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 Ltd’s draft Statement of Corporate Intent for the Three Years Commencing 1 July 2008

**Date**: 29 May 2008  
**Priority**: Semi-urgent  
**Security level**:  
**CCMAU Ref**: A68526  
**Treasury Ref**:  

<table>
<thead>
<tr>
<th>Minister</th>
<th>Action sought</th>
<th>Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minister of Finance</td>
<td><strong>Agree</strong> that the Minister for SOEs should sign the attached letter</td>
<td>3 June 2008</td>
</tr>
<tr>
<td>Minister for State Owned Enterprises</td>
<td><strong>Sign</strong> the attached letter to the Chair of Solid Energy</td>
<td>3 June 2008</td>
</tr>
<tr>
<td>Associate Minister of Finance (Hon Phil Goff)</td>
<td><strong>Note contents</strong></td>
<td>N/A</td>
</tr>
<tr>
<td>Associate Minister of Finance (Hon Clayton Cosgrove)</td>
<td><strong>Note contents</strong></td>
<td>N/A</td>
</tr>
</tbody>
</table>

**Key issues**

- Solid Energy has submitted its draft 2008 Statement of Corporate Intent (SCI) to Ministers for consideration.
- Officials have four significant concerns with the draft SCI, which taken together cause us serious concern. These concerns involve Solid Energy’s:
  - Nature and scope of business
  - Balance sheet gearing and dividend policy
  - Shareholder consultation thresholds
  - Commercial valuation
- These concerns are significant enough to justify shareholding Ministers writing to the Board of Solid Energy to request that consideration is given to redrafting the SCI.
- At this stage, we do not propose that you extend the date for receipt of the final SCI. However, an extension may be required depending on the Board’s response to the attached letter.

**Contacts**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Chris White</td>
<td>Manager, Climate Change, Energy and Commercial Operations, Treasury</td>
<td>[1]</td>
</tr>
<tr>
<td>Chris Jones</td>
<td>Senior Advisor - Energy, Land &amp; Environment (CCMAU)</td>
<td>[1]</td>
</tr>
<tr>
<td>Murray Wright</td>
<td>Executive Director, CCMAU</td>
<td>[1]</td>
</tr>
</tbody>
</table>

Please return this document to CCMAU
29 May 2008

Minister of Finance
Minister for State Owned Enterprises
Associate Minister of Finance (Hon Phil Goff)
Associate Minister of Finance (Hon Clayton Cosgrove)

Solid Energy’s draft Statement of Corporate Intent for the Three Years Commencing 1 July 2008

1. On 9 May 2008 Solid Energy delivered its draft Statement of Corporate Intent (SCI) and business plan to Ministers and officials.

2. We are currently working through the business plan with the company. The plan forecasts very significant increases in profit for Solid Energy over the next 3 years, relative to last year’s plan. At this stage we do not have any major concerns with the business plan.

3. We have four concerns with Solid Energy’s SCI, in relation to its:
   - Nature and scope of business
   - Balance sheet gearing and dividend policy
   - Shareholder consultation thresholds
   - Commercial valuation.

4. These concerns are each significant in their own right, but together they cause us serious concern. We think these concerns justify Ministers writing to the Board of Solid Energy requesting a redraft of its SCI.
Business plan

5. Solid Energy is forecasting a large increase in revenue 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.

6. Improved earnings are associated with an increase in forecast dividend payments to the Crown, up from nil in the current year, to $60 million in 2008/09 and $100 million in each subsequent year.

7. While the ratio of dividends to net profit is also forecast to increase, a significant proportion of profit is retained to fund an ambitious capital expenditure programme over the three year planning period, averaging $182 million per annum. Even with this capital spending programme, Solid Energy’s gearing is expected to decline over the forecast period, from 44.7% in the current year, to 33.1% in 2010/11, because of the very high level of profits.

