

The Chair  
Cabinet

## **SOLID ENERGY VOLUNTARY ADMINISTRATION PROPOSAL**

### **Proposal**

1. This paper notes a proposed restructuring of Solid Energy that has been negotiated over the last few months between Solid Energy's directors, major creditors and shareholding Ministers. The proposal is for a managed wind-down of the company, to be accomplished by way of a voluntary administration.

### **Executive Summary**

2. At current coal prices, Solid Energy is not financially viable and cannot continue operating without further restructuring its debt. In mid-March, the company's lenders approached the Crown with a proposal for a possible voluntary administration. The company and the banks have reached agreement in principle on the shape of a voluntary administration (VA) proposal. Treasury, on behalf of shareholding Ministers, has indicated support for that VA proposal.

3. The proposed agreement provides that:

- a. Two-thirds of the company's debt will be "parked" in a separate tranche, where it will no longer earn interest. This returns the company's balance sheet to a solvent position
- b. Trade creditors and employees will continue to be paid in the ordinary course of business
- c. Once the proposal has been adopted by creditors, the company will exit voluntary administration and be returned to the control of its directors, who will then run a process to sell the assets of the company over a period of two and a half years
- d. The agreement will terminate after two and a half years. At that point, any unsold assets will be liquidated. Crucially, this will be a solvent liquidation. New obligations to creditors (including trade creditors and employees) during the sales process will have priority for payment and should be paid in full, and
- e. Creditors whose debt has been parked will be paid off to the extent possible from any remaining cash generated by operations or asset sales, and will then forgive any remaining debt.

4. The proposed arrangement has the following benefits:

- a. Trade creditors and employees should be fully paid throughout the period of the agreement
- b. The commitment to a solvent liquidation enables the company's directors to stay in place and continue to run the company, and

- c. Lenders should benefit from higher realisations as a result of a more orderly sales process.
5. Shareholding Ministers support the proposal because it protects small creditors and increases the likelihood that the company's assets will be sold and continue to be operated by future owners. Ministers propose that the Crown support the proposed arrangement by:
- a. Amending the terms of Solid Energy's existing environmental rehabilitation indemnities so that access to reimbursement is extended to any purchaser of the company's mining assets (and in case of default, to relevant local authorities), and
  - b. Providing a tax indemnity to Solid Energy to cover any tax liability to the company that is generated by creditors' agreement to release debt as the final step in the solvent liquidation process.
6. Whilst the voluntary administration proposal is in its final stages of being agreed, there remain risks to it being successfully executed due to the numerous stakeholders involved, the short timeframe, and other complexities. The key risks are:
- a. Some of the company's key suppliers and customers have the right to terminate their contracts in the event of a voluntary administration, and some are taking the opportunity to try to improve their commercial position (for example by attempting to re-price contracts). Negotiations will likely continue until just prior to the proposed implementation date, but if too much economic value is lost from the company through these negotiations the Banks may take the view that it is not worth proceeding and prefer immediate liquidation.
  - b. Affected local authorities (located on the West Coast, Southland, and the Waikato) are being asked to agree to waive their right to claim in liquidation in return for the revised indemnity agreement. Whilst most councils have indicated their support for the proposal, there is a risk that one or two councils [Withheld under s9(2)(g)(i)] may not support it. Indications at this stage are that the banks may take a pragmatic approach so long as the value of potential council claims still outstanding at appointment date is not material.
7. In the event that the voluntary administration and subsequent Deed of Company Arrangement (DoCA) are not successfully executed, we expect that the company's directors will resign and ask shareholding Ministers to appoint a liquidator. In this event shareholding Ministers recommend that this process be allowed to run its course.

