

# **The Treasury**

## **Solid Energy Information Release**

**March 2013**

### **Release Document**

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

## Solid Energy: 2008/11 Draft Statement of Corporate Intent and Business Plan

<b>Date</b>	9 October 2008	<b>Priority</b>	Routine
<b>Security level</b>	Commercial: In Confidence	<b>CCMAU ref</b>	SEL-011/A70155

Minister	Action sought	Deadline
Minister of Finance	Note contents	N/A
Minister for State Owned Enterprises	Agree recommendations and sign letter	16 October 2008
Associate Minister of Finance (Hon Clayton Cosgrove)	Agree recommendations	16 October 2008
Associate Minister of Finance (Hon Phil Goff)	Note contents	N/A

### Key issues

- Solid Energy was granted an extension for submission of its final Statement of Corporate Intent (SCI) to shareholding Ministers until 31 October 2008, due to several concerns including scope of business and consultation thresholds. On 26 September 2008, the Minister for State Owned Enterprises (SOEs) met with the Chair to discuss the issues and agreed that quarterly consultation meetings would help resolve these concerns.
- Solid Energy has also provided its comprehensive 20 year business plan, which does not have any major strategic shifts from last year. However, the projected financial performance of the company has improved significantly due to large increases in international coal prices, which have boosted revenue significantly from the last quarter of the 2007/08 financial year.
- 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

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### Ministers' comments

## **Solid Energy: Draft 2008/11 Statement of Corporate Intent (SCI) and 2007/28 Business Plan**

### **Purpose**

1. The purpose of this report is to:
  - provide comment on Solid Energy's draft 2008-11 SCI
  - review Solid Energy's 2008-28 Business Plan and forecast financial performance.

### **Statement of Corporate Intent**

2. On 3 June 2008, the Minister for State Owned Enterprises (SOEs) wrote to Solid Energy's Chair, expressing concern over several areas of the draft SCI, and requested that the Board consider the comments and resubmit its draft SCI. Solid Energy did so, however officials still have concerns around the nature and scope of business and shareholder consultation thresholds in the revised draft.
3. Officials' noted concern that the Nature and Scope of Business does not limit Solid Energy's core operations to within New Zealand and that it does not place a limit on the scale of potential electricity generation projects. The second concern, relates to consultation thresholds, which if too high, gives Solid Energy the ability to undertake large projects without consultation using the significantly increased profits that are forecast.
4. The Minister for SOEs met with the Chair on 26 September 2008 and agreed that he would meet with the Chair and/or CEO of Solid Energy on a quarterly basis to discuss the company's operations where consultation was appropriate.
5. As formal consultation thresholds were not agreed at the meeting, we recommend the following approach is taken in the attached draft letter to the Chair:
  - request that Solid Energy remove from its SCI the specific shareholder consultation thresholds, instead referring to 'agreed thresholds', which is a similar approach taken by other SOEs
  - reiterate shareholding Ministers' preference for the following consultation thresholds; over \$30 million for core business items and over \$10 million for non-core business items.
6. The Minister for SOE's letter also raised concerns over Solid Energy's initial draft SCI commercial value of \$7.2 billion, up from \$450-500 million in 2007. The increase was due to including a discounted cashflow value for all of Solid Energy's projects, including the Coal-to-Liquids (CTL) plant, and several projects where commercial production remains some way off. The revised SCI has reduced the valuation to \$3.0 billion, by excluding the CTL project, however we believe this figure remains unrealistic. The valuation is however the company's estimate, so it is the Board's responsibility to justify it.



7. The revised draft SCI meets the statutory requirements set out in section 14 of the State-Owned Enterprises Act 1986.

## 2008 Business Plan Review

8. Solid Energy has again provided a comprehensive 20 year business plan. The document gives an overview of the world economy as it relates to its national and international markets, and provides the strategy and value projections for each of the company's projects.
9. Although still dominated by its core coal mining operations, Solid Energy continues to rapidly diversify into renewable energy, such as biofuel and biomass, and new energy uses for coal and coal bed gas.
10. Historically, Solid Energy's performance has been extremely variable, due to international coal prices, exchange rates and mining costs. The business plan recognises shareholding Ministers' outlook letter expectations, and has again provided several scenarios for the company's future value which are dependent upon world energy needs and carbons costs – refer to Table 1 below.

