



Australian Government

Takeovers Panel

Reasons for Decision
Northern Energy Corporation Limited
[2011] ATP 2

Catchwords:

Target statement – information deficiency – share valuation – independent expert report – technical expert report – assumptions – off-take agreement – further disclosure – decline to make a declaration – undertaking to make corrective disclosure – supplementary target’s statement

Corporations Act 2001 (Cth), sections 602, 638

ASIC Regulatory Guide 111, 112

Goodman Fielder Ltd (No 2) [2003] ATP 5

INTRODUCTION

1. The Panel, Ewen Crouch, Alice McCleary (sitting President) and Jennifer Seabrook, accepted an undertaking and declined to make a declaration of unacceptable circumstances on an application by Arkdale Pty Ltd in relation to the affairs of Northern Energy Corporation Limited. The application concerned whether the target’s statement, independent expert report and technical report were deficient. The Panel considered that subsequent further disclosure by Northern Energy in the form of a supplementary target’s statement, supplementary independent expert report and supplementary technical report, was sufficient to address its concerns.
2. In these reasons, the following definitions apply.

Arkdale	Arkdale Pty Ltd, a wholly-owned subsidiary of New Hope Corporation Limited ¹
Boyd	John T Boyd Company, mining and geological consultants
JORC Code	Australasian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves ²
LEA	Lonergan Edwards & Associates Limited
Northern Energy	Northern Energy Corporation Limited

FACTS

3. Northern Energy is an ASX listed company (ASX code: NEC). It has interests in a portfolio of coking and thermal coal projects in Queensland and New South Wales, which are being progressed towards development, being:
 - (a) 100% of the Maryborough project
 - (b) 100% of the Elimatta thermal coal project and
 - (c) other less advanced projects (Yamala, Ashford and Yetman).

¹ The bid documents and the application refer to the bidder as New Hope

² See Appendix 5A of the ASX Listing Rules

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4. Arkdale made a takeover offer for all the ordinary shares in Northern Energy at \$1.50 per share. The bid is scheduled to close at 7.00pm (Sydney time) on Tuesday, 22 February 2011.
5. Northern Energy's target's statement, issued on 23 November 2010, included a unanimous board recommendation that shareholders should reject the offer. The target's statement annexed an independent expert report by LEA.
6. LEA appointed Boyd to provide an opinion on technical mining matters including the reliability of reserve and resource estimates, recovery rates, mining plans and the appropriate operating and capital cost estimates. Boyd also provided an opinion on the value of Northern Energy's coal assets that are in the evaluation stage. LEA said it "has relied on the work undertaken by Boyd when forming our opinion on the value of Northern energy's coal assets".³ Boyd's report was annexed to LEA's report.
7. LEA concluded that Arkdale's offer was neither fair nor reasonable. It valued Northern Energy's shares on two bases:
 - (a) in accordance, it said, with ASIC RG 111 - at between \$3.48 and \$4.75 per share (the higher valuation range) and
 - (b) with an appropriate allowance for the dilutive effect of a capital raising of \$60 million to partially fund the Maryborough project - at between \$2.70 and \$3.99 per share (the lower valuation range).⁴
8. In the introductory section of the report, LEA set out the details of the higher valuation range, mentioning the lower valuation range in paragraph 16.
9. On 6 October 2010, being the day before Northern Energy's shares were placed in a trading halt pending announcement of Arkdale's approach to Northern Energy, Northern Energy's shares closed at \$1.05. The three-month volume weighted average price of Northern Energy's shares to 6 October 2010 was \$1.01.
10. The target's statement said:
 - (a) in the chairman's letter: "*[LEA], whose report is appended to this Target's Statement, has assessed the value of Northern Energy shares to be in a range of \$3.48 to \$4.75 per share. Even in the event of a discounted equity capital raising to meet funding requirements, the valuation range is \$2.70 to \$3.99 per share, the midpoint of which is more than twice the current New Hope Offer*"
 - (b) in section 1, on "Reasons why shareholders should reject New Hope's offer", reason 1 headlined "*The Independent Expert values Northern Energy's shares between \$3.48 and \$4.75*". The reference to the lower valuation range was in small print at bullet point 3 of the text under that headline and
 - (c) in section 1.1, with the same headline, the higher valuation range is mentioned twice and there is a chart comparing the offer price with that higher valuation range. The reference to the lower valuation range was also referred to.

³ LEA report paragraph 40

⁴ Assuming a capital raising at between \$1 and \$1.50: LEA report paragraph 15-16

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APPLICATION

11. By application dated 10 December 2010, Arkdale sought a declaration of unacceptable circumstances. It submitted that:
 - (a) material terms of an off-take agreement in respect of Northern Energy's Maryborough project had not been disclosed
 - (b) there were other deficiencies in the target's statement and
 - (c) there were deficiencies in the independent expert report.
12. Arkdale submitted that the effect of the circumstances was that:
 - (a) shareholders were unable to make an informed assessment of the merits of the offer and were making decisions on the basis of "*false and/or misleading disclosures*"
 - (b) the bidder was "*unable to ascertain with any degree of certainty what it can justify paying to Northern Energy shareholders to acquire their shares in the absence of details of the pricing arrangements under the Off-take Agreement*". This, it submitted, was contrary to the principle in s602(a)(i) and
 - (c) the acquisition of a substantial interest in Northern Energy was prevented from taking place in an efficient, competitive and informed market.