Comparison with prior years’ plans

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2006/07 Plan</td>
<td>79.0</td>
<td>56.9</td>
<td>60.7</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>2007/08 Plan</td>
<td></td>
<td>21.1</td>
<td>36.0</td>
<td>34.0</td>
<td>n/a</td>
</tr>
<tr>
<td>2008/09 Plan</td>
<td></td>
<td></td>
<td>205.6</td>
<td>210.2</td>
<td>167.6</td>
</tr>
<tr>
<td>Actual (a) / forecast (f) performance</td>
<td>94.1 (a)</td>
<td>19.0 (f)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual v Plan (yr 1)</td>
<td>+15.1</td>
<td>-2.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>08/09 v 07/08</td>
<td></td>
<td>+169.6</td>
<td>+176.2</td>
<td>n/a</td>
<td></td>
</tr>
</tbody>
</table>

Financial performance summary

<table>
<thead>
<tr>
<th>(all figures $ millions, unless otherwise specified)</th>
<th>2006/07 actual</th>
<th>2007/08 plan</th>
<th>2008/09 plan</th>
<th>2009/10 plan</th>
<th>2010/11 plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>564.6</td>
<td>483.2</td>
<td>892.9</td>
<td>1003.1</td>
<td>961.3</td>
</tr>
<tr>
<td>EBIT</td>
<td>150.5</td>
<td>43.9</td>
<td>303.1</td>
<td>315.5</td>
<td>255.3</td>
</tr>
<tr>
<td>NPAT</td>
<td>94.1</td>
<td>19.0 (f)</td>
<td>205.6</td>
<td>210.1</td>
<td>167.6</td>
</tr>
<tr>
<td>Dividend</td>
<td>Nil</td>
<td>Nil</td>
<td>60.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Dividend as a % of NPAT</td>
<td>Nil</td>
<td>Nil</td>
<td>29.2%</td>
<td>47.6%</td>
<td>59.7%</td>
</tr>
<tr>
<td>Total Shareholders’ Funds</td>
<td>327.9</td>
<td>356.2</td>
<td>499.0</td>
<td>609.2</td>
<td>676.7</td>
</tr>
<tr>
<td>Total Assets Employed</td>
<td>546.2</td>
<td>685.6</td>
<td>873.0</td>
<td>996.2</td>
<td>1083.9</td>
</tr>
<tr>
<td>Return on Shareholders’ Funds (%)</td>
<td>33.6%</td>
<td>5.5%</td>
<td>48.0%</td>
<td>37.9%</td>
<td>26.0%</td>
</tr>
<tr>
<td>Return on Assets (%)</td>
<td>19.1%</td>
<td>7.3%</td>
<td>38.9%</td>
<td>33.8%</td>
<td>24.5%</td>
</tr>
<tr>
<td>Debt to Debt + Equity 1 (%)</td>
<td>34.3%</td>
<td>44.7%</td>
<td>37.7%</td>
<td>34.1%</td>
<td>33.1%</td>
</tr>
</tbody>
</table>

1 Includes rehabilitation provision, equal to $167.0 million in 2008/09 (plan)
Nature and scope of business

8. Solid Energy has significantly changed the wording of its intended nature and scope of business section from last year’s SCI. The draft of this year’s nature and scope of business is extremely broad, as it defines everything that Solid Energy does (or might do in the future) as “core business”. This includes, for example:

- Gas production, primarily from coal and biomass
- Production of transport fuels, electricity and other chemical products
- Logistics management, transportation and distribution
- Marketing, sales and trading of: coal, gas, biomass, transport fuels, electricity and chemical products (and other complementary solutions and services)
- Management of land under its ownership or control
- Greenhouse gas mitigation and management.

9. There are very few qualifications or constraints associated with these activities. For example, there is no distinction between New Zealand-specific activities and those that may be carried out overseas, or recognition that New Zealand is Solid Energy’s primary focus.

10. The draft nature and scope of business therefore gives Solid Energy very broad discretion as to what activities it can undertake (subject to shareholder consultation under specific conditions).

11. This is the second major re-write of the nature and scope of business section in the SCI in two years. It appears that this section in the SCI has gone from one extreme to the other – last year’s SCI was very detailed, while this year’s draft has been pared back to the absolute minimum.

