The Treasury

Solid Energy Information Release

March 2013

Release Document

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[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

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[8] Information is out of scope or not relevant.

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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.
Treasury Report: Solid Energy Draft SCI and Business Plan 2010

Date: 7 July 2010  Report No: T2010/1239

Action Sought

<table>
<thead>
<tr>
<th>Action Sought</th>
<th>Deadline</th>
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<tr>
<td>Minister of Finance (Hon Bill English)</td>
<td>Send the enclosed letter to Solid Energy extending the time to submit its final SCI to 30 September and providing comment on the draft business plan.</td>
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<tr>
<td>Minister for State Owned Enterprises (Hon Simon Power)</td>
<td>Send the enclosed letter to Solid Energy extending the time to submit its final SCI to 30 September and providing comment on the draft business plan.</td>
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<tr>
<td>Associate Minister of Finance (Hon Steven Joyce)</td>
<td>Note contents of report</td>
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</table>

Contact for Telephone Discussion (if required)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Telephone</th>
<th>1st Contact</th>
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<tbody>
<tr>
<td>Andrew Blazey</td>
<td>Manager, Crown Ownership and Monitoring Unit</td>
<td>[1]</td>
<td>✓</td>
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Minister of Finance’s Office Actions (if required)

Once signed by the Minister of Finance please forward to Minister for State Owned Enterprises for signing.

Enclosure: Yes [Attached]
7 July 2010

**Treasury Report:** Solid Energy Draft SCI and Business Plan 2010

Executive Summary

On 1 July a revised SCI and business plan was received from Solid Energy (SEL). COMU recommends that Ministers do not support the tabling of SEL's SCI in its current form as it:

- includes the introduction of external equity; and
- effectively includes a 'no dividend policy', with insufficient evidence being provided on the value of its proposed investments.

We propose that you extend the deadline for Solid Energy to deliver its final SCI and business plan until 30 September 2010.

Recommended Action

We recommend that you:

a. **note** the SCI includes external equity investment in 2013 of $250 million and the suspension of dividend payments from 2010, which would not resume until 2019;

b. **agree** that the SCI is not acceptable to table in the House in its current form;

<table>
<thead>
<tr>
<th>Agree/disagree.</th>
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<tr>
<td>Minister of Finance</td>
<td>Minister for State Owned Enterprises</td>
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c. if you agree with b, **sign** the attached letter extending the deadline for Solid Energy to submit its final SCI to 30 September; and

d. **refer** a copy of this report to the Prime Minister.

<table>
<thead>
<tr>
<th>Referred/not referred.</th>
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Andrew Blazey  
Manager, Crown Ownership and Monitoring Unit  
for Secretary to the Treasury

Hon Bill English  
Minister of Finance

Hon Simon Power  
Minister for State Owned Enterprises
Treasury Report: Solid Energy Draft SCI and Business Plan 2010

Purpose of Report

1. The purpose of this report is to provide you with a letter of response to Solid Energy (SEL) on its proposed SCI and Business Plan. The letter extends the time period for SEL to meet your expectations in relation to these two documents.

Analysis

2. SEL delivered a draft SCI and business plan to shareholding Ministers on 30 April 2010, however the draft business plan did not include the three year forecast financial statements.

3. SEL advised that it was unlikely that forecast numbers would be available until mid-June. Shareholding Ministers provided SEL with an extension to deliver the final SCI on or before 31 July 2010.

4. On 1 July a revised SCI and business plan was delivered to COMU. Upon reviewing the material, the documents contain significant issues, including:

- the potential significant capital funding;
- the commercial robustness of the future investments;
- the current commercial valuation and gearing; and
- the revised dividend, and dividend policy, and forecast external equity investment in 2012.

Potential significant capital funding

5. SEL has included in its business plan total capital expenditure over the next three years of $970 million. The expenditure includes extensions to the existing coal operations of $508\(^1\) million and on renewable energy, biodiesel and wood pellets, of $67 million. This level of investment would effectively double the assets of SEL.