Final orders sought

13. Arkdale sought final orders that Northern Energy commission a corrected report from each of LEA and Boyd and issue a supplementary target's statement.

DISCUSSION

14. The Applicant's submissions can be grouped under 3 headings:
 - (a) off-take agreement pricing
 - (b) other disclosure issues in the target's statement and
 - (c) disclosure issues in the independent expert reports.

Off-take agreement pricing

15. Arkdale submitted that there had been inadequate disclosure of pricing and other arrangements under the off-take agreement in Northern Energy's ASX announcement of 22 April 2010, the target's statement and the independent expert report.
16. On 22 April 2010, Northern Energy announced that it had entered into an agreement for Xinyang Iron and Steel Group Company Ltd to take 65% of mine output for its planned Colton mine and any additional developments at Maryborough. The announcement said:
 - *The coal will be purchased at a price that is set with reference to the prevailing benchmark prices for Queensland hard coking coal.*

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...

Assuming a Colton mine life of at least 10 years at current coking coal prices the Agreement would result in revenue of approximately A\$700 million...

17. The target's statement repeated the statement about benchmarking price. LEA's report said:

The hard coking coal benchmark price is generally set by Australian suppliers and most often by the largest supplier of hard coking coal, the BHP Billiton / Mitsubishi Alliance (BMA Alliance). Most other hard coking coals are then sold at a minor discount to this benchmark price, depending on quality relativities to the benchmark coal.

18. Arkdale submitted that there was no information about how the price payable was to be benchmarked or whether it was subject to any discounts or other arrangements calculated by reference to the benchmark. In addition, termination, renewal or other material rights or obligations had not been disclosed.

19. Northern Energy submitted that the information disclosed in its 22 April 2010 announcement was appropriate disclosure and that the off-take agreement contained 'typical' provisions for:

- (a) *determination of a Contract Price by reference to a Benchmark Price;*
- (b) *the Benchmark Price to be determined based on the prices obtained for hard coking coal at certain Queensland hard coking coal mines;*
- (c) *adjustments to be made from time to time to the Contract Price based on the Ash content, Sulphur content and Phosphorus content of the coal produced.*

20. LEA noted that the hard coking coal benchmark price was generally set by Australian suppliers, most often by the largest supplier (the BHP Billiton / Mitsubishi Alliance), with most other hard coking coal sold at a minor discount "depending on quality relativities to the benchmark coal".⁵ For valuation purposes, LEA adopted a 3% discount.⁶

21. Arkdale submitted that that this may mislead shareholders as it may not represent the actual position for Northern Energy. It provided a proposed form of subsequent disclosure and submitted that Northern Energy should disclose details of the mine by reference to which the benchmark price would be set, confirm the applicable discount and confirm that the only discount to be applied to the benchmark price was one for quality variations and/or penalties.

22. We have not received a copy of the off-take agreement. It was subject to confidentiality provisions and Northern Energy expressed concern about a copy being provided to the bidder. Arkdale was prepared to allow us to see the document, but wanted to reserve the right to see it depending on what we decided.⁷ We were concerned that this would place us in a potentially difficult position. Equally, we would be concerned if Panel applications were to be used to extract due diligence from a reluctant target. Therefore we decided not to see the document.