## Background

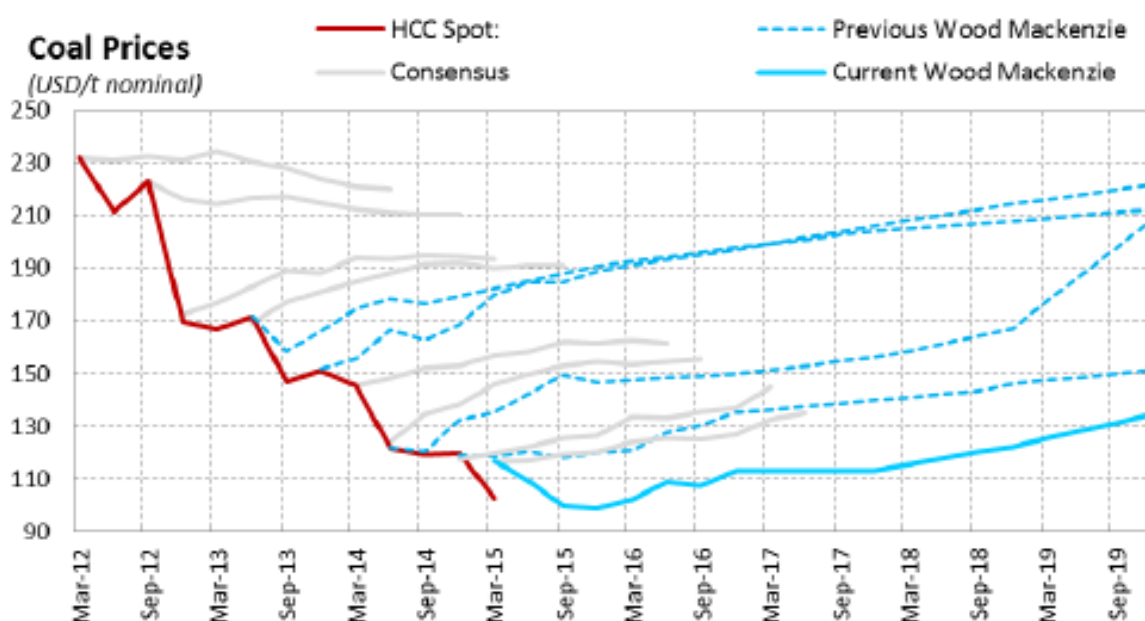
8. Solid Energy has \$320 million of interest bearing debt (held by banks and other note-holders), the first tranche of which matures in September 2016. The company has no prospect of repaying or refinancing this debt.
9. In the past two years, the Crown has provided the company with two separate support packages:
  - a. In October 2013 the Government negotiated a financial restructure package that saw Solid Energy's banks contribute \$75 million in equity to the company. The Crown also contributed \$25 million in equity and offered \$130 million in low-risk, secured loans for the company to use if needed (these have not been used), and
  - b. In September 2014, remediation liabilities totalling \$103 million were transferred from the company to the Crown, which strengthened the company's balance sheet so it could continue trading.

10. The rationale for providing support in each instance was that the company would be profitable once the forecast recovery in coal prices eventuated. However, the coal price has not recovered. It has continued to deteriorate, and with this deterioration has come a major restructuring of the coal industry, which has lowered the average cost of supply and reduced the upside in future forecasts.

11. The coal price peaked at US\$370/tonne in 2011, but has consistently reduced since that time and now sits at ~US\$82/tonne. WoodMackenzie<sup>1</sup> sees the key drivers of the continued fall in spot prices as being:

- a. the Chinese property market continues to be weak and is critical to Chinese domestic steel production (of which coal is the key ingredient), and
- b. aggressive pricing and favourable credit terms offered by Chinese domestic suppliers continues to undermine market sentiment.

12. With these factors at play, market conditions are not seen as conducive to price recovery in the near term. The future price path is uncertain and forecasts published by credible organisations, including WoodMackenzie, have been inaccurate in the recent past. The chart below illustrates that a recovery in the coal price has been repeatedly forecast over the past two years (reflected by the dotted lines), but it is yet to materialise (reflected by the hard line showing the actual price path).



13. The recent depreciation of the NZ dollar against the US dollar will help Solid Energy in the short term. For every 2c depreciation in the NZD/USD exchange rate, it improves Solid Energy's returns by [redacted] per annum (assuming a stable coal price). However, because Australia is the dominant supplier in the export market, a fall in the AUD/USD rate will exert downward pressure on the benchmark contract coal price in the longer term. This effectively negates any positive impact for Australian coal exporters from the depreciation of the AUD against the USD.

14. Because the NZD/USD exchange rate has a strong correlation to the AUD/USD exchange rate the positive impact to Solid Energy from the recent depreciation in the NZD has largely been offset by a corresponding reduction in the coal price.

<sup>1</sup> WoodMackenzie is a global research consultancy company which provides forecasts for commodity prices, including coal.

15. Any movements in the exchange rate and/or coal price will therefore be insufficient to enable the company to refinance its debt that falls due in September 2016, meaning that a restructure is required, irrespective of market conditions.

16. In March 2015, a formal insolvency was imminent [Withheld under s9(2)(f)(iv)]

17. The company's lenders effectively deferred the imminent insolvency by proposing a voluntary administration process to enable an orderly sell-down of the company's assets. The Minister of Finance then provided the company's directors with indemnities to enable them to continue in their roles whilst negotiations took place regarding the proposed voluntary administration.

