and in a worst case seek an equity injection.

Treasury has some concerns that proposed actions might not be effective. Solid Energy has struggled to demonstrate cost control in the past, reducing capital expenditure increases risks, there may not be any appetite domestically for increased coal supply and asset sales will be difficult in the current market. We are especially concerned that management are not considering a change in strategy when we consider that the growth strategy being pursued by the company is a significant contributor to the current situation.

We recommend that you move Solid Energy Limited to intensive monitoring status. To give this effect we recommend that you:

- Grant an extension in timing to complete the 2012/13 Business Plan and SCI to ensure that these documents contain convincing evidence that the proposals put forward are likely to be effective. We are recommending that you extend the deadline for submission of the SCI to 31 August 2012.

- Require the company to present the revised Business Plan to Ministers.

- Require reporting from the company to move to monthly from quarterly.

- Require the company to meet with Treasury monthly to discuss their reports.

- Note there will be additional scrutiny of the financial data supplied by Solid Energy to the Treasury.

- Note Treasury will use Deutsche Bank to support our monitoring advice.

- Write to the Board to set out this intensive monitoring approach, so that they will be clear about its purpose and have an opportunity to respond.

Recommended Action

We recommend that you:

a **note** that Solid Energy Limited is facing a deteriorating international coal market and this poses very significant challenges for the company given its current position and strategy

b **agree** to move Solid Energy into an intensive monitoring regime

Agree/disagree.

c **agree** to extended the deadline for the submission of Solid Energy's SCI until 31 August 2012, and

Agree/disagree.

d **sign** the attached letter informing Solid Energy of your decision to move them to intensive monitoring.

Andrew Blazey
Manager, Commercial Transactions Group

Hon Tony Ryall
Minister for State Owned Enterprises

Treasury Report: Solid Energy - Move to Intensive Monitoring

Purpose of Report

1. This report discusses the current situation at Solid Energy Limited. It proposes Treasury commence intensive monitoring in the company and outlines what this will involve.

Background and Current Company Position

2. Solid Energy has been pursuing an ambitious growth strategy based on its projections of strongly growing energy and coal prices. This strategy has involved the diversion of significant amounts of free cash flow and operating expenditure into a series of speculative new development projects beyond the company's core coal mining business. At the same time the company has taken on increasing levels of debt to pursue the strategy and has paid a low level of dividends to the Crown (the company has paid $164 million in dividends over the last 5 years, which equates to a yield of around 1% based on Solid Energy's SCI valuations).

3. Treasury has had concerns about this strategy (T2012/348 refers) and the recent scoping study completed by UBS raised additional doubts about its appropriateness, especially as the company readies itself for a potential IPO. This was further supported by Deutsche Bank in its review of Solid Energy's response to the scoping study (discussed in an Aide Memoire sent to you on 18 April).

4. In recent months, coal prices, most especially the critical hard coking coal price (HCC), have fallen significantly, well below the levels forecast in Solid Energy's past business plans. On current pricing following the existing strategy and planning assumptions Solid Energy is now informing us that it would face a [2],[5] dollar loss in 2012/13 if no action is taken.

5. Solid Energy's balance sheet is not in a strong position to cope with the downturn in market conditions. The company has taken on significant debt and is now geared at 37% (its own analysis – Treasury's figures are slightly less). The downturn has led to significant pressure on asset valuations and will result in some assets being impaired. The following table was included in Sold Energy's 3rd Quarter Report detailing possible impairments:

Business Unit	Operation	Value March 2012 ($M)	Possible Impairment ($M)
Renewables	Natures Flame (incl Feedstock)	$46	$28
	Biodiesel New Zealand	$14	$8
	Switch Energy Solutions	$2	$2
New Developments	Coal Seam Gas	$19	$19
	Briquetting	$21	$5
Coal	Spring Creek	$118	?
Total			$62

6. To address the situation the management and board have put forward a series of measures to reduce costs and increase revenue. Management estimates that these measures will deliver the [2],[5] turn around in EBIT needed. On reading the proposed plan (which is light on detail) we have doubts that the measures put forward will be sufficient to achieve this, as some appear trivial (not providing lunches to internal meetings) and others difficult to achieve (increase sales to NZ customers such as NZ Steel and Genesis). We also have concerns that (a) Solid Energy has not demonstrated a cost-focused operation in the past and (b) changing the company's attitude to cost control will be difficult. The recent decision to rent office space in Auckland and Nelson is an example.

7. [2],[4],[5]

8. The proposed actions will be difficult for the company to achieve. We are concerned that if management is unable to fully achieve their objectives, potential breaches to debt covenants and in a worst case scenario potential solvency issues could emerge in the medium term. The company is considering asset sales as an option, but in the current market environment this is problematic. The board is also raising an equity injection as a possible worst case solution to the problems.

