The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

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[3] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Recent market commentary on Rio Tinto or the NZ Aluminium Smelter

Date:	6 December 2012	**Report No:**	T2012/3170

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** contents	None
Associate Minister of Finance (Hon Steven Joyce)	**Note** contents	None
Minister for State Owned Enterprises (Hon Tony Ryall)	**Note** contents	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Actions for the Minister's Office Staff (if required)

None.

Enclosure: **Yes (attached)**

Treasury Report: Recent market commentary on Rio Tinto or the NZ Aluminium Smelter

1. We asked the JLMs and the Crown advisor to provide us with any recent market commentary on Rio Tinto or the NZ Aluminium Smelter (NZAS). The attached table summarises the relevant points of these reports. The main conclusions from the reports are that:

   - Aluminium is a poorly performing part of Rio Tinto. It apparently makes up 38% of Rio Tinto's costs ($US 14.5 billion out of $US 38 billion) and 39% of its capital base, but contributes less than 10% of Rio Tinto's earnings
   - Globally, EBITDA margins in aluminium production range from 10% to slightly negative, with Rio at the top of this range. This range may exclude Chinese aluminium smelters where margins are not readily available but may be significantly negative. For comparison, global EBITDA margins in iron ore, Rio Tinto's most profitable business, range from 50-65%, with again Rio Tinto at the top of the range
   - While aluminium prices are forecast to increase, returns to aluminium producers, including Rio Tinto, will still be unimpressive due to global overcapacity and increasing costs
   - Rio Tinto has ambitious cost reduction targets for its aluminium operations and plans no new investment in this area. Treasury's impression is that these top down cost reduction targets appear to be driving NZAS' behaviour at least as much, if not more, than any concerns about its electricity contract with Meridian
   - Rio Tinto has made little progress in its attempts to divest Pacific Aluminium, the business unit which includes Rio Tinto's majority share of NZAS, along with other Australian assets. The divestment plan was first announced over a year ago
   - Despite this, analysts seem to be broadly positive on Rio Tinto, mostly on the basis of its performance in iron ore
   - Macquarie, when looking at Contact Energy, rated the chances of Rio Tinto closing NZAS as "extremely low" on the basis that it was positioned in the middle of the world cost curve for aluminium smelters and that this would not (in Macquarie's view) materially change when the new contract with Meridian takes effect on 1 January 2013

2. Many of the reports on Rio Tinto either had similar comments to those summarised below, or did not specifically mention aluminium (on the basis that it is not a significant contributor to Rio's earnings) or the NZAS smelter (which is a small part of Rio Tinto's aluminium production).

Latest developments with Meridian and Pacific Aluminium

3. Meridian advised the Minister for SOEs yesterday (5 December) that Pacific Aluminium had contacted it and requested a meeting with Mark Binns on Monday 10 December. We understand a representative of Sumitomo will also be attending with Pacific Aluminium. Treasury will meet with Pacific Aluminium after it meets with Meridian.

4. We understand Pacific Aluminium and Sumitomo have requested a meeting with Ministers. Given that Sumitomo is attending, we suggest you agree, but we recommend the meeting is scheduled after we have met with them on Monday morning, and after our meeting with you at 4pm on Monday afternoon – so that we can brief you on the issues they are likely to raise.

Recommended Action

We recommend that you **note** the contents of this report.