18. The parties are currently working towards the company being placed into voluntary administration on or around 7 August. The creditor vote on the DoCA would then take place on about 11 September, allowing directors to sign-off the company's audited financial statements by 30 September. The directors have indicated that they are unwilling to remain in their roles beyond 30 September if a restructure has not been executed by then.

19. On 22 June 2015, we provided an oral update to Cabinet on the voluntary administration proposal from the banks [Cab MIN (15) 21/22 refers], noting that it was intended for the proposal to be finalised in early August. This paper provides more detail on the proposal and progress towards its execution.

## **Comment**

### *Proposal for voluntary administration*

20. At current coal prices, Solid Energy is not financially viable and cannot continue operating without further restructuring its debt. In mid-March, the company's lenders approached the Crown with a proposal for a possible voluntary administration. Treasury, on behalf of shareholding Ministers, has since indicated support for the VA proposal based on the provisions of certain term sheets developed jointly by the company and banks.

21. Under the VA regime, the administrator will propose a Deed of Company Arrangement (DoCA) to creditors, who must then vote on whether or not to adopt the proposal. The current proposal seeks to "pre-pack" the creditor agreement, which means that the detail of the DoCA will be negotiated and agreed between the company and its major creditors prior to the appointment of the administrator.

22. The DoCA proposes that affected creditors' debt be frozen and separated into two tranches, only one of which will bear interest. The frozen debt will be repaid to the extent possible from any excess cash generated by the company, and the proceeds of any asset sales. The separation of debt into two tranches will effectively strengthen the company's balance sheet, so as to allow it to continue operating for the time that would be required to carry out an orderly sale of its assets and, to the extent possible, repay its creditors.

23. The company will remain as a State Owned Enterprise and continue to be owned by the Crown during the DoCA period. It will continue to be governed by its Board of directors. Material business decisions will be subject however to approval of the Participants Committee, which will be made up of representatives from the major creditors and the Crown. The agreement is for a term of two and a half years, during which directors will be charged with running a sales process that will attempt to sell all the assets of the company.

24. Trade creditors and employees will continue to be paid in the ordinary course of business, and will have priority for payment (along with a very limited class of other priority creditors) on realisation of the company's assets prior to the company's liquidation.

25. Once the sales process is completed, creditors have been paid to the extent practical, and remaining debts have been released, it is proposed that the administrator will be appointed as liquidator. Affected creditors will then forgive the remainder of their debt, allowing the Company to enter a solvent liquidation process and be wound up. The requirement for payment in full of any new creditors, together with the release of debt unable to be repaid, ensures a solvent liquidation. The commitment to a solvent liquidation enables the company's directors to stay in place and continue to run the company.

26. The proposed arrangement is designed to provide a substantially better outcome for stakeholders than liquidation, at no greater cost. Trade creditors and employees are given payment priority and should be fully paid throughout the period of the DoCA. Redundancy payments are intended to be fully provisioned for and should also be fully paid in the event that parts of the business cannot be sold and are subsequently shut down. Lenders should benefit from higher realisations as a result of a more orderly sales process.

27. The plan is for the company to be put into voluntary administration on or around 7 August, with a watershed meeting (where creditors are asked to vote on the DoCA) to occur on about 11 September. For the DoCA to pass, it must have the support of 50% of creditors by number, and 75% by value. Once creditors have voted in favour of the DoCA, the company will pass back into the control of its directors and continue trading.

28. Whilst the Crown is not a party to the DoCA itself, we have had to contribute to the proposal to increase the likelihood of it being successfully executed. The Crown's contribution to the arrangements is set out below.

#### *Crown contribution for Rehabilitation and Related Liabilities*

29. The Banks have asked the Crown to contribute to the voluntary administration proposal by agreeing to modify its existing rehabilitation indemnities. Currently, two indemnities are in place:

- a. A pre-1987 indemnity that covers any liabilities arising from operations carried out by State Coal Mines prior to 1 April 1987, and
- b. A 2014 indemnity that covers rehabilitation liabilities arising on or after 1987 in respect of operations carried out prior to 30 September 2014

30. The indemnities are not transferrable. In liquidation, the 2014 indemnity (but not the pre-1987 indemnity) can be converted into bonds in favour of local authorities.

31. Under the new proposal, access to funds (which are allocated and capped by mine site) will be extended to any purchaser of the company's mining assets, and in the event of any default in respect of rehabilitation obligations, the funds could be claimed by local authorities.

