

The Treasury

Solid Energy Information Release

June 2013

Release Document

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The Treasury

Review of Monitoring of Solid Energy Limited

19 April 2013

Final Report. This Final Report has been prepared for The Treasury on the terms set out in the Introduction and the limitations set out in Section 2.3.

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1. Executive Summary

1.1. Introduction

Deloitte has been engaged to undertake an independent review of the monitoring of Solid Energy New Zealand Ltd (“Solid Energy”).

All services are provided subject to the terms and limitations set out in this Report and the Contract for Services: Internal Audit Services, dated 28 July 2011.

This engagement was performed in accordance with the terms contained within our engagement letter dated 12 March 2013. Where Deloitte has provided advice or recommendations to the Treasury, we are not responsible for whether, or the manner in which, suggested improvements, recommendations, or opportunities are implemented. The management of the Treasury, or their nominees, will need to consider carefully the full implications of each of these suggested improvements, recommendations, or opportunities, including any adverse effects and any financing requirements, and make such decisions as they consider appropriate.

1.2. Background

Solid Energy is a State Owned Enterprise (“SOE”). Over the last year, with the deterioration in market conditions, Solid Energy has experienced major financial difficulties.

Treasury, as the Crown’s advisor to shareholding Ministers on SOE policy and performance is responsible for monitoring the financial performance and viability of Solid Energy. This includes evaluating; taking necessary action and keeping Minister(s) informed when risks to the Crown ownership interest are identified.

1.3. Review objectives

The objectives of the review are to gauge:

- How well Treasury applied its stated monitoring procedures and practices to the monitoring of Solid Energy; and
- Whether Treasury had taken all the necessary and reasonable steps to protect the Crown’s ownership interest in Solid Energy including ensuring that Ministers were kept fully informed of concerns and actions taken.

1.4. Findings and recommendations

We have structured our key findings under the following key questions which were asked of us in the scope:

Did Treasury do all that was reasonably expected (and sufficient) given the information it had and the options available to it?

There is no straight forward answer to this question. Treasury early on identified a fundamental divergence of views between Treasury and the Company with respect to future energy prices. Treasury also identified the link between the Company's view on future energy prices, its investment strategies and its own internal views on valuation. These concerns were advised to Ministers and played back to the Company.

With hindsight it is clear that the Company's view on price path led to strategies for the business that materially increased risk. The strategies resulted in material value at risk in relation to core mining and development activities, high debt and an overhead structure – all of which meant the Company was poorly placed to cope with the massive price shock that it faced in 2012. For Treasury to have fully identified the extent of this risk it would have had to have either undertaken materially more analysis of the Company and its plans and would almost certainly have had to commission outside industry expertise to address some of the more complex technical matters such as mine plans and forward views on energy prices.

Further action by Treasury would have had to have involved a material elevation of concerns over price path assumptions and strategy. Given the extent of the gap that existed between the company's view of price path and the market's consensus view - a change of management would have been highly likely as a consequence of such an elevation. Depending on the subsequent Board response to a management change a change to the Board may have resulted also. Such an elevation would have had to have been initiated against a backdrop of a Company that was generally regarded as being well led and governed, was performing well financially, and which more often than not had been proven right with respect to its core planning assumptions in the short term.

What was the quality and timeliness of advice to Ministers and what evidence was there that the advice was considered and taken up?

Treasury identified the key areas of concern and advised these concerns to Ministers within reasonable timeframes. As noted above the key question is whether Treasury fully investigated or appreciated the implications of these concerns with respect to the risk of the Company. Treasury identified the Company's view on price path – and the actions stemming from this – as a cause for concern rather than alarm and Ministers acted accordingly.

What further action (earlier or otherwise) could Treasury have taken with the information it had and the advice it provided to Ministers?

Having identified the Company's views on price path and resulting strategies as a cause for concern Treasury could either have insisted that the Company provide substantive support for its views on price path and a risk assessment for the Company in the context of its chosen strategies or have initiated its own, detailed investigation with appropriate external support to fully identify the implications of the Company's strategies.

We note that external valuation advice for Solid Energy was commissioned in 2010 that did contest the Company's view on value, primarily due to differences in view on price path. Similarly, the UBS scoping study completed in November 2011 also contested the Company's views on price path and more fully identified the implications of these views with respect to cost structure, gearing and value. We note that while this independent advice did contest assumptions central to the Company's views on strategy and value, none of these processes called into question the underlying viability of the Company because none anticipated the collapse in coal prices that occurred in 2012.

Given key market or organisational events/drivers affecting Solid Energy's performance and viability, could Treasury have done something differently to manage risks to the Crown?

As noted had Treasury more fully appreciated the implications of the Company's view on price path it could have initiated a more substantive investigation earlier – probably as an outcome of the 2008 SCI process. Assuming that this investigation was undertaken to a sufficient level of detail and competence it is most likely that this would have caused Treasury to elevate concerns to Ministers to a point that Company's SCI was rejected. As discussed above a consequence of this would most likely have been a change to the leadership of the Company and possibly a change to the composition of the Board. We note, however that at that point many of the investment activities were in progress and any new management team or Board would have needed to develop and implement new strategies for the business which would have had their own risks given the nature of Solid Energy's business.

While Treasury could have done things differently and had it done so outcomes may have been different it is questionable as to whether it is reasonable to expect Treasury to have done so. While there were concerns identified with respect to the Company's plans and attitudes fundamentally the Company had performed well under its leadership and governance arrangements. For Treasury to have initiated fundamental action would have required it to effectively form the view that it lacked confidence in a Board and executive with a sound track record in a technically complex industry. The removal/refreshment of a Board by Ministers is a crude lever and has a high threshold for use. Notwithstanding this, with the benefit of hindsight, it is evident such a move may have been warranted. However, as discussed the outcome of such a decision would have had its own set of risks.

Concluding comment

We do not believe that the failure of Solid Energy has highlighted a material failure in Treasury's monitoring processes. We do believe that the failure does raise questions about how these processes are applied and whether Treasury's response was forceful enough or occurred soon enough given that the Company provided cause for concern over an extended period. However, there were influential countervailing factors that Treasury needed to consider when determining its response to issues identified.

Treasury is required to monitor a broad range of complex businesses each with different characteristics and risk profiles. It is unrealistic for Treasury to intensively monitor all of these businesses all of the time. Rather, it needs to be able to focus its resources on areas of greatest risk and need and to solve problems identified based on the specific circumstances in each instance. This requires that Treasury:

- Takes a portfolio approach whereby it identifies which entities require particular attention at which point in time;
- Looks for early indicators that current assessments of an entities status may need to change;
- Applies judgement to determine which set of tools to apply in circumstances where concerns about an entity are proven to be justified;
- Think laterally about the avenues available to it to influence change where this is needed and conventional processes are not resulting in a satisfactory response by the SOE to the concerns identified; and
- Ensures that areas of concern, where these are material, are not allowed to persist.

1.5. Management Response

The Treasury accepts the report and agrees that it offers a balanced view of the Treasury's monitoring activity in the period under review, and accurately sets out the evolution of the monitoring approach over that time.

We welcome the important findings that Treasury identified the key areas of concern and advised ministers within reasonable timeframes, and that there was not a material failure in Treasury's monitoring processes. We agree that reinforcing the proper operation of SOE governance and accountability are key aspects of the monitoring process. We also concur with the view that monitoring needs to be prioritised across the portfolio, be well informed, takes account of the industries in which the SOEs operate and the risks they face.

We do note however, the question around whether we could have taken a stronger stance on the company's strategy given our concerns, and undertaken further work. These are always difficult judgements to make, and as has been highlighted, the environment at the time can have an important bearing on those judgements. In particular seeking to replace a company's Board is a significant decision for which there is a high threshold and uncertain outcomes.

The Treasury is undertaking a programme of work to design ways to more actively manage the Crown's interest in a broad range of its assets, including the State-Owned Enterprise portfolio. This work commenced prior to the situation with Solid Energy becoming critical; however, as we implement this work programme, the lessons from the experience with Solid Energy will offer important insights.

The work programme includes a number of actions that are similar to the recommendations in this report, including formalising interaction between monitoring and appointments staff in, reviewing governance, accountability and incentives for Boards, use of external expertise, and the tools available to support Treasury's monitoring role.

As part of implementing the work programme we will report to the Treasury's Executive Leadership Team, and to Ministers, on how we are taking forward each of the recommendations in this report.

1.6. Report clearance

The contents of this Report have been discussed and agreed with Vicky Robertson (Deputy Chief Executive), John Crawford (Deputy Secretary, Commercial Transactions), Andrew Turner (Deputy Secretary, COMU) and Gary Taylor (Risk Advisor).

1.7. General Distribution Disclaimer

This Report is provided solely for the exclusive use of the Treasury for the purpose of determining if Treasury processes were followed and all reasonable steps taken in the monitoring of Solid Energy. Our report is not to be used for any other purpose, recited or referred to in any document, copied or made available (in whole or in part) to any other person without our prior written express consent. We accept or assume no duty, responsibility or liability to any other party in connection with the report or this engagement, including without limitation, liability for negligence in relation to the factual findings expressed or implied in this Report.

1.8. Statement of Responsibility

This Report has been prepared in accordance with our letter of engagement. As a member of the New Zealand Institute of Chartered Accountants, all work performed by Deloitte is subject to the Accounting Professional and Ethical Standards, which include requirements in the areas of ethics, independence, documenting the terms of the engagement, and quality control.

The procedures that we have undertaken do not constitute an assurance engagement in accordance with New Zealand Standards for Assurance Engagements, nor do they represent any form of audit under New Zealand Standards on Auditing, and consequently, no *assurance conclusion* or *audit opinion* will be provided

2. Introduction and Scope

2.1. Context

Solid Energy is a SOE which over the last year with the deterioration in market conditions has experienced major financial difficulties. On 21 February 2013 Solid Energy publicly announced it was in discussions with banks and Treasury on the debt and equity support required for future operations of the business.

Treasury as the Crown's advisor to shareholding Ministers on State Owned Enterprise policy and performance is responsible for monitoring the financial performance and viability of Solid Energy. This includes evaluating; taking necessary action and keeping Minister(s) informed when risks to the Crown ownership interest are identified. Since announcements of Solid Energy's difficulties there has been substantial interest in the cause of this financial distress and in particular the adequacy of Treasury's monitoring of Solid Energy.

2.2. Terms of Reference

Treasury has requested that Deloitte undertake an independent review of Treasury's performance in the monitoring of Solid Energy including:

- How well Treasury applied its stated monitoring procedures and practices to the monitoring of Solid Energy; and
- Whether Treasury had taken all the necessary and reasonable steps to protect the Crown's ownership interest in Solid Energy including ensuring that Ministers were kept fully informed of concerns and actions taken.

As a result of reviewing the above, Deloitte has also been requested to provide a view as to whether Treasury's current financial monitoring procedures and practices were sufficient to meet the stated purpose/objective of Treasury's SOE monitoring function. The purpose/objective is stated in the key accountability documents. A full terms of reference including areas out of scope is included as Appendix 1.

The review covered the period from January 2006 to January 2013 ("the Review Period").

2.3. Limitations

Our review covers a period of over 7 years. Over this period there have been a number of organisational restructures and a number of staff involved in the monitoring of Solid Energy are no longer employed at Treasury. There is likely to have been literally hundreds of communications between Treasury, Ministers and the Company in the form of formal and informal written communication and various meetings in person. Despite our terms of reference stating that all documents held by Treasury and all staff involved in monitoring Solid Energy are in scope, it is neither possible nor practical to attempt to cover all of these areas.

We have instead focussed our review on the written formal communications to Ministers and supporting documentation and reports. We have supplemented information and insight obtained through our document review by interviews with relevant Treasury staff. These people have had various responsibilities in the monitoring of Solid Energy and have directed us to additional areas of supporting information where appropriate.

Our findings are therefore limited on the basis that:

- Our document review was limited to specific documents used in the monitoring process. For example we did not review every business plan and SCI but selected specific documents to review. We had limited access to emails and informal minutes from meetings; and
- A number of the points raised in interviews may not have been substantiated in their entirety through the document review.

We also note that we have had no discussions with current or past members of the Solid Energy Board or management team. Further, we have not undertaken a detailed investigation as to the reasons behind the material deterioration in Solid Energy's financial performance and position.

3. Approach

In undertaking a review of the monitoring of Solid Energy we applied the following approach:

Establish the governance and accountability framework

With reference to relevant legislation, documented guidance and discussions with Treasury staff we have confirmed our understanding of the governance and accountability framework within which Treasury's monitoring of SOEs is undertaken

Establish key features of the monitoring process

Through discussions with Treasury staff and reference to relevant guidance we established the key components of the processes applied by Treasury to monitor SOEs

Monitoring in the context of Solid Energy

We reviewed the actual events that unfolded with respect to Solid Energy and reviewed what monitoring processes were applied and assessed how well these were applied in this context. This process involved:

- Review of relevant documentation;
- Discussions with relevant Treasury staff.

Formulate recommendations

Based on the analysis undertaken we have assessed whether there are lessons to be learned from the Solid Energy experience with respect to either:

- Process; or
- How processes are applied.

Response to Key Questions

We have also used our analysis to answer four key questions being:

- Did Treasury do all that was reasonably expected (and sufficient) given the information it had and the options available to it?
- What was the quality and timeliness of advice to Ministers and what evidence was there the advice was considered and taken up?
- What further action (earlier or otherwise) could Treasury have taken with the information it had and the advice provided to Ministers?
- Given key market or organisation events/drivers affecting Solid Energy's performance and viability, could Treasury have done something different to manage risks to the Crown?

4. Background

4.1. Solid Energy

Solid Energy's core business is the mining of coking coal for export markets and thermal coal for New Zealand Steel, Huntly power station and a number of domestic industrial customers. Solid Energy has also invested in technology to develop energy forms such as underground coal gasification ("UCG"), coal seam gas ("CSG") and Southland's lignite resources.

Solid Energy has a history of being a turnaround story. State Coal Mines was the predecessor to Solid Energy and ran for many years as a Government trading enterprise until 1987. In 1987 SOE's were established and Coal Corporation of New Zealand ("Coalcorp") was incorporated as a private company. It purchased a large part of the business of State Coal Mines. In 1996 Coalcorp as it had become, was rebranded as Solid Energy. Coalcorp inherited many of the liabilities and assets of State Coal Mines. In 1999 Coalcorp underwent a period of financial distress and in 2000 Solid Energy's CEO, was bought in to wind up the Company. Instead the Company was restructured and turned around into Solid Energy. Over the Review Period until 2012, Solid Energy significantly increased its total revenue and generated reasonable levels of profitability that were used to underwrite a strategy of diversification.

Business Strategy

Prior to 2005 Solid Energy's core business was the extraction of coal for domestic and export markets. In 2005 Solid Energy began a strategy of diversification into other non-core business activities. This diversification included two key streams of development; "New Energy" and "Renewable Energy".

Coal

Throughout its history Solid Energy has continued to develop its core mining business. During the period 2006 to 2012 Solid Energy incurred substantial expenditure to develop and upgrade its core mines. Over the period 2010 to 2012¹, capital investment in coal activities totalled circa \$350 million (circa 78% of total capex excluding land purchases). Significant investments over the Review Period include:

- Acquisition of New Vale Open Cast mine in 2006;
- Capital expenditure at Stockton, including the [2], [5] washing plant;
- Capital expenditure at Spring Creek, including the purchase of Cargill stake in 2012 for circa [2], [5] and
- Purchase of the assets of Pike River Coal in July 2012 for \$7 million.

¹ This breakdown is based on publically available information. Prior to 2010 capital expenditure was reported as an aggregate figure.

New Energy

Solid Energy's New Energy strategy included a plan to use the significant lignite resources of Southland to provide additional revenue streams other than from traditional coal mining. Lignite is a low quality resource and in itself has little export value. Solid Energy believed that with the use of technology it was possible to increase the value of the resource, effectively generating substantial value. As an enabler for this strategy Solid Energy purchased large tracts of land in Southland which provided it access to lignite resources.

The technologies which would support the strategy included:

- Briquetting: a process whereby the moisture is removed and the lignite compressed into a product suitable for sale;
- Coal to Fertiliser ("CTF"): this uses a technology of gasification to convert lignite to a number of products including ammonia; and
- Coal to liquids ("CTL"): several different processes are being explored which would allow lignite to be converted into liquid transport fuels.

Following on from the purchase of lignite containing land in 2005 – 2007, Solid Energy began in 2007 investigating UCG. In 2004 Solid Energy commenced investigations into CSG in Taranaki and Huntly. The Huntly development included a pilot plant for both UCG and CSG both of which operated successfully.

Renewable Energy

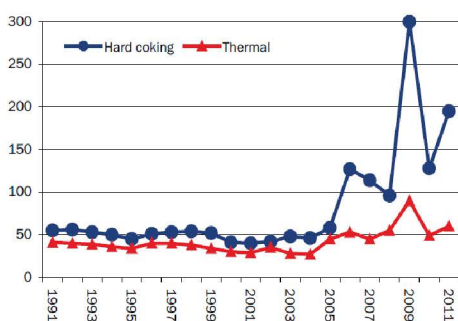
In 2003 Solid Energy acquired the business of Natures Flame which is a wood pellet business primarily geared for the export of wood pellets to the European market. In 2007 the Renewable Energy business was expanded into the biodiesel market with the acquisition of Canterbury Biodiesel.