**Table 1. Company value scenario assumptions**

Key Driver	Base Case <sup>1</sup>	High Energy <sup>2</sup> Low Carbon <sup>3</sup>	Low Energy <sup>2</sup> High Carbon <sup>3</sup>
Oil Price	US\$260 by 2028	US\$400 by 2028	US\$180 by 2028
Coal Price-Coking (Export)	US\$342/t by 2028	US\$520/t by 2028	US\$240/t by 2028
Coal Price-Thermal (Domestic)	US\$168/t by 2028	US\$248/t by 2028	US\$122/t by 2028
Cost of Carbon	Limited global action, CO2 units NZ\$43/t by 2028	Weak global agreement NZ\$20/t by 2028, NZETS globally aligned	Global CO2 reductions, high CO2 unit cost
Exchange Rate	Long term average NZ\$ = US0.68		
NZ Steel	Business as usual	Production maximised	Exit New Zealand
Solid Energy Projects	UCG & CTL marginal Stockton, Huntly East close		
Valuation including CTL	\$7.8b	\$23.6b	\$2.3 b
Valuation excluding CTL	\$3.0b	\$7.2b	\$1.2b

<sup>1</sup> The base case scenario is used as the plan numbers and is based on current, or what is considered the most likely scenario for each of the cost and revenue drivers.

<sup>2</sup> High/Low Energy refers to demand for coal, oil, gas and other energy-related costs.

<sup>3</sup> High/Low Carbon refers to charges for carbon management and/or credit units.

11. Global steel production is expected to continue to increase international demand and prices for high quality coking coal, driven by the economies of China and India. An expected increase in Brazilian steel production capacity should boost coal demand even further.
12. Assessing the impact of carbon charges on Solid Energy's business will remain dependent on how major economies develop regulatory systems to control emissions.

## Financial Performance

13. Solid Energy is forecasting a large increase in revenue, costs and profits over the next two years, before a slight decline in 2010/11. The improved financial forecasts are largely due to a continuation of strong international coal prices. Budget dividend payments to the Crown have increased significantly to between \$100 - 130 million for each of the next three years.
14. For the 30 June 2008 year, Solid Energy recorded a NPAT of \$34.4 million compared to budget NPAT of \$21.1 million. Solid Energy will pay 100% of NPAT as a dividend, which will go someway to changing Solid Energy's traditionally low dividend payments.
15. While dividends are forecast to increase, a significant proportion of profit is to be retained to fund an ambitious capital expenditure programme of \$520 million over the next 3 years and \$1.8 billion over the next 20 years. Significant projects include coal bed methane (\$80 million), underground coal gasification (\$143 million) and coal to liquids (\$187 million).

**Table 2. Comparison with prior years' plans**

Net Profit After Tax (NPAT)	2006/07 \$ million	2007/08 \$ million	2008/09 \$ million	2009/10 \$ million	2010/11 \$ million
2006/07 Plan	79.0	56.9	60.7	n/a	n/a
2007/08 Plan		21.1	36.0	34.0	n/a
2008/09 Plan			205.6	210.2	167.6
Actual performance	94.1	34.4			
Actual v Plan (yr 1)	+15.1	+13.3			
08/09 v 07/08			+169.6	+176.2	n/a

**Table 3. Financial performance summary**

(all figures \$ millions, unless otherwise specified)	2006/07 actual	2007/08 actual	2008/09 plan	2009/10 plan	2010/11 plan
Total Revenue	564.6	552.3	892.9	1,003.1	961.3
EBIT	150.5	52.3	303.1	315.5	255.3
NPAT	94.1	34.4	205.6	210.1	167.6
Dividend	Nil	34.4	100.0	130.0	110.0
Dividend as a % of NPAT	Nil	100%	48.6%	61.8%	65.6%
Total Shareholders' Funds	327.9	368.4	473.4	553.6	611.1
Total Assets Employed	546.2	656.5	841.6	969.3	1,057.0
Return on Shareholders' Funds (%)	33.6%	9.7%	49.0%	41.0%	26.0%
Return on Assets (%)	19.1%	5.7%	40.0%	34.0%	25.0%
Debt to Debt + Equity* (%)	29.5%	31.9%	38.0%	37.5%	37.3%

\* Includes rehabilitation provision, equal to \$167.0 million in 2008/09 (plan)



## Coal business

### Outlook

16. Significant market opportunities are available to Solid Energy from long-term export market price projections. Recent increases have seen thermal coal increase from US\$55/t in 2006/07 to US\$125/t, and coking coal from US\$96/t in 2007/08 to US\$300/t. Although steel industry demand remains bullish, many market analysts predict some reduction in coal prices over the next three years. The long term outlook remains positive with further upside potential if demand from China, India and Brazil exceeds current assumptions.
17. On the cost side, Stockton in particular has faced significant increases, which are expected to continue. Staffing, energy and environmental impacts are all driving these increases.