9. There is still no acknowledgement from either the board or management that the underlying strategy that the company is pursuing may not be appropriate. In fact, the current situation the company faces suggests that not only has the strategy been inappropriate, it has put Solid Energy in a vulnerable position. The company is still forecasting coal prices to trend back towards its long-term view (significantly higher than consensus), and this view (along with cost control) drives a significant uplift in Solid Energy's forecast profitability in later years.

10. This view on future coal prices (and the strategy that it drives) has been an ongoing source of tension between the Treasury and the company, which was heightened following the UBS scoping study that indicated a change of course was required to make the company IPO ready. Recent reporting in the media, such as the report attached in appendix A, and recent market weakness in commodity stocks such as Rio Tinto and BHP Billiton, give us significant concern that there may not be a recovery in coal prices in the medium term and that Solid Energy management are underprepared should this situation eventuate. As such, our view of downside risk is a fall in prices below the consensus forecast, not Solid Energy's elevated view.

11. We are concerned that the response that the company is proposing (cost control, scaling back of capital expenditure and asset sales) will not be sufficient should the forecast uplift in coal prices not occur. If prices turn out to be lower than consensus forecasts for a sustained period, the company will be at serious risk, even if it is successful at implementing the actions that it has outlined.

12. Solid Energy is not without strategic choices. It could change strategic direction by focusing on increasing value out of its core coal operations and abandoning or dramatically scaling back its new development programme. A change in strategy would assist in cost control (Solid Energy spent $21m in 2010/11 on R&D costs associated with New Developments and its corporate overhead costs have doubled from $22.2m in 06/07 to $43.2m in 2010/11) and would also reduce capital expenditure needs allowing the company to repay debt. Pursuing a strategy like this would result in some short term costs (increased write offs, redundancy & loss on sales of assets) but would reduce the company's vulnerability to downward swings in commodity markets such as at present. UBS in its scoping study of Solid Energy suggested that such a strategic change would also maximise the value that the Crown would receive from the proposed partial share sale.

Summary of Actions, Responses and Risks

13. The following table summarises the actions that the company is undertaking, how it proposes to achieve the actions and Treasury's summation of the risks.

Table 1 – Actions, Responses and Risks

Action	Response	Risks
Implement Cost Control	[2]	Company has poor record of cost control. Increase in business and production risks due to some actions (e.g. reduced stripping rates).
Reduce Capital Expenditure	Reduce Cap Ex [2]	[2],[4],[5]
Sell additional domestic coal	Sell additional coal on the domestic market to existing customers.	There may be no appetite for increased supply in the domestic coal market.
Sell Assets	Sell off some non-core assets	[2],[4],[5]
Write Down Assets	Write down asset values (approximately $60 million)	Write downs may be significantly higher than this.
Increase Equity	Request a capital injection from the Crown or other party.	Current Crown fiscal position makes capital injection undesirable. Capital from another source would run counter to the government's partial asset sale objectives.

Further Analysis of Company Position

14. In addition to the information supplied by the company directly, Treasury has done some further analysis of the company based on CFISnet data. A summary of this analysis is included in the table below.

Table 2 - Profitability

	Ave 2010/11Q	2011/12 Q Sept	2011/12 Q Dec	2011/12 Q March	% chg Dec –Mar
Revenue ($000)	207,817	270,375	268,637	218,857	-18.5%
EBITDAF ($000)	49,926	76,857	56,551	45,999	-18.7%
NPAT ($000)	21,796	43,641	26,644	17,048	-36.0%
Coal Sales – International ($000)	122,637	180,121	180,071	140,139	-22.2%
Coal Volume – International (kt)	506	593	630	605	-4.0%
Coal Sales – Domestic ($000)	54,147	69,426	70,542	63,549	-9.9%
Coal Volume – Domestic (kt)	506	541	585	516	-12%

15. The analysis reveals that there has been deterioration in the company's profitability between the December and March quarters. While sales volumes have remained relatively unchanged revenue and profitability has fallen sharply. This is particularly true of international coal sales where revenue fell by 22% between Q2 and Q3 while production was down by only 4%. This is consistent with the decline in coal prices that we are observing in the international market. The fall in domestic coal sales, while smaller, suggests that there is also weakness in this sector and therefore it is unlikely to be able to pick up much slack from the fall off in international prices. Financial reporting information for April suggests that the situation has continued to worsen.

16. Interestingly, the comparison with the average quarter in 2010/11 indicates that the quarter 3 revenue and profit figures are not dramatically out of line with previous historical results. This adds support to Treasury's view that the current growth strategy is a major contributor to the current issues that the company faces, as it needs continuingly growing prices to generate cash flow and sustain the debt necessary to fund its development activities.