4.2. Financial performance summary

Coal price volatility

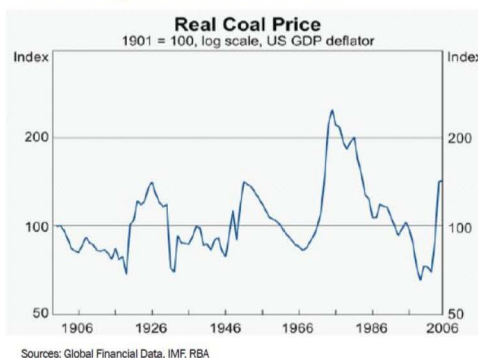
Solid Energy is a business that is exposed to significant volatility in earnings as a result of movements in underlying commodity prices for export markets and movements in exchange rates. There is a diverse range of views on forward price paths for coal but what is evident looking at historical trends is that despite more recent volatility in prices over the long run there has been little upward movement in real prices. The following two charts sourced from the Forsyth Barr 2010 independent valuation of Solid Energy show this trend and recent volatility in prices.

Chart 4. Coal Prices (US\$/tonne)



Sources: ABARE, Bloomberg, IRESS

Chart 5. Long-Term Real Coal Price Index



Sources: Global Financial Data, IMF, RBA

Financial performance snapshot (2006 – 2012)

The following table outlines key performance indicators for Solid Energy over the Review Period to June 2012 based on public information. Financial information to 31 December 2012 is not yet available in the public domain.

Solid Energy - financial snap shot

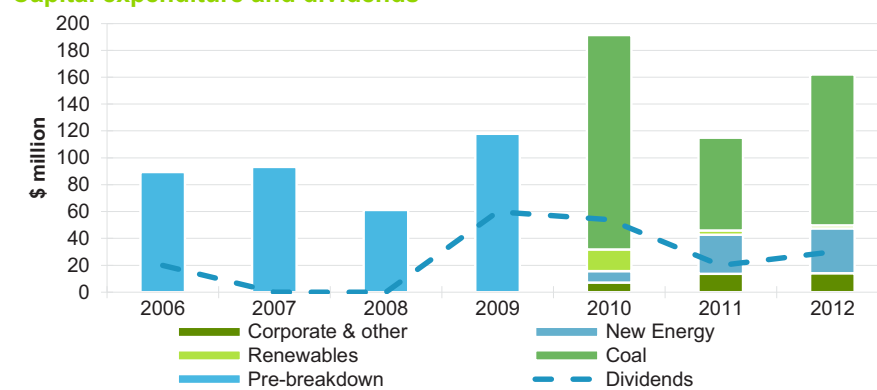
12 months ending 1-Jun	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	Total
Coal sold ('000s of T)	4,670	4,800	4,500	4,000	3,800	4,100	4,600	30,470
Average price per tonne (NZ\$)	122	116	123	245	182	202	213	169
Financial performance								
Total revenue	570	556	552	980	690	829	978	5,155
Gross profit	222	144	97	383	142	174	163	1,325
EBITDA	168	152	86	340	142	170	204	1,263
EBIT	131	125	43	291	95	117	72	875
Net income	86	96	35	111	68	87	(40)	443
EBITDA margin	29.5%	27.4%	15.6%	34.7%	20.5%	20.5%	20.9%	
NPAT margin	15.1%	17.3%	6.4%	11.3%	9.8%	10.5%	(4.1)%	
Cashflows								
Cash from operations	94	114	41	147	86	129	142	753
Dividends	20	-	-	60	54	20	30	184
Capex	89	93	61	118	177	118	166	822
Cash before financing	(15)	21	(21)	(31)	(145)	(9)	(54)	(252)
Balance sheet								
PP&E	215	280	338	425	546	613	677	
Debt	65	29	46	75	225	236	313	
Equity	234	342	368	434	443	519	423	
Gearing	21.6%	7.9%	11.2%	14.7%	33.7%	31.3%	42.5%	
EBITDA / Interest	62.2x	31.6x	21.1x	172.8x	31.9x	15.2x	14.7x	

Source: CapitalIQ, Deloitte analysis

For the purposes of our review any assessment of the quality of Treasury performance and financial analysis is out of scope. However to understand the context of decision making of Treasury and Ministers it is worth considering high level financial performance and position. Key movements/trends across the period are:

- Total revenue increased 72% from \$570 million in FY06 to \$978 million in FY12.
- The revenue increase was achieved on a similar volume of coal sales and while there was a dip in sales through FY09 and FY10, sales volumes averaged 4.3 – 4.5 million tonnes.
- Increasing average sales price from around NZD\$120/tonne to circa \$200/tonne is the primary driver of increased revenue.
- FY09 saw record revenue due to the record international coal prices achieved in the first five months of the year with hard coking coal at US\$300/tonne. This did not feed through to profit, as by January 2010 prices had fallen below US\$100/tonne and shipments were being delayed or cancelled by customers.
- Despite revenues increasing EBITDA margin has fallen from around 30% in FY06/07 to 21% for FY10 – FY12. We understand the key drivers for this are increasing coal production costs and increasing costs for new energy and renewables activities.
- In FY12 despite strong cash flows from operations as a result of reducing coal prices there were a number of impairments which resulted in an after tax loss of \$40 million.
- Despite reasonable growth in operating cash flows (excluding FY08), capital expenditure over the same period increased substantially. The chart below shows capital expenditure over the same period. A breakdown of capital expenditure is not shown for the years FY06 to FY09 for FY10 to FY12 where it is available the breakdown shows the dominance of coal investment and the growing cost of the strategy of diversification. It should be noted this does not include head office and project costs related to New and Renewable Energy projects which were expensed.

Capital expenditure and dividends



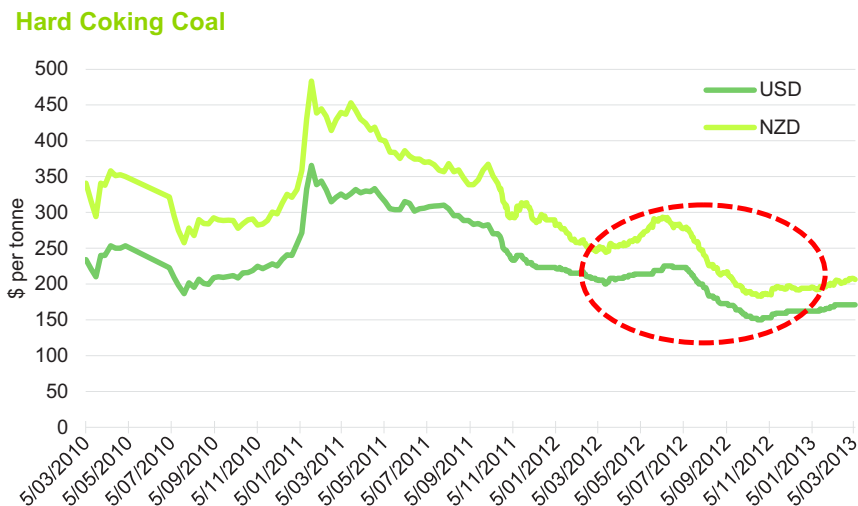
Source: CapitalIQ, AR, Deloitte analysis

- Dividend payments have been inconsistent with no dividends paid in FY07 and FY08 despite material amounts of capital expenditure.
- Dividends over the 7 year period were \$184 million compared to capital expenditure of \$822 million.

- Cash flows from operations were positive over the 7 year period (amounting to some \$659.8 million).
- Before cash flows from financiers, cash flows over the period have generally been negative, primarily due to the level of investment funded. The result has been that this cash deficit has been funded from drawdowns of debt.
- Excluding FY06 where debt was mainly short term, gearing has increased substantially from less than 10% to 42.5% in FY12.

4.3. Solid Energy distress

From the start of the 2011 calendar year until March 2012 prices for both hard coking coal (“HCC”) and thermal coal have been in a reasonably constant state of decline as shown by chart below. In February 2012 Solid Energy noted in its results announcements for the 6 months to 31 December 2011 that the business was facing challenging times but was maintaining underlying operating cash flows.



For the 6 months from January to June 2012 prices for HCC were reasonably stable at around US\$200 - US\$220/tonne.

A confidential memo prepared by Solid Energy on 27 April 2012 set out the following discussion² regarding issues the Board should consider when setting its FY13 budget:

- *“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 Semi HCC/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*

² The selected sections included below have been extracted verbatim.

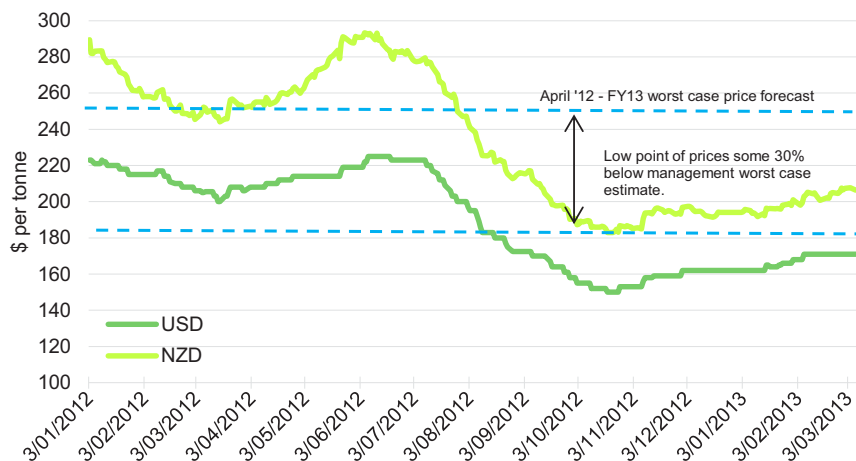
- We have \$280M of debt and our gearing is 37% today. While we have substantial bank facility head room we cannot access this (at reasonable gearing) without increased equity.
- We have little market information to confirm we are at the price floor, and little information to support an outlook of a price rebound in the next 6-12 months or possibly longer”

The memo presented a number of financial scenarios depending on where the price path for FY13 settled. Without any significant management response (i.e. production/cost cutting) the NPAT impact of market pricing as it stood in April 2012 was to reduce FY13 NPAT forecasts from a budget of [2], [5] to a loss of [2], [5]. On the same basis operating cash flows were to decline from [2], [5] forecast for FY13 in 2011 to a deficit of [2], [5]

Management noted that a number of initiatives were commenced early on in 2012 to cut costs and production. They estimated that these would improve FY13 forecast NPAT to [2], [5] and operating cash flow to [2], [5]. To prepare these updated estimates management used an estimate of export prices for FY13 – FY15 which assumed that prices for hard coking coal would rise very slowly through FY13 from a low of NZ\$250/tonne and continue rising through FY14-15. It was noted there was more downside in the forecast than upside. The worst case scenario (which we have not seen the financial forecasts for) was for prices for HCC to stay at NZ\$250/tonne with no price rebound in FY13 and a slight rise in FY14-15.

Unfortunately as shown in the chart below, after a brief rally from April 2012 to June 2012 from the start of July 2012 prices began to fall. By the start of November 2012 prices had fallen circa US\$110/tonne (40%) from June 2012 and were around NZ\$70 below managements worst case estimate. Crudely we estimate this corresponded to a cash loss on 6 months of sales of between \$100 million - \$150 million below management worst case.

Hard Coking Coal



In August 2012 Solid Energy announced through continuous disclosure that it was reviewing all aspects of its business in response to the extremely challenging market conditions. In addition the CEO stated that the industry consensus was that the market bottom remained some way off. The Company at that time estimated that the impact on revenues as a result of the fall in demand and prices was about \$200 million in the FY13 year.

Finally in February 2013 the Company announced that “despite some modest recovery of international coal prices from a low of around US\$140 per tonne in September 2012 - (down from US\$224 in June 2012 and a high of US\$350 in January 2011) – the Company expects any sustained recovery will be prolonged”. In addition it noted that it was in discussions with banks and the Treasury on a restructuring and turnaround plan to provide a sustainable business in the future.

5. Establish Model Components

5.1. Establishment of COMU

5.1.1. Structural Changes

Prior to 2009 the Crown Company Monitoring Advisory Unit ("CCMAU") existed as a semi-autonomous unit of the Treasury. In 2009 it was fully absorbed into the Treasury and its SOE monitoring functions were transferred to the Crown Ownership Monitoring Unit ("COMU") of the Treasury. We understand that prior to 2009 the Treasury provided a contestable process to CCMAU, providing its own views and advice to the relevant Ministers.

In 2007 there was a restructuring project at the Treasury called "Stepping Up" which involved a general watering down of the policy and SOE monitoring functions of the Treasury.

In November 2009 CCMAU was aggregated into the Treasury with the view that there were benefits in aggregating the monitoring functions. This included an aggregation of sector expertise and access to policy advice and other functions provided by the Treasury.

Processes captured in the Owner's Expectation Manual ("OEM") were originally written by CCMAU and the Treasury in 2002 with input from relevant Ministers. It was designed to document in a single place the arrangements for companies and entities monitored by CCMAU with an emphasis on SOEs. It was updated in 2007 and a Briefing to Incoming Ministers in November 2008 noted that there were no fundamental changes in the expectations of Ministers over the years. The OEM was updated again in 2012 for changes that occurred between 2008 and 2012.

5.1.2. Key changes from 2008 to 2012

The following is a brief discussion of the key changes implemented across the period 2008 to 2012. These have been compiled from our document review and through the interviews we conducted.

- Increased focus on continuous disclosure. In 2009 shareholding Ministers introduced a regime for the nine largest SOEs to keep the public informed on matters that could have a material effect on an SOE's commercial value. We understand this was extended to all SOEs from 2012.

- In 2010 there was a move from an assist relationship with the executive to an assess relationship with the Board. And a move from a narrow “performance against plan” focus to a broader performance focus supported by benchmarking and increased public scrutiny of performance. This led to the following changes:
 - Placing the Board at the centre of the monitoring approach. Involving greater interaction with the Board, COMU meeting with Board Chairs two to four times a year
 - Quarterly reporting on historic performance to also include a forward view of planned performance levels
 - Greater formality around key interactions between the entity and COMU
 - Introduction of annual general meetings with the opportunity for shareholding Ministers to attend
 - COMU periodically commissioning independent valuations
 - COMU undertaking benchmarking of key companies against peers
 - COMU seeking more external advice
 - Standardised performance measures developed for reporting
 - Boards providing information on the outcomes of past investments through formal post investment reviews (“PIRs”) (from 2011)
 - COMU prioritising its monitoring efforts based on the entity’s size, complexity and difficulty of current issues
 - Increased information available to the public via COMU’s website to enhance transparency and accountability. Includes individual SOE performance and annual portfolio report (November 2010 first annual portfolio report).
- We understand that COMU wrote to all SOE’s in 2010 notifying them of the key changes noted above.
- In 2010 the Minister’s expectations letter set out a desire for boards to modify dividend policies to become more commensurate with listed peers as well as more consistent pay-out levels and improvements in pay-outs over the years.

5.2. Mixed Ownership Model

The Government has been pursuing the mixed ownership model (“MOM”) agenda since late 2010. Following re-election in late November 2011 the monitoring functions undertaken by COMU for Solid Energy and the other MOM entities were transferred to the specially formed Commercial Transactions Group (“CTG”) within the Treasury which is responsible for readying the companies for mixed ownership.

The role of the CTG was in all respects the same as COMU in so far as the core monitoring activities and the Appointments and Governance (“A&G”) team continues to support CTG in its Board appointments. The exception was an increased level of contact with internal and external advisors in preparation for the partial sale and public listing. Also key personnel in CTG previously worked in COMU and were aware of the issues associated with the companies transferred into CTG.

We understand that Solid Energy was transferred into the CTG in late October 2011 which was around the time that the Scoping Study undertaken by UBS was released. Despite the cross-over in responsibility from COMU to CTG we understand that CTG was very much involved with the oversight of Solid Energy throughout of the scoping study period.

5.3. SOE and Companies Act

SOEs were established under the State Owned Enterprises Act 1986 (“SOE Act”). As registered companies they are bound by the requirements of the Companies Act 1993 (“Companies Act”). They differ to other Crown entities because they provide services directly to the public and are subject to the same market conditions as any competitor. The primary purpose of an SOE as defined in the SOE Act is to be as profitable and efficient as comparable businesses that are not owned by the Crown. The specific purpose of an SOE is described in its Statement of Corporate Intent (“SCI”).

As owners of SOEs the Government manages its investments for the benefit of all New Zealanders. Under the SOE Act, the shareholding Ministers are responsible to the House of Representatives for the performance of the functions provided under the Act and any rules of the SOE. The shareholding Ministers’ monitoring role is similar to that undertaken as an equity owner in private companies. There are a number of issues faced by the shareholding Minister that differ to a private sector equity owner including:

- SOEs do not have a share price that can be used to monitor company performance (similar to privately held companies);
- The shareholding Minister cannot divest themselves of ownership; and
- Additional public scrutiny.

Because of these issues the Minister requires timely and relevant performance information. The SOE Act gives the Minister certain powers over and above ordinary shareholders. Powers and requirements under the SOE Act include:

- The SOE providing a SCI which is tabled in the House of Representatives;
- The SOE providing annual and half-yearly reports which are tabled in the House of Representatives;
- The ability for the Minister to direct the SOE to change the SCI;

- The ability for the Minister to require information from the SOE;
- The ability for the Minister to determine the level of dividend payable; and
- The requirement for the Minister to consult with the Board on matters related to directing a board to alter the company's SCI, or to determine the level of dividend payable,.

SOEs fall under the Companies Act 1993 which grants shareholding Ministers' with the same rights and powers where these are consistent with the company's constitution. These include (for example):

- The ability to appoint and remove Board members; and
- Approving major transactions.

5.4. Roles and Responsibilities

The various role and responsibilities are defined in legislation or other establishing documents. The following section is a brief summary of these.

5.4.1. Management

Management is the executive team appointed by the Board to carry out the functions of the Company as delegated by the Board. Management is accountable to the Board.

5.4.2. Board

The SOE Board is accountable and responsible to the shareholding Ministers for the Company's performance and reporting on that performance. They are the primary monitor of performance and the key mechanism that Ministers have in holding the Company to account.

