

The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

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THE TREASURY

Kaitohutohu Kaupapa Rawa

Reference: T2013/632

SE-1-3-14

Date: 15 March 2013

To: Prime Minister (Rt Hon John Key)
Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)
Minister for State Owned Enterprises (Hon Tony Ryall)

Deadline: 5:15 pm, Monday 18 March 2013

Aide Memoire: NZ Aluminium Smelter Negotiations

On Monday 18 March you are meeting to discuss developments with the negotiations between Meridian and Pacific Aluminium (PA, a business unit of Rio Tinto) and Sumitomo regarding the electricity pricing contract for the Bluff smelter. This note briefs you on the current state of the negotiations and outlines the broad options available to the Government.

Background

Meridian representatives will attend the meeting on Monday and will be able to provide detailed information on the contractual arrangements and negotiations. It might be best to split the meeting in two: part one with Meridian covering the state of the negotiations; and part two without Meridian covering consideration of Government intervention.

Given Meridian's attendance and ability to cover the commercial aspects, we have focused this note on the options for the Government over and above the commercial negotiations. At a high level, however, Ministers should note that Meridian has made an offer to PA that would provide substantial gains for PA, [2,5,6,7]

[2,5,6,7]

[2,5,6,7]

Meridian met with representatives from PA, NZAS, and Sumitomo on 12 March. After that meeting Treasury met with the PA, NZAS and Sumitomo representatives. The messages they gave us were as follows:

- NZAS's financial accounts for calendar 2012 would be made public soon and would show a \$60m cash loss for the 2012 year (i.e. after capital expenditure) and that Rio Tinto had written down its investment in NZAS to zero.
- [2,6,7]

- PA and Sumitomo would be reporting to London and Tokyo on the likelihood of a deal with Meridian that meets the de-merger objectives, and if not a "strategic review" was the probable next step - as had been done for Rio Tinto's Gove alumina refinery, which resulted in Australian state and Federal assistance.
- There is still a gap to bridge with Meridian in the negotiations.
- Aluminium prices are now around \$1,900/tonne, after a "false dawn" last year when they had risen to around \$2,100/tonne. [2]

The smelter owners say they are not counting on aluminium prices recovering – the contract structure needed to be "based on fearing the worst".

- [2]

[2]

- [2,4]
- The increase in Transpower's transmission charges from [2] at present to [2] shortly is an issue. The Electricity Authority's proposed transmission pricing methodology was not a net benefit for NZAS and was highly complex with uncertain impacts. PA wanted to approach Transpower or the Government to seek relief on transmission charges.
- High wholesale electricity prices are increasing the electricity market prudential requirements for the smelter's owners, causing them further concern.
- The smelter owners are keen to meet Ministers shortly.

Subsequent to those meetings the negotiations broke down. It now appears unlikely that any further progress will be made between the parties so a commercial solution is now unlikely.

In broad terms, we understand that the negotiating gap between the parties is about [2] per annum for the first four years of the contract. The gap between the parties for years five onwards [2]

[2,4]

[5,6]

[4,5]

Longer-Term Implications

In the longer term, if the decision by the smelter's owners was for the smelter to cease operations, the implications depend on how this was done. The options are:

- a phased closure consistent with the existing contract – notice of closure is provided at 1 January 2015, to take effect from 1 January 2016, with operations ceasing either immediately on that date or over the following 3 years (2016-2018) and the company meeting its clean up obligations, or
- immediate closure - the smelter closes within the next year.

[2,4,6]

¹ NZAS buys electricity from the wholesale market at the wholesale price. If the wholesale price is higher than the contract price, Meridian makes cash payments to NZAS, and vice versa. The net effect is to fix the price paid by NZAS at the contract price.

[2,4,6]

Based on this logic, we concluded that NZAS has a more credible threat to close the smelter from 2016 onwards. A smelter closure would result in reduced profitability for Meridian, and therefore Meridian has a commercial incentive to offer incentives to NZAS to stay beyond 2016. The current negotiating gap between the parties, however, is far more than the amount that would be commercially sensible for Meridian to pay.

Economic Implications

The decommissioning of NZAS would generate positive and negative effects. The principal positive effect relates to the release of an additional 12% of electricity supply (currently contracted to NZAS at a discounted price) to the national market. This additional supply would likely result in lower prices, lower thermal fuel expenditure and a deferral of investment in new generation (around \$2 billion in NPV terms).

The principal negative effects relate to the requirement to invest in additional grid capacity to transmit this supply (around \$200 million), the potential for hydro spillage due to transmission constraints, and to the adjustments that will need to take place in Southland's labour and other supplier markets.

The short-term negative effects on the Southland economy could be significant, 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.

Each of these effects would be muted if a phased exit from 2016 was adopted. This would allow for additional grid capacity to be put in place and for the smelter's labour force and suppliers to adjust over time. The effects would be at their most severe if immediate closure occurred with Rio simply walking away from the contract. If that occurred Meridian could be left with contractual remedies against a company in liquidation and local government could be faced with the cleanup costs for the site.

Overall, given the assessment of the most likely outcome and the costs involved in avoiding that outcome, our advice from a national welfare perspective has been that requests from PA for assistance should be rejected as it would result in a significant transfer of value from New Zealanders to PA and Rio Tinto shareholders.

Options for the Government

[4,5,6]

[4,5,6]

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