6. The below table, which includes many of SELs ‘New Energy’ projects, provides an indication of the project development stage, the Internal Rate of Return (IRR) and payback period. Although each project shows a good IRR it is important to note that the IRR and payback period are a function of forecast future prices.

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\(^1\) The investment is principally on the Stockton Plateau $245 million and Liverpool $91 million. Liverpool is currently at the pre-feasibility stage.
Table 1: Summary of Capital Expenditure

<table>
<thead>
<tr>
<th>Operation Project</th>
<th>Development Stage(^2)</th>
<th>Planned date of first production (fiscal year)</th>
<th>NPV $ millions</th>
<th>IRR</th>
<th>Discounted payback period (8%)</th>
<th>CAPEX 3 years ($millions)</th>
<th>Potential future investment</th>
<th>Long-run Marginal Cost</th>
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</thead>
<tbody>
<tr>
<td>Coal Seam Huntly</td>
<td>PAG4</td>
<td>2011</td>
<td>70</td>
<td>26%</td>
<td>9.1</td>
<td>27</td>
<td>Coal Seam Gas $60M (by 2013)</td>
<td>$6.90/GJ</td>
</tr>
<tr>
<td>Coal Seam Taranaki</td>
<td>PAG2</td>
<td>2012</td>
<td>265</td>
<td>27%</td>
<td>7.5</td>
<td>0</td>
<td>$5.17/GJ</td>
<td></td>
</tr>
<tr>
<td>Coals-to Liquid</td>
<td>PAG1</td>
<td>2017</td>
<td>11,230</td>
<td>25%</td>
<td>11.9</td>
<td>111</td>
<td>$6.7B (by 2020)</td>
<td>US$91/bbl</td>
</tr>
<tr>
<td>Coals-to Fertiliser</td>
<td>PAG3</td>
<td>2011</td>
<td>4,305</td>
<td>24%</td>
<td>10.1</td>
<td>0</td>
<td>$2.7B (by 2017)</td>
<td>US$475/t</td>
</tr>
<tr>
<td>Lignite Upgrading</td>
<td>PAG3</td>
<td>2011</td>
<td>303</td>
<td>21%</td>
<td>10.9</td>
<td>114</td>
<td>$515M (by 2016)</td>
<td>NZ$124/t</td>
</tr>
</tbody>
</table>

The commercial robustness of the future investments

7. Regarding future prices, SEL uses the global oil price to proxy the price of energy based commodities and has created three scenarios for future oil prices (base, high and low). These are used for its valuation and strategies for oil, coal, gas and biomass. SELs oil price forecast is below. The price growth forecast by SEL is bullish, even the base case assumption (middle line on graph) exceeds high growth path of MED and the International Energy Agency, which show the price of oil not exceeding $180 per barrel over the same period.\(^3\) All scenarios used by SEL also show price growth that is significantly higher than historic levels.

Figure 1: Solid Energy Forecast Oil Price

8. More conventional oil price forecasts would reduce the IRR, to potentially below project WACC (making the projects uneconomic), and increase the payback period of the projects. Before shareholding Ministers provide their support to any of the projects, we

\(^2\) The SEL Project Assessment Guidance (PAG) is a stage-gate approval process in which where the accuracy of the cost estimates will increase at each stage: 1. Desktop review; 2. Conceptual study; 3. Secondary assessment; 4. Pre-feasibility study; 5 Feasibility study.

\(^3\) Price Waterhouse Coopers were contracted by SEL to review its commercial valuation methodology and note “Solid Energy’s long term projections of the forward oil price, which is a driver of coal prices, is the high end of the range of long term oil price projections currently in the market place".
would first expect that SEL to test the feasibility of each project against more conventional oil price forecasts.\(^4\)

**Valuation and gearing**


10. The level of gearing has been calculated as total debt divided by shareholders equity. Calculating the gearing level based on the accounting measure of shareholder equity can be misleading particularly where there is a significant difference between the accounting measure of shareholder equity and the commercial value of the company. This is highlighted by SEL whose shareholder equity is $0.47 billion (2010) and its estimate of commercial value of $3.5 billion.