5.4.3. Treasury / COMU

The shareholding Ministers appoint the Treasury as the monitor for SOEs. COMU within the Treasury provides shareholding Ministers with advice on financial and non-financial performance of SOEs. COMU also assists in the board appointments process. The primary interactions with the SOE are via the board chair.

5.4.4. Ministers

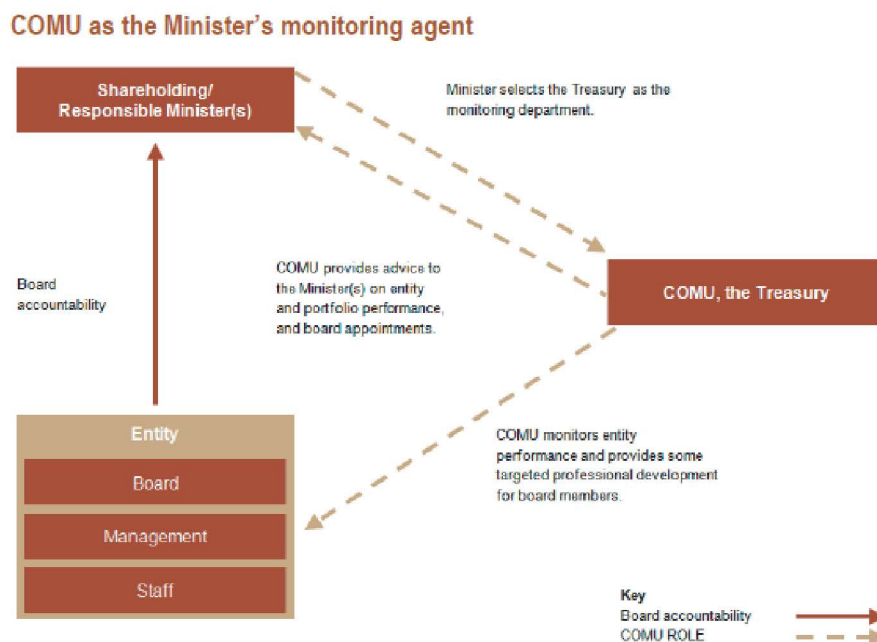
An SOE has two shareholding Ministers. One is the Minister of Finance and the other is the responsible Minister (normally the Minister for SOEs). The responsible Minister normally adopts the lead shareholder role and is the key contact point.

Ministers are responsible to the House of Representatives for the functions given to them by legislation or other rules. These include:

- Appointing and removing boards;
- Monitoring performance;
- The ability to require information;
- Providing comment on and directing changes to the SCI; and
- Presenting annual and half-yearly reports to the House of Representatives.

5.5. Accountability Framework

The diagram below illustrates how COMU interacts with shareholding Ministers and the Board.



Source: Owner's Expectation Manual, page 16.

5.5.1. Key Accountability Documents

The SOE Act outlines the requirements around its key accountability document – the SCI, and reporting performance to the shareholding Minister and wider public through the House of Representatives. This section summarises the key requirements.

Annual requirements

- Shareholding Minister sends expectation letter to each SOE Board detailing information requirements, the timing and specific issues expected to address in upcoming planning round.
- The Board may send a strategic issues letter to the shareholding Minister in response to the expectations letter.
- SOE Boards provide the shareholding Minister with a draft SCI, supported by the Company's business plan. It is expected that this contains meaningful performance measures and targets relating to SOE performance.
- Shareholding Minister's may provide comment on the draft SCI. The final SCI is tabled in the House of Representatives and is made publicly available.
- The annual report is required to be provided to the shareholding Minister within three months of the end of the financial year. The content is outlined in the Companies Act and SOE Act. The Minister will present this in the House of Representatives. These are made public after tabling.

Half yearly requirements

- Half-yearly reports are required to be provided to the shareholding Minister. The content of which should be specified in the SCI. The Minister is required to table these in the House of Representatives. Once this occurs these can be made public.

Quarterly requirements

- Shareholding Ministers expect each SOE to provide quarterly reports using a standard format (although this is not a requirement under the SOE Act). These are not made public, although Cabinet receives a summary report on each SOE. Under the continuous disclosure regime much of the non-financial quarterly information which relates to operational performance such as production volumes and business activities is disclosed quarterly.
- SOE's upload financial information to the Crown Financial Information System ("CFISnet").

Other requirements:

- "No surprises" policy. The Minister expects to be informed on significant issues at appropriate times that could be contentious or could attract public interest. Communication can be in a number of forms, with the Ministers' office typically being the first point of contact.
- Post-investment reviews. Since 2010 Ministers require information on the outcomes of past investment decisions where these meet certain threshold criteria. COMU uses this information to advise the Minister on significant projects undertaken by the SOE.

- Business case reviews. Shareholding Ministers should be consulted on significant investments. The thresholds for consultation should be set out in the SCI. There is the expectation that boards seek from management rigorous business cases and to provide officials with the same.
- Continuous disclosure regime. The SOE Act does not contain a continuous disclosure regime, but from 2010, shareholding Ministers introduced a regime for the nine largest SOE's to keep the public informed on matters that may have a material effect on an SOE's commercial value.
- Annual general meeting. The Companies Act requires all companies to call an AGM. Allows discussion with the full board and the shareholding Minister. This meeting is not intended to be a public meeting.
- Select Committees. SOEs may be required to appear before a select committee. In addition SOEs are required to attend the Financial and Expenditure Committee.

5.6. COMU Operating Model

5.6.1. Structure

COMU is a business unit within the Treasury and is structured in three teams:

- Commercial Monitoring team. Provides advice to the Minister and monitors a range of entities, including SOEs. Each entity subject to monitoring is assigned a relationship manager from this team
- A&G team. Provides advice and supports the Minister on appointments of boards and governance issues. The team also provides targeted professional development opportunities for directors.
- Multiple Objective Monitoring team. Provides advice to the Minister and monitors a range of entities. Each entity subject to monitoring is assigned a relationship manager from this team. The work of the financial analysis team has been undertaken within the two monitoring teams and through the use of external contractors/consultants.

The CTG was established as a separate portfolio within the Treasury in September 2011 and includes the team working on extending the mixed ownership model.

5.6.2. Principles / Objectives

From the perspective of the shareholding Minister, boards are responsible and accountable for individual company performance and are the primary monitor of performance. COMU has seven operating principles that have been developed to support the Boards' accountability and monitoring role. COMU's operating principles as set out in the OEM page 15 are:

- Key engagements are with entity boards.
- Monitoring efforts are prioritised in relation to performance issues and risks within each entity.
- A portfolio perspective to monitoring is used to ensure that the Crown's balance sheet is fit-for-purpose.
- COMU will provide independent analysis, commentary and judgements to Ministers.

- COMU will provide performance information to the public through our website.
- Monitoring of international corporate governance changes to allow COMU to adjust procedures as appropriate.
- COMU will share its knowledge with other government agencies undertaking monitoring roles, both in New Zealand and internationally.

COMU's work supports the Treasury outcome of "A More Effective and Efficient State Sector" and intermediate outcome of "The Crown balance sheet is managed efficiently and effectively" as set out in Treasury's Statement of Intent 2012-2017.

5.6.3. Policies / Guidelines

As part of the aim for increased transparency and disclosure since 2009 and the re-development of COMU's website, a project was undertaken to document methods and practices undertaken by COMU and publish them on the COMU website. The main benefits for undertaking this were to:

- Confirm practices used internally at COMU;
- Provide greater transparency externally for improved awareness of COMU activities; and
- Allow access to information by overseas jurisdictions on practices.

Key published documents are:

- Guidance on the Monitoring of State-Owned Enterprises. Aimed as a foundation document to be used by COMU for monitoring. It sets out in detail the annual monitoring cycle; what COMU does with the information; and how the activity supports the shareholding Minister.
- Board Appointments, Induction, and Professional Development. Sets out the end-to-end process for board appointments.

In addition to the above the OEM has been published. This is designed to help boards operate effectively in their roles and to clarify their responsibilities. We understand that this will be updated over time as processes, policies, and expectations change.

5.6.4. Processes

The following sets out a number of the processes that COMU undertakes and has involvement in:

Business planning process:

- COMU considers key expectations for the year ahead and provides advice to the Minister regarding the letter of expectations.
- COMU receives and analyses the draft SCI and business plan and provides advice to the Minister. One of the key elements of this process is the establishment of a panel of experts (including 1-2 external parties) which review the findings of the reviewers. Typically the COMU monitoring team present the key issues and findings to the panel, who challenge this view to ensure robust and considered advice is provided to the Minister.

Monitoring and reporting:

- SOEs provide quarterly reports and COMU uses performance measures developed for SOEs to analyse financial performance measures. COMU also assess non-financial performance. The output is a Performance Report to Cabinet which provides a view on individual SOE performance and aggregated performance of the Crown's portfolio, the report includes a section setting out any key issues which Ministers should be aware of.
- SOEs provide half-yearly reports to COMU. Analysis performed by COMU during the half-yearly reporting process supplements that undertaken during quarterly reporting. This allows COMU to understand how the SOE is performing against the SCI and the agreed financial targets. COMU produces a single page analysis of each SOE for inclusion in the reporting pack to Ministers. The shareholding Minister presents the half-yearly report to the House of Representatives. In addition COMU also supports the shareholding Minister by providing Ministers with key performance highlights, issues and risks faced by the entities monitored.
- The full annual reporting process enables COMU to gauge how the SOE performed against the SCI. In addition SOE's must also submit a forecast quarterly budget in July (consistent with the business plan and SCI) to allow quarterly performance against plan to be assessed. COMU produces a single page analysis for each SOE. Similar to the half-yearly report, it is the shareholding Minister who presents it to the House of Representatives. As with the half-yearly results COMU supports the shareholding Minister by providing key performance highlights, issues and risks as well as providing a list of initial areas for discussion at the annual general meeting.
- Where there is serious underperformance of an SOE, the Minister has a number of options which include seeking more detailed information (e.g. monthly accounts and cash flow forecasts).

Independent valuations:

- Boards are required to assess an estimate of the commercial value of the entities they govern and disclose the results of this annually in the SCI. To increase transparency, COMU has commissioned independent commercial valuation reports. The last round of these were commissioned in 2011 and we understand it is possible further valuation may be undertaken in the future. COMU reports to shareholding Ministers on year-to-year change in commercial value of the SOE portfolio. This reporting includes a comparison between the SOE's own commercial valuations, and that of the independent valuer appointed by COMU where these have been undertaken.

Annual public meeting:

- COMU usually attend the annual public meeting and reports back to the Minister.

Annual meeting of shareholders:

- The SOE is responsible for arranging the annual meeting of shareholders. COMU will advise the Minister on any relevant matters for the meeting. Generally an agenda is provided by the SOE ahead of the meeting and COMU prepare a list of questions for the Minister to table at the meeting.

Post-investment reviews:

- SOEs are required to provide post investment reviews (“PIRs”). The information required is prescribed and is only required where investments meet specific thresholds. On receipt, COMU analyses the findings and reports to the shareholding Minister with a portfolio overview of COMU's findings and recommendations.

Annual Portfolio Report:

- COMU prepares the Annual Portfolio report on an annual basis from publicly available information. It covers performance of the individual entities and performance of the entire commercial portfolio over a five-year period. It is based on the measures and ratios that SOEs have been instructed to include in its reporting. COMU analyses the information and compares performance to SOE plans.

Benchmarking:

- COMU has developed a set of financial metrics to assess performance.

Engagement with boards:

- COMU aim to meet with SOE chairs approximately every quarter. Other meeting are arranged on an “as needed” basis. We understand that COMU aim to attend meetings between the Board/Chair and the shareholding Minister. For meetings with the Minister, COMU typically prepare a briefing report on issues to be discussed.

COMU meetings with shareholding Ministers:

- COMU has a regular meeting with the Minister for State-Owned Enterprises and regular meetings with other shareholding Ministers. COMU prepares an agenda and a “State of Play” report outlining perspectives on current issues in the portfolio.

Environmental scanning:

- COMU continuously undertakes environmental scanning to give context to performance and future needs and is used to help inform advice to the shareholding Ministers. A number of information sources are used. There is no individual output but information gathered is incorporated when COMU reports on the performance of relevant SOEs.

Monitoring plans:

- Monitoring plans are sometimes developed by COMU to capture what particular aspects of an SOE performance will be monitored and how. These may be developed (for example) where an issue has arisen that requires specific focused monitoring.

Advice:

- We understand that all written advice provided by COMU to the Minister is peer reviewed by another staff member and then reviewed by a manager prior to being provided to the Minister.

5.6.5. Board Appointments

Introduction

SOEs as registered companies are bound by the requirements of the Companies Act. Boards are appointed by the shareholding Minister and are accountable for the performance of the SOE's they govern. Shareholding Ministers can remove board members by shareholder resolution under the Companies Act (s156). The Companies Act allows an alternate process if specified in the Company's constitution. We understand that the constitution of Solid Energy allows for the removal of any director under s156 of the Act, and does not define an alternate process.

Appointments of SOE Boards are a key lever that Ministers have for influencing performance of SOEs. The formal removal of Board members rarely occurs. However, Board composition is lever Ministers take very seriously and we understand they will make changes where necessary. We understand that formally removing someone from an SOE Board has not happened for an extended period. However, a number of directors have retired out of the sequence where dictated by the needs of the Company and Board. Each situation is unique to the circumstances of the individual, company, and board at the time.

Directors are appointed generally for terms of up to three years, and may be reappointed on expiry.

Roles and Responsibilities

Shareholding Minister:

The Shareholding Minister is responsible for all appointments to SOE Boards in accordance with the requirements of the Companies Act. While COMU has a dedicated A&G team who manages the overall appointment process, the Minister has the final say on appointments.

As discussed the shareholding Minister can also remove board members. This role is primarily derived from the Companies Act as a result of the Ministers shareholding in the SOE.

COMU:

COMU advises the Minister on appointments and manages the overall appointment process. It identifies candidates for Ministerial consideration, undertakes due diligence including interviews and reference checks. COMU maintains a database of candidates and manages the induction process.

COMU also monitors board evaluations. COMU's role is derived from a Cabinet approved appointments process and is captured in the OEM. Further detail on the appointment process is covered in the following section.

In addition to the formal channels between the Chair and Ministers/COMU, COMU holds relationships with management of the Company which enables it to request further information. The relationships with management are typically with the CEO, CFO and Head of External Affairs.

Chair:

The Chair is responsible for maintaining an on-going review of the Board's membership profile, succession planning, as well as participating in the process to identify and appoint new board members. It is the Minister's expectations that a process is in place to undertake, at a minimum, annual performance reviews of the Board as a whole, as well as of the Chair and directors. This requirement is captured within the OEM. We understand there is no formal requirement for the Board or chair to report the findings of these performance reviews to COMU or to the Minister. However, there is a requirement for the Chair to confirm each that the reviews have been undertaken.

Appointment and Retirement Processes

The board appointment process and retirement processes are captured in a number of sources and documents. Primary sources identified include:

- Board Appointments, Induction, and Professional Development (December 2011, COMU);
- OEM (July 2012, COMU); and
- COMU website.

We understand that COMU has a detailed process document that sets out the board appointment process.

Directors are typically appointed for three years and COMU tracks expiry of terms. There are normally two appointment rounds per year (early and late calendar year) that are run to fill Board vacancies and for re-appointments. These typically capture appointments for all SOEs in each round and take approximately six months to complete.

The key process steps followed is referred to in Treasury Reports to the Minister as a “Cabinet approved process”. The steps followed are clearly spelt out in these reports to the Minister as each round begins. Key steps include:

1. COMU identifies forthcoming term expiry's, develops skills profiles and succession needs for each Board;
2. Chairs advise preferences for succession;
3. Minister agrees skills profile and provides an early indication of likely reappointments;
4. Minister calls for nominations from colleagues and COMU calls for nominations from representative agencies;
5. COMU advertises on websites and checks its candidate database;
6. COMU develops a long list of nominations and expressions of interests received for each Board;
7. Minister shortlists those to be interviewed;
8. COMU and chairs conduct due diligence interviews with shortlisted candidates;
9. COMU provides recommendations on preferred candidates;
10. Minister confirms final preferences and conducts any final checks with colleagues. The Minister is required to certify that due process has been followed and that candidates have no unmanageable conflicts of interest;
11. Final reference checks are carried out by COMU, if required;
12. Cabinet Appointments and Honours Committee (APH) confirms appointments;
13. Cabinet ratifies appointments;

14. Chair initiates induction programme (this usually has COMU involvement);

15. COMU initiates sector induction programme.

The Minister certifies that the process followed for appointments adheres to the Cabinet approved process and that appropriate conflict of interest enquiries are made in the paper for the APH.

From our discussions with COMU, there appears to be less documentation surrounding the procedures to guide the process in the event of a Minister requiring the removal of a director. The Minister clearly has this power under the Companies Act via a shareholder resolution. In our view this is not unsurprising given the very serious circumstances that need to occur before this option is considered.

We also note that the appointments process detailed above relates to business as usual appointment rounds. There is less documentation surrounding procedures where a board appointment is required under more urgent circumstances such as was the case with the resignation of the Chair in August 2012. We understand that this process is much the same as the standard process but is undertaken in a more time constrained fashion. Further we understand it is not unusual for urgent action to be required. In the case of Solid Energy we understand that Treasury knew several months ahead of time that a change in Chair was coming. The urgency in the final appointment process for the new Chair did not relate to the actual process, but the circumstances at the time (i.e. difficulty identifying preferred candidates, the fluidity of Solid Energy's situation and confirming the intentions of the incumbent Chair).

