

The Treasury

Solid Energy Information Release

March 2013

Release Document

www.treasury.govt.nz/publications/information-releases/solidenergy

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
- [2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information, or who is the subject of the information
- [3] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [4] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [5] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [6] 9(2)(j) - to protect the commercial position of the person who supplied the information, or who is the subject of the information; to enable the Crown to carry out commercial activities without disadvantage or prejudice; and to enable the Crown to negotiate without disadvantage or prejudice
- [7] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied
- [8] Information is out of scope or not relevant.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [3] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

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

Solid Energy: 2007/10 Draft Statement of Corporate Intent (SCI) and Business Plan

Date	29 June 2007	Priority	Urgent
Security level		CCMAU ref	SEL-011/A63560
		Treasury ref	T2007/ 1090

Minister	Action sought	Deadline
Minister of Finance	This report is for your information.	N/A
Minister for State Owned Enterprises	Approve recommendations and sign letter.	10 July 2007
Associate Minister of Finance (Hon Clayton Cosgrove)	Approve recommendations.	10 July 2007
Associate Minister of Finance (Hon Phil Goff)	This report is for your information.	N/A

Key issues

- The two main issues for shareholding Ministers raised by Solid Energy's draft Business Plan and SCI are the deteriorating short-term performance of core coal mining activities, and the development of risky, but potentially long-term value enhancing, alternative energy activities.
- Solid Energy's strong performance in the last two years is not forecast to continue due to a forecast drop in export coal volumes and lower export coal prices for the next three years, but improving long-term prospects underpin significant increases in commercial value.
- Solid Energy plans to invest up to \$130 million over the next three years developing its alternative energy business. Included is a further \$31 million in Southland lignite land purchases and \$38 million on a small scale underground gasification plant. We expect Solid Energy to consult on key projects before committing significant capital on relatively risky and unproven projects.
- Dividends for the next three years have been reduced to nil to support capital investment.
- We recommend that the Minister for State Owned Enterprises sign the attached draft letter to the Chair of Solid Energy, asking Solid Energy to consider shareholders' comments before submitting its final SCI for tabling in the House or Representatives.

Contacts

Michael Moore	Manager - Energy, Land & Environment (CCMAU)	<input type="checkbox"/>	First contact
Chris Hewson	Senior Advisor - Energy, Land & Environment (CCMAU)	<input type="checkbox"/>	
Jean-Pierre Andre	Senior Analyst - Climate Change, Energy and Commercial Operations (The Treasury)	<input type="checkbox"/>	
<input type="checkbox"/>	Analyst - Climate Change, Energy and Commercial Operations (The Treasury)	<input type="checkbox"/>	

Ministers' comments

--

Reference: SEL-011/A63560

Level 2, 1 The Terrace
PO Box 10-465
Wellington
New Zealand
Telephone +64-4-474 8220
Facsimile +64-4-499 2107
www.ccmau.govt.nz

29 June 2007

Minister for State Owned Enterprises
Associate Minister of Finance (Hon Clayton Cosgrove)cc Minister of Finance
Associate Minister of Finance (Hon Phil Goff)**Solid Energy: 2007/10 Draft Statement of Corporate Intent (SCI)
and 2007/27 Business Plan****Purpose**

1. The purpose of this report is to:
 - discuss Solid Energy's draft 2007/10 SCI and Business Plan
 - detail the company's forecast financial performance
 - outline the challenges and risks presented in the Business Plan and the strategies Solid Energy plans to adopt to manage these
 - indicate our concern in relation to capital expenditure programmes, which are of sufficient scale and risk to require shareholder consultation, and recommend further interaction between officials and the company to investigate such proposals
 - recommend Solid Energy be asked to finalise the SCI and provide 75 copies for tabling in the House of Representatives.

Executive summary

2. Solid Energy's draft 2007-2027 long-term Business Plan and SCI show the company's continued plan to expand its core coal mining activities and diversify into a number of mainly coal-derived alternative energy opportunities. Bioenergy, coal to gas projects and lignite gasification are all potentially a major part of Solid Energy's future.
3. Within the medium term, however, coal mining remains the driver of financial performance. Solid Energy is forecasting profits ranging from \$22-36 million for

the coming three years, significantly down from the strong results of 2006 (\$86 million) and 2007 (forecast ~\$100 million). Lower export volumes, a forecast decline in the current very high coking coal price and a higher New Zealand dollar have dampened the export sales outlook. We believe the export forecast may be conservative, however, and that prices may remain close to current high levels due to growing worldwide energy demands. Domestic sales and margins remain steady, dominated by large long-term contracts with Genesis Energy and NZ Steel.