⁵ LEA report, paragraph 124

⁶ LEA report, paragraph 168

⁷ Arkdale later changed its position on this, but it was by then too late

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23. The information disclosed in LEA's report about the benchmark price would clearly leave shareholders with an understanding that this was a reference to the agreement. We would be most concerned if either LEA had not reviewed the agreement or had not reflected its terms in its statement about the generally set benchmark price. In our view, it would be quite misleading to shareholders to make a statement about generally set pricing unless its purpose was to inform the shareholders of what was contained in Northern Energy's agreement.
24. For this reason we have no doubt that LEA would have reviewed the agreement for the purpose of its valuation and reflected its terms in its report. Accordingly, shareholders are informed about the benchmark and the discount.
25. The test for disclosure in a target's statement is that the information must be of a type that the shareholders and their professional advisers would reasonably require to make an informed assessment of whether to accept the offer.⁸
26. Given the information available to Northern Energy shareholders in the 22 April 2010 announcement and the independent expert report, we do not consider that the additional disclosure sought by Arkdale would be material to a shareholder's decision whether to accept the offer under the bid. Based on the information available to us, we therefore do not consider that further disclosure is required in relation to the off-take agreement.
27. The 22 April 2010 announcement disclosed that Northern Energy expected the off-take agreement to produce revenue of approximately \$700 million. The additional information sought by Arkdale would not, in our view, have enabled shareholders to perform their own calculations as to the value of the agreement.
28. A condition of the bid is that Northern Energy's target's statement confirms that the price at which coal will be purchased under the off-take agreement "*is equivalent to the average quarterly price for Peak Downs, Saraji and Goonyella hard coking coal adjusted for quality variations and/or penalties.*"⁹ The target's statement did not do this. In our view, the board was entitled not to do this.¹⁰ The condition, and seeking disclosure of the additional information in relation to the off-take agreement, appears to be a form of forced due diligence.
29. Arkdale also submitted, among other things, that it was not able to ascertain with any degree of certainty what it was able to pay Northern Energy shareholders and that non-disclosure of the arrangements under the off-take agreement were intended to deter the bid. This, it submitted, was tantamount to putting in place a poison pill.
30. We do not agree. Provided directors act for proper purposes and within the Act (notably s638(1)), their use of Northern Energy's information for the company's advantage is not "tantamount to a poison pill". As the Panel said in *Goodman Fielder 02*:

⁸ Section 638(1)

⁹ Condition 8.10(f)

¹⁰ *Goodman Fielder Ltd 02* [2003] ATP 5 at [94]

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*Goodman Fielder has a proprietary interest in its confidential information and the directors have a right and obligation to use it for the best advantage of the company.*¹¹

Other disclosure issues in the target's statement

31. Arkdale submitted that aspects of the target's statement were misleading in that:
- (a) there was no critical analysis or discussion of key assumptions when presenting the independent expert valuation
 - (b) there was insufficient disclosure in relation to the time frame within which the board believed Northern Energy would trade within the valuation range
 - (c) the "Resources" table at paragraph 9.1 did not comply with the JORC Code and
 - (d) detailed disclosure of funding options available to Northern Energy were not disclosed.

Critical analysis of key assumptions when presenting independent expert valuation

32. Arkdale submitted that directors could not "*blindly rely upon an independent expert's report to make a recommendation*" and, to avoid liability for breach of duty, directors should independently assess the report, including considering the key assumptions.
33. ASIC submitted that an independent expert report should not be the only information on which directors rely to make a recommendation, and noted ASIC Regulatory Guide 112 *Independence of Experts*. RG 112 says:

*The directors of a commissioning party should not adopt or recommend that security holders accept the findings of an expert report without critically analysing the report. The directors should satisfy themselves that the information relied on in the report is accurate and that the report has not omitted material information known to the directors but not given to the expert.*¹²

34. We agree that directors cannot "blindly rely" on an expert report, but do not think directors should second-guess the expert, although they may form an opinion different to the expert's. We think that the critical analysis ASIC is referring to is a review to make sure that there is nothing obviously wrong with the expert report. The second part of RG 112.56 explains the position. For example, directors should check that the expert has all the material information.
35. We think the above explanation is consistent with ASIC's submissions. It submitted that, if the directors "*have a reasonable basis for disagreeing with a material aspect of the expert's conclusions*", any area of disagreement should be disclosed to shareholders.
36. Northern Energy conceded that there should be disclosure to shareholders if they had a reasonable basis for disagreeing but submitted that this was not the case here.

¹¹ *Goodman Fielder Ltd (No 2)* [2003] ATP 5 at [87]-[88]

¹² RG 112 at [112.56]

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37. Northern Energy further submitted that there was “no statutory or other obligation upon a Northern Energy Director with respect to justification of the conclusions in the Independent Expert’s Report”. Further, it submitted that LEA and Boyd were “well known experts” in their respective fields and that Northern Energy had no reason to doubt their expertise.
38. Northern Energy engaged LEA (who in turn engaged Boyd) to provide an independent expert report assessing the value of its shares. In our view, in the absence of factors indicating a reasonable basis for disagreeing with a material aspect of the expert’s conclusion, the directors should be entitled to rely on the expert’s report and valuation.
39. LEA said it had valued Northern Energy on two bases:
- (a) “in accordance with RG 111, which implicitly reflects an assumption of the availability of funding required to develop the Maryborough Project and bring it into production”. This resulted in a higher valuation range and
 - (b) with an appropriate allowance for the level of dilution likely to be suffered by existing shareholders to meet funding commitments. This resulted in a lower valuation range.
40. The target’s statement prominently referred to the higher independent expert valuation in the range of \$3.48 - \$4.75 per Northern Energy share (assuming Northern Energy has the financial capacity to meet its funding requirements). For example, the higher range is referred to in the chairman’s letter on page 2 and is the first of “Five good reasons to REJECT New Hope’s inadequate Offer”, starting on page 6.
41. LEA subsequently stated (in a draft supplementary independent expert report) that LEA:
- ...consider it more appropriate that Northern Energy shareholders have greater regard to the assessed lower range value of Northern Energy of \$2.70 to \$3.99 per share...*
42. LEA’s preference for the lower valuation is material new information that is relevant to Northern Energy shareholders that will necessarily affect presentation of LEA’s valuation in the target’s statement. It should have been made quite clear to the directors in the initial report.
43. Northern Energy submitted that it “understands that ASIC Regulatory Guide 111 requires that the independent expert have regard to the higher valuation range in assessing its value”. The higher value assumes that it has the financial capacity to meet its funding requirements.
44. ASIC submitted that RG 111:
- does not require a valuation to be prepared on an undiluted basis... the valuation should incorporate all relevant discounting factors (including any appropriate dilutionary impact) which reasonably reflect the capital requirements for the project to be developed.*