Table 3 -Solvency

	FY 2010/11	2011/12 Q Sept	2011/12 Q Dec	2011/12 Q March	% chg Dec –Mar	April FR*
Current Ratio	2.02	1.73	1.88	1.62	-19.9%	
Interest Cover	17.9	24.6	16.2	18.1	1.0%	
Net Gearing	28.9%	34.1%	29.8%	32.2%	11.5%	34.7%
Term Debt ($000)	220,000	220,000	245,000	285,000	22.8%	310,000

*April Financial Reporting Data

17. The analysis also shows that there are no immediate concerns with solvency. However, there are some worrying signs, such as the decline in the current ratio from 2.02 in June down to 1.62 in March.

18. Long term debt is also growing rapidly – up 22.8% between June and March and continuing to grow in April (based on Crown Financial reporting numbers). This increase in debt has been previously forecast to support the growth strategy, but we are worried that it exposes the company to increased risk in the current trading position. It is also contrary to the standard practices of business in the coal industry that operate with no or low debt levels to reflect the risks associated with the industry.

19. Net gearing is also growing, up 11.5% between June and March. Our analysis shows a slightly lower net gearing of 32.2% to the company's 37%, however the company's figure will most likely reflect more up to date data, as the Crown financial reporting data show debt continuing to grow in April.

20. The trends presented in this analysis in addition to management commentary, suggest that the company has a challenging period ahead of it. If the trends continue and the coal price remains weak the company could be at serious risk. Given this, an increased level of monitoring by the Treasury seems warranted.

Proposed Interventions

21. We are recommending that Solid Energy be moved to intensive monitoring. The intention of this is to work with the board and the company to keep Ministers informed of risks and new developments but at the same time maintain the accountability of the Board.

22. We are proposing that you:

- Grant an extension in timing to complete the 2012/13 Business Plan and SCI to ensure that these documents contain convincing evidence that the proposals put forward are likely to be effective. Solid Energy's current Business Plan is very light on detail (it totals 10 pages, compared to 25 pages in 2011 Business Plan and 167 pages in the 2010 business plan), presumably because it has been prepared in a situation of high uncertainty, where the company has not yet determined what its short-term strategy should be. We are recommending that you extend the deadline for submission of the SCI to 31 August 2012.

- Require the company to present the revised Business Plan to Ministers to give you confidence that the proposed actions will address the underlying problems.

- Require reporting from the company to move to monthly from quarterly (noting that quarterly financial information will still be required for Cabinet reporting purposes).

- Note there will be additional scrutiny of the financial data supplied by Solid Energy to the Treasury to ensure that the company's strategies and actions are having the necessary effect to turn around performance and any early warning signs of further problems are picked up.

- Require the company to meet with Treasury monthly to discuss their reports to give us "soft" as well as hard information that we can use in our advice to Ministers.

- Note Treasury will use Deutsche Bank to support our monitoring advice, especially their insights into the coal market and market views of the likely direction of coal prices.

- Write to the Board to set out this intensive monitoring approach, so that they will be clear about its purpose and have an opportunity to respond.

Escalation Strategies

23. Should these actions prove insufficient, and the company's position continues to weaken further, possible interventions that could be considered are:

    - Ask if the board to consider appointing an advisory firm to work with it to ensure that Solid Energy is making the necessary changes to return to profitability, and to provide the board with an alternative source of analysis and challenge to management.

    - Ask the company to provide you with a monthly dashboard so it is required to explicitly consider the risks facing it and the actions it is proposing.

24. Ultimately, if Ministers are not satisfied with Solid Energy's strategy or performance you have the option of making changes to the board.

Steps Forward

25. With your agreement we will move Solid Energy Limited to intensive monitoring as outlined in the report. Attached is a letter for you to sign to the Solid Energy board requesting that they take certain steps to support this.

26. Solid Energy has always been envisaged as being offered later in the partial share sales programme. Current developments support this conclusion. It is difficult to see Solid Energy being ready for an initial public offering in less than 2 years.

APPENDIX 1

Recent Reuters Report on the Coal Market

Chinese buyers default on coal, iron ore shipments-trade

Mon May 21, 2012 2:12pm GMT

* At least six defaults of coal cargoes - traders

* U.S. cargoes bear brunt of defaults

* South African, Colombian supplies also hit

* China buys more lignite, seen replacing some Indonesian

* Chinese buyers also reneging on iron ore contracts

By Fayen Wong and Randy Fabi

SHANGHAI/SINGAPORE, May 21 (Reuters) - Chinese buyers are deferring or have defaulted on coal and iron ore deliveries following a drop in prices, traders said, providing more evidence that a slowdown in the world's second-largest economy is hitting its appetite for commodities.

China is the world's biggest consumer of iron ore, coal and other base metals, but recent data has shown the economy cooling more quickly than expected, with industrial output growth slowing sharply in April and fixed asset investment, a key driver of the economy, hitting its lowest in nearly a decade.