4. Solid Energy is entering a period where significant strategic decisions must be made, which may lead to a change in its future focus and value. Alternative energy investments of up to \$130 million are planned for the next three years. This includes a further \$31 million of Southland lignite land purchases taking total land purchases to date to \$65 million. Investments of \$55 million in Coal to Gas activities and \$39 million in Bioenergy represent largely new areas for the company. In total, this expenditure significantly exceeds formal consultation thresholds, and in the attached letter we indicate Ministers' expectation that Solid Energy consults on certain relatively risky and unproven projects that are likely to exceed consultation threshold over the course of the project.
5. To fund these investments, and a further \$260 million of investment for coal mining, Solid Energy plans to suspend dividend payments for the next three years, compared to last years projection of \$91 million for the same period. It also plans to raise its gearing target to 40%, taking the company to the higher end of comparatives with similar sized Australian mining companies. This would take gearing beyond the 35% gearing level outlined in the statement of shareholders' preferences.
6. Solid Energy's draft SCI commercial valuation has increased to \$450-500 million from \$350 million in 2006. The increase reflects the long-term benefits of the new NZ Steel contract, Spring Creek developments and forecast longer term high export prices. This is a very significant improvement even though short-term financial performance is forecast to be weaker.

Scope and strategy

7. Solid Energy's first long-term Business Plan in 2001 focused on coal production capabilities and investment in new mining operations. The 2007-2027 plan illustrates the intention to diversify from its core coal mining business to the development of alternative energy opportunities including bioenergy, coal to gas projects and lignite gasification.
8. For the coming three years, two major issues shape Solid Energy's strategy; the difficulties of accessing economically viable coal reserves, and the impact that climate change and world energy prices have on the further development of the company's alternative energy programmes. Solid Energy is entering a period where significant strategic decisions must be made, which may lead to a change in its future focus and value. Accordingly, in this report we are examining its strategy in some depth.
9. In Solid Energy's draft SCI, the scope of activities have been consequentially revised to include further detail on the long-term planned range of energy products for the company. Though we are comfortable with this change, there are still considerable risks and uncertainties around the alternative energy opportunities.
10. Solid Energy manages the uncertainty over future energy production by considering a range of possible energy and carbon pricing scenarios in the Business Plan and developing business responses and options that can be triggered depending on energy market and environmental conditions.
11. It is our expectation that Solid Energy should consult regarding key projects before committing significant capital into new and relatively risky and unproven alternative energy opportunities. We consider that where alternative energy projects have considerable carbon emissions (such as Underground Coal Gasification and Lignite Gasification), business cases supporting the capital investment should also take into account how the investment fits within the New Zealand Energy Strategy.

Coal business

Mine specific viability assessment

12. Coal prices are crucial to Solid Energy as its mines are small, with a high cost of mining in comparison to Australian mines. This is especially the case for the higher cost underground mines such as Huntly North and Spring Creek.
13. Despite recent high prices, some of these mines are of marginal value, but continued operation maintains their option value if prices rise further. Closure would also mean losing hard to replace specialist underground mining capability.
14. We are comfortable with Solid Energy's approach of regular economic reviews of individual mines as a means to cope with uncertain international prices.


Table 1. Coal business investment summary

	Capital Investment			Revenue		Staff	
	Yr 1	Yr 2&3		Yr 1	Yr 2/3	Yr 1	Yr 2/3
Export	\$90m	\$60m	Stockton Water Mgmt Plan and Stockton Washery Subject to Washery viability	\$215m	\$240m	600	600
Domestic	\$40m	\$62m	Development of Huntly North to meet NZ Steel contract	\$210m	\$215m	530	470

