The Treasury

Solid Energy Information Release

May 2013

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From: Juston Anderson
Sent: Friday, 5 October 2012 11:54 a.m.
To: John Crawford; Andrew Blazey; [4]
Subject: FW: Spring Creek - Solid Energy board paper
Attachments: Spring_Creek_Board_Report_21_September_2012.pdf

Categories: File in i-manage

FYI.

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From: Vicki Blyth [mailto:Vicki.Blyth@solidenergy.co.nz]
Sent: Friday, 5 October 2012 11:49 a.m.
To: Juston Anderson; ^AssocMoF: [4]
Subject: Spring Creek

This is the report that was released to the Grey Star, the Press and the EPMU on 25 September.

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21 September 2012

SPRING CREEK MINE

REPORT FOR THE BOARD OF DIRECTORS OF SOLID ENERGY NEW ZEALAND

PREPARED BY:

LARRY HULL
GROUP MANAGER COAL OPERATIONS

21 SEPTEMBER 2012

SPRING CREEK MINE

BACKGROUND

Spring Creek Mine is an underground mine located near Greymouth on the west coast of the south island of New Zealand. Spring Creek opened in 1999 and is one of two underground mines owned and operated by Solid Energy New Zealand.

Spring Creek is characterized by its excellent quality coal which is very low in ash and very low in sulphur. It has been successfully used as a blend coal to reduce the overall sulphur of some of the coal produced at Solid Energy's Stockton Mine.

However, the mine also has very challenging geology with numerous rock faults and steep grades. The seam is very thick (sometimes 40 metres or more).

HYDRAULIC EXTRACTION

Spring Creek is similar to most underground mines in that it uses two distinct mining methods – Development and Extraction (sometimes referred to as "retreat" mining). Development is simply a "necessary evil" to provide the mine with the essential roadways for ventilation, haulage of men and material, and, most importantly, to allow access to be able to "extract" the coal reserve. In the case of Spring Creek, development also includes the very expensive installation of pumping station(s) to accompany the hydraulic mining. Development is very slow and expensive and, on its own could not support a mine commercially. It is when the mine is able to extract coal that it becomes commercially viable.

Extraction at Spring Creek is very unique in that a water cannon is used to literally "wash" the coal down to a pump station for delivery to the surface. This type of mining is referred to as "hydraulic" and is very efficient and is particularly advantageous in very thick seams where maximum extraction would otherwise be difficult to achieve. The steep grades at Spring Creek make ideal conditions for hydraulic mining in extraction. Conversely, however, the steep grades make for very difficult and expensive mining in development.

THE CURRENT SITUATION

Spring Creek is currently in a prolonged period of development. This has resulted in cash costs that are now exceeding $100 million since its last extraction panel. Originally, the mine plan had called for extraction to begin in July 2012. Instead, that date has been delayed to at the earliest February 2013. **This additional time in development will cost the company tens of millions of dollars.**

In fairness to the employees at the mine, it must be noted that management and the workers (along with their union representatives) have worked diligently and together to try and devise a plan to keep the mine open. I have attached a PowerPoint presentation titled "**SPRING CREEK TEAM PROPOSAL"**. It is very important to note that this scenario results in **the mine closing at the end of FY 15** with associated redundancies, etc. This case is **very aggressive** and has an extremely low probability of success in my opinion. Mine management had presented a very similar case a few weeks ago and I had represented that, at best, it had a 10% probability (**P 10**). This new case is even **more aggressive** but since it also includes the input and approval of the team representing the hourly employees, I would give it a probability of max 20% (**P 20).**

RISKS

Included in this report as an appendix is a document titled **"Review of SC Team Option"**. This document covers senior management's review of various assumptions used and the risks associated with those assumptions.

Also, I would highlight additional points and/or risks that I feel are pertinent:

1) The mine has **failed to deliver** on a single plan submitted during its 12 year life. The geology at the mine is so severe and unpredictable that planning to any measure is very difficult.
2) The mine is already **53%** behind its budgeted development meters for the first two months of FY 13. The mine has encountered an unexpected rock fault which has increased the rock development required but the point is still that planning and reaching targets has proven to be impossible at this mine.
3) The mine always stands the risk of receiving a prohibition notice from the DoL. Spring Creek has received several of these in the past year, at one time idling the mine for several weeks. There is a very high probability (P 80 to P100) that one or more of these notices will be given during the period prior to extraction. This does NOT mean that the mine will necessarily do anything wrong. The DoL has been very aggressive on several occasions of late.
4) The average sale price of coal in the market may be much less than expected. Currently, spot prices are $30 or more per ton below those used in this case.
5) The mine is assuming an aggressive and optimistic date (end of January 2013) for the completion of the pump station. This date could easily slip 1 to 3 months or longer. Each month would mean another $6-8 million needed to begin extraction.

CONCLUSION

Spring Creek Mine will need a cash infusion of **at least** $27 million to close the timing gap to extraction at the end of January / first of February 2013. That is provided that the plan submitted by the mine happens perfectly which, as I have noted, is extremely unlikely. In my opinion, this number could easily become $50 million or more. The risks are very high.