Coal and iron ore prices could fall further before recovering towards the tail end of the second quarter, traders say, sparking more defaults or deferred deliveries.

"There are a few distressed cargoes but no one is gung-ho enough to take them. Chinese utilities aren't buying because they have a lot of coal and traders are also afraid of getting burnt. It's very bearish now," said a trader.

The defaults come on the heels of a slump in global thermal coal benchmark prices to two-year lows and increases the prospect of an even steeper fall unless China revives buying to absorb the global coal surplus as exporters ramp up production.

"We need China to buy heavily, a severely hot summer across Europe followed by a long, cold winter, and some production cuts for the market to rebalance," a European coal trader said.

At least six defaulted thermal coal cargoes were being re-offered at a discount, traders said, including contracts for shipments from the United States, Colombia and South Africa.

"Many of them signed for the spot cargoes in early April and prices have fallen around $10 a tonne since then. Say if the Chinese traders were buying a cape-sized shipment, they'd be suffering a loss of nearly $1.5 million alone," said a trader at an international firm who has been offered defaulted cargoes.

"That doesn't even take into account the losses on freight rates. So rather than being bankrupted by these deals, they would rather dishonour the contract to survive," he added.

China's premier called for additional efforts to support growth on Sunday, signalling Beijing's willingness to take action to bolster its economy.

Some analysts said they were bearish regarding China's prospects of steeply ramping up coal imports any time soon.

"China doesn't look likely to provide an upside demand surprise which could clean up the market in the near-term," said Marcus Garvey, analyst with Credit Suisse, citing high power plant stocks and a slowdown in power generation in April.

China's premier called for additional efforts to support growth on Sunday, signalling Beijing's willingness to take action to bolster its sagging economy.

Traders said they expected demand to pick up next month, coinciding with peak summer consumption of coal in China.

Indonesian Coal Mining Association executive director Supriatna Suhala said coal exporters were facing tougher competition, but he expected any slowdown in China to be "only temporary".

Concerns over defaults were also spilling over to the iron ore markets, where prices have dropped around 10 percent since late April to hover at $134 a tonne.

"We ourselves have had one of our buyers default on us after just a few hours. We sold the cargo to an end-user in China and a few hours later the buyer came back, saying 'the market's falling too fast we want a lower price'," said a Singapore-based iron ore trader.

In October last year, Chinese mills also sought delivery delays when iron ore prices slid nearly 31 percent as weak steel demand forced producers to curb output.

For copper, traders said Chinese merchants have been delaying term deliveries since March, while sluggish demand also prompted buyers to re-export some cargoes.

A Reuters poll expects China's economic expansion in the second quarter to slip to 7.9 percent, which would mark the sixth consecutive quarter of weakening growth.

Reflecting greater caution, BHP Billiton, the world's biggest miner, has put the brakes on an $80 billion plan to grow the company's iron ore, copper and energy operations.

Slumping commodity prices and escalating costs have squeezed cash flows, pushing BHP to join rival Rio Tinto reconsidering the pace of their long-term expansion in countries such as Australia and Canada.

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Office of Hon Tony Ryall

Minister of Health
Minister for State Owned Enterprises

John Palmer
Chair
Solid Energy Limited
PO Box 1303
CHRISTCHURCH 8013

Dear Mr Palmer

Thank you for your recent quarterly report and the other briefings that you have provided me on the current situation at Solid Energy Limited. Based on the situation outlined in these reports I am writing to ask you to:

- Revise and resubmit the 2012/13 Business Plan and SCI to ensure that these documents contain convincing evidence that the proposals put forward are likely to be effective in the current business environment. Under section 14.4 of the State Owned Enterprises Act I am extending the date for submission of Solid Energy Limited's completed SCI to 31 August 2012.

- Present the revised Business Plan to me to give me your assurance that the proposed actions will address the underlying challenges.

- Report to shareholding Ministers monthly, rather than quarterly as at present. These reports should continue to fully and accurately summarise Solid Energy's performance against budget, identify the cause of major variances, signal any potential, developing or ongoing issues, highlight major achievements for the month and contain a clear statement of Solid Energy's outlook for the rest of the financial year in terms of achieving its SCI targets, key opportunities, threats and management plans. The reports should also continue to include financial statements (noting that quarterly financial information will still be required for Cabinet reporting purposes). The reports should update me on the business environment faced by Solid Energy and the company's progress in implementing its revised Business Plan. Please send these reports directly to my office, as well as a copy to the Treasury. The normal practice for SOE reports to shareholding Ministers is for them to be signed by the chair.

- Meet monthly with the Treasury to discuss each monthly report.

For your information I am also asking the Treasury to increase its use of external advisors in support of its monitoring function of Solid Energy during the current challenging business environment.

Yours sincerely

Hon Tony Ryall
Minister for State Owned Enterprises

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