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45. Without funding, there would be no development. We doubt that the prominence given to the higher valuation range by the directors in the target's statement was helpful to shareholders. We doubt that inclusion of the higher range in the expert report was helpful to the directors, particularly without a clear statement of LEA's preference for the lower valuation range. It is unclear why LEA interpreted RG 111 in such a different way to ASIC, and LEA provided no reference to any statement in RG 111 that would require its interpretation.¹³
46. Northern Energy submitted that it had been careful to ensure that each reference to the higher valuation range contained a proximate reference to the lower valuation range. While that may be so, there was a significant difference in prominence. Given the preference now expressed by LEA and ASIC's interpretation of RG 111, it is appropriate that the lower valuation range be put before shareholders clearly.
47. We also think it should be made clear that ASIC disagrees with the independent expert¹⁴ that ASIC policy required the expert to value Northern Energy assuming that Northern Energy had the financial capacity to meet its funding requirements.
48. Northern Energy agreed to issue a supplementary target's statement to make it clear that the independent expert prefers the lower valuation range. Accordingly, we do not need to consider the question of the presentation of the independent expert's valuation in the target's statement further.

Timeframe for trading within valuation range

49. Arkdale submitted that there was insufficient disclosure in relation to the time frame within which the board believed Northern Energy would trade within the valuation range.
50. Northern Energy submitted that it had not provided guidance to the market as to likely share price performance and it would be inappropriate for a board to offer a view as to future share price performance. Further, it submitted that it was a matter for the expert to address when assessing the reasonableness of the offer.
51. LEA agreed to issue a supplementary expert report including additional information on the market price of Northern Energy shares and the likely price of Northern Energy shares if the offer lapsed. This will make the position clearer. The additional disclosure resolves our concerns. Arkdale is able to put its view before Northern Energy's shareholders, if it wishes. We therefore do not need to consider this issue further.

Table 9.1: Compliance with JORC Code

52. Arkdale submitted that Northern Energy had included exploration targets in the "Resources" table at paragraph 9.1 of the target's statement and omitted required

¹³ We note that ASIC is currently reviewing RG 111. To the extent that this issue needs to be clarified, the review would be a useful vehicle for that to occur

¹⁴ In LEA report, paragraph 31

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disclosure relating to the work done to arrive at the exploration targets. It submitted this was not compliant with reporting requirements under the JORC Code and that the overall impression given by the table was that the exploration targets were resources.

53. Northern Energy agreed to replace the tables with versions complying with the JORC Code. We asked that the amended disclosure prominently alert shareholders to the fact that it was inappropriate to refer to the exploration targets as “resources” in the original target’s statement, to clarify the measurements in the tables and to include a competent person’s statement. Northern Energy agreed to do so. This resolves our concerns.

Disclosure of funding options

54. Arkdale submitted that, given unqualified statements by Northern Energy as to its ability to fund its development and the assumptions made in the independent expert report regarding the availability of funding, Northern Energy should provide detailed disclosure of funding options available to it.
55. Northern Energy submitted that the sources of funding referred to at page 16 of the target’s statement include those outlined in Northern Energy’s ASX announcement on 11 October 2010 (titled “Emerging Producer”).
56. Northern Energy further submitted that:
- (a) the statement in section 6 of the target’s statement regarding capital requirements adequately summarised its view of the risks around its ability to source an appropriate level of funding and
 - (b) there was a reasonable basis to consider that funding would be able to be secured from the sources identified.
57. LEA considered funding requirements in its assessment of the Maryborough Project using a discounted cash flow valuation methodology.¹⁵ Other valuation methodologies were used for the other projects.
58. LEA assumed, for the purposes of the Maryborough valuation, that in order to partially satisfy the funding requirements, \$60 million would be raised by way of equity capital raising.¹⁶ LEA’s lower valuation range takes the dilutive impact of this capital raising into account. We therefore consider it is appropriate that LEA’s preference for the lower valuation range (over the higher valuation range) be emphasised in the target’s statement. The supplementary target’s statement will emphasise the lower valuation range. This accommodates the funding issue, in our view. The supplementary target’s statement also notes that Northern Energy has not secured the funding required to bring its various projects into production. This resolves our concerns.