32. Affected local authorities (located on the West Coast of the South Island, in the Waikato, and Southland) have been asked to agree to waive any right to claim for damages when the company goes into administration or liquidation, and in return will gain assurance as to the availability of funding for rehabilitation under the new Crown indemnity. Whilst final agreement from affected councils is still outstanding, indications are that most will support it, particularly those councils on the West Coast which see the proposal as providing an opportunity for mining operations to continue in the region. [Withheld under s9(2)(g)(i)]

33. There are no immediate fiscal implications arising from this proposal, as the liabilities relating to the indemnities are already recognised in the Crown accounts. However, a number of potential future risks are discussed in the 'Financial Implications' section below.

#### *Crown provision of tax indemnity*

34. To achieve a solvent liquidation means that once all available funds have been applied to creditors at the end of the VA period, any remaining debt must be forgiven by the company's banks. However, the forgiveness of debt at the completion of the liquidation process will result in debt remission income for Solid Energy for tax purposes, thereby creating a further liability for the Company (which will no longer have any funds available to pay the associated tax).

35. From the Banks' point of view, income tax on debt remission reduces the recoveries to creditors and provides a windfall gain to the Crown (because in an insolvent liquidation, these funds would not be recoverable by the IRD). The Banks have therefore proposed that if the Company's tax losses are insufficient to shelter this liability, then the Crown should agree to fund any income tax payment by providing an indemnity limited solely to tax attributable to remissions on debt afforded to the company. This facilitates a solvent liquidation.

36. Because shareholding Ministers agree that a solvent liquidation is desirable (i.e. it should enable the company's employees and trade creditors to be paid in full), we have agreed in principle to provide an indemnity in relation to income tax on debt remission only.

37. The indemnity will be granted by the Minister of Finance under section 65ZD of the Public Finance Act. This is on the basis that it is expedient in the public interest to do so. The banks would not have agreed to the voluntary administration proposal without an indemnity, and the alternative is an insolvent liquidation, where debt would not be released and tax would not be payable in any case.

#### *Risks to successful execution of voluntary administration and subsequent DoCA*

38. Final agreement between creditors, directors, the company's banks, affected local authorities and the Crown is pending. Risks remain that at least one of these parties cannot agree final terms. Depending on the magnitude of any potential disagreement, it could cause the proposal to fail given the interdependencies of the various agreements between the parties.

39. The greatest risk to the successful execution of the voluntary administration is that some of the company's key suppliers and customers have the right to terminate their contracts in the event of a voluntary administration and some are taking the opportunity to try to improve their commercial position (for example by attempting to re-price contracts). Negotiations will likely continue until just prior to the proposed implementation date, but if too much economic value is lost through these negotiations the Banks may take the view that it is not worth proceeding. [Withheld under s9(2)(b)(ii)]

40. In addition, Treasury and Solid Energy have engaged with affected local authorities (predominantly on the West Coast, Southland, and the Waikato) seeking their agreement to waive their right to claim in liquidation in return for increased rights and certainty under the revised indemnity agreements. Final agreements from all affected councils are outstanding and there is a risk that one or two councils may not support the proposal, and the banks will need to ask whether the VA is still viable.

### *Risks following successful execution of the DoCA*

41. In the event that the voluntary administration and subsequent DoCA are successfully executed, further risks to the Crown could materialise at a later date.

[Withheld under s9(2)(b)(ii)]

[Withheld under s9(2)(b)(ii)]

[Withheld under s9(2)(f)(iv)]

[Withheld under s9(2)(f)(iv) & s9(2)(b)(ii)]

[Withheld under s9(2)(f)(iv) & s9(2)(b)(ii)]

### *Likely outcome if not successfully executed*

46. In the event that the voluntary administration agreement cannot be successfully executed, it is likely that the company's directors will resign and ask shareholding Ministers to appoint a liquidator. Cabinet has previously agreed to a liquidation over a further injection of funds [Cab MIN (15) 21/22 refers], and shareholding Ministers recommend that this process be allowed to run its course.

47. If the company was put into liquidation now, it is generally accepted that this would be a worse outcome for most stakeholders than a managed wind-down and sales process which is what is being proposed under the voluntary administration process. Liquidation is not favoured by the banks because of the likely negative impact on asset realisations from a forced sale. It is not favoured by the Crown because of the likely costs involved and poor outcomes to a number of parties, including employees and creditors whose immediate futures would be uncertain.

## Other options considered

48. Shareholding Ministers believe that successful execution of the proposed voluntary administration would be the best outcome on the basis that:

- a. It caps the Crown's exposure to what it has already provided for the company in previous support packages, notwithstanding the risk relating to assets that some assets are unsold at the end of the process, and
- b. It sends a clear message to company directors, creditors, and banks that the Crown is prepared to let its commercial companies fail in the event they become unviable.

