The Treasury

Solid Energy Information Release

May 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.

From: John Crawford
Sent: Friday, 11 May 2012 10:02 p.m.
To: Chris White; Juston Anderson; Andrew Blazey
Subject: Fw: CEO Board memo FY13 budget (V2).docx
Attachments: CEO Board memo FY13 budget (V2).docx

Let's discuss monday

From: Don Elder [mailto:don.elder@solidenergy.co.nz]
Sent: Friday, May 11, 2012 08:08 PM
To: John Crawford
Cc: ^SOLID: Bill Luff; Anthony Burg <Anthony.Burg@solidenergy.co.nz>
Subject: CEO Board memo FY13 budget (V2).docx

Hi John
John Palmer and the Solid Energy Board have asked that I send you the attached document.
This is the note I sent our Directors two weeks ago, in advance of them receiving the draft budget for review at our April 27 Board meeting. It provides a context for the budget that is significantly more substantial (and sensitive) than the other documentation we provided you on Monday this week.
Regards
Don
Dr Don Elder, CEO, Solid Energy NZ Ltd
PO Box 1303, Christchurch, New Zealand
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From: Don Elder 27 April 2012
To: Board cc ELT + Steve Surridge, Greg Robinson

Advance heads up on Business Plan & draft FY13 Budget

1. Since about 2006 we have been following a long term core business strategy which has remained essentially unchanged. The underlying market and economic assumptions and drivers supporting it have remained consistent and strong, even through the 2008/2009 GFC. While we prepared scenarios that reflected uncertainty in key external drivers (export demand and prices, CO2 policies) in fact demand and prices have increased within a narrow and remarkably predictable range around our base case projections. Only major market disruptions (GFC, Queensland floods) caused significant deviations, and even these were only temporary and largely within our p20 - p80 probability ranges for price volatility.

2. Our long term business plans since ~2006 have projected that we would fund most of our growth to 2008-2010 from strong operating cashflows, then we would fund with debt up towards our bank capacity to 2012-2013. After this we would need new sources of capital. Without this we would have to either delay growth strategy implementation, or give up significant future value to new partners at a subsidiary or project level. Our scenario work showed that we could withstand market demand and price volatility within the p20-p80 range, while still delivering our core strategic projects, for a year or so, but demand and price volatility outside this range would be increasingly challenging by 2012-2013 as our debt levels rose and until we obtained new capital.

3. In December 2008 / early 2009:
   - As the GFC hit in late 2008 the HCC price collapsed as customers unilaterally reset prices. USD prices fell 57% from (in 2008$) USD300/t to USD129/t for the remaining 6 months of FY09 and FY10. However the NZD:USD also fell almost 40%. The resulting fall in the NZD price was 33%, to about NZD270/t (in 2012$)
   - However most customers accepted staggered delivery of contracted shipments at $300/t among new shipments at USD125/t. The blended price we received for the remainder of FY09 and FY10 was close to NZD300/t.
   - We were able to largely maintain our export mix of HCC and SHCC coal
   - At November 2009 we had 0 debt (gearing 0%) and $200M of unused debt headroom
   - While we had a range of scenarios we believed it most likely that our key markets would rebound early and strongly. This occurred.

4. The situation today is considerably more challenging:
   - In the past 6 months HCC prices have fallen 67% from USD300/t to ~USD200/t. The NZD:USD has stayed unchanged or risen slightly. Our NZD prices have fallen 35% from ~NZD375/t to ~NZD245/t. Even at these prices we are having to shift our export mix to less HCC and more SHCC/Thermal coal
   - On an annualised basis this reduces our export revenue (and profit before tax) by [2], [5]
   - Quarterly pricing means that, unlike 2009, there is no carryover effect for shipments at the previous prices
   - We have $280M of debt and our gearing is 37% today. While we have substantial bank facility head room we cannot access this (at reasonable gearing) without increased equity.
   - We have little market information to confirm we are at the price floor, and little information to support an outlook of a price rebound in the next 6-12 months or possibly longer
   - A possible scenario at present is therefore that current prices (NZD) remain unchanged throughout FY13
   - A likely scenario is that prices rise back towards longer-term trend levels only very slowly through FY13 and then through FY14-15

5. The effects of this export revenue loss on our current FY13 projection (before responses) compared to our FY13 projection as contained in our 2011 budgets prepared in June last year are estimated below:

	FY13 (2011)	FY13 now before responses
Export revenue	[2]. [5]	
Total revenue		
EBIT		
PBT		
NPAT		
Operating cashflow		
Gearing		

- Capex [2], [5]

6. This is the challenge we have been working on for the past month, and intensely for the past 2 weeks as we prepare draft plans and budgets for FY13.