¹⁵ See LEA report, paragraphs 180 and 207

¹⁶ The LEA report, paragraphs 207-209, set out that \$84m was required

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Disclosure issues in the independent expert report

59. LEA valued Northern Energy shares, in the higher range, at between \$3.48 and \$4.75. It noted that the valuation “*significantly exceeds the share market price of Northern Energy prior to the announcement of the approach from New Hope*”. LEA noted 5 factors that could contribute to the difference (in summary):
- (a) the assessed value represented a controlling interest, while market trading represented portfolio interests
 - (b) the shares had been higher (\$1.74) in April 2010 following the placement to Xinyang
 - (c) the resource super profit tax had had a negative impact, particularly because Xstrata had withdrawn from a project in the Surat Basin and projects in that basin - including the Elimatta Project - were dependent on it proceeding
 - (d) a number of brokers had increased their assessed value of Northern Energy following a recent update and
 - (e) Northern Energy’s management considered that the company had less share market visibility compared to other coal companies.
60. Arkdale submitted that these factors did not explain the difference, but rather the difference was due to assumptions made without a reasonable basis. Arkdale identified numerous assumptions in three categories - general assumptions, Maryborough project-specific assumptions and Elimatta project-specific assumptions.
61. We summarise them as follows:
- General assumptions*
- (a) recurring annualised corporate costs. It was submitted that they had been materially undervalued
 - (b) non-company factors such as securing port and rail infrastructure, obtaining additional mining lease approvals and procuring an additional Environmental Impact Statement. It was submitted that LEA had failed to take these into account
 - (c) categorising development assets as production assets. It was submitted that this was inconsistent with ASIC regulatory guide RG 111
- Maryborough assumptions*
- (d) production assumptions adopted Northern Energy’s own development targets. It was submitted that Northern Energy had consistently failed to achieve its development targets
 - (e) it was submitted that the valuation did not reflect an appropriate risk weighting or cost of capital for development
 - (f) the ‘resource multiple methodology’ was used to cross-check the valuation. It was submitted that it had been improperly applied

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- (g) it was submitted that Boyd had not used reasonable assumptions or JORC compliant reserves and resources
- (h) Northern Energy could partially fund its development of the Maryborough project through a capital raising at \$1 - \$1.50 per share. It was submitted that this was not reasonable as approximately 50% of Northern Energy's pre-approach market capitalisation would be required

Elimatta assumptions

- (i) the project was valued using a 'multiple of resource' approach. It was submitted that a discounted cash flow approach should have been used, which would have produced a lower valuation and taken into account risk and capital requirements
- (j) the multiplier adopted by Boyd was 1.5x to 2x. It was submitted that this was well above all but one listed developing companies.

Preliminary submission on expert report

- 62. Northern Energy made a preliminary submission that ASIC was in discussion with LEA regarding the content of the independent expert report. It submitted that this would "*result in the same issues determined contemporaneously by two regulatory bodies. In light of this, it may be preferable for [the Panel's] assessment of the Application on these matters be (sic) deferred....*"
- 63. ASIC made a preliminary submission that it had no objection to the Panel commencing proceedings and said that it may wish to make or support submissions to the extent that it has any continuing unresolved issues with the independent expert report.
- 64. We decided to conduct proceedings on the disclosure issues in the expert report. We asked Northern Energy and ASIC to provide a status update of the review of the independent expert report and technical report being conducted by ASIC before we engaged in detail on that aspect of the application. We agreed with Northern Energy that it would have been preferable to have these issues resolved as far as possible between Northern Energy and ASIC.
- 65. An update was provided; however, the issues had not been resolved. ASIC stated that it would not seek any further response from Northern Energy in relation to its concerns while the matter was before the Panel. Accordingly, we issued a brief on the disclosure issues in the expert report.
- 66. ASIC had also raised other issues with LEA that were not before us.

General assumptions

Assumed level of recurring annualised corporate costs

- 67. Arkdale submitted that the assumed level of recurring annualised corporate costs had been materially undervalued having regard to corporate costs for other coal companies, and that increasing these costs would have a significant impact on LEA's valuation range.

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68. We consider that the appropriate level of assumed recurring annualised corporate costs is a matter for the expert engaged by Northern Energy. Further, even if the level of annualised corporate costs was increased, it does not appear that it would have a material impact on the overall valuation of the company.

