Is Solid Energy too Big to Fail?

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Much has been written in recent weeks about the demise of Solid Energy. One question though that doesn't seem to have received attention is why the government is looking to bail out the company.

Solid Energy is a State Owned Enterprise (SOE). As such it is tasked with being as successful as comparable private enterprises. Being tasked with a mission unfortunately doesn't guarantee the mission's success. Private enterprises fail, and their shareholders, bondholders and other stakeholders bear the consequences.

Why is Solid Energy any different? As a SOE, Solid Energy's debt is not guaranteed by the government. The lack of a government guarantee is why SOEs pay a premium on their debt. That premium is typically 100 to 200 basis points above the rate the central government pays for its borrowings. The question is why was Solid Energy paying investors in its bonds a premium if the government is going to underwrite the bonds anyway?

More generally, if the government is going to bail out SOEs when they get into trouble, what is the point of any SOE paying a premium to banks on its debt? The government might as well save taxpayers some money and require the SOEs to borrow through the Treasury's Debt Management Office.

As at 30 June 2012, the SOEs (excluding Kiwibank) had, in aggregate, total borrowings of around $10b. If the SOEs are paying an average premium above the government stock rate of around 100 basis points (ie 1 percentage point), the government is effectively paying around $100m per annum extra to the banks for the risk the banks are supposedly bearing. This is money well spent if the banks and other creditors are required to do their job and monitor and impose financial disciplines on the companies. It is not money well spent if the taxpayer ends up bearing all the financial risk regardless.

In the case of Solid Energy the government has indicated it will look to the banks to bear some of the pain associated with Solid Energy's collapse. One can only hope that turns out to be the case but if the government is not prepared to let the company go into receivership it is hard to see what leverage the government has with the banks and therefore how credible the government's threat really is. Moreover, unless the banks bear some significant loss, lenders to other SOEs will presume that the government will come to their aide should other SOEs get into financial difficulty and the lenders will be discouraged from monitoring their activities. This would weaken the incentives for SOEs to perform.

Would international financial markets penalise New Zealand if the government did not step in and guarantee Solid Energy's debt? No doubt there would be protests from the banks that are exposed to Solid Energy and a widening of SOE spreads could occur. Offsetting these effects though would be the benefits to the government's overall credit rating as the government clearly demonstrates that taxpayers are not liable for SOEs' debt.

The reality is, despite its grandiose expansion plans, Solid Energy is only a very small part of the New Zealand economy. Coal accounts for less than 0.2% of New Zealand's exports and the company employs an even smaller percentage of the country's labour force. Coal is a significant part of the West Coast and northern Waikato economies. However, while there may be disruption during a receivership, it is not clear that Solid Energy's core activities – its underground and opencast mines at Huntly and on the West Coast – would not continue to operate anyway. If the mines are commercially viable, they will continue producing coal, albeit under new ownership while the new business owners would not be distracted by plans for developing lignite, biofuels and the other fanciful projects that led to Solid Energy's collapse.

One must have considerable sympathy for the disruption faced by workers, creditors and other stakeholders at Solid Energy if the company goes under. But it is not clear why the government should have more regard for the employees or stakeholders of Solid Energy than for the 200 staff who were recently laid off by Telecom or for the hundreds of employees and creditors affected by the collapse of Mainzeal.

Following the 2011 general elections, the government announced it was looking to sell down it shares in Solid Energy, along with four other companies listed by the government in its mixed ownership divestiture program. The government's desire at the time to reduce its holding in Solid Energy is hardly surprising. Coal mining is a highly risky commercial venture, as demonstrated by the financial problems Solid Energy's predecessor (State Coal Mines) faced when it was corporatised in the mid 1980s, the trouble Solid Energy got into over its currency hedges in the late 1990s and the most recent financial difficulties of the business. It is also hard to reconcile government ownership of a coal mining business with successive governments' commitments to a cleaner, greener economy.

The most recent demise of Solid Energy, while regrettable, provides an opportunity for the government to exit its interest in a highly risky business and to demonstrate to the financial markets and SOEs that the government is serious about not guaranteeing SOEs or other commercial ventures in the New Zealand economy.

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Article published in the National Business Review, 22 March 2013