18.

[5]  
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### Capital Expenditure

19. The key focus areas for capital expenditure in the coal business, over the next three years, are similar to last year's business plan. These include the Stockton Washery Plant (\$100 million), the Millerton, Cypress and Liverpool opencast mine developments within the Stockton licence (S1/240 and S1/241 respectively) and the Huntly East and Ohinewai developments (S1/242 and S1/243) in Waikato. Note that under Solid Energy's proposed consultation thresholds, the company does not need to consult further with Ministers on any of these projects.

### Valuation

20. Protecting and maximising value from the Stockton Plateau remains a key strategic issue for the short to medium term. Obtaining economically viable hard coking coal reserves is the largest constraint to Solid Energy taking advantage of high world prices.
21. Under the base case scenario, net present values of the coal business are:
  - South Island Export \$2,400 million
  - South Island Domestic \$14 million
  - North Island Domestic \$642 million.

## Renewables

22. Solid Energy's biomass subsidiary, Natures Flame, holds a strong positioning in the market through its wood residue contracts, strong revenue growth and brand awareness. Expansion opportunities are expected to be realised from the new Taupo Pellet plant (opening in late 2009 with further expansion by 2012) with production increasing to ten times the current level of the Rolleston and Rotorua

plants. Capex in the next three years is forecast at \$23 million, with the projects net present value under the base case, calculated at \$135 million.

23. Subsidiary Biodiesel NZ is progressing the construction of its Rolleston plant (capable of producing 15 million litres per annum with expansion capability to 70 million litres) which is due for completion by the end of 2008. The current strategy is based around establishing quality feedstock sources, growing and protecting its market through long-term contracts, product differentiation, leading technical expertise, and participation in the regulatory environment. Capex in the next three years is forecast at \$54 million, with the projects net present value, under the base case, calculated at \$147 million.

## New Energy

### *Coal Bed Methane (CBM)*

24. Over the last year, CBM development has focused on confirming the technical feasibility of commercial level gas production from the Huntly fields with US joint venture partner Resource Development Technology Ltd. Gas sampling has confirmed very high quality gas that can be injected directly into the main gas pipeline, providing open access to the North Island gas market. However, short-term market conditions appear unfavourable with falling gas prices due to additional Maui gas becoming available and excessive well drilling costs that are 3-4 times higher than in Australia.
25. Under the base case, peak gas flows of 3 Petajoules per annum are projected with an expected field life through until 2027. Current New Zealand gas production totals approximately 160PJ per annum.
26. The medium and long term strategy remains supply to the main pipeline (by 2010/11), however in the short term CBM flared gas is being used to generate grid electricity (1MW) or delivery via truck tankers. Capex in the next three years is forecast at \$24 million, with the projects net present value under the base case, calculated at \$39 million.

### *Underground Coal Gasification (UCG)*

27. UCG is the in-situ gasification of coal, achieved by injecting oxidants to ignite the coal and bring the gas to the surface through boreholes. If successful, UCG will provide a strategically-significant low-cost gas to New Zealand. UCG can enable energy extraction from coal sources that would otherwise be too deep or expensive to mine, however challenges exist around carbon emissions (on an energy equivalent basis, UCG gas emits more carbon than coal), groundwater contamination and subsidence.
28. Solid Energy recognises these issues as part of the projects long-term development strategy. If they can be effectively managed, a pilot production plant may be operational by 2011, with a commercial plant producing 20PJ per annum by 2015. ☐

Capex in the next three years is forecast at \$3 million, with the projects net present value under the base case,



calculated at \$160 million (though this is largely based on international experience which inherent inaccuracies).

#### *Coal-to-Liquids (CTL)*

29. Solid Energy has invested \$70 million in land and mineral purchases in Southland, to secure sufficient resource to supply a CTL plant for 50+ years. However, a number of key properties are still required to make the resource contiguous. There has been positive interest from technology providers Sasol and Shell in establishing a plant capable of producing high value diesel, a combination of transport fuels, or pure hydrogen.
30. Management of the carbon footprint is recognised as a key enabler of the CTL project with a number of management solutions under investigation including blending feedstock with renewables, use of renewable energy for the production process, and carbon capture and storage. The current timeline estimates are for a pre-feasibility study by June 2010, planning and approvals from June 2011 onward and operation from June 2017.
31. The short term strategy focuses on additional key land acquisitions, further coal resource studies, building relationships with technology providers, pursuing carbon management work streams. Capex in the next three years is forecast at \$62 million, with the projects net present value, under the base case, \$4.8 billion.

