Office of Hon Simon Power

MP for Rangitikei
Minister of Justice
Minister for State Owned Enterprises
Minister of Commerce
Minister Responsible for the Law Commission
Associate Minister of Finance
Deputy Leader of the House

2 8 MAY 2009

Mr John Palmer
Chair
Solid Energy Ltd
PO Box 1303
Christchurch 8140

Dear Mr Palmer

Draft Statement of Corporate Intent (SCI)

The purpose of this letter is to provide some preliminary feedback on Solid Energy Ltd's (Solid Energy's) draft 2009/10 SCI and business plan, prior to our scheduled meeting on 9 June 2009.

Not surprisingly, I am disappointed with the forecast decline in Solid Energy's financial performance over the next three years, in particular the dramatic decline in profitability and dividends. While this is understandable, given the significant decline in forecast coal prices, it is far from clear why Solid Energy forecasts

The government has a strong desire to improve the effectiveness and efficiency of its balance sheet. As the SOE portfolio represents a significant part of the Crown's balance sheet, I have given considerable thought recently as to the most direct and effective tools I have available to improve the governance, accountability and ultimately financial performance of SOEs.

Capital structure is one such tool. I would like all SOEs to increase their gearing from current levels, to a level more consistent with a BBB flat credit rating. I urge the Solid Energy Board to give serious consideration to this proposal.

I note that Solid Energy currently has a gearing target of 35%, including the company's rehabilitation liability as if it were debt. Given that the nature of the rehabilitation liability is significantly different from debt, I am sceptical that this is an appropriate treatment. I have asked my officials to engage with you on this issue.

I would also like to standardise and simplify the dividend policy for all SOEs, to ensure that a more consistent share of profits is returned to the Crown as

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shareholder. In this regard, I propose that there is a discussion about how best to achieve this at our meeting on 9 June.

Related to dividend policy, I wish to outline an expectation that all SOEs pay two dividends per year, an interim and a final dividend. Further, I expect that as soon as an SOE becomes aware that it is unlikely to be able to make a forecast interim or final dividend payment, it must promptly notify the shareholder and then make a public disclosure explaining the reasons why.

The adoption of these capital-related expectations is on the understanding that if Solid Energy is unable to fund a significant commercially-viable investment from its own cash flows or from debt markets, then it can seek an equity injection from its shareholder. A decision on equity funding will be made on a case by case basis, depending on the commercial merits of the proposal.

As you are aware, section 14(3) of the SOE Act 1986 requires that "each statement of corporate intent shall also include the board's estimate of the current commercial value of the Crown's investment in the group and a statement of the manner in which that value was assessed."

I wish to make my expectations around this clause explicit to all SOEs, because in my experience, most SOE boards fail to produce a credible commercial valuation every year. For the avoidance of doubt, my expectation is that a credible commercial valuation will be:

- based on a discounted cash flow approach (unless otherwise agreed to by CCMAU) and use a discount rate that reflects the company's expected cost of capital
- conducted every year
- based on the latest business plan forecasts
- subject to some external, independent scrutiny (eg over the key valuation assumptions) and/or completed by an independent external party
- transparently reported in the SCI, including the methodology used, key assumptions and major reasons for any valuation change since last year.

To assist SOEs to comply with the final bullet above, I have attached a model commercial valuation disclosure statement which I expect all SOEs to adapt for use in their respective SCIs.

I understand that the Solid Energy Board has commenced an independent commercial valuation of the company, and that this is due for completion in August. In the meantime, the commercial valuation in your draft SCI is based on the book value of Solid Energy's equity. This is not acceptable.

Solid Energy is aware of the requirements of section 14(3) of the SOE Act and the timing for delivery of a draft SCI. Solid Energy must in future, comply with the SOE Act and deliver its draft SCI, including a credible commercial valuation that is consistent with my expectations as outlined above, not later than 1 month before the commencement of its financial year. The use of the book value of equity is not an acceptable substitute for a commercial valuation.

However, I hereby grant Solid Energy an extension to submit its final SCI until 31 August 2009, to allow for inclusion of the independent commercial valuation currently being prepared.

Finally, I have the following specific disclosure-related comments on Solid Energy's draft 2009/10 SCI:

- financial ratio forecasts/targets – as a minimum, these should cover the profitability, efficiency, liquidity and solvency of the business. Specific additional measures that should be included in Solid Energy's SCI are:
    - a relevant productivity measure(s)
    - an Economic Value Added (or Shareholder Value Added) analysis, showing how well the company expects to perform over the forecast period, relative to the cost of the capital invested in the company
    - planned capital expenditure, per annum
- performance targets should, as a minimum: be clearly described and easily understood, be relevant to the company's objectives and (generally) demonstrate a material improvement in performance over the planning period
- performance targets should also provide a comparison with the previous year's forecasts, and provide an explanation for any material changes
- there should be an informative and objective commentary on the material industry-wide factors impacting (and/or expected to impact) on the company's strategy, forecast investment programme and financial performance over the planning period, with a particular focus on opportunities, risks and returns
- transparency of subsidiary companies – relevant performance targets should be provided for any significant subsidiary companies or joint ventures.

I encourage you to contact CCMAU if you have any short-term feedback on the expectations outlined above. I look forward to meeting with you on 9 June 2009.

Yours sincerely

Hon Simon Power
Minister for State Owned Enterprises
on behalf of Shareholding Ministers

cc: Hon Bill English, Minister of Finance

Attachment: Commercial Valuation Model Disclosure Statement for use in Statements of Corporate Intent

Example for the SOECorp Group

The Board's estimate of the current commercial value of the Crown's investment in the SOECorp Group is [$1.650 billion]. Key points about the manner in which that value was assessed are:

- The valuation was calculated as at [31 March 2009]
- The discounted cash flow (DCF) methodology was used to calculate a Net Present Value (NPV) of the entire SOECorp Group, including all subsidiaries, on an after-tax basis
- The DCF / NPV was based on the nominal (ie not inflation-adjusted) future cash flows set out in the SOECorp Group's 3-year business plan, with forward projections then also made about years 4 to 10, and a terminal value of [$500 million] was included in the terminal year. The growth assumption assumed in the terminal value was [X%]
- A discount rate of [X%] was assumed
- The valuation was prepared [internally by the SOECorp Group's finance team, and was externally peer reviewed by XYZ Corporate Finance Ltd], prior to approval by the Board
- Other material factors that are relevant to the determination of this valuation are [……………….]

The valuation compares with a commercial value as at [31 March 2008 of $1.545 billion]. The key reasons for the [increase] in commercial value are:

- [An increase in year 1 to year 3 cash flows of $X million due to changed expectations for the future price of x
- A reduction in year 4 to year 10 cash flows of $X due to…………………
- A reduction in the terminal value assumed of $X million due to……………….
- A change in the discount rate assumed from XX% to XX% because……………….]

These changes could be represented graphically in a waterfall (or similar type of) diagram.