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

Source	Date	Subject of report	Relevant commentary
Macquarie (NZ)	30 Nov	Contact Energy	NZAS is currently positioned in the middle (53% of global capacity has a higher cost) of the global cash cost and this does not materially change post the Jan 2013 electricity price step-up on our analysis. We see the probability of a closure of this plant as extremely low.
JP Morgan	14 Nov	Rio Tinto	Rio continues to be our preferred diversified resources exposure. While we acknowledge iron ore currently dominates near term earnings, the division is generating best in class returns. Further, at the current share price, based on our NPV, investors get the aluminium and energy businesses for free. The company offers solid production growth, and a strong balance sheet.
Deutsche Bank (Australia)	16 Oct	Rio Tinto	Rio Tinto has a very high-quality suite of assets that are generally: low operating cost, long life, expandable, located in low-risk countries (Australia, North America, Europe) and considered premium quality relative to the sector, offering above-average returns and operating margins. Rio has effectively strengthened its balance sheet, with growth firmly back on the agenda, with the key growth project being the expansion of the Pilbara iron ore assets ... Rio Tinto's proposed "transformation program" to double the aluminium division EBITDA margins to 40% by 2016/17 will continue to be a challenge, but we believe will be a success over the long run. Furthermore, we believe Rio Tinto looks undervalued on most metrics ...we rate the stock a Buy. On cost cutting, US$500m of savings have been achieved with further cost reductions planned. Rio has a US$38bn cost base, of which US$14.5bn is in aluminium alone. Small assets in the Rio portfolio must be able to grow to stay in the portfolio (hence the planned sale of diamonds, Pacific Aluminium and Palabora. Eleven assets are located in the low expandability, high cost quadrant are deemed marginal). It is already at the upper end of performance in Aluminium, but the margins are low…there will be no new investment in this division.
Nomura	16 Oct	Rio Tinto	The near-term outlook [for aluminium prices] remains lacklustre with weak Western demand, high inventories, and limited production cutbacks.

Morgan Stanley	4 Oct	Rio Tinto	We project that Aluminium (39% of capital employed) generates no earnings in ‘12e. Rio has identified US$1.25bn EBITDA by ‘15 (it delivered US$0.2bn in ‘11) from cost savings, capacity creep and new volumes. However, to see the full benefit, prices would need to recover, which requires global capacity adjustments beyond Rio’s control. Rio’s 40% EBITDA margin target [for aluminium] may prove ambitious, in our view, but we expect a sustainable margin of 27% by 2015, including an aluminium price of US$2,400/tonne Key value drivers/risks (includes) reduction in global aluminium smelting capacity.
Credit Suisse	14 Aug	Rio Tinto	To many investors, Rio Tinto’s aluminium division is something of a black sheep generating very low return on assets, prompting the reclassification of 13 aluminium assets in October 2011 and an $8.9bn impairment charge in the FY11 results. Rio now reports the earnings of the 13 Aluminium assets to be divested separately in ‘Other Operations’ which suffered a $227mn net loss in 1H12. Appetite for aluminium assets remains low given the global over capacity and poor returns and Rio, so far, has been unable to divest these assets either through an IPO, spin-off, trade sale or in-specie distribution. According to Rio, around 25% of the global smelting capacity is currently loss making while government subsidies or incentives, particularly in China, continue to support loss making smelters. Weak aluminium prices and high raw material costs ... continued to weigh on Rio’s aluminium division (excluding the assets now reported in Other) in 1H12 with the business reporting underlying earnings of just $24mn. We forecast a FY12 net loss of $53mn for Rio Tinto Alcan (and that excludes the forecast loss of ~$500mn in Pacific Aluminium). We forecast EBITDA margins in Aluminium to improve from 8.4% in FY12 to 12.5% in FY15 reflecting both cost savings and higher aluminium price of US$1.09/lb (versus US$0.92/lb in FY12). [Treasury comment: $US0.92/lb = $US2,030/tonne and US$1.08/lb = $US2,380/tonne. Current spot prices are around $US2,000/tonne] Rio’s higher cost smelters: Sebree in the US, Bell Bay, Tomago and Boyne Island in Australia, and Tiwai Point in New Zealand are to be divested while the Lynemouth smelter in the UK was closed down in March 2012. Tiwai Point, Lynemouth and Kitimat (Canada) are all grouped together in the middle of the cost curve at 50% [Treasury comment: Rio is investing in modernising and expanding production at Kitimat].
Deutsche Bank (Australia)	3 July	Australian mining sector	We remain positive on Rio Tinto and the company is in an enviable position with the highest returning projects in the iron ore industry. On the negative side, the Aluminium division continues to drag on performance.