Consideration of non-company related factors

69. Arkdale submitted that, in assessing the fairness of the offer, LEA failed to take into account material non-company related factors including securing port and rail infrastructure, obtaining additional mining lease approvals and procuring an additional environmental impact statement.
70. Northern Energy submitted that it understood that these risks “*were considered by and allowed for by JT Boyd in its report*”. It referred to section 3.8 of the report, which identified significant project risks. This had been supplemented by an addendum to the report dated 22 December 2010 which referred to an assumed one-year delay in the Maryborough project start-up and expansion. It further submitted that it understood that LEA had taken these factors into account in determining the additional equity risk premium of 2% that was used in its valuation of Maryborough.
71. ASIC submitted that Northern Energy’s explanation was inadequate because LEA did not disclose what risks the additional equity risk premium encapsulated and therefore it could not be determined if the risks accounted for by Boyd were the same as those accounted for by LEA.
72. We are satisfied with the explanation provided by Northern Energy in its submissions. However, we consider that the explanation provided by Northern Energy in its submissions was more likely to be understood by shareholders than that found in the target’s statement and accompanying reports. We asked Northern Energy to make further disclosure, including that explanation of how each expert had taken into account non-company related factors, in the supplementary target’s statement, the supplementary expert report or the supplementary technical report. It agreed to do so. This resolves our concerns.

Categorising development assets as production assets

73. Arkdale submitted, in relation to Maryborough, that statements concerning the value ascribed to Northern Energy’s development assets were misleading because they were categorised as production assets rather than development assets. This, it submitted, was inconsistent with ASIC RG 111.
74. Similarly, ASIC, in its correspondence with LEA, was concerned with the disclosure and application of appropriate discounting for a number of risk factors including the adoption of the equity beta¹⁷ and other discounting factors applying to coal production companies.
75. Appendix C of the independent expert report set out why LEA chose an equity beta of 1.4. LEA said it had regard to the risk of coal mining operations in Australia, risk factors for Maryborough and the betas of other listed coal companies, although it noted that “*none of the other listed companies have activities that are directly comparable to*

¹⁷ The measure of the expected volatility of the return on an investment relative to the market as a whole; in other words, the risk of achieving the cash flow

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the Maryborough Project being developed by Northern Energy". LEA also looked at the historical betas for Northern Energy. ASIC was concerned that a beta of 1.4 was lower than the company's historical market beta.

76. Northern Energy submitted that the equity beta of 1.4 was appropriate because the beta would be higher for coal developing companies that are "*barely past the exploration stage*" and lower for companies "*on the verge of production*". Maryborough, it submitted, was projected to be producing coal in less than 2 years, and its characteristics were therefore closer to a producer (ie, the lower end of the scale).
77. It further submitted that, in any event, LEA had allowed for specific risks associated with development of the Maryborough project by adding a specific risk premium of 2%. Moreover, if a higher beta had been adopted, there would be a reduced need to include the additional separate risk premium. Accordingly, it submitted, if LEA adopted a higher equity beta, the specific risk premium would be reduced and the net effect on the valuation would be nil. Northern Energy also provided a table of examples of equity betas adopted by independent experts in previous transactions.
78. Arkdale submitted that it was not appropriate to take a company's cash flow and apply an industry beta with a risk premium, and in any event the 2% risk premium applied did not sufficiently reflect the risk.
79. LEA also provided additional information regarding other coal sector expert reports and the betas those experts had relied on.
80. The choice of an appropriate equity beta is a matter for the judgment of the independent expert, but it must be explained properly.
81. We found the explanation that Northern Energy provided in its submissions to the supplementary brief of how the beta was derived helpful. It explained that as a project got closer to production, its prospective characteristics became more those of a producer, making a lower beta more applicable. Northern Energy also provided a table of betas used in other expert reports in the coal sector. We are satisfied with the explanation provided to us, but consider that explanation more likely to be understood by shareholders than the one found in the independent expert report.
82. We asked Northern Energy to make further disclosure including that explanation in the supplementary expert report (and also including the table of examples of equity betas adopted by independent experts in the coal sector with a line item for Northern Energy). It agreed to do so. This resolves our concerns.

Maryborough specific assumptions

Assumptions based on Northern Energy's development targets

83. Arkdale submitted that the valuation approach adopted by LEA for the Maryborough project was an un-risked valuation based on Northern Energy's own development targets. It submitted that Northern Energy had failed to achieve its development targets previously and that LEA should have considered this in its valuation.
84. We consider that this is a matter for the judgment of the independent expert. If Northern Energy's directors had a reasonable basis for disagreeing, that should have been disclosed to shareholders. We understand that they did not disagree.

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Appropriate risk weighting or cost of capital

85. Arkdale submitted that the valuation did not reflect an appropriate risk weighting or cost of capital for the Maryborough project. This appeared to us to be a similar argument to that involving the beta.
86. Northern Energy submitted that LEA had confirmed that it considered their approach reflected an appropriate risk weighting and cost of capital for the Maryborough project.
87. We consider that this is a matter for the judgment of the independent expert. Again, if Northern Energy's directors had a reasonable basis for disagreeing, that should have been disclosed to shareholders. In any event, the bidder could address this matter in its response to shareholders. We therefore do not consider this further.