7. We have prepared a wide range of scenarios, based on our two most important uncertainties – availability of new capital, and export prices:
    - Capital:
        - **No new capital (likely). This is the case we are currently using.**
        - Limited new capital (possible)
        - Significant new capital (unlikely)
    - Export prices – all cases have prices below long-term trends for FY13-FY15:
        - Worst case – HCC ~NZD250/t, no price rebound FY13, slight rise FY14-15. Asset divestments very hard and minimal cash return.
        - **Low case – HCC prices rise v slowly through FY13, slightly faster FY14-15. Asset divestments hard, cash returns low. This is the case we have now moved to.**
        - Mid case – HCC prices rise moderately through FY13 – 15. Asset divestments easier, cash returns still below carrying value.
        - Higher cases – no longer under consideration based on current market information
    - Impairments – in the Worst and Low cases low near-term market prices and very weak external investment interest means we cannot justify current carrying values for a number of marginal assets. Unless we get clear and strong value indications through our current divestment processes.

      ELT now believes that based on market information we should take significant or total impairments in the current year, FY12 for, at least, CSG, Renewables, and Spring Creek (subject to current partner discussions), and we should also consider expensing in the remainder of FY12 and in FY13 some activities we would previously have capitalised. The magnitude of this FY12 impairment, driven by current market conditions, could be ~$60M+.
    - Asset divestments – assumptions depend on price scenarios. In the *Low* case we are now using only land divestment is assumed to be achievable at near carrying value. Spring Creek partial sale is assumed achievable but at price not yet certain. For other assets we are using 4 scenarios within the low price case:
        - Best (preferred) case – assumed p10 - p20 - only 10-20% likely (ie unlikely) in FY13
        - Possible Case ~p50
        - **Most Likely Case ~ p80 This is the case we now recommend without new information**
        - Worst Case ~ p90 - p95

8. Our initial downturn responses commenced several months ago. We have progressively been digging deeper and deeper into these both in current business management and in business planning for FY13 and beyond, to create the [2], [5] minimum EBIT or cashflow turnaround we need. This has involved every level of business operations, projects and corporate activities.

9. Our primary objectives have been:
    1. Reduce all non-critical expenditure to preserve and generate short-term cash through FY13 at a minimum
    2. Preserve future optionality for our highest ranking strategic opportunities, if and where possible (delay projects but try to avoid closing out options if possible), and
    3. Maintain key people capability built up to date in hard to recruit strategic areas

[2], [5]

11. Through the measures identified to date we estimate a [2], [5] reduction in costs in the draft FY13 budget. Some of these will result in increased business risk, which we have identified and will manage. Others will result in slow-down in long-term project development. Others will result simply in people having to work smarter and harder. We are conscious that this is an additional risk in Christchurch where many people at all levels are still struggling with personal post-earthquake issues.
12. We have not yet factored in cash achievable from asset divestments as the potential cash from these is still very uncertain as shown in our asset divestment scenarios above. We expect to include estimates of potential divestment cash in our final budgets to be prepared next month.
13. The effects of all these measures on our latest draft FY13 budget (close to the version you will receive next week) are shown below:

	FY13 2012 budget	FY13 before responses	FY13 latest
• Export revenue	[2], [5]		
• Total revenue			
• All costs			
• EBIT			
• PBT			
• NPAT			
• Operating cashflow			
• Gearing			
• Dividend			
• Capex			

[2], [5]

There is still significantly more downside than upside to the FY13 budgets and is likely to be for the next month through to mid-June until export prices are set for the July-September quarter. A little of this downside may still be reflected in the draft budgets we send you on Monday.

Regards
Don