Changes in Appointment Processes since 2006

No significant changes were identified in board appointment processes since 2006, based on a review of documentation provided and interviews we conducted.

Previously there had been the advisory unit in the Treasury and CCMAU acting on behalf of the Ministers. This structure was replaced in 2009 by the creation of COMU. We understand the move into the Treasury did not substantially change the appointments process. The scope of the appointments teams work increased however as it took on more appointments for Treasury.

For the SOEs which have moved across to the CTG there has been no change to the appointments process. We understand the A&G team still manage appointments for these companies.

Processes captured in the OEM were originally written by CCMAU and the Treasury in 2002 with input from relevant Ministers. It was designed to document in a single place the arrangements for companies and entities monitored by CCMAU with an emphasis on SOEs. It was updated in 2007 and a Briefing to Incoming Ministers in November 2008 noted that there have been no fundamental changes in the expectations of Ministers over the years.

The OEM was updated again in 2012 with the section on boards and A&G being updated. This included strengthening the role of the chair in the appointments process as well as the need to act if there is an issue with director or chair performance.

A number of other less fundamental changes were noted that did not impact significantly on the process described above include:

- Development of a new candidate database in 2009 to facilitate the identification of candidates.
- Use of a new provider in 2012 to complete background checks on candidates selected for board appointments.

5.6.6. Risk Management

The OEM notes that boards are responsible for managing risks, and should establish processes and practices within the SOE to manage all risks associated with its operations. Boards are required to keep shareholding Ministers informed of risk management strategies through business plans and other reports when necessary as per the “no surprises” policy.

COMU has the ability to identify risks relating to individual SOEs through a number of processes, including regular reporting requirements, environmental scanning and receiving a strategic issues letter from the Board in response to the shareholding Ministers expectations letter.

The Treasury Report - Improving the Effectiveness of COMU's Monitoring - notes the move to prioritise monitoring efforts in relation to the performance issues and risks within each entity. Entities are grouped into high, moderate, or low level of focus. The report notes that the priority allocated should be reviewed each quarter and is based on COMU's judgement.

6. Key Events

6.1. Background and areas of concern

Before embarking on an assessment of Treasury's monitoring of Solid Energy, it is worth restating the scope of the review:

- How well did Treasury apply its stated monitoring procedures and practices to the monitoring of Solid Energy; and
- Whether Treasury had taken all the necessary and reasonable steps to protect the Crown's ownership interest in Solid Energy including ensuring that Ministers were kept fully informed of concerns and actions taken.

It is our view that the processes which exist and are used within Treasury are on balance applied robustly to the review of a wide ranging portfolio of companies including Solid Energy. This is in the context of a relatively modest budget for monitoring and a wide reaching mandate. This mandate includes significant responsibility for administrative process and multiple levels of engagement across 45 different SOEs, Crown Research Institutes, Crown Financial Institutions, Airports and various other Crown Entities.. Many of the SOE's operate in very different sectors and industries and therefore face unique sets of business and commercial risks.

Solid Energy is a business which operates as a small competitor in a global commodities market place (it has circa 2-4% of the global market share of the hard coking coal market). Solid Energy is exposed to commodity and foreign exchange risk. In addition it operates its business within demanding geographic areas such as the Stockton plateau and underground mines and is therefore required to adhere to robust health and safety practices. As a result of its business operations Solid Energy is one of the more complex entities within COMU's portfolio.

Against this backdrop, over the Review Period Solid Energy had begun what could be considered to be a relatively aggressive plan to diversify its business activities into new and renewable energy businesses. There is no doubt that monitoring Solid Energy throughout the Review Period had a number of unique and varied challenges including an at times difficult relationship between the Board and management team of Solid Energy and Treasury and Ministers.

Following our review of key documents and substantiated through the interviews with Treasury staff we have identified the following key areas of concern that were raised and identified by Treasury. We have where appropriate expanded the discussion of these concerns in the subsequent sections. .

6.2. Timeline of events

Appendix 4 sets out a brief overview of key events throughout the Review Period including actions taken by Treasury and Ministers. We have primarily focussed on significant actual or planned investments and formal communications between Solid Energy and the Treasury over the period. It should be noted there will be untold informal interactions between the parties which may have

identified particular issues or concerns. While other concerns may exist we are only able to comment on those interactions outside of the core documented interactions which we have been made aware of through our documentation review and interviews with Treasury staff.

From June 2012 Solid Energy was placed into intensive monitoring. It is our understanding from the interviews with Treasury personnel that the events that subsequently unfolded required reasonably fluid decision making from Treasury and Ministers and subsequently involved the use of extensive external expertise. It is our view that based on the information provided to us little more could have been done from June 2012 onwards that would have changed the ultimate outcome that Solid Energy found itself in February 2013. It was at this point it announced publicly that it was in negotiations with its shareholders and banks. Therefore, our detailed review of specific key events set out below focuses on events prior to June 2012.

6.3. Key areas of concern

The following high level timeline illustrates in our view the key areas of concern presented to Treasury arising from the monitoring of Solid Energy.

Date	Key Event
2006 – 2012	Attitude to Treasury monitoring process and Board/CEO dynamic
May 2008	Draft SCI issues – significant revaluation of the Company
May 2010	National Resources Limited proposal
November 2010	Independent valuations commissioned indicate a value circa 50% of that prepared by the Board.
July 2010	Draft SCI issues (valuation, request for equity and suspension of dividends)
November 2011	UBS Scoping Study
May 2012	Email correspondence from CEO

6.4. Attitude to Treasury monitoring process and Board/CEO dynamic

It is difficult in the formal written correspondence to identify the true nature of the relationship between the Chair/ CEO of Solid Energy and Treasury. Despite this, several of the Treasury staff interviewed identified a sense of tension from the Chair and CEO particularly when challenged on more fundamental aspects of their business and strategy.

We have identified no single event which can be identified that is so significant as to require fundamental action with respect to the Chair or CEO, but rather a series of small events which cumulatively over time create an impression of an entity that was not as respectful of Treasury's role/responsibility as Ministers would expect from an SOE.

There are however long standing examples of tardiness and efforts to push the boundaries of the monitoring process including:

- Numerous occasions when Solid Energy was late in filing draft SCI and business plans which put pressure on Treasury resources or required extensions from Ministers;
- Continued efforts to change the rules around consultation levels with respect to investment activity;

- An inconsistent dividend policy despite on-going requests from Minister ;
- Requests for injections of new equity when it was very clear this was not an option Government would consider;
- Lack of disclosures regarding commercial valuations, even when provided with a framework as to what was required; and
- The Company's persistence with a view regarding energy prices that was out of line with consensus views and a refusal to provide supporting analysis when challenged on this view.

We understand that these issues were evidenced through until April 2012 at which point we understand Solid Energy started engaging in a more cooperative engagement with Treasury.

We have been provided with examples of the company's lack of respect for commercial expertise that set the scene for difficult interactions, particularly surrounding "core" issues with Solid Energy's governance that Treasury identified and in particular those related to the business strategy.

The earliest written example we have been provided with was from April 2011. It was then an analyst from COMU requested certain financial analysis be provided which tested financial metrics derived from Solid Energy's own project evaluation models. It is our understanding that the Chair approached Treasury indicating that he believed the request was unprofessional and management were not to provide the analysis. Following robust disagreement from Treasury, the Chair instructed the Solid Energy management team to provide the analysis. It is our understanding it was never provided.

The CEO over the Review Period joined the Company in 2000 to effectively lead a sales process for the remaining core coal assets following financial distress in 1999. We understand after a period of some negotiation was able to persuade Ministers at the time that there was an underlying business with value. There is no doubt that as a result of the successful turnaround the CEO gained significant political and public credibility. In the wake of both the Christchurch earthquakes and the Pike River disaster Solid Energy was a strong sponsor of the local communities' assisting in numerous ways in Christchurch and in supporting the rescue and recovery efforts at Pike River.

6.5. Company strategy and price path

With hindsight unquestionably a major cause of the financial difficulties ultimately faced by Solid Energy was a strategy of diversification and expansion underpinned by management's view of coal and oil prices over the long term which was substantially above the consensus market forecast. Based on the material we have reviewed it does not appear that the Board obtained independent verification of these forecasts

We understand from Solid Energy's own analysis³ that its forecasts while more optimistic than market consensus in the longer term, in the short term management believe they were proven to be more right than wrong in many past years.

In Solid Energy's view it was the extent to which prices fell below any expected range in 2012 and a balance sheet that was moderately geared that meant the Company had insufficient balance sheet headroom to deal with the large operating loss that ensued. While it is too early to say if Solid Energy could be proven correct in the long run, the Company did not operate in a sufficiently prudent manner

³ Appendix 1 – Solid Energy Response to Scoping Study

(effectively taking a view contrary to the consensus market view) to ensure its underlying business remained viable long enough to test its long term view of pricing.

In our view the Company's internal price path resulted in the following behaviours:

- Justification of a diversification strategy which was capital intensive and required significant upfront investment long before revenue streams were forecast to eventuate;
- Justification for significant investment in expanding the underlying coal business, including the continued development at Spring Creek and substantial capital expenditure at Stockton;
- Confidence from the Board to increase gearing of the balance sheet under a premise that prices would fall within a forecast probability band (P20 to P80);
- A high forward view of the price of carbon and therefore justification for investment in renewable energy projects, including biodiesel and the wood pallet business;
- A high internal view of the value of both the coal business and renewable energy business; and
- A high internal view of the net present value ("NPV") of new energy projects which justified the continued development of projects at each internal project milestone.

The fundamental issue is that the Board supported management's view of energy prices and based on this, supported management's strategies for the business. The divergence of views between Solid Energy and the market analysts (Forsyth Barr, Macquarie, UBS and Deutsche Bank) accounts for the majority differences in view on strategy and value. An assessment of the extent of this difference is outlined in section below.

In Solid Energy's response to the UBS Scoping Study it is evident how much its internal view of pricing drove investment decisions. Solid Energy goes on to state *"...business plans are based on our internal view of price and therefore include mine design based on those future prices and the resultant economics. The UBS study applied Solid Energy production profiles, mine designs, capex and operating assumptions to a consensus price path. Solid Energy would consider different sequencing of operations and possibly even different asset mix base in this different view of the long term future price."*

As well as the diversification strategy that the Company executed it also submitted the National Resources Limited ("NRL") proposal. Given the extent of the proposed investment, a cross departmental response from Treasury, DPMC and MED was commissioned which rejected the proposal in its entirety. Given that the proposal was rejected by Ministers it is not a relevant consideration in the context of the Company's subsequent difficulties but does reinforce the view that the Company was not in step with the Ministers expectations with respect to the scope of the Company's business and access to new capital. It further demonstrated willingness on the part of the Company to attempt to execute a business strategy which was outside of its core expertise.

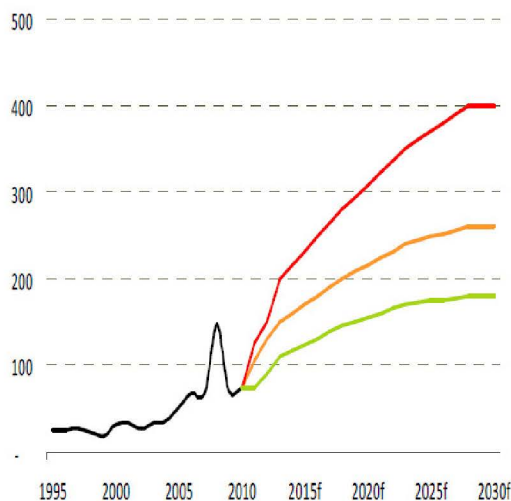
The response to the NRL proposal did go on to note: *"Officials (MED) share Solid's view of a rising price path for the kind of resources contemplated here. It's also abundantly clear that resources enjoy periods of super profits – vivid examples being oil immediately prior to the GFC and coal and iron ore as China's economy grows. However, Solid's price paths are off the bullish end of the chart – using MED's projections would lead to quite different views about the risk/return profile of projects. Indeed, Solid itself notes that many of their proposed projects would be only marginally economic if conventional price paths are followed (MED and International Energy Agency). Given that the*

investments will only be economic at prices above those predicted by market experts, one would need to be convinced that Solid's view was correct before committing to their programmes."

The following charts clearly highlight the difference in pricing assumptions with the top end of MED's forecasts falling at or below Solid Energy's low case forecasts. The charts have been designed so that the price point of US\$200 is aligned in each.

Solid

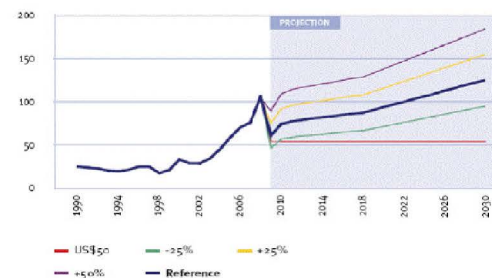
Crude Oil
USD per barrel



MED

Oil Price

US\$/bbl



6.5.1. Treasury action

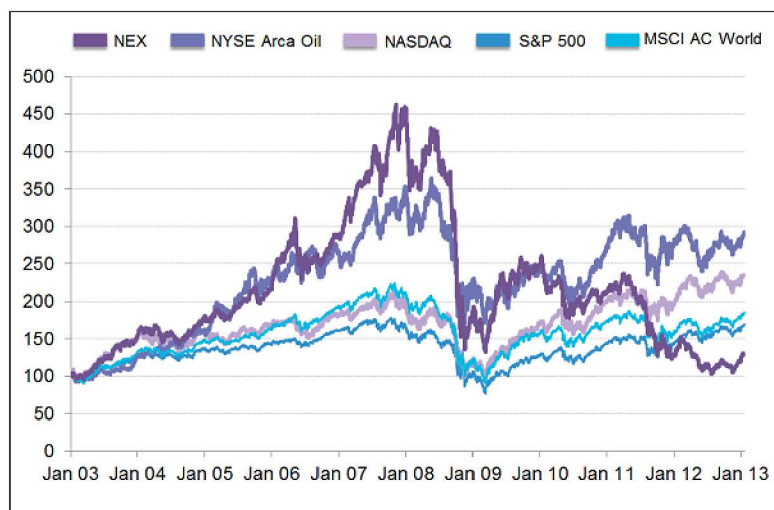
Treasury identified these concerns regarding the linkage of the strategy and high view of long term prices and offered substantial challenge to the Board. The concerns were played back in varying degrees of seriousness to Ministers over a number of years and in particular during the SCI and business planning process in 2008, 2009 and 2010.

While these concerns were raised it was generally the view of Treasury that despite having concerns the commercial valuation included in the SCI was the responsibility of the Board. The exception was the NRL proposal which was outwardly rejected. We noted in our review and interviews that these concern were countered by:

- **Highly regarded Chair:** John Palmer had been a long standing chairman of Air New Zealand and a highly respected company director. In 2007 and 2009 he won the Deloitte/NZ Management magazine Chairman of the year. Before being appointed as Solid Energy chair he had been Chairman of Air New Zealand since November 2001.
- **Management track record:** The CEO and executive team had early successes in that they had turned the business around from financial distress in 2000, strengthened by Solid Energy's actions post the Christchurch earthquake and Pike River and its other community involvement. This built a certain level of political goodwill which in our experience takes time to erode.

- **Financial performance:** Over the period 2006 to 2012, Solid Energy had sound financial performance and had a seemingly sound financial position notwithstanding concerns regarding the Company's strategy. Revenue had increased substantially from 2006 and while profitability was lumpy it still averaged circa \$60 million p.a. and operating cash flow averaged circa \$110 million over the period.

Global market trends: Solid Energy's alternative energy strategy was commenced in an environment where these types of investments were "in favour" globally. The chart below shows the WilderHill New Energy Global Innovation Index⁴ ("NEX") and the NYSE Arca Oil Index⁵. It is clear just how in favour renewable energy companies were in the pre-GFC period particularly from early 2005 through to early 2008 - the period over which Solid Energy initiated the majority of their new energy projects.



AMEX Oil, Nasdaq and S&P 500 rebased
30 Dec 2002 = 100

Source: Bloomberg New Energy Finance

6.5.2. 2008 SCI commercial valuation

Solid Energy provided Treasury with its draft SCI and business plan for the three years commencing 1 July 2008. In this SCI the Board set out its view of the commercial valuation of Solid Energy with an initial valuation of \$7.8 billion (the range given was -70%/+200%). The SCI tabled for 2007 had set out a commercial value of between \$450 million and \$500 million (midpoint \$475 million). The 2008 valuation was therefore a factor of 16 times greater.

Following analysis of the valuation Treasury determined that a key driver of this value was the CTL project which required capital expenditure and return calculations some 20 years in future. Treasury requested that the Board caveat the CTL value and present valuation scenarios with high levels of probability and present the speculative/growth scenarios separately. As a result the SCI was requested by Treasury to be redrafted.

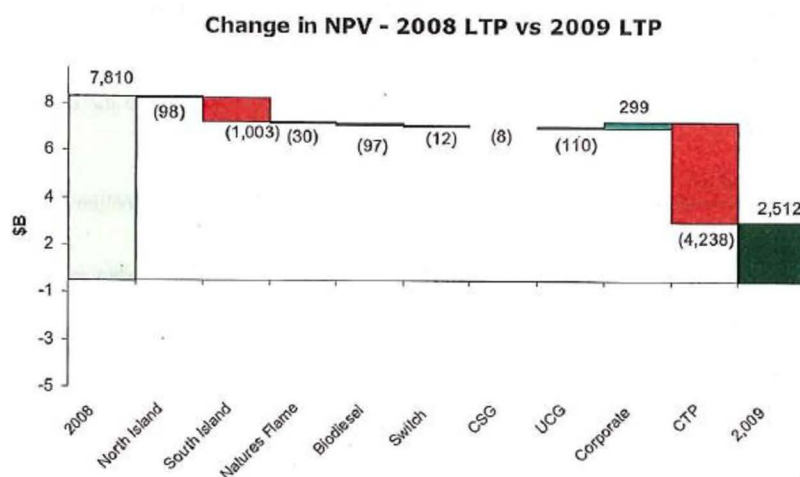
⁴ The NEX index is a modified dollar weighted index of publicly traded companies active in renewable and low-carbon energy, and which stand to benefit from responses to climate change and energy security concerns.