RECOMMENDATION

My recommendation as Group Manager Coal Operations and a member of the Executive Leadership Team (ELT) would be to put **Spring Creek on Care and Maintenance**. Every indication is that the prices for coal will be very soft for some period of time. It has also become very evident that Solid Energy as a company will struggle with its cash position throughout FY13 and probably beyond. The team at Spring Creek has worked together to come up with a plan that could well set the stage for a "reset" to restart Spring Creek at a later date when prices have improved and the company's cash situation has been righted. Until then, I see no other alternative.

LARRY HULL

Review of SC Team Option as presented 21 September 2012

This is a summary review of the Option presented by Spring Creek Mine Management

Assumption	Comment
Revenue Assumptions **= HIGH RISK**	The forecast has applied both a SSCC revenue curve (Sourced from UBS) and current domestic off take expectations. Our observations are: • The UBS forecast should average $150/t NZD FOB for the 3 years for the SSCC price. The FY2013 number used in the analysis is incorrect (high by $13/t) • The mine has applied a full 32,000 tonnes of domestic sales in FY13 - FY15, which represents an annual sales amount. It is unlikely that this could be achieved given the pro-rated nature of these years and this may overstate the APR, specifically on some tonnes sold in the FY13 year by $45/t. • The scenario assumes that Spring Creek will receive SSCC pricing. Spring Creek needs Stockton coal to achieve SSCC pricing and given that Stockton is not producing SSCC currently (based on the pricing), it is a significant risk to assume that Spring Creek will receive this revenue benchmark instead of Thermal pricing
Mine plan observations **= VERY HIGH RISK**	• The geology risks remain high especially as there is a low level of knowledge around some of the areas that the mine will develop into and extract from. Within the last 6 months, two such events (where updated geological information has been developed) have impacted the mine plan (both negatively). • All panels remain fault bounded, with the fault between Panel 10/11 shown as discontinuous within the main heading panel take off area. This reduces flexibility to react to unplanned changes in geology • The mine plan will still have to manage the split zone (non-coal) identified within Panel 10 as has been the case for all scenarios. There is uncertainty around the definition of the split zone and the recoverable level of coal • Some roadway design gradients are on the margins of what can technically be developed. This reduces the flexibility to adapt the plan for geological variations (which happen)

Development Productivity Risks
 	
= MEDIUM / HIGH RISK
	• The plan presented, is expected to achieve higher level of development productivity than what is currently being achieved. It appears as if development activity under the scenario presented needs to be 30% more productive on a shift by shift basis than assumed in the budget. The ability for the site to achieve a significant increase in productivity over what has been experienced is unproven and history demonstrates that the operation will struggle here.
	• The mine schedule developed assumes there are no discrete risk events materialising and reducing utilisation and/or productivity (delay to first extraction coal). Over the last two years these have included:
	  • Prohibition Notices,
	  • Heatings,
	  • Industrial action,
	  • Suspension of operations,
	  • Turnover of critical staff
	  • Absenteeism impacting unit availability
	• The mine has underperformed on budget development expectations by nearly 50% over the last two years alone. As at August, the mine had achieved 47% of the FY13 budgeted level of development metres

Extraction **= LOW / MEDIUM RISK**	• The original budgeted mine plan/design assumed coal produced from Panel 11 would report to a second pit bottom as opposed to the plan now presented – this needs significant testing if this scenario is advanced further. Until very recently, mine management considered that this was impossible

	• No changes have been made to previously modelled/assumed extraction rates. These have not historically been a constraint on production
Cost risks (per month) **= MEDIUM RISK**	We have not been able to fully interrogate the cost development included in the Schedule. It is probable that the estimate does not include the full level of operating costs associated with running Spring Creek

This is a summary review of the Care and Maintenance option as proposed by mine management

Assumption	**Comment**
Cost risk: **= LOW RISK**	There will be some risks associated with the actual cost and time required to set the mine up for Care and Maintenance (necessary set up of ventilation circuits etc) but outside of this, there is a high level of certainty as to the actual costs associated with placing the mine on Care and Maintenance. Solid Energy will retain the option to close the mine
Capital and cost assumptions	None of the cost assumptions presented for Care and Maintenance have been fully reviewed and approved. Further, the plan assumes that $1m capital is required for Care and Maintenance, which does not appear to have any basis
Length of Care and Maintenance	The mine has assumed that SENZ would continue to fund C and M for at least 3 years. This is an untested assumption
Surplus assets	Neither scenario addresses any value associated with the disposal of surplus assets, which should be higher for the Care and Maintenance case versus the Team Option
Expectations of cost of care and Maintenance	The budgeted costs for Care and Maintenance still include the current senior management cost (mine manager) which would not be required for Care and Maintenance
Future Prospects	The Care and Maintenance option provides Solid Energy with significant future options for Spring Creek, included: - The opportunity to change the culture and management of the mine - The ability to conduct the necessary planning to improve mining certainty - Sale of a resource in a state untainted by operational performance - The ability for Solid Energy to assess the outcome of the Pike River Royal Commission of Inquiry Report.