International market

15. The international steel industry has few hard coking coal (HCC) alternatives for steel production and is unlikely to be affected by carbon charges which would be passed through to the customer. Protecting and maximising value from the Stockton Plateau is a key strategic issue for the short to medium term, with HCC sales having a positive net present value under all future energy and carbon pricing scenarios.
16. Export prices for HCC are expected to remain high by historical standards for the longer term. As a price-taker, export sales are subject to variances in coal prices driven by Australian producers and global steel market demand, though a short-term drop is forecast through to 2009. Obtaining economically viable HCC reserves is the largest constraint to Solid Energy taking advantage of high world prices.
17. However, the re-opening of Spring Creek Mine with joint-venture partner Cargill is forecast to add 780,000 tonnes per annum from November 2007. But in the short term, delays at the Stockton ridgeline mine, due to the relocation of native snails, will continue to impact export sales for 2007/08, until mine stripping increases accessible coal.

Domestic market

18. Subject to climate change policies, Solid Energy's long-term forecast for domestic sales is extremely optimistic, with the expectation that the need for coal will not diminish in the face of the run down of the Maui gas-field. Other sources competing for a share of current indigenous thermal energy markets include imported coal, imported liquefied natural gas and biomass.
19. Large scale investment in mines supplying the domestic market will only be undertaken with the support of a customer contract, ensuring Solid Energy generates a reasonable return while managing the energy and carbon price risks.
20. Sales to Genesis, NZ Steel and Fonterra make up over 90% of domestic revenue. Negotiations for a new supply contract to NZ Steel have been delayed by access to suitable New Zealand coal and testing blends with imported product. 

21. There is less emphasis on importing coal than in prior years. Although attractive from a security of supply perspective, it increases the coal price and currency fluctuation risk. Small scale importation will only be used to support additional industrial growth for the North Island market.
22. Beyond the term of the existing contracts, the availability of proven, accessible, economic reserves of coal and the shortage of skilled labour is an ongoing long-term supply risk for Solid Energy.

Inventory levels

23. Solid Energy's long-term contract obligations, if not met, expose the company to significant risk. Security of supply is critical, especially in the North Island.
24. Reserve status coal is defined as within current mine permits and economically viable. Reserve inventory targets are 5-7 years for each coal type, enabling a quick response to market, without over committing capital to new developments or encouraging energy users to look at coal alternatives because of the risk of supply.
25. Despite a 30% increase in reserve status inventory during 2006/07, the short-term operating plan requires advancing the status of a number of resources due for mining in the next three years. Critical prospects include Awaroa extension and Huntly North for domestic supply and Millerton (Stockton) for export.
26. Solid Energy has agreed to supply additional inventory status data in their quarterly reporting. Officials will work with the company to develop a key performance indicator for reserve level inventories.

Alternative energy investments

27. In the short-term, alternative energy will only provide minor revenue flows to Solid Energy. In the longer term, they are likely to be less affected by energy price and carbon costs. Until then, the focus will be on overcoming significant technical, environmental and market uncertainties.
28. While we are comfortable with Solid Energy diversifying, subject to appropriate consultation, this should be not at the expense of its core business of coal mining.
29. Table 2 below, summarises planned developments over the next three years for each energy source, as they move toward long-term commercialisation, subject to meeting ongoing viability reviews and milestone requirements.

Table 2. Alternative energy investment summary.

Bioenergy	Capital Investment			Revenue		Staff	
	Yr 1	Yr 2/3	Description	Yr 1	Yr 2&3	Yr1	Yr 2/3
Biomass	\$19m	\$11m	\$18m Taupo pellet factory. Subject to feasibility study, domestic residential growth, commercial conversions and securing feedstock	\$15m	\$25m	2	2
Biodiesel	\$4m	\$17m	Rolleston bio-refinery and oil seed extraction facility. Subject to securing oil feedstock, feasibility, market development.	\$14m	\$5m	20	28

Coal to Gas	Capital Investment			Revenue		Staff	
	Yr 1	Yr 2/3	Description	Yr 1	Yr 2&3	Yr 1	Yr 2/3
Coal Bed Methane	\$5m	\$9m	\$10m commercialisation plant Subject to technological factors and test drilling	\$0	\$3m	3	5
Underground Gasification	\$8m	\$30m	\$21m small generation plant Subject to development and testing of pilot plant, technology partner, market assessment	\$0	\$1m	1	5