#### **Carbon Management**

32. During 2007/08, Solid Energy created an internal carbon management group. This programme has two components: "business support" activities which relates to liability management and "carbon opportunities" which is about generating carbon credits at a cost lower than the market price. The key objective of the group is to recognise the huge uncertainty that exists around future carbon costs, and develop options that have a maximum degree of flexibility to best suit the company's investment decisions in the future.

#### **Strategy Comment**

33. Officials continue to hold reservations about the feasibility of the UCG and CTL projects due to the current uncertainties over global energy pricing, and investment and carbon sequestration developments required. Therefore we still believe Solid Energy should proceed with caution.
34. Solid Energy is aware of shareholding Ministers expectation that focus not be lost on core mining activities, where significant profits are forecast in the coming years. It is these profits that will largely fund development of Solid Energy's new energy and renewable projects, at the expense of larger dividend payments. Regular consultation with shareholding Ministers is expected, and should provide updates on business plan projects.

#### **Consultation**

35. Treasury has been consulted on this report and agrees with its content.



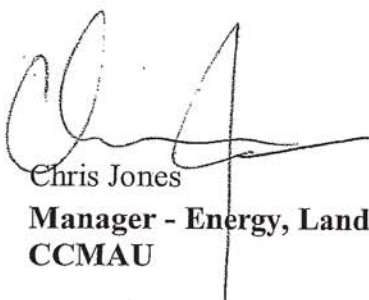
## Recommendations

36. We recommend that you:

- a **note** that Solid Energy responded to shareholding Ministers request to provide a revised SCI, with changes to the nature and scope of activities and shareholder consultation thresholds
- b **note** that the revised draft SCI did not meet shareholding Ministers' expectations, and that at a meeting with the Minister for SOEs, it was agreed with the Chair that quarterly update meetings would be arranged to discuss consultation issues such as capital projects outlined in the business plan
- c **note** that Solid Energy has also provided its comprehensive 20 year business plan, which does not have any major strategic shifts from last year; however Solid Energy's projected financial performance has improved significantly due to large increases in international coal prices, which is expected to lead to significantly improved dividends in the short to medium term
- d **note** that for the 30 June 2008 year, Solid Energy recorded a net profit after tax of \$34.4 million, compared to budget of \$21.1 million, and that subsequent to balance date the Board resolved to return 100% of its profit as a dividend, which will go someway to changing Solid Energy's traditionally low dividend payments
- e **agree** that the Minister for State Owned Enterprises sign the attached letter to the Chair of Solid Energy, on behalf of shareholding Ministers, asking the company, after considering your comments, to provide 75 copies of its final SCI for tabling in the House of Representatives.

(agree / disagree)

**Minister for State Owned Enterprises**



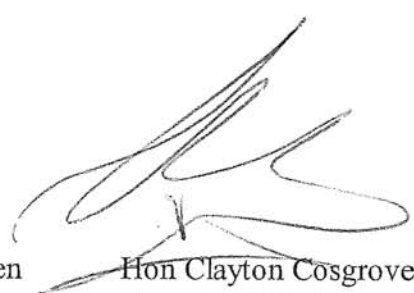
Chris Jones  
**Manager - Energy, Land & Environment**  
**CCMAU**

(agree / disagree)

**Associate Minister of Finance**

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 the Environment  
Minister of Labour  
Minister of Broadcasting  
Minister for State Owned Enterprises  
Associate Minister of Finance

John Palmer  
Chair  
Solid Energy New Zealand Ltd  
PO Box 1303  
Christchurch 8140

Dear John

### **2008/11 Draft Statement of Corporate Intent (SCI) and 2008/28 Business Plan**

Thank you for submitting Solid Energy's revised draft SCI and long-term Business Plan, for shareholding Ministers' consideration. We appreciate the effort that has gone into these documents, and the consideration given to my letter of 3 June 2008.

#### *Statement of Corporate Intent*

In my earlier letter, I raised concerns with the definition of Solid Energy's nature and scope of business and the shareholder consultation thresholds outlined in the draft SCI.

At our meeting on 26 September 2008, we discussed these issues and agreed that a practical response would be to meet on a quarterly basis to discuss: Solid Energy's financial/non-financial performance, any material changes to the business plan, upcoming decisions where it may be appropriate to consult with shareholding Ministers, and strategic issues for Solid Energy over the next two to three years. I also understand the quarterly report structure is being reviewed, and will provide a more detailed operational and planning commentary along with the financial results for the quarter. It is expected that these measures will help to resolve our concerns.