⁵ The NYSE Arca Oil Index is a price-weighted index of the leading companies involved in the exploration, production, and development of petroleum. It measures the performance of the oil industry through changes in the sum of the prices of component stocks.

The 2008 draft SCI also suggested that the investment consultation levels be increased to \$125 million for core and non-core projects (this was at the time some 25% of the then current equity value). Treasury countered this suggestion with a proposal for \$30 million and \$10 million respectively for core and non-core projects. Other MOM companies at the time had consultation levels around 3-4% for core and 0.5% to 1.5% for non-core projects as a percentage of their equity values.

Treasury identified the key drivers of the high valuation were primarily the coal price path and the inclusion of early stage projects. After voicing these concerns with Ministers and the Company, the Company prepared a revised commercial valuation of \$2.9 billion.

While we have not reviewed the 2008 SCI valuation report we were provided with the 2009 equivalent (valuation date 1 July 2009). The figure below was extracted from the 2009 valuation report and sets out a revised value of \$2.5 billion down from \$2.9 billion in 2008. We note that there was a substantial amount of variation in the values between years for certain assets as shown below.



In particular the value of South Island coal (primarily Stockton) had reduced significantly and corporate costs had increased markedly. We note while the Coal to Products⁶ ("CTP") project was excluded from the 2008 valuation Solid Energy had included it in 2009 ascribing a value of \$574 million to the projects. Seeing such variance in annual valuations in our view gives rise to serious concern and in particular raises questions as to whether there is a lack of commercial judgement being applied.

While Treasury stated it did not believe the valuation it was left as being the Board's responsibility to value company. We note the high coal prices used in the valuations of the new energy and renewable energy projects justified not only investment in renewables but also more expensive mine plans and capital expenditure in Solid Energy's core coal business.

⁶ We understand this represents all of the lignite conversion projects including briquettes, CTL and CTF.

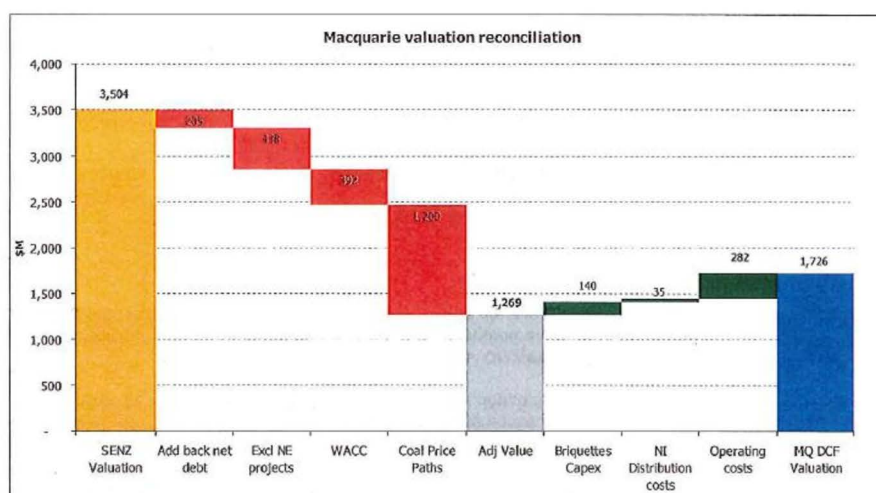
6.5.3. 2010 & 2011 Independent analyst valuations and Solid response

One of the changes implemented by COMU in 2010 was to commission independent valuation reports periodically as a way of benchmarking the commercial valuations prepared by SOE Boards for the SCIs. We understand the first reports were commissioned in 2007 for the electricity utilities.

Forsyth Barr and Macquarie Equities Research were commissioned in 2010 to undertake an independent valuation of Solid Energy based on public information. The valuers established a value for the business (each using a slightly different methodology) of \$1.7 billion. We understand Solid Energy undertook its own independent review of the valuations, bridging in the following two charts the difference to Solid Energy's own valuation of \$3.5 billion as at the same date.

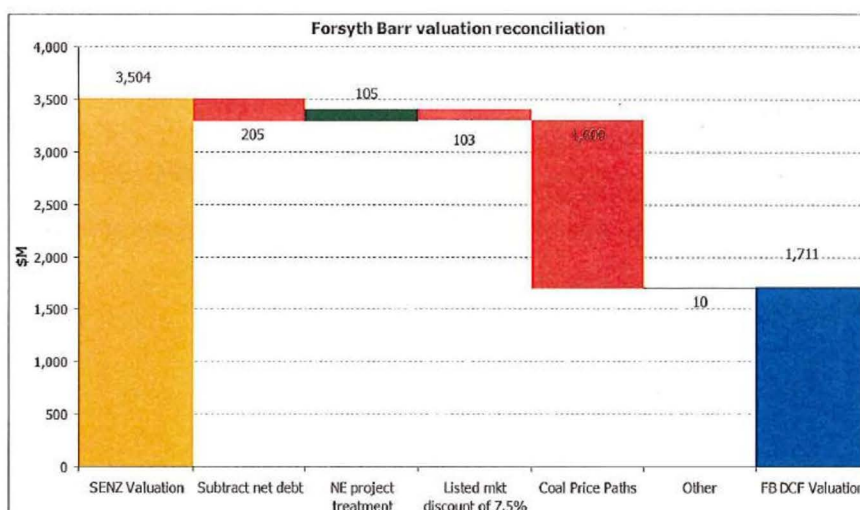
The key differences for the Macquarie valuation were:

- Coal price path. Macquarie HCC forecasts were similar to Solid Energy but dropped off from 2013 onwards;
- No value ascribed to new energy projects other than the briquette which excluded capital expenditure;
- WACC 11.8% vs. Solid Energy 10.8%;
- Differences in operating costs.



The key differences for the Forsyth Barr valuation were:

- Coal price path. Forecasts were similar to Solid Energy but plateau after two years while Solid Energy continued to rise;
- Simple approach to valuing new energy projects \$105 million higher than Solid Energy estimate;
- Inclusion of a listed market discount.



We believe the exercise of undertaking the independent valuations is useful if only to draw the attention of the Board about how external investors view the effectiveness of the Company's strategy. Of concern was the extent to which Solid Energy's forecast view of coal price differed from the investment community. The gap was so material that in our view a more serious response could have been instigated by Treasury. The extent to which any such response would have meaningfully altered Solid Energy's strategy remains to be tested.

Treasury recommended that the Minister advise the Solid Energy Chair that "Ministers expect valuations prepared to be robust and they expect external independent review with calculation of value and key assumptions". In addition they noted "Solid Energy should be encouraged to use market based price assumptions to derive its valuation".

6.5.4. 2010 and 2011 SCI

The 2010 and 2011 draft SCIs provide useful insight into the extent of Solid Energy's diversification strategy and a continuing disregard for Minister's expectations.

2010 SCI

The 2010 draft SCI sets out an expansionary phase in the Company strategy such that no dividends were forecast until 2019. Instead Solid Energy planned to reinvest earnings in its development of projects.

The SCI disclosed a massive capital profile noting modest investment in the coal business was being made from free cash flows; investment in renewables (wood pallets, USG, CSG, briquette) was to be funded from capital structure (i.e. debt) and the significant forecast capital expenditure related to CTF and CTL would be funded under a separate capital strategy. Solid Energy undertook to develop a "Detailed governance and capital strategy document". We have been provided with a copy of a draft capital structure report prepared by PWC but are unclear as to whether this was finalised.

COMU advised Ministers to notify Solid Energy that:

- Any request for external equity was inconsistent with the current Government's policy;
- Ministers were not prepared to support a suspension of dividends until the business case for each development project has been considered and approved.

2011 SCI

The 2011 draft SCI highlighted on-going issues around the lack of disclosure of assumptions and methodology for SCI commercial valuations. COMU set out concerns regarding the integrity of the valuations given there was a 60% increase in the draft SCI valuation from \$2.5 billion to \$3.9 billion. A question was formally raised to ask if it was reasonable to have such a movement when the underlying long term energy outlook had not changed.

6.6. UBS Scoping Study

As part of the MOM programme, a series of Scoping Studies were commissioned and were designed to provide high level valuations for each MOM company and assess the readiness of the Company for an IPO. We understand recommendations were received for each company which generally outlined a series of actions to be worked through prior to an IPO.

Leading up to the scoping study for Solid Energy it is clear through the series of events listed above that the Board/CEO were difficult and at times did not follow the Minister's expectations. The strategy of diversification into new projects and continued development in its core coal business were underpinned by a forecast of high long term coal and oil prices.

Treasury commissioned UBS, a global investment bank, to undertake the Scoping Study which was completed over September and October 2011. The report set out a clear summary of UBS's view of the business and strategy which was less than favourable. The key recommendations were:

- Focus on the core coal business;
- Divest the renewables business;
- Wind back the investment in new energy to a maximum of \$15 million p.a.;
- Increase expenditure to further prove reserves;
- Reduce head office costs and overheads; and
- When listed the business should be debt free.

In addition the report suggested that the Board be reduced from eight to six directors with a renewed mix of expertise including two directors with coal experience and one with international oil and gas processing experience.

The UBS valuation for the business was \$1.3 billion, compared to the SCI value at the time of \$3.0 billion. The major driver for the difference (as with the independent valuations from 2010/11) was Solid Energy's forecast coal price being significantly above the consensus market forecast. In UBS's view this meant that development costs and capital expenditure across the business were higher than supported by the consensus price path and effectively the strategy that Solid Energy had been pursuing was not justified. UBS went on to note that they had requested managements support for their views of price but that no material was forthcoming. As discussed, in a later response in February 2012 on the Scoping Study Solid Energy agreed that with a lower price path they might not have been investing in many of the projects they had been.

The scoping study also revealed the full costs of executing the strategy which included:

- Since 2005 some \$165 million had been spent on renewable and new energy projects, [\$85 million of which was related to the acquisition of land in Southland providing access to lignite resources];
- 37 FTEs supporting new energy projects and 53 FTEs supporting Natures Flame and biodiesel;

In its advice to Ministers CTG noted that in addition to its role in assessing the MOM policy in regard to Solid Energy, the Scoping Study provided independent confirmation of issues identified in previous Treasury reports on the performance of Solid Energy. It was also highlighted that there was likely to be restructuring implications for governance, management and operations given:

- The apparent lack of investigation and scrutiny of management's price path assumptions, given the importance of that parameter in driving the Company's strategy, investments, operations and costs; and
- High level of corporate overheads and staffing.

In advice provided to Ministers in March 2012, CTG stated that effectively there was no confidence in Solid Energy's business strategy and that the price path was completely out of kilter with the market, resulting in higher capital and operating than was supported by prices.

Solid Energy was given the opportunity to respond to the UBS report. When it did so it said that an IPO wasn't the best option for the Company as it wouldn't value the growth areas of the business. It was suggested that a separate equity raising process may have been a better option whereby equity capital was raised from an institutional investor as opposed to the public. Treasury commissioned its external advisors Deutsche Bank to undertake a review of the adequacy of the Company's response.

In summary, the UBS report effectively called the Board's capability into question and concluded the strategy it was executing was not the correct one. Notwithstanding these concerns it is important to note that the Scoping Study:

- Still valued the business at \$1.3 billion enterprise value;
- Set out a pathway to prepare the business for an IPO; and
- Did not call into question the underlying viability of the coal business.

6.7. April 2012 to July 2012 – Move to intensive monitoring

As discussed on 11 May 2012, Treasury received a confidential Board memo from the CEO of Solid Energy which set out a number of earnings scenarios which the Company faced as a result of falling prices. We understand that as a result of this information and the information contained within the UBS scoping study, Treasury in quick order prepared a high level financial model which it used to run its own pricing scenarios. Treasury's view as a result of this modelling was that Solid Energy could be facing a far worse financial position than it had communicated to date with Treasury.

In its advice to Minister's dated 5 June 2012 Treasury set out that it had some concerns that Solid Energy's proposed actions to control costs might not be effective. In its view Solid Energy had struggled to demonstrate cost control in the past, that the proposed plan to reduce capital expenditure increased risks, and that there were risks around their domestic sales and divestment strategy.

Treasury also advised that it was especially concerned that management was not considering a change in its strategy when in Treasury's view the growth strategy being pursued by the Company was a significant contributor to the current situation.

The move to intensive monitoring would require the following actions by Ministers:

- Grant an extension in timing for the 2012/13 Business Plan and SCI.
- Require the Company to present the revised business plan to Ministers.
- Require reporting from the Company to move to monthly from quarterly reporting.
- Require the Company to meet with Treasury monthly to discuss its reports.
- Note there would be additional scrutiny of the financial data supplied by Solid Energy to the Treasury.
- Note Treasury would use Deutsche Bank to support its monitoring advice.
- Write to the Board to set out this intensive monitoring approach, so that they would be clear about its purpose and have an opportunity to respond.

We understand from our document review and interviews that there was an initial reservation from Solid Energy regarding the move to intensive monitoring and in particular Treasury's motivation. By late June 2012, however the Company realised that it would require the support of its shareholder and was therefore generally collaborative in its working relationship.

6.8. Events post June 2012

It is evident reviewing the formal advice from Treasury to Ministers that the financial position of Solid Energy deteriorated quickly over the remainder of 2012 and into 2013. During this process there appeared to be substantial and on-going dialogue between Treasury, Ministers and Solid Energy. Further we understand that during this time Treasury used a substantial number of tools available to it including:

- Use of its advisor Deutsche Bank to support analysis;
- Recommendation to Solid Energy to appoint an investigating accountant;
- Use of additional advice from Korda Mentha, Macquarie and Polaris;
- Monthly reporting.

In our view it is difficult to be able to assess the adequacy of responses during this period as decisions are being made in real time. In addition it is the importance of personal interactions and informal conversations which build the trust of parties involved and how each party plays off to each other is critical to the success of such situations.

From our review of the formal documentation it appears the analysis prepared by external parties provided Treasury with a good understanding of the risks and issues which they have reported to Ministers accordingly in a timely manner.

7. Conclusions

7.1. Conclusions

Having reviewed:

- the legislative and monitoring framework for SOEs;
- the role of Treasury within that framework;
- the lead up to Solid Energy's financial distress; and
- the monitoring activity undertaken by Treasury through that period and the advice given.

We conclude the following:

- it appears that the ultimate failure of Solid Energy was primarily due to a steep and sustained fall in coal prices in mid to late 2012 that neither the Company nor the analyst community had foreseen;
- in the lead up to that failure Solid Energy had reduced its capacity to manage through a period of distress by increasing its gearing and cost structure;
- the increase in gearing primarily arose from a decision to fund investment activity from debt, notwithstanding generally strong operating cash flows over most of the period under review;
- investment activity related to both its core coal business and diversified activities;
- the rationale for investment was fundamentally underpinned by the Company's long term view on energy prices which were generally well above consensus market expectations;
- the Board of Solid Energy supported the investment strategy, notwithstanding concerns raised by Treasury as to the Company's assumptions with respect to energy prices and the reasonableness of strategies developed and valuations calculated off the back of these assumptions. We understand that despite repeated requests for independent verification of management's pricing forecasts, these were never undertaken or provided;
- Treasury's anxiety with respect to the Company's strategy was elevated further by the general attitude of Solid Energy to Treasury and the related monitoring processes;
- Concerns identified by Treasury were balanced against the reality that Solid Energy was considered to have a well-regarded CEO, strong Board and for most of the period operated profitability and produced strong operating cash flows; and

- The Scoping Study undertaken by UBS validated concerns held by COMU/CTG with respect to price path assumptions and strategy but also identified additional concerns that had not been identified previously being;
 - The cost structure of the Company and in particular the proportion of indirect costs linked to the Company's development activities;
 - The Company's gearing – UBS expressed a view that coal companies should have no debt; and
 - The size and composition of the Company's Board.

We do not believe that the failure of Solid Energy has highlighted a material failure in Treasury's monitoring processes.

We do believe that the failure does raise questions about how these processes are applied and whether Treasury's response was forceful enough or occurred soon enough given that the Company provided cause for concern over an extended period. However, as noted above, there were influential countervailing factors that Treasury needed to consider when determining its response to issues identified.

It is possible that had coal prices stayed around the low case forecast by management in April 2012 of NZ\$250/tonne, assuming Solid Energy had executed its planned cost savings, the business may have avoided the financial distress it faced in early 2013. In that case it could have then worked systematically through the UBS recommendations creating a reasonable amount of value for the government through the proposed IPO.

Did Treasury do all that was reasonably expected (and sufficient) given the information it had and the options available to it?

There is no straight forward answer to this question. Treasury early on identified a fundamental divergence of views between Treasury and the Company with respect to future energy prices. Treasury also identified the link between the Company's view on future energy prices, its investment strategies and its own internal views on valuation. These concerns were advised to Ministers and played back to the Company.

With hindsight it is clear that the Company's view on price path led to strategies for the business that materially increased risk. The strategies resulted in material value at risk in relation to core mining and development activities, high debt and an overhead structure – all of which meant the Company was poorly placed to cope with the massive price shock that it faced in 2012. For Treasury to have fully identified the extent of this risk it would have had to have either undertaken materially more analysis of the Company and its plans and would almost certainly have had to commission outside industry expertise to address some of the more complex technical matters such as mine plans and forward views on energy prices.