Lignite's	Capital Investment			Revenue		Staff	
	Yr 1	Yr 2/3	Description	Yr 1	Yr 2&3	Yr 1	Yr 2/3
Southland Lignite's	\$10m	\$16m	Purchase land and resource Subject to investment partner, market assessment, government discussions on national strategic assets status	\$1m	\$1m	0	0

Bioenergy

30. Solid Energy's biomass subsidiary, Nature Flame, has experienced considerable growth since the beginning in 2004. Investments in the wider bioenergy sector will significantly increase the company's low emission energy capacity. A new \$20 million plant in Taupo is critical to gaining market dominance and achieving economy of scale advantages. In our opinion this project is not particularly risky and further consultation is unnecessary.
31. Wholly owned subsidiary, Canterbury Biodiesel, represents a new business area for the company, and is forecast to secure a market dominance position within 12 to 18 months. Resource strategy centres on securing a diverse range of feedstock sources and market demand to prove viability and support plant expenditure of \$19 million over the next 3 years. The risky nature of this project means that further consultation is necessary before significant capital is committed.

Coal-to-gas

32. Coal-to-gas activities allow the unlocking of coal seam reserves that would be uneconomic using traditional mining techniques. Coal Bed Methane (CBM) is the extraction of gas existing within coal seams. Underground Coal Gasification (UCG) is the in-situ gasification of coal, achieved by injecting oxidants to create a reaction process and bring the gas to the surface through boreholes.
33. CBM development is considered to have positive net present value (NPV) under all energy and carbon pricing scenarios, subject to continued favourable pilot-well test results. The ability to stage capital is a key advantage, with less up front capital required than for coal mining. Over the next three years, subject to meeting milestones, investment of \$15 million in the first commercial plant is planned, with development revenue of \$5 million forecast by 2009/10.. In our opinion this project is not particularly risky and further consultation is unnecessary.
34. UCG is at the research and development phase, but under most energy and carbon pricing scenarios is the highest value new project. Subject to resource proving, pilot testing and commercialisation, UCG will compete directly with Liquefied Natural Gas. To extract maximum value, Solid Energy plans to control and own the supply chain to the end user point of sale. This technology is new to New Zealand, but proven offshore, and could be used to power a generator as large as Huntly. Planned investment includes an \$8 million UCG provider fee in 2007/08 and pilot project investment of \$30 million over the following two years. Commercialisation is not expected until 2016, with major capital commitments from 2012/13.
35. Due to the risks and potential long-term capital investment associated with this project, the importance of consultation with Ministers should be stressed. In addition to the commercial rationale, consultation should consider the carbon footprint of UCG and acknowledge wider Crown priorities and the New Zealand Energy Strategy.

Southland lignite gasification products

36. The vast Southland lignite resource gives New Zealand the opportunity to produce its own transport fuels and many other syngas based products. The coal-to-liquids project is in its early stages, with the purchase of mining properties enabling Solid Energy to secure resource and keep its options open.
37. Solid Energy has already invested \$65 million in land and mineral purchases to date, to secure 600 million tonnes of contiguous resource. An additional \$50 million is planned to bring the total to 1 billion tonnes. While it is reasonable to assume the land, as a liquid asset, can be resold at little risk, mineral right purchases and testing studies would be at risk (to date \$20 million) if the project does not eventuate and no buyer for the rights can be found.
38. Solid Energy does not have competencies in coal-to-liquids conversion and will require a technology integration partner to support and largely fund the capital investment of over US\$6 billion. Moreover, under the status quo and high carbon

tax scenarios, the project is not considered viable. However, in an energy constrained environment, where oil is priced at over US\$100 per barrel, the project would be increasingly viable, with large revenue and profit potential.

39. We hold reservations about the feasibility of the Coal-to-liquids projects due to the current uncertainties over global energy pricing and large scale investment and carbon sequestration developments that are required. Therefore we believe Solid Energy should proceed with caution. Consultation with Ministers is expected where further capital expenditure exceeds that outlined in the business plan. As with UCG, consultation should consider the carbon emissions and acknowledge wider Crown priorities and the New Zealand Energy Strategy.
40. Also, we believe that Solid Energy should consider having an exit strategy for the land and mineral rights it has purchased. We note the risk of write-downs on the non-land components of the project is currently offset by likely gains in the purchased farmland, given the recent improving outlook for dairy farming.