12. In general we are comfortable with a shorter, more focused nature and scope of business, but in our view Solid Energy’s draft has gone too far in this direction, and some important points of reference and distinctions from last year’s version have been lost.

13. For example, last year’s SCI stated that Solid Energy will “investigate, develop and operate electricity generation up to 20 MW at mine sites to meet the company’s own demand and contribute to security of national supply” (emphasis added). This is consistent with the views expressed by Ministers in the 2005 Statement of Shareholder Preferences (SSP) which stated that Ministers “did not see wider energy production, including all forms of electricity generation, as being core business”. The caveat associated with electricity generation is missing from this year’s draft SCI.

14. We are conscious of the announcement by the Minister for State Owned Enterprises in June 2006, encouraging SOEs to diversify into new business areas, and therefore have no desire to unduly constrain Solid Energy’s activities. However, we are also conscious that such diversification was predicated on a number of preconditions, such as ‘spill over’ benefits and providing a robust evaluation process with explicit performance indicators and a defined exit
strategy. We do not believe that Solid Energy has yet fulfilled these expectations in respect of its ‘new’ activities, and therefore does not have the right to arbitrarily expand its nature and scope of activities.

15. Therefore, we are concerned that Solid Energy appears to have prematurely expanded its nature and scope of business without first consulting with its shareholders about proposed new activities.

16. Solid Energy contends that the nature and scope of business in the draft SCI was redefined “to improve clarity and to accurately reflect the current business plan” and that it may “potentially” become involved in electricity production and chemical production over the next three years, as a result of the planned coal bed methane and underground coal gasification projects.

Balance sheet gearing and dividend policy

17. Solid Energy’s current dividend policy (which is consistent with previous years’ SCIs) is to “distribute funds that are surplus to investment and operating requirements having regard to capital structure, short and medium term capital requirements and risk management”. The SCI does not specify what the desired capital structure is, or target a particular percentage of net profit after tax to be paid as a dividend.

18. We are not confident that this dividend policy provides sufficient discipline on the company – particularly now that Solid Energy is forecasting very significant profits over the next few years.

19. In our view a robust dividend policy should:
   - Be explicitly linked to a desired capital structure. In the SSP Ministers stated a preference for Solid Energy to maintain a capital structure consistent with a BBB(flat) credit rating, and that a debt to debt plus equity ratio (“gearing ratio”) of around 35% was consistent with this
   - Be explicitly linked to target financial ratios that are consistent with the desired capital structure, for example funds from operations (FFO) to debt, and FFO to interest
   - Have a target long-run ratio for dividends to net profit after tax (e.g. 60-65% of net profit after tax), but with flexibility to change this in any year based on performance against the target financial ratios.

20. Such a dividend policy (similar to Meridian’s) should provide Solid Energy with sufficient certainty to allow it to plan capital spending to meet its needs, while also providing an appropriate level of discipline.

21. As an outcome of a more tightly specified dividend and capital structure policy, we would expect to see higher forecast dividends in the final two years of the Plan, to bring Solid Energy close to the desired gearing level of 35%, consistent with BBB(flat). Of course the dividends would be dependent on Solid Energy actually delivering the profits that it is now forecasting. Given the volatility of Solid Energy’s business, this is far from certain.
22. Solid Energy argues that its current dividend policy is appropriate, given the uncertainty of earnings, and the lumpy capital investments it makes.

23. We do not agree. Other companies have significant, lumpy capital investments and uncertainty around earnings, and have much more clearly specified capital structure and dividend policies.

Shareholder consultation thresholds

24. The draft SCI states that Solid Energy will consult Ministers if any capital expenditure “exceeds 25% of shareholders funds”. Based on the Business Plan’s forecast for shareholder equity of $499 million in 2008/09 this means a consultation threshold of just under $125 million, rising to an estimated $170 million in 2010/11.

25. In our view this threshold is too high, particularly in comparison with other SOEs, and needs to be reduced. We would also prefer two consultation thresholds – one for investments in Solid Energy’s core business, and a lower one for investments in non-core activities. This would obviously necessitate a distinction between core and non-core business activities, as defined in the nature and scope of business (referred to above).