#### *Shareholder Consultation*

In addition to the planned improvements in quarterly communications, my expectation remains that there will be ongoing dialogue with shareholders between quarters, where issues arise that warrant disclosure under the 'no surprises' policy, or where consultation is appropriate. I also expect consultation to be undertaken in good faith, to ensure Ministers have an appropriate amount of time and information to consider a particular decision.

The Board can also refer to our consultation expectations set out in Chapter 7 of the recently revised *Owner's Expectations Manual for State-Owned Enterprises* (available on the CCCMAU website). I would be happy to provide additional clarity, if necessary.



I recognise that Solid Energy reduced the consultation threshold in its revised draft SCI (dated August 2008), but it remains out of step with other SOEs. Therefore, I reiterate our earlier communicated threshold preference, i.e. >\$30 million for items within core business and >\$10 million for items of non-core business.

Following revisions to shareholder consultation thresholds, the disclosures in section eight of the revised draft SCI (dated August 2008) now provide a level of detail greater than that of other large SOEs. As the agreed shareholder consultation thresholds do not need to be disclosed in the SCI, we would be comfortable if the final SCI was simplified as follows;

“Solid Energy will, in addition to the information above, and in relation to any single transaction, or connected series of transactions that commit the company, consult with Shareholding Ministers on items over agreed thresholds including:

- substantial capital investment
- substantial expansion of activities outside our core business
- subscriptions for or sale of shares or equity interests in any company that are material, involve a significant overseas equity investment, or are outside our scope of business
- sale or other disposal of a substantial part of the business.”

The limitations placed on Solid Energy's electricity generation projects in last year's SCI are no longer present. Although the business plan does not present a case for any generation projects over 20MW (or \$10 million), such opportunities may exist with the commercialisation of projects such as Coal Bed Methane and Underground Coal Gasification (UCG). If Solid Energy intends investing in any electricity generation project above 20MW capacity (or exceeding \$10 million), our expectation is that we will be consulted before an investment decision is made.

#### *Key Performance Indicators (KPIs)*

With the increased focus on corporate social responsibility, it is pleasing to see the formalisation of Solid Energy's sustainable business principles and policy statements. Although many are not new to the company, they have resulted in additional KPIs being added to the SCI, such as public reputation and health programme effectiveness. I encourage the Board to continue refining its KPIs, in order to improve transparency and accountability, and show how Solid Energy is targeting continual improvement in all of these areas.

#### *Financial structure*

This year's SCI included changes to Solid Energy's financial structure, with the setting of long-term dividend and gearing percentage targets. The targets within the SCI period have also been revised. We believe it is important that wherever possible, the Board adheres to a robust capital structure and dividend policy so as to allow it to meet its capital spending needs, while also providing an appropriate level of discipline. As profit and capital expenditure is expected to rise in the next few years, certainty over financial structure will be increasingly important.

We are comfortable with Solid Energy's forecast capital structure and dividend for 2008/09, and also with the payment of a \$34.375 million dividend for 2007/08. On this basis, we are happy with the wording in the SCI.

However, we think that the dividend policy could be more detailed and specific, with a wider range of target financial ratios and a more explicit link to our preferred capital structure, which is consistent with a credit rating of BBB(flat). We will be looking for further improvements in this regard in next year's SCI, and encourage you to work with officials on this.

#### *Commercial Valuation*

The Board's estimate of the commercial valuation of Solid Energy has increased by approximately 600% from last year's SCI due to including net present values for projects that are yet to be fully developed such as the Millerton and Cypress mines and UCG. We believe this is an aggressive approach to valuing the company; however, the commercial valuation in the SCI is a matter for the Board to decide.

#### *2008-28 Business Plan*

While the strategy contained in the 2008-28 business plan is broadly consistent with last year, the impact of increases in international coal prices has had a large improvement on the forecast profitability of the business. It is encouraging that Solid Energy is well positioned to take advantage of these prices, following the production difficulties at Stockton during 2007/08.

Shareholding Ministers remain supportive of research and development into new energy projects. The formation of a carbon management group, focusing on a range of carbon mitigation options that may be appropriate under future international emission policies and carbon pricing mechanisms, should see Solid Energy well positioned if it proceeds with projects such as UCG or Coal-to-Liquids.

#### *Final SCI*

Once the Board of Solid Energy has had an opportunity to consider our comments, please forward 75 copies of the final SCI to me by 31 October 2008, for tabling in the House of Representatives.

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

Trevor Mallard

**Minister for State Owned Enterprises**  
*on behalf of shareholding Ministers*

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