Shareholder consultation thresholds

41. While individual alternative energy investments to date have not exceeded shareholder consultation threshold's (25% of shareholder funds, currently ~\$60 million), as they are part of a much larger long-term programme that are likely to exceed \$60 million in the long term, we are concerned there has been little substantive consultation with officials or Ministers. In the attached letter we indicate Ministers' expectation that Solid Energy consults on key projects such as biodiesel, underground coal gasification and coal to liquids, even though individually projects may sum to less than \$60 million over the next three years.

Financial performance

42. Solid Energy has developed five long-term business models, forecasting the impact of differing energy prices and carbon tax policies for their coal mining and alternative energy business. However, the base case scenario put forward as the most likely is with rising energy prices (measured by the price of oil) and a moderate carbon price. The scenarios give vastly different long-term outlooks, but show management is actively seeking to diversify its operations to insulate the company from the uncertainty of future energy and carbon pricing.. We consider the long planning horizon provides reassurance to shareholding Ministers that Solid Energy is planning soundly for the risks faced by its uncertain business environment.
43. Financial performance in 2006/07 has again been strong, with a forecast surplus of \$100 million against a budget of \$79 million. Costly delays in relocating native snails at Stockton have been more than offset by the \$55 million gain on sale of a 49% share in the Spring Creek mine.
44. The 2007/08 forecast has fallen to \$21 million, due to lower forecast export coal prices and a significantly higher New Zealand dollar. Average sales return per ton is forecast to fall to \$110 from \$130 in 2006/07. Domestic sales for the medium-term have been reduced due to the lower of above-contract sales to Genesis and

the loss of the Fonterra Clandebye contract. Overhead expenses have, in the short-term, been held flat on the 2006/07 budget.

45. With reduced medium-term profits and investment plans, Solid Energy plans to suspend dividend payments until 2010/11, when profits are expected to exceed \$100 million on an ongoing basis. Last years business plan forecast longer-term profits in the range of \$40-70 million per annum
46. We consider the assumptions behind the short-term outlook are not unreasonable, though forecast export volumes may be conservative and prices may remain close to current high levels due to growing worldwide energy demands. Solid Energy's inability to take further advantage of the high prices reflects the lack of readily available coal reserves. Table 4 shows Solid Energy is forecasting returns on shareholders' funds of between 6% and 9%, marginally below its weighted average cost of capital.

Table 3. Comparison of NPAT to previous plans

Net Profit after tax (NPAT) \$million	2005/06	2006/07	2007/08	2008/09	2009/10
2005/06 Plan	98	120	41	44	48
2006/07 Plan		79	57	61	46
2007/08 Plan			21	35	33
Actual performance	86	100*			
Actual v Plan	(12)	21			
07/08 plan v 06/07 plan			(36)	(26)	(13)

Table 4. Financial performance indicators

\$ million	2005/06 Actual	2006/07 FCast*	2007/08 Plan	2008/09 Plan	2009/10 Plan
Total revenue	569	513	483	540	543
Volume (M Tons Sold)	4.7	4.6	4.9	5.3	5.4
EBIT	127	168	45	73	71
Net surplus after tax	86	100	22	36	34
Dividend	20	0	0	0	0
Total assets	441	556	686	723	774
Shareholder funds	234	334	357	392	425
Return on equity (ROE) %	42%	36%	6%	9%	9%
Total debt	207	222	329	332	349
Gearing ratio %	32%	33%	42%	40%	39%

Sources: Solid Energy's 2007/27 Business Plan and 2006 annual report. *Forecast.

47. It should be noted that as a price taker on the international coal market, Solid Energy is exposed to short-term price and currency fluctuations. It is inevitable this volatility will continue to cause significant year to year variability, and the company must be cautious about long-term investments based on short-term prices.

Company value

48. Valuations under the various business plan scenarios, which take into account long-term investment strategies, illustrate the medium to long-term uncertainty of the business. At the extreme, NPV is forecast at \$621 million in a low energy/high carbon cost environment, to \$7.3 billion in a high energy/low carbon cost environment.
49. For the draft SCI's commercial valuation, Solid Energy determines the NPV of discounted cash flows for its business on a more restricted and conservative basis. It only includes business areas with a high probability of eventuating, and use of existing consented mines with approved feasibility studies. Export prices and climate change impacts are treated as being consistent with current trends and policies. The 2007 commercial valuation has increased to \$450-500 million, from \$350 million in 2006.
50. The increase in valuation reflects the long-term benefits of the new NZ Steel contract, Spring Creek developments (after previously being written down) and long-term higher export prices, offsetting the decrease in short-term profit projections. We believe that the assumptions underpinning the valuation in its SCI are reasonable, and the increases are a credit to the company that is managing its business well by focussing on long-term value creation.