Further action by Treasury would have had to have involved a material elevation of concerns over price path assumptions and strategy. Given the extent of the gap that existed between the company's view of price path and the market's consensus view - a change of management would have been highly likely as a consequence of such an elevation. Depending on the subsequent Board response to a management change a change to the Board may have resulted also. Such an elevation would have had to have been initiated against a backdrop of a Company that was generally

regarded as being well led and governed, was performing well financially, and which more often than not had been proven right with respect to its core planning assumptions in the short term.

What was the quality and timeliness of advice to Ministers and what evidence was there that the advice was considered and taken up?

Treasury identified the key areas of concern and advised these concerns to Ministers within reasonable timeframes. As noted above the key question is whether Treasury fully investigated or appreciated the implications of these concerns with respect to the risk of the Company. Treasury identified the Company's view on price path – and the actions stemming from this – as a cause for concern rather than alarm and Ministers acted accordingly.

What further action (earlier or otherwise) could Treasury have taken with the information it had and the advice it provided to Ministers?

Having identified the Company's views on price path and resulting strategies as a cause for concern Treasury could either have insisted that the Company provide substantive support for its views on price path and a risk assessment for the Company in the context of its chosen strategies or have initiated its own, detailed investigation with appropriate external support to fully identify the implications of the Company's strategies.

We note that external valuation advice for Solid Energy was commissioned in 2010 that did contest the Company's view on value, primarily due to differences in view on price path. Similarly, the UBS scoping study completed in November 2011 also contested the Company's views on price path and more fully identified the implications of these views with respect to cost structure, gearing and value. We note that while this independent advice did contest assumptions central to the Company's views on strategy and value, none of these processes called into question the underlying viability of the Company because none anticipated the collapse in coal prices that occurred in 2012.

Given key market or organisational events/drivers affecting Solid Energy's performance and viability, could Treasury have done something differently to manage risks to the Crown?

As noted had Treasury more fully appreciated the implications of the Company's view on price path it could have initiated a more substantive investigation earlier – probably as an outcome of the 2008 SCI process. Assuming that this investigation was undertaken to a sufficient level of detail and competence it is most likely that this would have caused Treasury to elevate concerns to Ministers to a point that Company's SCI was rejected. As discussed above a consequence of this would most likely have been a change to the leadership of the Company and possibly a change to the composition of the Board. We note, however that at that point many of the investment activities were in progress and any new management team or Board would have needed to develop and implement new strategies for the business which would have had their own risks given the nature of Solid Energy's business.

While Treasury could have done things differently and had it done so outcomes may have been different it is questionable as to whether it is reasonable to expect Treasury to have done so. While there were concerns identified with respect to the Company's plans and attitudes fundamentally the Company had performed well under its leadership and governance arrangements. For Treasury to have initiated fundamental action would have required it to effectively form the view that it lacked confidence in a Board and executive with a sound track record in a technically complex industry. The removal/refreshment of a Board by Ministers is a crude lever and has a high threshold for use.

Notwithstanding this, with the benefit of hindsight, it is evident such a move may have been warranted. However, as discussed the outcome of such a decision would have had its own set of risks.

8. Recommendations

8.1. Areas that could possibly be strengthened

As noted above we believe that generally the COMU monitoring processes are sound. Further, we believe that the changes made to these processes in 2010 have materially enhanced the monitoring framework and reinforced where key accountabilities lie in the context of the overall SOE framework.

We believe that COMU will be most effective where its efforts are directed at reinforcing the proper operation of the SOE governance and accountability framework. In particular we believe that COMUs efforts will be most effective where these are directed at building an effective and trusted relationship with Board Chairs such that they assume prime responsibility for addressing areas of material concern. In our view it is unrealistic to expect COMU to develop the technical and analytical skills to develop alternative views on core aspects of SOE operations. It is not the role of COMU to “second guess” the plan and strategies developed by SOEs. Rather, COMU needs to be effective at identifying areas of concern with respect to current and prospective SOE performance and to place onus back on SOEs to address these concerns, using the resources available to the SOE that it would be inefficient and inappropriate for COMU to replicate.

In this context we have identified a number of areas where processes could be strengthened. We discuss these below.

8.1.1. More formality around sharing of views with respect to Board/Chair performance between the Monitoring and Appointments functions.

The revisions to the COMU monitoring framework clearly reinforced the COMU/Chair relationship as the pivotal component in the overall monitoring of SOEs. Both the Monitoring and Appointment arms of COMU interact with the SOEs. While both will have the Chair as the primary contact the Monitoring team will also interacted with senior management.

From our discussions with COMU personnel it is clear that there is a considerable exchange of views with respect to Chair/Board performance and senior members of the Monitoring team will assist with the Board recruitment process from time to time. However, we understand that such interaction is relatively informal.

We believe that there is scope to formalise this process, particularly in the case of the larger and more complex SOEs. In particular we see that this could involve:

- Developing a shared view of Chair’s respect for/understanding of the role of COMU as advisor to the Minister;
- Developing a shared view as to the performance/capability of the Board based on actual performance;

- Developing a set of indicators of performance that could provide an early warning of areas of concern. These indicators could include such measures as:
 - Timeliness of responses to routine monitoring
 - Timeliness of responses to ad hoc enquiry
 - Qualitative measures of the attitude of the Board to COMU
 - Actual performance variance from SCI budget

We understand that there is regular dialogue between the Monitoring and Appointments teams with respect to Board performance and that these are informed by the interactions that each has with the Company in their respective roles and other feedback received. However, we are unclear how formalised this interaction is and whether this results in a synthesised view as to Board performance or, where concerns are identified, how plans are developed and roles assigned to ensure that there is a synthesised set of actions across COMU to ensure that these concerns are resolved.

8.1.2. Use of appropriate external expertise where areas of concern are identified and these remain unaddressed

The larger SOEs are complex organisations with considerable resources, expertise and information at their disposal. It is unrealistic and inappropriate for COMU to seek to match these attributes. Fundamentally it is the role of the Board to test and challenge management on the performance of and plans for the business. Moreover, if the Board requires reassurance on certain aspects of performance or proposed actions then it has the ability to commission any additional advice required to provide further assurance. It is important that COMU does not undermine this accountability.

However, we believe that there are circumstances where it is legitimate for COMU to commission its own advice⁷. In particular this could be:

- Where there are persistent concerns of a specific technical nature which the Company fails to address and where these link to important aspects of a SOE's strategy; and
- Where there are more fundamental concerns with respect to the overall strategic direction of an SOE.

In the first instance the initial advice could be commissioned directly by COMU to provide it comfort as to the reasonableness of the SOE's stance on specific issues. This could result in one of several outcomes being:

- The external advice provides COMU with additional comfort with no further action necessary and no visibility to the Company;
- The external advice identifies some additional questions for COMU to raise with the SOE; and

⁷ We note that Treasury do currently commission external advice. A recent example was a strategic review of Kordia which was undertaken following concerns raised by Treasury.

- The external advice raises more material concerns at which point reference could be made to this when raising concerns with the Chair.

In the second instance the request for external advice would be more broadly based and more fully involve the SOE. In most instances this would be presented as being COMU obtaining additional comfort in circumstances where the Government is being asked to support a material investment programme or change of strategy.

We do not see that seeking such external advice should be the norm. However, what is important is that the COMU processes in place and the judgement necessary to identify the circumstances where such advice is needed and can add value.

8.1.3. Build appreciation of COMU's role through the quality of analysis so that views hold weight

COMU will be most effective if its role is valued by the SOEs and the Chairs in particular. If COMU develops a reputation for "seeing through" plans and performance such that SOEs know that issues will be identified and that management will be held to account then:

- SOEs are more likely to be diligent with respect to core accountability and planning processes – i.e. if they understand that a poor level of compliance and interaction with COMU will be viewed unfavourably by Boards.
- There is a greater chance of monitoring becoming "self-fulfilling" - i.e. SOEs understand that deficiencies will be identified so incentives are created to ensure proper respect for the accountability and monitoring processes
- Chairs will look to COMU as a valued advisor to Ministers and who are focussed on ensuring good performance across a complex portfolio

There is clearly a base load of process activity that all SOEs are subject to. To build respect we consider that it is important that COMU:

- Takes a portfolio view informed by a thorough understanding of each entity that enables its resources/capabilities to be concentrated on areas of greatest risk;
- Avoids raising issues with SOEs of a minor or compliance nature where little or no value is provided to the SOE or the overall monitoring process;
- Applies a "light touch" to the overall monitoring process where there are no causes for concern – possibly even permitting certain SOEs to avoid certain aspects of the monitoring process where these are not mandated by Parliament;
- Avoids the perception of a generic or "one size fits all" approach to issues – for example capital structure or dividend policy;
- Uses direct rather than indirect engagement with respect to issues of concern – for example a focus on capital structure shouldn't be used as an indirect mechanism for solving concerns with respect to investment or dividend policies;
- Focuses its efforts and analysis on areas where there are genuine concerns and ensures that this analysis is of a high quality that can be worked through with Chairs – so that where

genuine issues exist Chairs are presented with a strong case that will require them to work through the issues identified with the Board/management;

- A set of “early warning” signs are established⁸ so that potential areas of concern are identified which could include;
 - Material sector disruption
 - A history of surprises in relation to financial performance
 - Lax adherence to key processes as evidenced by issues of timeliness or quality of information provided
 - Material changes in strategy
 - Material new investments
 - CEO/Chair attitude to COMU
 - Longstanding CEOs with a new Board
 - Change of longstanding CEO
- Develop a set of tools that can be deployed either in whole or in part where there is early warning of potential issues.

We have set out below some views as to what this toolkit could include.

8.2. Toolkit (possibly on a discretionary basis where early warning triggered)

Where COMU has performance concerns, we have identified some additional tools that could be applied on an “as required” basis. In the first instance the onus should be on the SOEs to undertake much of the additional analysis sought.

Before discussing potential new tools, we have considered the effectiveness of several of the tools already available to COMU.

Use of capital structure to constrain investment decisions

Over the period 2008 to 2010 there was a general trend of encouraging SOEs to increase their level of gearing, in particular targeting a Standard and Poor’s BBB rating. The reason was twofold 1) to increase dividends from SOEs as a way of improving the Government’s finances 2) to increase the level of private sector scrutiny, in particular from banks, of SOE performance. In the case of Solid Energy there appears to be a third reason which was to encourage the Board into backing its view of the value of Solid Energy and therefore its ability to gear up the balance sheet. It was thought that in

⁸ We understand that COMU effectively already follow the approach proposed, which has on occasions led to various actions being taken on certain entities (e.g. Kordia strategic review, entities put on “watch” or on a monthly reporting regime, board changes)

the event the Company was not able to access debt funding then that would be a signal to the Board to constrain their investment activity.

It appears from recent media and commentary from Government that in the case of Solid Energy this scrutiny did not eventuate and instead banks had a view that SOEs were backed by an “implicit” government guarantee which it is confirmed does not exist.

While capital structure is a useful tool to encourage boards to focus on efficient operations and increase private sector scrutiny it needs to be used in a well-informed manner taking into account the risks faced by SOEs and the unique characteristics of the industries they operate within. Ultimately however under the SOE model of governance it is the responsibility of boards to determine an appropriate capital structure.

Detailed ComCo analytics

While it can be difficult to identify genuinely comparable companies for New Zealand entities for most of the large SOEs there are listed companies in their relevant sectors and information in relation to which can be used to inform ComCo analysis. While such analysis needs to be applied with caution with respect to absolute measures (margins etc.) such analysis can identify:

- Key value drivers;
- Key ratios; and
- Sector change.

Insist on support for fundamental assumptions

While the large SOE's are complex businesses in most instances financial viability and performance are influenced by a limited number of key value drivers – generally price and volume. Where market information exists it is reasonable that SOE expectations are benchmarked to this market data. Where concerns exist and these are material to the performance on the SOE then the SOE should be required to provide authentication for these assumptions.

High level modelling of key value drivers

Financial modelling can be a powerful tool for identifying risks and quantifying the significance of key assumptions (and deviations from these). Where there are initial concerns with respect to SOE performance or plans, high level modelling of key value drivers can be applied to demonstrate the impact on key metrics (profitability, return on assets, capital structure, liquidity etc.) of variations from planned performance. Such modelling can be used to determine the extent to which concerns are justified (i.e. there is a real risk) and in tandem with other analysis, help support discussions with Chairs where concerns need to be elevated.

We note while modelling is a powerful tool it is often extraordinary circumstances or events which occur which give rise to the financial performance issues amongst many companies. The use of modelling will not necessarily have identified these.

Segmental analysis

In some cases an aggregated view of a SOEs current and prospective performance will not provide sufficient insight as to the underlying performance or risk. This can occur either where the SOE undertakes a range of relatively discrete activities (such as for NZ Post), where within a more homogenous entity – such as the electricity generators – there is the potential for poor performance at an asset level to be disguised or where there is material investment activity being undertaken by SOEs that are also managing a set of mature assets. How the segmental analysis is constructed will depend on the specific concerns COMU has identified.

We understand there are situations where Treasury has required segmental financial results where it has identified areas of concern. We simply note that increased use of this type of reporting, where concerns exist, is likely to bolster Treasury's ability to have benefits in the management of issues.

External expertise to support analytics where concerns identified

As noted above, it is not plausible for COMU or the wider Treasury to maintain deep sector or technical expertise with respect to the business activities undertaken by the SOEs in the way that an investment bank or consultancy business might. However, COMU should have the capability to identify where such expertise needs to be called on and to be able to contract the right expertise in the right way.

In the context of Solid Energy, it is possible that the use of a respected industry professional as a circuit breaker in so far as they could mediate a position between the Company and COMU may have been useful. We note that such a process could reduce but not eliminate risk given that even the scoping study did not identify the extent and speed of the deterioration in coal prices.

Understand debt facilities

The SOE model relies on scrutiny by parties other than COMU – the banks in particular. While we do not consider it necessary for COMU to have a detailed understanding of the facilities arranged for all SOEs, we expect that such an understanding should be developed where concerns have been identified. In particular it is important that COMU understand what headroom is available in current facilities, key covenants and the tenure of facilities.

8.3. Other Observations

Risk register

It is clear that Solid Energy is a complex business with numerous interacting facets of its operations and business. Other SOEs are similarly complex we believe, in addition to the regular reporting regime, a register (such as is likely to exist for internal operational risk practices) could be requested for at least the more complex SOEs along with strategies and plans to mitigate these. The annual business planning process covers a section on risks however our view is the register should be dynamic and in particular identify not just operational risks but quantify risks to earnings as a result of market movements.

We expect all businesses of the size of Solid Energy would operate a similar process internally so there should be limited additional work to optimise the output for Treasury's purposes. The risks could be reviewed and recorded within COMU in a manner to help inform how COMU undertakes its

monitoring activity at the SOE level. The risk information could also be used at a portfolio level to help ensure monitoring effort is targeted at the right SOEs.

Consultation process

Treasury, in advising the Minister on the 2007/10 draft SCI and business plan, highlighted the need for Solid Energy to consult on key projects before committing significant capital on relatively risky unproven projects. A letter by the Minister for SOEs to the chair notes there is the expectation to be consulted on certain relatively risk and unproven projects that are likely to exceed consultation thresholds over the course of the project.

From our document review it is clear there was limited consultation on a number of the investments that Solid Energy made throughout the review period. One of the reasons for this was the ability to classify its projects as operating expenditure or that a lack of consultation was not required as it was less than the required percentage of the project spend. We believe as part of the annual planning round there may need to be more focus on communicating with boards the requirements of consultation with respect to investment decisions and the consequences of a lack of consultation.

Board evaluation

The Owner's Expectation Manual notes that "[directors]....may be reappointed at the expiry of that term, subject to their contribution having been satisfactory and their skills continuing to be relevant to the Board." This implies some form of consideration of the Board's performance for the period.

The Owner's Expectation Manual notes the roles and responsibilities in relation to board and director evaluation. It notes that the Crown requires each board to undertake periodic evaluation of performance which is an important contribution to the process by which Ministers consider the make-up of boards when considering appointments and reappointments. The Minister expects processes to be in place for the following:

- A formal high-level board feedback report to COMU on overall board performance, key focus areas for continuing development and assurance that the process has been appropriately implemented; and
- Board succession plan.

In our review we noted that confirmation that Board evaluation processes have been followed have been received in some but not all years of our review. COMU confirmed that there has been a change to its processes to ensure reminders are now given. The expectation for Boards is that the evaluations are undertaken.

From discussions with COMU we understand that as part of the on-going Board succession work there are regular interactions with Chairs (and other directors) to form a view on the performance of the Board and individual directors. However, we are less clear as to the formality of these discussions and whether they result in a synthesised "COMU" view that is then factored into risk assessment and monitoring processes.

Appointment of Directors

As discussed previously the action by Ministers to remove a director or a complete Board is a blunt instrument with far reaching consequences. One recommendation, which was discussed during our interviews where concerns are identified or a need for particular capability is identified, is to use the appointment of directors into routine vacancies as a circuit breaker. It would be envisaged that Directors with a specific skill set are identified as a way of generating a new perspective on issues/concerns where there was previously misalignment between the Board and COMU.

Intensive monitoring process

We understand that when a decision was taken to put Solid Energy into an intensive monitoring process there was no formal, documented process for giving effect to this decision. However, we understand there are a number of precedents⁹ which were referred to. While Treasury ultimately established a framework with which to monitor Solid Energy under the intensive regime there may be some benefit in documenting what process should be followed based on this experience. This document could then be made available to SOE's in the event such an option is required. It is important in formulating such a document that there is no one size fits all approach given the complexity of the businesses and unique risks each business faces. Such instances of intensive monitoring are likely to be fluid and decisions will be made based on the best available information at the time. Rather, any documentation of the process would seek to include key steps/events/analysis which at a minimum would be expected to be undertaken.

