

The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Treasury Report: Project 14: Meeting with Phil Baker

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|--------------|--------------|-------------------|------------|
| Date: | 27 July 2012 | Report No: | T2012/1736 |
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Action Sought

| | Action Sought | Deadline |
|--|---|-------------------------|
| Minister of Finance (Hon English) | Note contents and refer to Hon Heatley | 2pm Monday 30 July 2012 |
| Associate Minister of Finance (Hon Joyce) | Note contents | 2pm Monday 30 July 2012 |
| Minister of State Owned Enterprises (Hon Ryall) | Note contents | 2pm Monday 30 July 2012 |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|-----------------|---|------------------|-----|--------------------|
| Juston Anderson | Senior Analyst, Commercial Transactions Group | 890 7211 | [1] | ✓ |
| Chris White | Manager, Commercial Transactions Group | 890 7256 | [1] | |

Actions for the Minister's Office Staff (if required)

If the Minister agrees, send a copy of the report to Hon Heatley's office.

Enclosure: Yes (attached)

[Meridian letter to Pacific Aluminium 18 July 2012 \(Treasury:2408456v1\)](#)

[Pacific Aluminium Letter to Mark Binns Meridian 24 July 2012 \(Treasury:2407362v1\)](#)

[Meridian Letter to Pacific Aluminium 24 July 2012 \(Treasury:2407367v1\)](#)

Treasury Report: Project 14: Meeting with Phil Baker

1. You are scheduled to meet with representatives of Pacific Aluminium (PA) at 2pm on Monday 30 July. We understand Minister Heatley is also attending. This note provides our views on the approach that PA is likely to take to the meeting, and our advice on the responses that Ministers could give to PA.

Attendees at the meeting

2. We understand that attending the meeting will be:
 - Phil Baker, Chief Financial Officer, Pacific Aluminium
 - Ryan Cavanagh, General Manager, Operations, NZAS
 - Andrew Horvat, General Manager, Energy, Pacific Aluminium, and
 - Lesley Silverwood, Director, Energy, Pacific Aluminium
3. The PA website has the following information on Mr Baker:



PHIL BAKER - CHIEF FINANCIAL OFFICER

Phil was Chief Financial Officer of Lihir Gold, where he was also Acting Chief Executive Officer for some months in 2010. Prior to this he was Chief Financial Officer and Company Secretary for each of fully integrated global magnesia supplier QMAG, and listed cancer therapeutics company Peplin. Phil worked for over 20 years at MIM in senior finance, project and business development, and operational roles.

4. Mr Baker is leading the discussions with Meridian and we expect he will lead the meeting with Ministers. Mr Cavanagh is the senior manager at the smelter in Bluff. We expect the other two attendees will be there to provide technical support to Mr Baker.
5. We expect that Mr Baker is highly motivated to gain concessions from Meridian or the Government. As you know, Rio Tinto is seeking to exit from its ownership of PA, initially through a trade sale, which has not progressed, and now through the proposal for a de-merger and ASX listing of PA. If concessions cannot be gained regarding NZAS' electricity supply, it is likely that NZAS (or at least, the 80% of it owned by PA) will be transferred from PA back to Rio Tinto. Rio Tinto would then be faced with the difficult choice of what to do with NZAS, presumably in consultation with the minority owner, Sumitomo.
6. The three PA representatives are flying in from Brisbane, where PA's head office is, and staying in Wellington at least overnight. Treasury will be taking the opportunity to meet with them immediately after the meeting with Ministers. It is likely that the PA representatives and Mr Cavanagh from NZAS will meet with Mark Binns and other executives from Meridian on Tuesday.

Likely approach from PA

7. There has been a recent exchange of letters between PA and Meridian. A copy of this exchange is attached to this report.

8. The letter from PA dated 24 July 2012 sets out the likely elements of PA's engagement with Ministers.^[4]
9. Based on this letter, the broad themes that PA are likely to raise with Ministers are set out below^[4]
- NZAS' financial position is "dire" and is forecast to be worse next year because under the new contract with Meridian the price it pays is to "increase by^[2] .
 - As a result, NZAS is likely to close down without significant concessions from Meridian or the Crown.
 - The financial impacts on Meridian of a NZAS closure would be significant. According to PA, Meridian's earnings "could be reduced by^[2] million per annum on average over a protracted period of many years".
 - The wider impacts on the economy and other electricity companies would be significant and negative. For example according to PA, NZAS contributes "\$525 million to the Southland GDP" and supports "3,200 direct and indirect jobs ... in the region" and "a substantial northward flow of surplus cheap hydro power would have [an impact] on the value of generation in the [New Zealand Electricity Market, NZEM] and consequential potential curtailment of generation capacity in New Zealand".
 - In rejecting PA's approach, Meridian has not taken into account these wider impacts. PA is disappointed that "Meridian Energy would only take account of its own commercial self-interest when dealing with NZAS, and broader implications for the NZEM or the Southland or national economy are not Meridian Energy's concern ... Meridian's narrow view of and focus on self-interest would appear to be contrary to the interests of Meridian's shareholder".
 - Meridian or the Crown should negotiate with PA, because some form of future "gain sharing" arrangement is possible; it is not just PA seeking a price reduction.
 - Various arguments around the "unfairness" of the contract between Meridian and NZAS, for example, according to PA:
 - Meridian is making a "cash profit ... on energy sold to NZAS ... in the order of^[2] per annum... when NZAS is in cash loss. This is not only inequitable as between NZAS and Meridian Energy, it is also unsustainable."
 - The new contract between Meridian and NZAS due to commence in 2013 "is one of the highest priced electricity contracts in the developed world for an aluminium smelter. In the absence of renegotiated terms, the Meridian Energy contract makes NZAS uncompetitive and financially unviable"
 - "Meridian Energy is in effect a monopoly supplier to NZAS, a position that can be acceptable to NZAS provided there is a realistic appreciation of the interdependence, the need to make adjustments from time to time to sustain the relationship and so that the relationship remains beneficial for both parties."

- “Over the years the value share [from the smelter] has shifted significantly in Meridian Energy’s favour, to the point where today Meridian Energy is the only party making money out of NZAS. This is not good business and cannot continue”
- “The massive and inequitable value transfer from NZAS to Meridian Energy is not sustainable and threatens the very survival of NZAS.”
- PA “would like to resolve this matter as soon as possible and within a timeframe that does not impact adversely on the timing of the New Zealand Government’s privatisation process and the divestment process for Pacific Aluminium.”

Treasury’s views on PA’s letter

10. Many of the points that PA makes were covered in our previous advice (T2012/1470 refers).
11. It may well be true that NZAS is currently in a “dire” financial position, but that is largely due to the state of the aluminium market worldwide, and the current level of the \$NZ. [4]
12. [2,5,6,7]
13. We do not agree with PA’s comment that “the cost of mature hydro generation [is] less than \$10/MWh” and therefore “just over \$50 million is estimated to be the cost to generate electricity for NZAS implying that the cash profit to be made on energy sold to NZAS will be in the order of^[2] per annum”. The Ministry of Business, Innovation and Employment estimates that the long-run marginal cost of hydro generation is around \$70/MWh for Benmore, and for Manapouri is somewhere above \$100/MWh.
14. If it is true that “in the absence of renegotiated terms NZAS [is] uncompetitive and financially unviable”, then NZAS should close down. Both New Zealand and Meridian are likely to be better off if NZAS closes (in line with the terms of the contract) compared to accepting PA’s proposal to^[2] the price that NZAS pays for electricity (although noting there would be short-term negative effects on the Southland economy, and significant distributional effects nationally).
15. We do not agree with PA that Meridian should take into account wider economic and social factors. Meridian has an obligation under the SOE Act to be “an organisation that exhibits a sense of social responsibility by **having regard to** the interests of the community in which it operates and by **endeavouring to accommodate** or encourage these **when able to do so**” (emphasis added). However this is co-equal with Meridian’s obligation to be “as profitable and efficient as comparable businesses that are not owned by the Crown”, and both objectives are subject to Meridian’s overall objective under the SOE Act of “operat[ing] as a successful business”.

16. None of this requires the Meridian board to^[4] in order to avoid supposed wider economic and social impacts of the smelter closing (even if we accepted PA's figures for those impacts, which appear to be inflated). We also note that, legally, Meridian must act in its own interests, not the interests of its shareholders (unlike PA, which presumably is legally able to act in the interests of Rio Tinto).
17. The only new items in PA's letter are the issue of PA being willing to negotiate some form of "gain sharing" arrangement, and the possibility of PA and Meridian agreeing a price between^[2] and^[2] "Gain sharing" could mean the (reduced) price that PA pays for electricity being linked to aluminium prices or the \$NZ exchange rate (the current contract with Meridian already has a link to aluminium prices). We understood that Meridian had previously raised "gain sharing" but PA had shown no interest. Meridian's letter of 24 July says that Meridian has so far put negligible value on any "gain sharing" arrangement. Although we haven't seen the details of any possible arrangement, we are inclined to agree.
18. Regarding the economic impact of the smelter closing, there would be both positive and negative impacts – the primary positive being the release of significant amounts of electricity for use elsewhere in the New Zealand economy, and the consequent fall in wholesale electricity prices and deferral of new generation projects. Offsetting this would be the requirement to invest in additional grid capacity to transmit this electricity north (around \$200 million), the potential for hydro spillage due to transmission constraints, and the adjustments that will need to take place in Southland's labour and other supplier markets.
19. The short-term negative effects on the Southland economy could be significant, although less than the figures quoted by PA, with NZAS accounting directly for 1.5% of the regional labour force and providing approximately \$60 million of revenue to local suppliers. The size of the long-term impact will depend on how many people are unable to find new employment in Southland and decide to relocate.

Suggested response from Ministers

20. We suggest that Ministers make the following points in response to PA:
 - Meridian is not expected to take decisions based on wider social and economic interests. Meridian's objective is to be a commercially successful business, and Ministers will support the Meridian board when it makes commercial decisions.
 - PA should continue discussions with Meridian and attempt to reach a commercially acceptable outcome. You could mention that you understand Meridian is meeting with PA on Tuesday 31 July.
 - While the closure of the smelter would have some negative effects, particularly for Southland and the wider New Zealand economy, there would be wider economic benefits from a nationwide reduction in electricity prices and a deferral of new generation projects.
 - If the smelter were to close, and there were negative effects on the local economy, Ministers could take steps to help alleviate those, and that would be preferable to Meridian transferring value to PA, in the hope that some of this would "trickle down" to the Southland economy.
 - Ministers would also like to see this issue resolved, one way or the other, as soon as possible.

21. In relation to the Government share offers you could, if you wished, advise PA that under New Zealand securities law the Government would need to disclose PA's approach to Meridian in the offer document for the MRP IPO.
22. [4]
23. Based on our previous advice (T2012/1470 refers) we recommend that you do not indicate that the Government is willing to intervene. Our view remains that any request by PA for Government assistance should be rejected, because it would result in a significant transfer of value from New Zealanders to PA and Rio Tinto shareholders.[4]
24. [4,6]

Recommended Action

We recommend that you

- a. **note** the contents of this report, and
- b. **refer** a copy of this report to the Minister of Energy and Resources, Hon Heatley.

*Referred/Not Referred.
Minister of Finance*

Chris White
Manager, Commercial Transactions Group

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

[2,5,7]

[2,5,7]

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