Capital structure and dividend policy

51. Solid Energy's gearing target of 30% for last year was based on benchmarking of similar sized coal companies in Australia, the level of risk associated to being a price-taker on international markets and external financing facilities. This is compared to shareholders' expectation of 35% as expressed in the statement of shareholders' preferences.
52. In November 2007 the external financing facility will be renegotiated, seeking a 25% increase to \$250 million. Solid Energy believes the increased diversity of the Business Plan, reduced exposure to export-based assets and increase in low-risk land assets justifies increasing its gearing ratio to 40% over the next 3-4 years to allow planned investment while gearing levels are expected to be at their highest. Analysis shows a 40% gearing is at the high end for coal companies in Australia¹.

¹ Research by CCMAU found that, in 2005, the average gearing ratio of seven Australian Coal companies was 18% with the highest being 42%. One of the seven exceeded 35% and five were less than 20%.

53. We are comfortable with the dividend and investment plan, provided the interim investment milestones are met, and if profits exceed those budgeted or projects are delayed, excess capital may be paid by way of a special dividend. Solid Energy is at the cusp of major changes in its business, which could add significant long-term value. Insisting on dividends irrespective of its capital expenditure programme could jeopardise new projects and so potential value creation.

Draft SCI

54. Solid Energy has revised the nature and scope of activities, to detail a long-term emphasis on its planned range of energy products. At present, alternative energy developments remain a minor revenue source, however, the SCI's intention is to define the long-term direction for the company. We are comfortable with this change subject to Solid Energy taking on board the comments around consultation and caution around this expansion.
55. The SCI meets the statutory requirements set out in section 14 of the State-Owned Enterprise Act 1986.

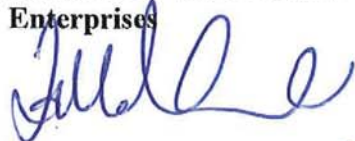
Recommendations

56. We recommend that you:

- a **note** that the two main issues for shareholders raised by Solid Energy's business plan and SCI are the deteriorating short term performance of core coal mining activities, and the development of risky but potentially long-term value enhancing alternative energy activities
- b **note** that Solid Energy has grown its commercial value significantly (from \$350 million to \$450- \$500 million), even though short-term performance is weaker than of late because of a short term decline in export coal prices
- c **note** that, based on long-term scenarios of energy and carbon pricing that are used to validate long-term investments, Solid Energy is entering a period where significant strategic decisions must be made, which may lead to a change in its future focus and value.
- d **note** that, subject to ongoing viability and milestones, Solid Energy plans to invest up to \$130 million in alternative coal-derived energy activities, including \$31 million of Southland lignite land purchases, \$55 million in coal-to-gas activities and \$39 million in Bioenergy.
- e **note** that we expect that Solid Energy consults on certain relatively risky and unproven projects that are likely to exceed consultation thresholds over the course of the project
- f **note** that Solid Energy intends to raise its gearing target to 40%, and suspend dividends for the next three years to support the capital investment.
- g **note** that the SCI meets the requirements of section 14 of the State-Owned Enterprises Act 1986
- h **agree** that Solid Energy be asked to provide 75 copies of its final SCI for tabling in the House of Representatives and that the SCI can be tabled on receipt

(agree / disagree)

**Minister for State Owned
Enterprises**



(agree / disagree)

Associate Minister of Finance

- i **sign** the attached letter to the Chair of Solid Energy providing feedback on the draft SCI and Business Plan including an expectation that Solid Energy will consult with shareholders where new capital expenditure projects will in total exceed the consultation threshold.

(agree / disagree)

**Minister for State Owned
Enterprises**

(agree / disagree)

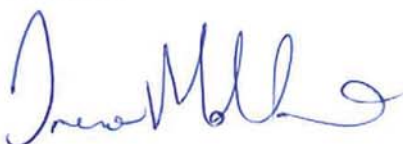
Associate Minister of Finance



Michael Moore
**Manager - Energy, Land & Environment
CCMAU**



Jean-Pierre Andre
**Senior Analyst - Commercial Investments
For the Secretary of the Treasury**



Hon Trevor Mallard
**Minister for State Owned
Enterprises**

Hon Dr Michael Cullen
Minister of Finance

Hon Clayton Cosgrove
**Associate Minister of
Finance**



Hon Trevor Mallard

Minister for Economic Development
Minister for Industry and Regional Development
Minister for State Owned Enterprises
Minister for Sport and Recreation
Associate Minister of Finance
Minister for the Rugby World Cup

10 JUL 2007

John Palmer
Chair
Solid Energy New Zealand Ltd
PO Box 1303
Christchurch

Dear John

2007/10 Draft Statement of Corporate Intent and 2007/27 Business Plan

Thank you for submitting Solid Energy's draft Statement of Corporate Intent (SCI), long-term Business Plan. Shareholding Ministers appreciate the effort that has gone into these documents, which provide a good understanding of Solid Energy's core coal mining business and also the opportunities for alternative energy investments.

Strategy

We understand that Solid Energy has reached an important strategic turning point in its business, which could lead to a significant change in its future focus and value. We are supportive of Solid Energy continuing to expand its core coal mining activities and investigating ways to apply its expertise to a range of alternative energy options with the prospect of long-term value gains. However, we do note that expansion and diversification has a number of risks.

It is our expectation that Solid Energy will consult regarding key projects (discussed below) before committing significant capital into new and relatively risky and unproven alternative energy opportunities. Furthermore, diversification should not be at the expense or loss of focus on your core business, coal mining.

Company performance

The benefit of Solid Energy taking a longer-term perspective can be seen by the lift in your commercial value, which is a creditable improvement in the face of a forecast short-term dip in financial performance compared to the record highs of 2005/06 and the current year

The forecast decline in export sales are of concern, particularly as world coal prices remain high by historical standards. Ministers would support efforts in this area to take advantage of strong international demand, while recognising recent difficulties in securing hard coking resource. We continue to support your cautious approach to mine development for domestic supply by requiring long-term relationships with buyers.

Consultation regarding alternative energy investments

While Ministers' support, in principle, the need to diversify long-term operations due to the uncertainty surrounding world energy prices and carbon emission policies, capital investment is a significant step. For example, shareholding Ministers met with Solid Energy last year to discuss purchases, without sufficient consultation, of Southland lignite land.

Ministers have the expectation that when Solid Energy looks into new business areas, that it consult prior to committing significant capital expenditure into risky and unproven projects. To this end, it is Ministers' preference that for projects which, in total over time, are likely to exceed consultation thresholds, Solid Energy provides the commercial rationale and considers their fit within the New Zealand Energy Strategy before significant expenditure is made.

We understand that advanced planning has been completed on several projects where, although expenditure in the next three years does not exceed formal consultation thresholds, long-term commercialisation would require shareholder consultation. These projects include biodiesel, underground coal gasification activities, and coal to liquids.

On this last project, we also believe that Solid Energy should consider having an exit strategy for the land and mineral rights it has purchased. We recognise that given the recent improving outlook for dairy farming, gains in the purchased farmland has significantly reduced the risk of write-downs on the investment to date.

Financial structure

Ministers note the intention to increase Solid Energy's gearing target to 40%, and the suspension of dividend payments until 2011/12. We are comfortable with this policy, provided interim milestones are met for the investments being funded, however, should there be significant variations in profits and/or capital investment, payment of a dividend should be reconsidered.

Draft SCI

Shareholding Ministers agree with the changes made to the nature and scope of activities in the draft SCI. We ask that you forward 75 copies of the final SCI to CCMAU for tabling in the House of Representatives at your earliest convenience.

Ministers appreciate the efforts of the Board, management and staff of Solid Energy over the last year, and wish you all the best for the year ahead.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Trevor Mallard', with a stylized, cursive script.

Hon Trevor Mallard

Minister for State Owned Enterprises

on behalf of shareholding Ministers

cc: Dr Don Elder, Chief Executive, Solid Energy New Zealand Ltd