11. Re-calculating the level of gearing based on Solids own commercial valuation\(^5\) results in a gearing level of 5% 2010, 8% 2011, 12% 2012 and 20% in 2013 (assuming no external equity investment).

12. If SEL considers that $3.5 billion is a robust estimation of its commercial value then SEL should not have difficulty in sourcing further debt financing above the 2010 debt level of $180 million.

13. In addition to the level of gearing, the level of interest cover is another metric that should also be considered with regard to the appropriate amount of debt on the balance sheet. SEL forecasts the interest cover (EBIT/Interest) to move from 6.8 to 7.2 from 2011 to 2013. The level of interest cover for the BBB credit rating is in the range of 2.5 - 4.5 times EBIT depending on risk and firm size. Given the risks associated with SEL COMU’s preliminary view is that interest cover near to high end of the range is appropriate.

14. Both debt to commercial value, assuming the commercial valuation is robust, and the level of interest cover indicate that SEL could be further geared. Additional debt on the balance sheet is likely to provide greater financial discipline for SEL as it would need to convince bankers of the merits of its projects as well as shareholding Ministers.

**Revised dividend, and dividend policy, and forecast external equity investment in 2012**

15. In the 2009 SCI SEL targets a balance of debt and equity that achieves financial ratios consistent with a BBB credit rating and SELs dividend policy was to pay dividends consistent with maintaining a 35% gearing ratio projected one year ahead. The forecast dividends were $24 million 2010, $10 million 2011 and $28 million 2012.

16. Based on the target level of gearing of 35% and forecast capital expenditure SEL no longer plans to pay dividends until 2019. However, the level of gearing is just one factor that should be considered with respect to the dividend policy. Other factors such as the interest cover and the debt level compared against SEL’s commercial valuation, 5% in 2010 and increasing to 20% in 2013 (assuming no private equity investment), should also be considered. Potentially the SEL balance sheet could sustain a greater level of debt and dividend payments need not be suspended at present.

17. SEL has recently been the focus of media attention due to the Chair’s comments on the possibility of future privatisation to develop the potential of SEL. SEL has forecast the injection of external equity of $250 million in 2013.

\(^4\) Even if Ministers were confident in the Solid oil forecast, there are likely to be other lower risk ways the Crown might invest that would also what to be considered.
18. The actual future capital requirements of SEL will be dictated by the potential economic investments opportunities. Our view is that how the investment would be financed, be that debt or equity, is a second order question that does not need to be covered by the SCI without first determining the feasible investment opportunities.

19. The combination of debt and equity used to finance each project should be based on how the associated risks can most efficiently and effectively managed. This includes both the expected return and the volatility of the return, the need to bring in skills and technology, and the possible sources of funding.

**Next Steps**

20. Attached is a letter to the SEL Chair advising that the revised SCI provided on 1 July 2010 does not meet shareholding Ministers’ expectations and will not be tabled in its current form. The letter also provides SEL with an extension to provide a further revised SCI by 30 September 2010.
Dear Mr Palmer

STATEMENT OF CORPORATE INTENT

We are writing to you to extend the deadline for Solid Energy to submit its final 2010 Statement of Corporate Intent (SCI). The reason for the extension is that the revised SCI provided to the Crown Ownership and Monitoring Unit (COMU) on 1 July 2010 does not meet our expectations and will not be tabled in its current form.

The two principal reasons for our view on this matter are:

- introducing external equity is not consistent with this Government's current policies and as such will not be supported by shareholding Ministers; and
- as shareholding Ministers we are not prepared to support a suspension of dividends until the business case for each development project has been considered and approved.

Would you please provide an updated draft of the SCI to COMU by the end of August 2010 and following feedback from shareholding Ministers, deliver the final SCI on or before 30 September.

Yours sincerely

Hon Bill English
Minister of Finance

Hon Simon Power
Minister for State Owned Enterprises

cc: Don Elder  
Chief Executive Officer  
Solid Energy