26. The consultation thresholds for most large SOEs (including Solid Energy) are provided below for comparison:

<table>
<thead>
<tr>
<th></th>
<th>Core ($m)</th>
<th>Non-core ($m)</th>
<th>Shareholder's funds ($m)</th>
<th>Core (%)</th>
<th>Non-core (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meridian</td>
<td>120</td>
<td>40</td>
<td>4,250</td>
<td>2.8%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Mighty River Power</td>
<td>60</td>
<td>15</td>
<td>2,160</td>
<td>2.8%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Genesis</td>
<td>65</td>
<td>22</td>
<td>1,500</td>
<td>4.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Landcorp</td>
<td>15</td>
<td>5</td>
<td>1,100</td>
<td>1.4%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Solid Energy</td>
<td>125</td>
<td>125</td>
<td>500</td>
<td>25.0%</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

27. The thresholds for Meridian, Mighty River Power (MRP) and Genesis are broadly similar. The thresholds for Meridian and MRP were set as dollar amounts that were roughly equal to 3% and 1% of total assets at that time (in the table above we have converted these thresholds into percentages of shareholders funds for comparison with Solid Energy’s threshold). The threshold for Genesis was set at 3% and 1% of total assets, and so it has grown over time as the assets of Genesis have grown – therefore it is slightly higher as a percentage of shareholder funds than the thresholds for Meridian and MRP.
28. Solid Energy considers that its current consultation threshold is appropriate “given the modest SHF [i.e. shareholders funds] and the significant capital expenditure in the business plan”.

29. We do not agree – in our view on both a dollar amount and percentage of shareholder funds basis, the thresholds for Solid Energy are significantly out of line with the other SOEs. It does not seem sensible for Solid Energy to have a dollar consultation threshold which is higher than Meridian’s, or twice the threshold of MRP and Genesis.

30. To illustrate the potential risk to shareholders from such a high consultation threshold, it is theoretically possible that Solid Energy will not need to consult on any of its planned projects over the next 20 years, including the coal bed methane project (involving capital expenditure of $79.7 million) and underground coal gasification project (involving capital expenditure of $142.5 million). Depending on the timing of expenditure and the approach taken by Solid Energy, the coal to liquids project (involving capital expenditure of $186.7 million) is the only planned project captured by the consultation threshold.

Comment
31. Taken together, the three issues above cause us serious concern, as they expose the shareholder to unnecessary and/or inappropriate risk. The broad scope of business allows Solid Energy to expand into new, potentially risky areas of business. The high consultation threshold means that the Board does not need to seek the views of shareholding Ministers unless it is planning very large investments (of around $125 million in 2008/09). Finally, the relatively loose dividend policy, combined with high forecast profitability, gives Solid Energy a large amount of capital to use to fund its expansion plans.

Commercial valuation
32. Our fourth concern is over the wording of Solid Energy’s estimate of the value of the Crown’s investment in the company.

33. The draft SCI states that “… the value of the Crown’s investment in Solid Energy is estimated to be $7.8B”. The draft then lists a number of opportunities and threats that may substantially affect this assessment, and concludes with the statement that these factors “are estimated to affect Solid Energy’s base value by -70% to +200%”.

34. This contrasts with last year’s SCI which stated that “the current value of the business is the value that can be achieved with a high level of probability (but is not risk free) … this core commercial value is estimated at $450 – $500 million”.

35. We do not think it is credible for the company’s estimate of its commercial value to increase by a factor of 15 in one year; nor do we think an estimate subject to
variability of -70% to +200% is robust enough to be presented in the way that it has in the draft SCI.

36. In our view, the approach taken in last year’s SCI is appropriate, and we would prefer a similar approach to be taken this year. Obviously, the comparable figure in this year’s SCI will be considerably higher, given the uplift in coal prices and Solid Energy’s forecast profits.