49. If the voluntary administration is not successfully executed, liquidation is the next preferred option, as it also achieves the objectives noted above. [Withheld under s9(2)(f)(iv)]

50. Shareholding Ministers do not propose providing a further support package for the company on the basis that:

- a. It directly exposes the Crown to the realisable value of the Crown's assets which is inextricably linked to the coal price. In the voluntary administration and liquidation scenarios, it is the company's creditors (predominantly its banks) who bear that risk
- b. The company will likely require further financial support from the Crown if the downside coal price scenario materialises, and
- c. It sets a precedent for bailing-out Crown owned companies and banks that have entered commercial agreements with the full knowledge that they are not guaranteed by the Crown.

## Consultation

51. No other departments have been consulted in the preparation of this paper.

## Financial Implications

52. The immediate financial implications to the Crown from Solid Energy being put into voluntary administration are currently being worked through with the Crown's auditors, and we will report back to Cabinet if there are any material implications.

53. As part of the 2013 restructure, the Crown provided \$130 million in low-risk, secured loans for the company to use if needed. These have not been drawn down, and will be extinguished as part of the current proposed restructure.

54. In addition to the existing financial obligations the Crown currently has in relation to the remediation indemnities (discussed in paragraphs 29 to 33), the Minister of Finance intends to grant a tax indemnity to the company in relation to the forgiveness of the company's debts by its banks (discussed in paragraphs 34 to 37) .

55. In respect of any unsold assets, there is a risk that the Crown will be exposed to residual rehabilitation liabilities if the available indemnity funding is not sufficient to carry out the work required.

56. There is a risk that market conditions deteriorate to the extent that the company does not generate enough cash from the asset sale process to pay out priority creditors (employees and trade new creditors) in the proposed solvent liquidation process.

[Withheld under s9(2)(f)(iv)]



[Withheld under s9(2)(f)(iv)]

[Withheld under s9(2)(f)(iv) & s9(2)(b)(ii)]

## **Human Rights**

58. Not applicable.

## **Property Rights**

59. Not applicable.

## **Legislative Implications**

60. Not applicable.

## **Regulatory Impact Analysis**

61. Not applicable.

## **Treaty of Waitangi Implications**

62. There are no immediate Treaty implications from the company being put into voluntary administration. However, a number of Solid Energy's assets are subject to Rights of First Refusal which will be triggered in the event of the company trying to sell them. There is also some unsettled land that may attract interest from local Iwi. Treasury will work with the Office of Treaty Settlements to address these issues as they arise, and we will report back to Cabinet in the event there are material Treaty issues in relation to the planned sale of Solid Energy's assets.

## **Publicity**

63. If the voluntary administration is executed successfully, the company plans to announce it on the date of execution, on or around 7 August. Our offices will also make a statement and respond to media queries at that time. Our key messages will be:

- a. The voluntary administration follows months of negotiations with Solid Energy's banks, and it is hoped that this will provide the best opportunity for some of its mining operations to continue
- b. The Government has provided two separate support packages for the company in 2013 and 2014. The company is continuing to lose money as the coal price has not recovered, and there will be no more support packages as we are not willing to expose taxpayers to any further losses. To do so would effectively be transferring value to the banks, which now have by far the largest economic stake in the company.

64. Given the wide number of parties now involved in the discussions, it is possible that the proposal will leak to the media ahead of the planned execution date. Our offices and the company have communication plans in place should that happen.

## Recommendations

65. The Minister of Finance and the Minister for State Owned Enterprises recommend that Cabinet:

- 1 **note** that Solid Energy is likely to be put into voluntary administration on or around 7 August
- 2 **note** that agreement to the proposal is being sought by Solid Energy's largest creditors, its banks, and affected local authorities and whilst indications are that sufficient agreement can be reached for the proposal to proceed, there is a risk that it will not be accepted by one or more stakeholder and the associated value loss may cause the process to fail
- 3 **note** that shareholding Ministers have agreed that the Crown's existing rehabilitation indemnities will be amended to allow the funds to be available to any purchaser of the company's assets or in the event of any default in respect of rehabilitation obligations, the funds could be claimed by local authorities
- 4 **note** that the Minister of Finance intends to grant a tax indemnity to Solid Energy to avoid the situation where it has to pay tax on the debt remission income it will generate when creditors write-off a portion of their debts, but the indemnity will have no net impact to the Crown, nor provide any inequitable benefit to the company's creditors, and
- 5 **note** that in the event the voluntary administration proposal is not supported by creditors, the company's directors are expected to resign and ask shareholding Ministers to appoint a liquidator.

Hon Bill English  
**Minister of Finance**

Dated:

Hon Todd McClay  
**Minister for State Owned Enterprises**

Dated: