

The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

www.treasury.govt.nz/publications/information-releases/nzas

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
- [2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information, or who is the subject of the information
- [3] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [4] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [5] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [6] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
- [7] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied
- [8] 9(2)(h) – to maintain professional legal privilege

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [3] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.



THE TREASURY

Kaitohutohu Kaupapa Rawa

Date: 10 July 2012

To: Minister of Finance
Associate Minister of Finance (Hon Joyce)
Minister for State Owned Enterprises

Aide Memoire: Project 14¹: Process and timing

As you know the New Zealand Aluminium Smelter (NZAS) has approached Meridian seeking to negotiate a significant reduction in the contractual price it pays for electricity. Underlying this is an implicit threat that if a lower price is not agreed, NZAS will close the smelter at Bluff.

This note advises you of:

- the details of Meridian's contract with the New Zealand Aluminium Smelter (NZAS)
- what NZAS is seeking from Meridian, and
- the process and timing for advice on this issue.

Meridian's contract with NZAS

Meridian signed a contract with NZAS in 2007 that takes effect from 1 January 2013, replacing a series of contracts that originally dated back to the 1960s and that expire on 31 December 2012. The details of the previous contracts are complex. However these contracts should not be relevant, as even if NZAS decided today to close its smelter, we understand it would still have to meet its obligations under the 2007 agreement.

Under the 2007 agreement, Meridian sells electricity into the wholesale market at the prevailing spot price. NZAS also purchases the electricity it uses from the market at the spot price. Separately, the 2007 agreement states that Meridian pays NZAS the difference between the wholesale spot price and an agreed price (or alternatively, if the wholesale price is below the agreed price, RTANZ pays Meridian the difference).

The net effect is that NZAS always pays the agreed price for the amount of electricity specified in the 2007 agreement (572 MW). NZAS can purchase electricity above this amount either directly from the wholesale market, or through other contracts with Meridian or other generators. NZAS can also choose to use less than the amount specified in the contract with Meridian; if so, it effectively "sells" the excess back into the wholesale market, and receives the difference between the wholesale price and the agreed price for the volume of electricity it doesn't use.

¹ "Project 14" is our internal title for this work, given its commercial sensitivity.

The agreed price NZAS pays Meridian escalates over time based on a multi-year average price for electricity in New Zealand, the world price for aluminium, and a component reflecting general price inflation. The agreed price is not adjusted for changes in the \$NZ exchange rate, which is a critical determinant of NZAS's profitability given that it exports virtually all of its output.

We understand the agreed price represents a significant step-up from what NZAS is currently paying for electricity under the old contracts. Electricity is the single largest cost for NZAS, representing roughly half of its total costs.

NZAS has a separate contract with Transpower where it pays for transmission of electricity to its smelter.

If the smelter uses the contracted amount of 572 MW for 24 hours a day then it would consume around 5,000 GWh in a year. This represents roughly 12% of total electricity consumption in New Zealand. Historically, the smelter has consumed between 4,800 GWh and 5,300 GWh a year.

The term of the 2007 agreement is 1 January 2013 to 31 December 2030. The agreement includes termination provisions that allow either party to exit from it gradually over a period of several years. These provisions are obviously critical given the implicit threat of NZAS closing the smelter.

[2,5,7]

What NZAS is seeking from Meridian

We understand that NZAS's opening position for discussions with Meridian is a roughly [2] reduction in the price that it pays for electricity under the 2007 contract. We understand the current agreed price for electricity is around [2] , and NZAS is seeking a new price of around [2] .

For comparison, a large commercial customer would currently expect to pay around \$90/MWh for a 1-2 year contract for electricity (plus transmission costs). A residential customer would expect to pay around \$120/MWh (plus transmission costs). The futures market currently expects the wholesale price to be between \$86 and \$90/MWh over the next three years.

Since April 2012, NZAS has reduced its consumption of electricity from full capacity to around 540 MW, by closing the smallest of its four production lines at the smelter. NZAS has stated that it did this because of deteriorating market conditions, including uncertainty in electricity pricing, the strength of the \$NZ, and low global metals prices. Uncertainty in electricity pricing is primarily a short-term issue, driven by low inflows into the South Island hydro lakes, and the uncertainty may now be easing. However the strength of the \$NZ and depressed global aluminium prices are linked to global economic conditions and so may be longer-term issues.

As you may be aware, NZAS's majority owner, Rio Tinto, has transferred its interests in five Australian aluminium assets (mines, smelters and an associated power station) and NZAS into a separate company (Pacific Aluminium) and is attempting to find a buyer for this company. This is obviously a factor behind the attempt by NZAS/Pacific Aluminium to re-negotiate the contract with Meridian.

The ultimate ownership of NZAS is 79.36% by Rio Tinto (via Pacific Aluminium) and 20.64% by Sumitomo Chemical Company.

Process from here

We have met with the Ministry of Business, Innovation and Employment and the Department of Prime Minister and Cabinet, and have jointly begun work on three streams of analysis to feed into advice for Ministers. The three streams of work look at the impacts of a potential NZAS exit on:

- the electricity industry in New Zealand
- the Government Share Offers, and in particular the impact on MRP and the pending MRP IPO, and
- the national economy, and the regional economy in Southland

Meridian is preparing a paper for its board to consider on Friday this week, in response to the approach from NZAS. Following board consideration of the issue, Meridian had intended to formally respond to NZAS early next week, but we understand that it may delay responding for a week, to allow for Meridian management to carry out further analysis for the board.

We understand that Meridian is undertaking detailed modelling of the impact of a potential NZAS exit on the electricity market and Meridian's financial position. Meridian has advised that given the complexity of these issues it will be adopting a 2, 4 and 6 week modelling and reporting cycle for its board, with each successive cycle providing more detail. We will keep in touch with Meridian's work and incorporate its findings into our advice, to the extent that is appropriate.

Timing

At your request, we are aiming to have some initial advice to Ministers by Thursday this week. This will necessarily be very high level and tentative, as NZAS has a number of different "exit options", and detailed modelling of the impacts of each option is complex and will take some time.

We expect that once NZAS receives a response from Meridian, it will want to engage with Ministers. Our advice by the end of this week will aim to inform Ministers for any such initial engagement. Further advice will follow.

Communications

There is a significant risk that knowledge of this issue will become public soon, either from an announcement by NZAS, Pacific Aluminium or Rio Tinto, or otherwise. We will work with your offices to prepare communications material in the event that this happens.

Juston Anderson, Senior Analyst, Commercial Transactions Group, 04 890 7211
John Crawford, Deputy Secretary, Commercial Transactions, Commercial Transactions Group, 04 917 6251