Guidance on “Deemed Director” liability

During our interviews there were a number of occasions where the issue of “Deemed Director” was raised. This was in the context of both Treasury and Minister's ensuring they remained sufficiently arm's length from the decision making responsibilities of the Board. There was concern that if there was too greater involvement in some of these areas of responsibility that a legal liability may be ensued.

There are certain circumstances where a shareholder may be deemed a director, such as where a shareholder is, by virtue of the Company's constitution, given powers that would ordinarily be exercised by the Board. In addition, where the constitution of a company requires the Board to exercise, or refrain from exercising, a power in accordance with a decision or direction of a shareholder or shareholders, that shareholder or those shareholders will be deemed directors and required to comply with the duties of directors.

We are of the view that this area of law, should be clarified for Treasury and Ministers¹⁰. This will ensure all actions which can lawfully be taken are and that concerns regarding decision making of a board are exposed early on through appropriate actions.

⁹ There have been several instances of intensive monitoring of entities over the last 10+ years (e.g. Solid Energy 1999-2000, Terralink 2000-2001, Public Trust (various), KiwiRail, Learning Media and Kordia.

¹⁰ We understand that Treasury does have an internal document, which was produced by the Treasury Legal Team, about the issue of deemed directors.

8.4. Concluding comment

COMU is required to monitor a broad range of complex businesses each with different characteristics and risk profiles. It is unrealistic for COMU to intensively monitor all of these businesses all of the time. Rather, it needs to be able to focus its resources on areas of greatest risk and need and to solve problems identified based on the specific circumstances in each instance. This requires that COMU:

- Takes a portfolio approach whereby it identifies which entities require particular attention at which point in time;
- Looks for early indicators that current assessments of an entities status may need to change;
- Applies judgement to determine which set of tools to apply in circumstances where concerns about an entity are proven to be justified;
- Think laterally about the avenues available to it to influence change where this is needed and conventional processes are not resulting in a satisfactory response by the SOE to the concerns identified; and
- Ensures that areas of concern, where these are material, are not allowed to persist.

9. Appendix 1: Terms of Reference

Terms of Reference – For the Review of Treasury’s Monitoring of Solid Energy Limited (“Solid Energy”)

Purpose	<p>To assess:</p> <ul style="list-style-type: none"> Treasury’s performance in the monitoring of Solid Energy <ul style="list-style-type: none"> How well did Treasury apply its stated monitoring procedures and practices to the monitoring of Solid Energy and; Whether Treasury had taken all the necessary and reasonable steps to protect the Crown’s ownership interest in Solid Energy including ensuring that Ministers were kept fully informed of concerns and actions taken. As a result of reviewing the above, a view as to whether Treasury’s current financial monitoring procedures and practices were sufficient to meet the stated purpose/objective of Treasury’s State Owned Enterprise (SOE) monitoring function. The purpose/objective is stated in the key accountability documents.
Scope	<p>In scope:</p> <ul style="list-style-type: none"> Review how well Treasury performed its monitoring and appointment functions in relation to Solid Energy from 2006 to January 2013. This includes the process followed for making appointments to the Solid Energy Board and evaluating the effectiveness of the Board Review all documentation held by the Treasury including information generated externally such as reports provided by Solid Energy’s on its actual and forecast financial performance, as well as generated by Treasury Interview all Treasury managers and staff involved in monitoring of Solid Energy Based on information gained during the above review, provide an opinion on any measures Treasury could take to improve its monitoring and appointment functions. This would include a view as to whether Treasury’s current financial monitoring procedures and practices are sufficient to meet the stated purpose/objective of Treasury’s State Owned Enterprise (SOE) monitoring function. <p>Out of Scope</p> <ul style="list-style-type: none"> Designing future Treasury SOE monitoring models information/documentation held by external parties interviews with external parties any assessment of the quality of external information received and Treasury performance and financial analysis
Review Sponsor	Vicky Robertson Deputy Chief Executive
Review Manager (Treasury)	Gary Taylor Risk Advisor Office of the Executive
Reviewer	Deloitte

Background	<p>Solid Energy New Zealand Limited is a State Owned Enterprise. Over the last few years with the deterioration in market conditions, Solid Energy has experienced major financial difficulties.</p> <p>Treasury as the Crown's lead advisor on the financial performance of public institutions is responsible for monitoring the financial performance and viability of Solid Energy. This includes evaluating; taking necessary action and keeping Minister(s) informed when risks to the Crown ownership interest are identified.</p>
Period to be covered by the Review	<p>The review will cover the period from 2006 to January 2013.</p>
Steps	<p>The Review will involve:</p> <ul style="list-style-type: none"> • Interview relevant key Treasury staff that have been involved in monitoring during the period • Review Treasury's business objectives, process and practice for monitoring and evaluating the financial performance and viability of public institutions with particular emphasis on how it has been applied to Solid Energy • Review of key documentation/information including: <ol style="list-style-type: none"> 1. Monitoring and evaluation framework including policies, guidelines, processes/ procedures and systems (as applied and changed between 2006 to 2013) 2. Treasury Reports 3. Aide memoires 4. Emails to/from the Minister of Finance /Minister for State Owned Enterprises Offices 5. Treasury action plan(s) regarding Solid Energy including updates of progress 6. Internal risk assessment and reporting practices as it relates to Solid Energy 7. Externally commissioned studies/reviews on Solid Energy 8. Communications, if any, with the Office of the Auditor General regarding Solid Energy 9. Documents/emails or records of communications including conversations with Solid Energy's Board, Chief Executive or other members of the company's executive 10. Any other documentation that is relevant to the purpose of the Review • Any other activity that the reviewer after consultation with the Review Sponsor considers necessary to complete the review.
Requirements	<p>The reviewer should demonstrate a sound understanding and experience of the following:</p> <ul style="list-style-type: none"> • Treasury's role in monitoring the Crown's ownership interest in public institutions such as Solid Energy • The reporting and accountability obligations for Treasury to Ministers • Financial forecasting models and financial viability assessments • Sound understanding of risk management practices • Is sufficiently independent from Solid Energy and Treasury staff that are responsible for monitoring the financial performance and viability of public institutions

Final Report	The Review Report will be provided to the Review Sponsor at the completion of the Review
Timeframe for Review	<p>The timeframe for the review is :</p> <ul style="list-style-type: none"> • 28 February 2013 - Finalise Terms of Reference for the Review • 28 February - engage contractor to undertake the Review • 4 March - commence planning • 11 March – commence fieldwork • 27 March - complete field work • 5 April - provide draft report • 24 April - presentation of the final report

Specific key questions that the Sponsor would like the Review to address:

1. Did Treasury do all that was reasonably expected (and sufficient) given the information it had and the options available to it?
2. What was the quality and timeliness of advice to Ministers and what evidence was there the advice was considered and taken up?
3. What further action (earlier or otherwise) could Treasury have taken with the information it had and the advice it provided to Ministers?
4. Given key market or organisational events/drivers affecting Solid Energy's performance and viability, could Treasury have done something differently to manage risks to the Crown?

10. Appendix 2: Glossary of Terms

Abbreviation	Definition
A&G	Appointments and Governance
AGM	Annual general meeting
APH	Appointments and Honours Committee
CCMAU	Crown Company Monitoring Advisory Unit
CFISnet	Crown Financial Information System
The Company	Solid Energy New Zealand Ltd
Coalcorp	Coal Corporation of New Zealand
COMU	Crown Ownership Monitoring Unit
CTF	Coal to Fertiliser
CTG	Commercial Transactions Group
CTL	Coal to Liquids
CTP	Coal to Products
CSG	Coal seam gasification
DPMC	Department of the Prime Minister and Cabinet
EBITDA	Earnings before interest, tax, depreciation and amortisation
FTE	Full-time equivalent
FYXX	Financial year ending 30 June 20XX
GFC	Global financial crisis
HCC	Hard Coking Coal
IPO	Initial public offering
MED	Ministry of Economic Development
MOM	Mixed ownership model
NEX	Wilder Hill New Energy Global Innovation Index
NPAT	Net profit after tax
NPV	Net present value
NRL	National Resource Limited
NZD	New Zealand Dollar
OEM	Owner's Expectation Manual
PIRs	Post investment reviews
The Review Period	2006 to January 2013

Abbreviation	Definition
SCI	Statement of Corporate Intent
SOE	State Owned Enterprise
SOE Act	State Owned Enterprise Act 1986
Solid Energy	Solid Energy New Zealand Ltd
UCG	Underground coal gasification

11. Appendix 3: Documents Reviewed

- The Treasury: All 58 documents listed under Solid Energy Information Releases. Note we reviewed the originals of these documents as provided to us which contained all confidential information not shown in the public documents.
(<http://www.treasury.govt.nz/publications/informationreleases/solidenergy>)
- Crown Ownership Monitoring Unit: 2010 Annual Portfolio Report
- Crown Ownership Monitoring Unit: 2011 Annual Portfolio Report
- Crown Ownership Monitoring Unit: 2012 Annual Portfolio Report
- Crown Ownership Monitoring Unit: Guidance on the Monitoring of State-Owned Enterprises (June 2011)
- Crown Ownership Monitoring Unit: Owner's Expectation Manual (July 2012)
- Crown Ownership Monitoring Unit: Board Appointments, Induction, and Professional Development (December 2011);
- Solid Energy Valuation (30 June 2009)
- Solid Energy Independent Valuations Summary of Differences (12 November 2010)
- Solid Energy Annual Report (selected sections) of 2007, 2008, 2009, 2010, 2011 and 2012
- Solid Energy Final SCI 2011
- Solid Energy – Response to UBS Scoping Study
- Selected continuous disclosures from Solid Energy February 2010 to 2013
- Selected media releases from Solid Energy 2006 to 2013
- Forsyth Barr Valuation of Solid Energy 2010 & 2011
- Macquarie Valuation of Solid Energy 2010
- PWC: Covering letter – Review of the methodology used for the valuation of Solid Energy New Zealand Limited (28 July 2009)
- PWC: Benchmarking of the Solid Energy Valuation of Coal Operations (30 July 2009)

- Various letters and emails re Board and director performance evaluations (9 October 2006 – 31 January 2013)
- Email exchange between Chair and Treasury April 2011
- UBS Scoping Study on Solid Energy
- File note of Solid Energy meeting (22 June 2012)
- Select Committee News (15 March 2013)
- Don Elder: CEO Board memo – FY13 Budget (27 April 2012)
- Various letters from Minister for State Owned Enterprises to Solid Energy (28 May 2009 & 8 September 2010)
- Draft Debt Position and Possible Financing Structure (8 April)
- Solid Energy's Proposal for Natural Resources Ltd (7 May 2010)
- Solid Energy National Resource Company Response (27 August 2010)
- Solid Energy Timeline memo (29 January 2013)
- Minister's expectations letter dated 28 May 2009 (Referenced in SOE-011/A73696)
- Appendix III "Equity Analyst Style Report" (Referenced in SEL-033/A75020)
- Minutes from Select Committee 08/09 financial review of Solid Energy (Referenced T2010/659)
- Selected Strategic Issues Letters from Solid Energy 2006 to 2013
- Confirmation of Board performance evaluations as supplied to COMU for selected periods 2006 to 2013
- Post investment reviews for Natures Flame and the Stockton Washing Plan
- Selected Draft SCIs and Business Plans for period 2006 to 2011.

12. Appendix 4: Solid Energy - Timeline of Events

12.1. Key events related to monitoring

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
2005-2007	<p>Purchase of land in Southland with lignite resources.</p> <ul style="list-style-type: none"> At the time of its 2006 business plan, Solid Energy had made land and mineral purchases of \$50 million, and was planning a further \$67 million to \$137 million of spending in relation to lignite resource acquisition. This was to provide it options regarding a proposed coal to liquid conversion project. 	<ul style="list-style-type: none"> 2006 SCI and Business Plan 	<ul style="list-style-type: none"> Officials were concerned that considerable capital expenditure has occurred without any substantive prior consultation with officials or Ministers. Solid Energy's SCI required formal consultation if any capital expenditure item exceeds 25% of shareholder funds. The land and minerals purchases to keep the options open for the project in total were estimated to significantly exceed this threshold. They noted the lack of material consultation is unacceptable. This was noted in the draft letter commenting on Solid Energy's draft SCI and Business Plan. 	<ul style="list-style-type: none"> In August 2006 Ministers sent a letter stating "Accordingly, in line with our general expectation that state-owned enterprises consult on significant projects ahead of implementation, Ministers ask that, prior to further progress, Solid Energy provides us with a report by 31 October 2006 detailing: <ul style="list-style-type: none"> the current position of the coal to fuel project the business case for securing the mineral resource a broader picture of the potential coal to fuel project any other relevant information." In December 2006 Ministers met with Solid Energy to discuss a number of issues including the land purchases in Southland. Further opinions were to be expressed regarding the purchase of land which should have been consulted on. We are unsure of the final outcome of the Minister's action, particularly if a business case was provided to Treasury for the land purchase.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
2007	John Palmer appointed Chairman replacing Tim Saunders who had been Chairman from December 1998.	<ul style="list-style-type: none"> Appointment process Reference checks, John Palmer was Chairman of Air New Zealand since November 2001. 	<ul style="list-style-type: none"> Followed A&G process to appoint John Palmer as chair. 	<ul style="list-style-type: none"> Agreed with appointment of John Palmer to chairman.
2008	<p>Revaluation of Company from \$475 million to \$2.9 billion.</p> <ul style="list-style-type: none"> The original draft SCI had a value of ~\$7.8 billion. Following redraft and primarily due to excluding the CTL project the value reduced to \$2.9 billion. The Board noted in the draft and final SCI that the valuation was a "value in use" and therefore did not represent the value which would be reflected in a transaction for the Company. 	<ul style="list-style-type: none"> 2008/11 Draft SCI and business plan Communications and clarifications with Solid Energy over the SCI Letter of response from Ministers to Solid Energy Solid Energy response and subsequent final SCI. 	<ul style="list-style-type: none"> Treasury noted that the commercial valuation in the 2008/11 Draft SCI was not consistent with the approach used in the previous SCI. A major component of the refreshed valuation was the value of alternative projects (not committed / shareholder consultation) – particularly the CTL project - that generate value beyond the 20 year planning horizon. Treasury discounted the credibility of the commercial valuation approach used in this draft, and noted a preference for the approach used in the 2007/10 Draft SCI. Treasury clarified that it did not object to the inclusion of these alternative projects, however it further qualified this statement by stating that such estimates need "to be carefully explained and put in context, and have appropriate caveat around it". Treasury suggested that the 2008/11 SCI could present several estimates of the value of Solid Energy. At a minimum it should include a valuation estimate based on the value attributable to existing operations and / or extensions to these operations - "value that could be achieved with a high level of probability" (i.e. valuation approach used in the prior year's SCI). Other values could be provided assuming future planned / speculative investments (i.e. CTL) go ahead. Treasury recommended that the Minister request a redraft of the SCI, with no extension for the receipt of the final SCI. 	<ul style="list-style-type: none"> Letter sent requesting a redrafted SCI Ultimately conceded that it was the responsibility of the Board to assess the commercial value of Solid Energy Tabled final SCI which included a much reduced valuation of \$2.9 billion.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
2009	<p>Drop in coal prices which were offset somewhat by movements in FX.</p> <ul style="list-style-type: none"> The Company responded to preserve cash flows by reducing costs across the business. In addition a formal review was undertaken by COMU of the treasury policies of Solid Energy and if they contributed to an FX loss of \$102 million in 2H08. 	<ul style="list-style-type: none"> Commerce Select Committee's 2008/09 financial review Discussions with Solid Energy management 	<ul style="list-style-type: none"> Treasury noted that the losses incurred by Solid Energy were not due to a failure of Treasury policy or operations, but due to the sharp fall in the NZD in 2H08 and GFC-induced fall in sales volume, which led to an over-covered FX position. Treasury noted that Solid Energy had revised its strategy for the next 18 months in response to falling demand, by: <ul style="list-style-type: none"> Reviewing all operating and capital costs, which saw a reprioritisation of several projects Reduced production at several of its mines Advancing the Stockton coal washery using staff that otherwise would have been made redundant. 	Treasury recommended that the shareholding Ministers note the content of its report.
Sep 2009	<p>Solid Energy commits to refresh at Stockton. [2] [5] capex</p> <ul style="list-style-type: none"> Ministers were consulted on the purchase of mining assets following the new agreement for Downer EDI NZ Ltd for the management of the mine. 	<ul style="list-style-type: none"> We are unsure of exact documentation but understand a letter was received setting out the terms of the investment and included NPV analysis of the mines investment plan. 	<ul style="list-style-type: none"> Officials were comfortable that Solid Energy adequately considered a range of available options and had regard to shareholding Ministers' expectations that debt or financing instruments, rather than equity, be used to finance these assets. The analysis provided by the Company appeared to put forward a case that was compelling. 	<ul style="list-style-type: none"> Sent a letter confirming the shareholding Ministers were comfortable with the investment and had no further plans for consultation.
2010	<p>Solid Energy starts a borrowing programme to finance growth objectives.</p> <ul style="list-style-type: none"> SCI sets out that debt will increase to fund capex, flags equity needs in 2013. <p>2010 SCI states "The requirements of our capital investment programme across the three-year planning period, are likely to require an increase in our gearing target from 35% to 40% (not including rehabilitation). Based on our current plans and dividend projections it is likely that we will exceed these gearing targets in the three-year period. Where this possibility exists we will discuss it with the shareholder at the time. Additional equity and/or project financing is expected to</p>	<ul style="list-style-type: none"> 2010/13 SCI / Business Plan 	<ul style="list-style-type: none"> Treasury noted that the 2010/13 SCI / Business Plan included the provision for external equity investment in 2013 of \$250 million and the suspension of dividend payments from 2010, which would not resume until 2019. These changes were largely brought about in response to a revision of Solid Energy's capital expenditure programme (i.e. extension to coal business, renewable energy, biodiesel and wood pellets). It was observed that the IRR and payback period for each of the projects in the capex programme relied upon Solid Energy's forecast coal prices 	<ul style="list-style-type: none"> The draft letter from shareholding Ministers noted that: <ul style="list-style-type: none"> external equity was inconsistent with the current Government's policy they were not prepared to support a suspension of dividends until the business case for each development project has been considered and approved. Note the 2010 SCI was not finalised until late in 2010 and therefore spans the time period 2009 – 2010.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
	<i>be required by FY13 to fund this programme."</i>		<p>assumptions.</p> <ul style="list-style-type: none"> Treasury noted that introduction of external equity was not consistent with the Government's current policies and should not be supported by shareholding Ministers. Treasury recommended that the shareholding Ministers note the inclusion of external equity investment and the suspension of dividend payments 2010 – 2019; agree that the SCI is not acceptable to table in the House in its current form; and sign a letter to Solid Energy extending the deadline for it to submit its final SCI to 30 September. 	
2010-2011	<p>SCI for 2010/13 (valuation date 1 July 2010) sets out value of \$3.5 billion.</p> <ul style="list-style-type: none"> COMU commissions independent valuations by Macquarie and Forsyth Barr which both conclude the value of Solid Energy to be circa \$1.7 billion. Further analysis shows the majority of the difference relates to forward views of coal prices. Subsequently the 2011 SCI value provided is reduced to \$2.8billion. COMU commissions Forsyth Barr to provide an update of their valuation which confirms their previous view at circa \$1.7billion. 	<ul style="list-style-type: none"> SCI and Business Plan Forsyth Barr independent valuation 2010 and 2011 Macquarie Equities Research independent valuation 2010. November 2010 analysis of the value differences between the two independent reports and the SCI as provided by Solid Energy. 	<ul style="list-style-type: none"> Treasury expressed concern over the valuation estimate by Solid Energy, given that: <ul style="list-style-type: none"> The Solid Energy valuation estimate resulted in P/E and EV/ EBITDA ratios that were significantly above the ComCo average whilst the dividend yield was below the ComCo average. The independent valuation estimates resulted in P/E and EV/EBITDA ratios that were close or slightly above the market average, and the dividend yield that was slightly below the ComCo average. COMU noted that the commercial valuation of Solid Energy contained within its draft 2011/12 SCI failed to meet the standard of disclosure and the level of transparency requested by shareholding Ministers of all SOE Boards. These disclosure standards were communicated as part of the Shareholders' Expectations Letter to increase the transparency of the valuation. 	<p>2010 SCI</p> <ul style="list-style-type: none"> Shareholding Ministers issued a letter extending the timeline for the 2010 SCI to be finalised and rejecting the SCI for the reasons set out in the preceding issue. <p>2011 SCI</p> <ul style="list-style-type: none"> Shareholding Ministers requested Solid Energy Board reconsider its commercial valuation disclosure and provide a revised draft 2011/12 SCI by 30 November 2011. Following this, Solid Energy made significant changes to its disclosure and COMU / Treasury was of the view that this met the minimum requirements in terms of its level of transparency.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
2010	<p>NRL proposal</p> <ul style="list-style-type: none"> NRL was pitched as being an “audacious” vision for a majority state owned, diversified, natural resources company, which had preferential rights of access to NZ's hydrocarbon and mineral resources across all areas of its business. 	<ul style="list-style-type: none"> Solid Energy's Proposal for NRL. Support from DPMC and Ministry of Economic Development. 	<ul style="list-style-type: none"> COMU cautioned against decisions to progress the NRL proposal without heavily testing the strength of the following arguments upon which the proposal relied: <ul style="list-style-type: none"> aggressive future oil price; short window of opportunity; if supernormal profits arise from this window, they could not be captured by a royalty or tax regime; and the benefit of granting Solid Energy first right of refusal to newly issued areas, cancelled permits and released permits would outweigh the disadvantage of such a proposal. Given these assumptions were not consistent with independent experts, Treasury did not support the development of a single NRL as the optimal way of maximising the value of NZ's mineral resources, and noted that Solid Energy should focus on areas where it had specific capability and resources. 	<p>Treasury recommended that the shareholding Ministers:</p> <ul style="list-style-type: none"> note that COMU has reviewed the NRC proposal and does not support the development of a NRL as proposed; note the assumptions supporting the proposal are not consistent with those made by independent experts; agree that Solid Energy should focus on areas where it has specific capability and resource; specifically coal, lignite, non-conventional gas; and refer this report to the office of the Prime Minister
April 2011	<p>Chair calls into question professionalism of COMU</p> <ul style="list-style-type: none"> This occurs following a request for information and sensitivity analysis on its price path. 	<ul style="list-style-type: none"> Email correspondence between COMU and Solid Energy 	<ul style="list-style-type: none"> Following push back from Treasury. Solid Energy agreed to provide the information as required. We understand the requested analysis was never provided. This example illustrates the lack of professional respect that Solid Energy had for the rights of COMU and the Minister as representatives of the ultimate shareholder. 	<ul style="list-style-type: none"> We are unsure if Ministers were made aware of this issue.
Sept – Oct 2011	<p>UBS Scoping Study</p> <p>UBS concluded that in its current state, Solid Energy was not ready for an IPO. Solid Energy could meet the MOM objectives but would require a business strategy that:</p> <ul style="list-style-type: none"> focused on its core coal mining business; downsized the new development 	<ul style="list-style-type: none"> UBS Scoping Study 	<p>Treasury noted the following conclusions from the Scoping Study:</p> <ul style="list-style-type: none"> UBS did not have confidence in the business strategy of Solid Energy, and had concerns around its forecast price path for coal and oil (cf. market consensus). UBS were unable to obtain 	<ul style="list-style-type: none"> Ministers requested Solid Energy develops a revised strategy and business plan to prepare the Company for an IPO. This was to be provided by shareholding Ministers by 31 January 2013. Minister requested that Treasury summarise the conclusions of the MOM