37. We note that the major component of the $7.8 billion estimate is the coal to liquids (CTL) project, which as the business plan states is speculative, requires very significant capital investment (both by Solid Energy and by another company building the actual CTL conversion plant), and where a large portion of the value generated is beyond Solid Energy’s 20 year planning horizon. In addition, CTL has not yet been committed to, and has not been subject to shareholder consultation.

38. We have no objections to Solid Energy including an estimated commercial value in its SCI which includes CTL. Indeed, given the potential value generated from CTL, we think including such an estimate is important. However, any such estimate needs to be carefully explained, put in context, and have appropriate caveats around it.

39. We suggest that the SCI could present several commercial value estimates. The first would be based on last year’s approach of “the value that can be achieved with a high level of probability” (i.e. attributable to existing operations and/or extensions of those operations). Other commercial values could be provided assuming future planned or speculative investments (such as CTL) go ahead.

Next steps

40. If you share our concerns, then we suggest you write to the Board of Solid Energy asking them to consider redrafting the SCI. A draft letter is attached for this purpose.

41. At this stage we do not propose that you extend the date for receipt of the final SCI. Depending on Solid Energy’s response you may need to do so later. It is likely that coming to an agreed position with Solid Energy will take some time. However, given the significance of the issues with the draft SCI we think it is important to take this time to work through these with the Board.

Recommendations

We recommend that you:

a note that Solid Energy’s draft business plan forecasts $580 million in net profit after tax and $260 million of dividends over the next three years, compared to $91 million of profit and no dividends over three years in last year’s business plan;

b note that officials have the following concerns with Solid Energy’s draft SCI:
• The draft nature and scope of business is too broad and makes no distinction between Solid Energy’s core and non-core business, or its New Zealand operations versus operations overseas.

• The dividend policy does not provide sufficient discipline on the company, particularly now that Solid Energy is forecasting very significant profits over the next few years.

• Shareholder consultation thresholds are too high, particularly compared to other SOEs.

• The commercial value estimate is not consistent with the approach taken last year, and the very high figure given, unless carefully explained, risks giving a misleading picture to readers of the SCI.

c If you agree with our concerns, sign the attached letter to the Chair of Solid Energy requesting that the Board redraft its SCI.

(agree / disagree) (agree / disagree)
Hon Dr Michael Cullen Hon Trevor Mallard
Minister of Finance Minister for State Owned Enterprises

Chris White Murray Wright
Manager, Climate Change, Energy Executive Director
and Commercial Operations CCMAU
For Secretary to the Treasury

Hon Dr Michael Cullen Hon Trevor Mallard
Minister of Finance Minister for State Owned Enterprises
Dear John

Thank you for your draft Statement of Corporate Intent (SCI) for 2008/09 and business plan. We would like to commend Solid Energy for the quality and thoroughness of the business plan. Officials are still working through the detail of it, and Ministers will come back to you later with any comments.

This letter is to provide the Solid Energy Board with some initial feedback on the draft SCI. As discussed in detail below, Ministers have four issues with the SCI. The first three issues are significant in their own right – taken together, they cause us serious concern.

We would like the Board to consider our comments below, and provide us with a final draft of the SCI by 26 June 2008.

At this stage we do not propose extending the date for receipt of the final SCI, although we may need to do so later after considering your response to this letter. While we would prefer to table this year’s SCI within the statutory deadline, if necessary we are willing to extend the deadline and take some time to work through these issues with the Board.

Nature and scope of business

Solid Energy has significantly changed its intended nature and scope of business from last year’s SCI. The draft of this year’s nature and scope of business is extremely broad, as it defines everything that Solid Energy does (or might do in the future) as “core business”. There is also no recognition that New Zealand is Solid Energy’s primary focus and/or that specific activities are limited to New Zealand.

This is the second major rewrite of the nature and scope of business section in the SCI in two years. We would prefer to have an agreed nature and scope of business that can form part of the SCI for a number of years, rather than requiring significant rewrites each year.
It appears that this section in the SCI has gone from one extreme to the other – last year’s SCI was very detailed, while this year’s draft has been pared back to the absolute minimum. In general we are happy with a shorter, more focused nature and scope of business, but we think Solid Energy’s draft has gone too far in this direction, and some important points of reference and distinctions have been lost.