Improper application of resource multiple valuation methodology

88. LEA used a resource multiple methodology as a cross-check for its valuation of the Maryborough project. Arkdale submitted that LEA had simply divided its discount cash flow valuation by resource tonnes and that a proper application of the resource multiple methodology would not deliver a result consistent with LEA's valuation range.
89. LEA had compared its cross-check to other companies (appendices D and E of the expert report). We asked for this to be explained (see below).
90. We consider that this is a matter for the judgment of the independent expert. Again, if Northern Energy's directors had a reasonable basis for disagreeing, that should have been disclosed to shareholders.

Technical expert report – assumptions and compliance with JORC Code

91. Arkdale submitted that the technical report prepared by Boyd did not use reasonable assumptions and had not been prepared using JORC compliant reserves and resources. The key issues were the inclusion of mineable coal beyond JORC defined resources in cash flows and the inclusion of all JORC defined resources in cash flows.
92. Arkdale referred to ASX Companies Update 03/08 to support its submission and submitted that an additional valuation based on JORC Code compliant resources should be included in the supplementary reports. The ASX Update says:

The words 'ore' and 'reserves' must not be used in describing Mineral Resource Estimates as their terms imply economic viability and are only appropriate when all Modifying Factors have been considered....

Consequently the use of the terms 'in-ground value' or 'in situ value' is also contrary to the intent of clause 27 of the [JORC] Code and should not be reported by companies.

93. Arkdale further submitted that it was unreasonable for Boyd to assume that all Inferred Resources would be converted into Reserves.
94. ASIC was also concerned that there may not be a reasonable basis for the inclusion of Inferred Resources in the DCF valuation of the Maryborough project. ASIC referred to ASIC Consultation Paper 143: *Expert reports and independence of experts: Updates to RG 111 and RG 112* which provides (at CP 143:29):

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We consider that where mineral and coal and oil potential development assets are classified lower than a reserve category, this will usually indicate that the level of uncertainty involved with commercially developing the assets suggests that there is unlikely to be a reasonable basis for applying the DCF methodology... However, we recognise that there may be circumstances in which it is possible to apply the DCF methodology to such assets. If this is the case, it is important that the expert identifies why it considers the use of DCF methodology to be appropriate...

95. Northern Energy submitted that Boyd did not utilise non-JORC compliant resources in valuing Maryborough. Rather, Boyd included JORC compliant proven and probable reserves as well as JORC compliant inferred resources (ie, the valuation extends beyond JORC compliant reserves but not beyond JORC compliant resources). It further submitted that there was no general rule that required JORC compliant inferred resources used in a valuation to be discounted in the manner contemplated by Arkdale: the existence and level of any discount depended on the facts of each case and was a matter for consideration by the expert.
96. Arkdale, in rebuttals, submitted that in preparing the discounted cash flow model, it was more appropriate to use less than 100% of inferred resources. It pointed to a recent expert report that had included approximately 40% of inferred resources.
97. We consider that the level of discount for inferred resources is a matter for consideration by the expert. Again, if Northern Energy's directors had a reasonable basis for disagreeing, that should have been disclosed to shareholders.
98. However, given that Boyd used 100% of inferred resources in its valuation, and in the absence of the use of any other valuation methodology as a cross check, the cross-check conducted by the expert to support its choice of methodology is very important. Paragraphs 186 and 187 of LEA's report discuss the cross check of the valuation of the Maryborough project (using the implied value per resource tonne). We consider that disclosure regarding the cross check was inadequate. The explanation provided would be very difficult for a shareholder to understand.
99. We also think that, if appendices D and E of the expert report are relevant, then LEA should be able to show why the value per resource tonne of \$2.18 to \$3.04 is supported by them.
100. We requested disclosure in the supplementary expert report explaining, in a way shareholders were likely to understand, the cross check in paragraphs 186 and 187 and appendices D and E of the expert report given the caveats expressed in paragraph 188 of the report.
101. We requested further disclosure to explain why the value per resource tonne of \$2.18 to \$3.04 was supported by the detail in Appendices D and E of the independent expert report.
102. Northern Energy agreed to include such additional disclosure in a supplementary expert report. This resolves our concerns.

Inappropriate assumptions in IER regarding availability of funding

103. Arkdale submitted that it was not reasonable for the Maryborough project to be calculated on the basis that Northern Energy could fund its development through a dilutionary capital raising priced at between \$1 - \$1.50 per new share because the

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amount of capital required was approximately 50% of Northern Energy's market capitalisation prior to Arkdale's approach. Arkdale sought disclosure as to whether Northern Energy had received any expression of interest from potential underwriters to underwrite the rights issue at that price.

104. LEA has indicated that it preferred the lower valuation of \$2.70 to \$3.99 (which accounted for the effect of the dilution under the proposed capital raising). Northern Energy has agreed to issue supplementary disclosure emphasising the lower valuation. We consider that no further disclosure is required in relation to this issue. Nonetheless, it would have been preferable for additional disclosure to have been included in the original independent expert report in relation to the funding assumptions, given the importance of those assumptions to the valuation.
105. Arkdale submitted that the allowance for dilution did not address whether Northern Energy could actually raise capital at \$1-\$1.50 per share. We do not think we can substitute our opinion on this for those better placed to know, namely the directors and the expert. We also note that LEA expected that there would be some re-rating of Northern Energy.