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	<p>activities (including CTL and CTF);</p> <ul style="list-style-type: none"> divest the renewable businesses increase expenditure on drilling to give the market a clear indication of its level of coal reserves repayment of debt, as listed coal companies were debt free. reduce overheads and corporate head office costs 		<p>documentation and analysis supporting their forecasts.</p> <ul style="list-style-type: none"> UBS suggested that significant changes were required to Solid Energy's strategy and business before it would be IPO ready. UBS highlighted concerns around Solid Energy's valuation, given that: <ul style="list-style-type: none"> Solid Energy assumed a commodity price path for coal and oil for lignite conversion project projects that were significantly above the consensus view; Solid Energy's risk and return assessment for its lignite development projects being lower than equity / investment market expectations Treasury requested Solid Energy to develop a revised strategy and business plan to prepare the Company for an IPO, and provide this to shareholding Ministers by 31 January 2012. 	<p>Scoping Study.</p> <ul style="list-style-type: none"> On 27th January, the Chair indicated that most of the Minister's expectations "are well within Solid Energy's ability to fulfil", and indicated that a formal response would be provided on the third week of Feb, and would integrate their Strategic Issues letter due 28th Feb. A detailed response was not provided directly to Ministers as indicated, but was more or less included in their Strategic Issues letter on 28th February.
Oct 2011– Feb 2012	<p>Solid Energy considers Scoping Study and responds formally after an extension of time.</p> <p>Deutsche Bank review confirms inadequacy of Solid Energy's response to issues raised</p>	<ul style="list-style-type: none"> Solid Energy's note to Treasury on the Scoping Study Strategic Issues letter to shareholding Ministers Deutsche Bank review of Solid Energy's management response to UBS recommendations 	<ul style="list-style-type: none"> Treasury noted that Solid Energy was largely opposed to the majority of the conclusions of the Scoping Study This was on the basis that Solid Energy still felt their strategy was appropriate and that a retail-based IPO was not the appropriate way forward. Treasury noted its intention to commission Deutsche Bank to undertake a short-term analysis of Solid Energy. Treasury signalled that the likely options to Ministers were to: <ul style="list-style-type: none"> Support Solid Energy's current strategy and business plan, which Treasury noted would require a withdrawal of Solid Energy from the mixed ownership programme; 	<ul style="list-style-type: none"> Minister of SOEs met with Prime Minister, Minister of Finance and Associate Minister of Finance on 30 April 2012 to discuss Solid Energy. Minister of SOEs met with John Palmer and John Fletcher on 3 May.

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			<ul style="list-style-type: none"> - Ask the Board as to whether it will support a change in strategy consistent with the scoping study. • Treasury noted that Solid Energy's strategy and analysis effectively took a commodity price bet against the market. • Treasury also noted that it would take a minimum of 1 year to prepare Solid Energy for an IPO, although it was more likely that this would not occur until 2014. • Treasury maintained that the post investment review of the Taupo wood pellets processing plant supported the UBS scoping study (i.e. renewables energy investment did not fit within Solid Energy's core competencies, the investment diverted cash flow and management resources away from core business). • An analysis of Solid Energy's financial performance by Treasury indicated that all of Solid Energy's operating cash flows together with borrowing had been used to fund new investment. These investments had not driven an increase in profitability once movements in coal prices had been taken into account. • Deutsche Bank was largely supportive to the UBS Scoping Study findings and conclusions. Following this, Treasury requested to meet with Ministers on 23rd April (in advance of their scheduled meeting with John Palmer and John Fletcher in early May). 	

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Feb 2012	<p>2012 half year report.</p> <ul style="list-style-type: none"> Solid Energy reported strong financial results for the 6 months to December 2011 but highlighted the issues of falling prices and deteriorating demand in export markets. 	<ul style="list-style-type: none"> State Owned Enterprises, including Mixed Ownership Companies, provided updated financial forecasts, 13 March 2012 Solid Energy initiated correspondence with Treasury 	<p>Treasury were informed that:</p> <ul style="list-style-type: none"> Financial forecasts for 2013 and 2014 had been revised downwards due to lower international pricing (i.e. FX, sales volumes). As a result, dividend payments needed to be suspended and the capex programme tightened. 	<ul style="list-style-type: none"> Treasury recommended that shareholding Ministers note the contents of its report.
May 2012	<p>Correspondence received from Solid Energy containing financial scenarios.</p>	<ul style="list-style-type: none"> Board memo dated 27 April 2012. CFISnet financial forecast submitted March 2012 Solid Energy initiated contact regarding declining forecasts. 	<ul style="list-style-type: none"> We understand that the March 2012 CFISnet returns indicated a scaling back of future profitability. Solid Energy proactively contacted Treasury to advise of significant changes in their forecasts as a result of lower international pricing. Combining the information from CFISnet with the Board memo raised concerns within Treasury Treasury ran analysis which indicated based on some high level pricing scenarios that there could be potential solvency issues being faced by the Company. Questions were raised with the Company over the period March 2012 to May 2012 which continued to raise concern. 	<ul style="list-style-type: none"> Updated financial forecasts from the Mixed Ownership Companies update report sent to Ministers in late March setting out commentary from Solid Energy regarding the revision of its forecasts. Included comment that capital expenditure was being wound back to restrain gearing.
June 2012	<p>Treasury puts Solid Energy into intensive monitoring.</p> <ul style="list-style-type: none"> Evident reasonably early on that restructure of some degree will be necessary 	<ul style="list-style-type: none"> Board memo dated 27 April 2012. CFISnet financial forecast submitted March 2012 Draft 2012/13 BP and SCI provided May 2012 including management plans for managing through the low market prices. A number of other pieces of financial information and discussions with Solid Energy.] 	<ul style="list-style-type: none"> Treasury noted that the sharp fall in international coal prices had led to a significant deterioration in Solid Energy's financial performance and position, with the possibility of it incurring a financial loss if significant action was not taken. Treasury expressed concern that the actions proposed by Management to offset these risks (i.e. cost control, reductions in capital expenditure, sell additional coal domestically, asset sales, write downs and in a worst case seek an equity injection) would not be effective, due in part to their track record of cost cutting. 	<p>Ministers agreed to:</p> <ul style="list-style-type: none"> place Solid Energy in an intensive monitoring regime, require Solid Energy to report and meet with Treasury on a monthly basis, requested that Solid Energy provide a revised 2012/13 BP in a letter dated 13 June 2012.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
			<ul style="list-style-type: none"> Treasury expressed concern that Management continue to pursue a strategy that was not consistent with that proposed by UBS. In view of the above, Treasury recommended that Solid Energy was moved to an intensive monitoring status. It proposed that this would be given effect through the shareholding Ministers: <ul style="list-style-type: none"> granting an extension in timing to complete effective and realistic 2012/13 BP and SCI to 31 August 2012; require the Company to present the revised BP to Ministers require monthly reporting, and monthly meetings between Solid Energy and Treasury to discuss results. Treasury noted that the move to intensive monitoring would entail additional scrutiny of Solid Energy's performance, and that Deutsche Bank would support Treasury in this role. Furthermore, Treasury noted that "if Ministers are not satisfied with Solid Energy's strategy of performance you have the option of making changes to the Board". 	
August 2012	<p>Loss of confidence in Solid Energy's Board and management team.</p> <ul style="list-style-type: none"> Treasury received the SCI and business plan signed off by Board and 1 week later was advised that the business was managing to the downside scenario. 	<ul style="list-style-type: none"> Original draft 2012/13 BP and SCI provided May 2012 Revised business plan and SCI August 2012 First monthly monitoring meeting held with Solid Energy in August 2012. 	<ul style="list-style-type: none"> Treasury was of the view that the original draft 2012/13 BP and SCI provided to them lacked detail and did not provide sufficient evidence that it would be effective. It recommended that the deadline for this draft be extended to 31 August 2012. Updated SCI and business plan was received in August. The business plan submitted was out of 	<ul style="list-style-type: none"> Minister granted Solid Energy an extension to 31 August 2012 to revise its SCI and BP, in consideration of rapidly changing market conditions. Extension granted to 1 December 2012 Extension given to 28 February 2013.

Date	Events – 2006 to the present	Information available to Treasury	Treasury actions and advice	Minister's Response
			<p>date 1 week later due to the decision to manage to the downside scenario. Treasury requested that Solid Energy develop a document more representative of the current situation to provide to Ministers</p> <ul style="list-style-type: none"> • Treasury indicated that they were not satisfied that the revised plan was realistic enough to allow Solid Energy to manage their business over the next year. • In view of the rapidly deteriorating market conditions, and the fact that the newly appointed Chairman was to begin in his role from 1 October, Treasury proposed that a further extension be provided for the SCI to 1 December 2012, to ensure that the documentation contains a credible strategy and is supported by the incoming chair. • In late November, the new Chair signalled to Treasury that he was uncomfortable with signing off on the draft SCI due to contention around the commercial valuation and on-going strategy. Treasury recommended that the Minister grant a further extension to the submission of the SCI / BP (as is required by SOEs) to 28 February 2013. 	

12.2. Key events related to appointments

The table below sets out a timeline of key events related to the appointments process for Solid Energy over the Review Period.

Date	Event
Sept 2006	CCMAU recommends appointment of John Palmer as Chair from 1 January 2007. Tim Saunders retires after serving as Chairman from December 1998.
Dec 2008	CCMAU Board summary for Solid Energy notes that it "has one of the stronger Boards in the SOE portfolio. Well balanced, strongly led." CCMAU recommends appointment of Alan Broome, an Australian based mining expert.
Sept 2009	Intended re-appointment of John Palmer as Chair for 12 months 1 November 2009 – 31 October 2010.
2010	We understand the retirement of John Spencer as Deputy Chair in 2010 removed an important senior governance professional from the Board
April 2010	David Patterson's proposed appointment.
Sept 2010	John Palmer reappointed for further three year term.
Feb 2012	Aim to advance board appointment process for MOM boards. Scoping Study notes a need for significant change to the Board of Solid Energy for it to be ready for a partial IPO. It is possible serving directors may need to retire early. Focus needed on relevant mining experience.
Early 2012	COMU seek a discussion with the Minister to see if he is prepared to consider changes, out of sequence to the Solid Energy Board.
2012	Reappointment of Alan Broome's resulting from a decision to maintain the long serving coal mining expert
May 2012	Solid Energy Board and management team, Scoping Study Advisors, officials, and chair agree more mining expertise needed on Board.
June 2012	John Palmer announces decision to retire.
31 Aug 2012	John Palmer formally resigns.
3 Sep 2012	Appointment of Mark Ford to Chair occurred over a number of months. Appointment in principle mid to late august, commenced role as Chair 3 September. Under urgency, not all background checks completed at the time of appointment but we understand this is not unusual as a function of the need to fit into Cabinet Committee timings. Mark Ford indicates in discussions with COMU that he would see significant changes at board level. Agreement on two specific appointees John Waller and Pip Dunphy following discussions with Ford and COMU. Dunphy's appointment was fast tracked so she could represent the Board in discussions in December.
Oct 2012	Neville Sneddon coal mining expert appointed to the Board.
Nov 2012	Four directors resign in days. Only four directors retained. Preference keeping Board small in short term.

Date	Event
Dec 2012	<p>On the eve of the appointment of John Waller, he decides to turn down the appointment on the basis of potential conflicts of interest given BNZ's exposure to Solid Energy and his role as Chairman of BNZ.</p> <p>In the event, Waller deferred his commencement date until after current negotiations with the Banks are concluded to avoid conflict issues with his BNZ Chairmanship). We understand he has not formally declined it.</p>
Feb 2013	Small Board to remain. In total five Board members comprised of Mark Ford, Allan Broome, David Patterson, Neville Sneddon, and Pip Dunphy.

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