In 2005, Ministers wrote to the Board with a Statement of Shareholder Preferences (SSP) for Solid Energy. Given Solid Energy’s significant rewrite of its nature and scope of business in this year’s draft SCI, it is timely to reconsider what we said:

“We see SENZ’s core business as being its New Zealand coal operations, i.e. coal resource identification, acquisition, development, mining, management of transport to market, marketing and sales of New Zealand coals. We do not see wider energy production, including all forms of electricity generation, as being SENZ’s core business. Ministers acknowledge that SENZ’s core competencies in its core business, coal operations, are transferable to biomass and that SENZ’s focus on biomass operations is planned to grow. However, Shareholding Ministers do not see biomass as part of SENZ’s core business, but this will be reviewed over time if biomass becomes more fundamental to Solid Energy’s business.”

The SSP is now three years old, and there have been some changes in Solid Energy’s operating environment and the wider operating environment for SOEs since then. In particular, the Minister of State Owned Enterprises announced a policy change in June 2006, encouraging SOEs to diversify into adjacent products, markets and technologies.

In light of this policy announcement, Ministers are open to considering some broadening of Solid Energy’s nature and scope of business. However, we are also conscious that diversification was predicated on a number of preconditions, such as evidence of ‘spill over’ benefits and provision of a robust evaluation process (including explicit performance indicators and an exit strategy). In our view, these preconditions have not been met and therefore the current draft is too broad. In our view, the nature and scope of business must:

- Clearly distinguish between Solid Energy’s core and non-core operations
- Clearly set out that Solid Energy is a New Zealand company and that its New Zealand operations are of particular importance to the Government as owner
- Have some key points of reference and boundaries – an example would be last year’s reference to “investigate, develop and operate electricity generation up to 20 MW at mine sites to meet the company’s own demand and contribute to security of national supply” (emphasis added). This has been removed from the current draft SCI which refers only to “production of … electricity”, with no qualifications or limitations. The wording of the current draft is clearly inconsistent with Minister’s preferences as expressed in the SSP.

It is important to be clear about what the distinction between core and non-core operations means. In our view, the core business of any SOE is the operations that are of importance to the Government, and if not done well would pose a public policy problem. In almost all cases, this will be the SOE’s operations within New Zealand.
Non-core business covers complementary and related activities, within New Zealand or overseas, where an SOE can leverage its expertise in its core business and/or expand into new, growth areas.

The distinction between core and non-core business signals a different level of comfort by Ministers, and the requirement for higher levels of justification for carrying out or expanding non-core business, or divesting from core or non-core activities. This would for example be recognised in consultation thresholds for core and non-core business, which we discuss further below.

**Balance sheet gearing and dividend policy**

Ministers are not comfortable with Solid Energy’s dividend policy in the draft SCI. In our view a robust dividend policy should:

- Be explicitly linked to a desired capital structure. In the SSP we stated our preference for Solid Energy to maintain a capital structure consistent with a BBB(flat) credit rating, and that in our view a debt to debt plus equity ratio (“gearing ratio”) of around 35% was consistent with this
- Be explicitly linked to target financial ratios that are consistent with the desired capital structure
- Have a target long-run ratio for dividends to net profit after tax (e.g. 65% of net profit after tax), but with flexibility to change this in any given year, based on performance against the target financial ratios.

Such a dividend policy should provide Solid Energy with sufficient certainty around its capital structure to allow it to plan capital spending to meet its needs, while also providing an appropriate level of discipline. Dividend policies specified on this basis are in place for other large SOEs, who also have significant capital spending programmes.

Given the significant profits that Solid Energy is forecasting over the next three years, and the significant cashflow this provides to the company, establishing a more robust capital structure and dividend policy is particularly important.

**Shareholder consultation thresholds**

The draft SCI states that Solid Energy will consult Ministers if any capital expenditure “exceeds 25% of shareholders funds”. Based on the Business Plan’s forecast for shareholder equity of $499 million in 2008/09 this means a consultation threshold of just under $125 million.