Elimatta specific assumptions

Multiple of resource approach inappropriate

106. Arkdale submitted that using a multiple of resource approach in the valuation of the Elimatta project was inappropriate because the project had a reserve, meaning that it was more appropriate to use a DCF methodology. Further, it submitted that the un-risked valuation methodology did not take into account the \$580 million of capital required to develop the project.
107. Boyd adopted a comparable sales approach to derive the value of the Elimatta project (including the relevant comparable sale). ASIC submitted that it recognised the valuation was an "as is" valuation. We take this to mean that the valuation therefore did not need to take account of the capital required to develop the project. However, ASIC was concerned with the adoption of the comparable sale and the disclosure of risks accounted for in the valuation.
108. We consider that choice of methodology, if appropriately explained, is a matter for the expert. We also note that Maryborough is subject to an off-take agreement and Elimatta is not. In any event, Boyd has agreed to issue a further supplementary technical report, which further explains the choice of methodology.

Inappropriate multiplier

109. Arkdale submitted that the multiplier used by Boyd in its valuation of the Elimatta project was inappropriate because it gave the project a value per resource tonne above all but one of the listed developing companies (when Elimatta is not closer to production than those companies).
110. We consider that the choice of the multiplier is for the technical expert. In any event, Boyd has agreed to issue a further supplementary technical report, which further explains the choice of methodology.

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Other matters

111. LEA's independent expert report runs to approximately 80 pages including appendices and Boyd's report is a further 55 pages. They are not untypical examples of such reports. But we wonder how much such documents assist shareholders over a document that, in many fewer pages and without the repetition or historical background (which is usually provided elsewhere in a target's statement or bidder's statement), sets out clearly the expert's conclusions, assumptions and reasons.
112. We think LEA's report was long and would not have been clear to shareholders. In the instances where matters were raised, this was only remedied by the corrective disclosure we required. While an expert report is often technical, which can make it difficult to simplify, it would be more helpful to shareholders if written with them clearly in mind.

DECISION

Conclusion

113. If the further disclosure had not been provided, we were minded to declare that unacceptable circumstances exist in relation to the affairs of Northern Energy. Further disclosure has been agreed. Northern Energy undertook to prepare a supplementary target's statement (including a supplementary independent expert report and supplementary technical report) and to dispatch it to shareholders as soon as practicable (Annexure A).
114. Northern Energy and its advisers are based in Brisbane, which has been recently flooded. For some time, Northern Energy's office did not have power or email access. Similarly ASIC's office, and many of the advisers' offices, had been evacuated. Accordingly, obtaining appropriate sign-off and printing for dispatch was likely to prove difficult. In accepting this undertaking, we make it clear that we expect that "*as soon as practicable*" means that Northern Energy will dispatch to target shareholders by Friday 21 January 2011 unless there are further extenuating circumstances (for example in relation to obtaining consents) that justifies the further time.¹⁸ While we are prepared to give latitude, it is also important that shareholders are given the corrective information as soon as possible.
115. Given that the further information has now been offered, for the reasons above we decline to make a declaration of unacceptable circumstances.
116. We consider that it is not against the public interest to decline to make a declaration and we have regard to the matters in s657A(3).

Orders

117. Given that we make no declaration of unacceptable circumstances, we make no final orders, including as to costs.

¹⁸ *Post script* - dispatch was delayed until Thursday 27 January 2011

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**Alice McCleary
President of the sitting Panel
Decision dated 18 January 2011
Reasons published 1 February 2011**

Party: Arkdale

Northern Energy

Advisers: Blake Dawson

Pitt Capital Partners

HopgoodGanim Lawyers

Merrill Lynch



Australian Government

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ANNEXURE A

**AUSTRALIAN SECURITIES AND
INVESTMENTS COMMISSION ACT (CTH) SECTION 201A
UNDERTAKING**

NORTHERN ENERGY CORPORATION LIMITED

Pursuant to section 201A of the *Australian Securities and Investments Commission Act 2001* (Cth), Northern Energy Corporation Limited undertakes to the Panel that, in respect of the target's statement dated 23 November 2010 in response to the off-market takeover bid by Arkdale Pty Ltd (a wholly owned subsidiary of New Hope Corporation Limited), it will:

1. prepare a supplementary target's statement (including a supplementary independent expert report and supplementary technical report), in a form and content satisfactory to the Panel, and lodge it with ASIC, release it to ASX and despatch it to shareholders as soon as practicable and
2. confirm in writing to the Panel when it has satisfied its obligations under this undertaking.

Signed by HopgoodGanim Lawyers
with the authority, and on behalf, of
Northern Energy Corporation Limited
Dated 17 January 2011