In our view this threshold is too high, particularly in comparison with other SOEs, and needs to be reduced. We would also prefer two consultation thresholds – one for investments in Solid Energy’s core business, and a lower one for investments in non-core activities. This will necessitate a distinction between core and non-core business activities, as defined in the nature and scope of business, as discussed above.

We propose new consultation thresholds of $30 million for core business and $10 million for non-core business, which apply to any new transaction or series of
related transactions, including but not limited to capital investments and asset sales or acquisitions. These figures are approximately 6% and 2% respectively of Solid Energy’s expected shareholders funds in 2008/09.

For comparison, the consultation thresholds for other large SOEs are between 1% and 4% of shareholders funds for core business, and between 0.5% and 1.5% of shareholders funds for non-core business.

In dollar terms, the consultation thresholds for the three largest SOEs are between $60 and $120 million for core business. These companies are between three and eight times larger than Solid Energy, measured on the basis of shareholders funds. The consultation threshold for Landcorp Farming Limited is $15 million for core business and $5 million for non-core business, compared with shareholders funds of around $1,100 million.

It does not seem sensible to us for Solid Energy to have a dollar consultation threshold which is higher than the threshold for Meridian Energy Limited, or twice the threshold for Mighty River Power Limited and Genesis Energy Limited.

We acknowledge that Solid Energy’s current consultation threshold has been in place and accepted by Ministers for a number of years. However we are of the view that the threshold needs to be reduced, particularly in light of our comments above regarding nature and scope of business and gearing and dividend policy, and the forecast doubling of shareholder funds in the four years ending 2010/11.

In light of this forecast, we propose that the consultation thresholds are specified in dollar terms, and do not automatically adjust with changes in Solid Energy’s shareholder funds. The thresholds can be reviewed at regular intervals and adjusted if necessary.

**Commercial valuation**

We are concerned with the wording of Solid Energy’s estimate of the value of the Crown’s investment in the draft SCI.

The draft SCI states that “… the value of the Crown’s investment in Solid Energy is estimated to be $7.8B”. The draft then lists a number of opportunities and threats that may substantially affect this assessment, and concludes with the statement that these factors “are estimated to affect Solid Energy’s base value by -70% to +200%”.

This contrasts with last year’s SCI which stated “The current value of the business is the value that can be achieved with a high level of probability (but is not risk free) … this core commercial value is estimated at $450 – $500 million”.

In our view the approach taken in last year’s SCI is appropriate, and we would prefer a similar approach to be taken this year. Obviously the comparable figure in this year’s SCI will be considerably higher, given the uplift in coal prices and in Solid Energy’s forecast profits.

We note that the major component of the $7.8 billion estimate is the coal to liquids (CTL) project, which as your business plan states is speculative, requires very significant capital investment, and where a large portion of the value generated is...
beyond Solid Energy’s 20 year planning horizon. In addition, CTL has not yet been committed to, and has not been subject to shareholder consultation. Given these characteristics, we do not think it is credible to base the SCI’s commercial value estimate on the value potentially generated from CTL.

We have no objections to Solid Energy including an estimated commercial value from CTL in its SCI – in fact, given the potential value generated from CTL we think including such an estimate is important. However, given the nature of the CTL project the figure needs to be carefully explained, put in context, and with appropriate caveats around it.

This may mean the SCI presenting two (or more) commercial value estimates – the first based on last year’s approach of “the value that can be achieved with a high level of probability” (i.e. attributable to existing operations and/or extensions of those operations) and additional figure(s) taking into account future planned or speculative investments, such as CTL.

**Conclusion**

In conclusion, thank you again for providing a detailed and challenging business plan and SCI for shareholding Ministers’ consideration.

We would like the Board of Solid Energy to give careful consideration to our comments and provide us with a final draft of the SCI by 26 June 2008, for tabling in Parliament by the statutory deadline of 30 June 2008.

Yours sincerely

Hon Trevor Mallard

*Minister for State Owned Enterprises*

on behalf of Shareholding Ministers