The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Meeting with Pacific Aluminium (Tuesday 9 July)

Date:	5 July 2013	**Report No:**	T2013/1803

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Bill English)	**Note** contents of report prior to meeting with Pacific Aluminium.	8.30 am Tuesday 9 July 2013
Associate Minister of Finance (Hon Steven Joyce)	**Note** contents of report	none
Minister for State Owned Enterprises (Hon Tony Ryall)	**Note** contents of report prior to meeting with Pacific Aluminium.	8.30 am Tuesday 9 July 2013

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
[4]	Analyst, Government Share Offer Programme	04 917 6197 (wk)	[1]	✓
Chris White	Director, Government Share Offer Programme	04 890 7256 (wk)	[1]	

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

Return the signed report to Treasury.

Enclosure: No

5 July 2013 SE-1-3-14

Treasury Report: Meeting with Pacific Aluminium (Tuesday 9 July)

Executive Summary

On Tuesday 9 July you will meet with Sandeep Biswas (CEO), Phil Baker (CFO) and David Bloor (Vice President Health, Safety, Environment and Commercial) of Pacific Aluminium (PacAl). We understand a Sumitomo representative will also attend (most likely Waichiro Arai). A final list of attendees will be forwarded to your office when we receive it. This meeting has been arranged to discuss the electricity pricing agreement between Meridian and PacAl for the supply of electricity to the New Zealand Aluminium Smelter (NZAS) at Tiwai Point.

PacAl and Meridian have recently renegotiated this agreement with the following being the key revised terms:

- A lower price for electricity consumed by the smelter, which is to be pegged to the aluminium price on the London Metal Exchange during the first period of the contract. The lowest rate is [2,5,6,7] when the aluminium price is below [2,5,6,7] [1]. This compares to [2,5,6,7] under the existing contract, with this price escalating according to a formula based on inflation, wholesale electricity prices and aluminium prices.

- The establishment of contract periods with changes in volume, price and guarantee obligations occurring in the second period (from either [2,5,6] - to be agreed by both parties prior to the agreement being finalised).[2]

- A guarantee over the first period by NZAS parent companies Rio Tinto and Sumitomo. The guarantee moves to Pacific Aluminium in the second period in most circumstances.

Treasury estimates the benefit (in NPV terms) of the new price offered to PacAl will be in the region of [2,5,6,7] over the term of the contract.

PacAl management maintains that this offer is still not sufficient to return the NZAS to economic viability. Therefore they have informed Treasury that they will seek further concession from the Crown. Specifically they will request:

- A reduction in the price of power from the [2,5,6,7] agreed with Meridian down to their sought price of [2,5,6,7] when aluminium is below [2,5,6,7] (indicative cost [2,5,6,7] per year).

- A reduction in transmission charges from a current average of [2,5,6,7] down to an average of [2,5,6,7] (indicative cost [2,5,6,7] per year) with the charges capped at this level (rather than escalating as per current transmission pricing rules).

- Agreement to seek an FMA exemption from disclosing the price of power under the contract with Meridian in the offer document for the Meridian IPO.

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1 The current aluminium price is approximately $NZ 2,300 a tonne at today's exchange rate

2 Note that Transpower does not actually charge on a per MWh basis

The total value of this request is estimated to be around [2,5,6,7] per year or [2,5,6,7] in NPV terms across the length of the contract (to 2025). In return PacAl offer a quick agreement to the revised contract offered by Meridian (though still subject to the approval of both parent company boards).

Treasury's view is that there is no economic justification for offering a government subsidy to ensure the continued operation of the smelter. Therefore we recommend that the Government does not agree to the first two requests made by PacAl. This is especially true of the request around transmission which we believe is not within the power of Ministers to give without significant regulatory reform. We recommend that Ministers do agree to the request around seeking an exemption for the disclosure of contract price in the offer document, as this is a more reasonable request and will be of high value to PacAl.

[2,4,5]

A summary of key lines that Treasury recommends Ministers make at the meeting is as follows:

- You have negotiated so hard with Meridian that it is at its point of indifference
- A subsidy to the smelter makes no economic sense for New Zealand
- [4,5]
-
- Meridian, with the Crown's blessing, has set a deadline of 19 July at which point it will withdraw its offer – this has been well signalled and will be followed through
- The Crown will not be offering any additional financial support
- However, the Crown will apply or support Meridian applying for an application to the FMA for an exemption to allow the contract price to be withheld
- We therefore suggest you take the deal in the next ten days while you still can

We will discuss this report and the meeting with PacAl with you further at the Government Share Offers meeting on Monday.

Recommended Action

We recommend that you **note** the contents of this report ahead of your meeting with Pacific Aluminium at 8.30am Tuesday 9 July.

Chris White
Director Government Share Offer Programme

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

Treasury Report: Meeting with Pacific Aluminium (Tuesday 9 July)

Purpose of Report

1. You are meeting with Sandeep Biswas (CEO), Phil Baker (CFO) and David Bloor (Vice President Health, Safety, Environment and Commercial) of Pacific Aluminium (PacAl) and a representative of Sumitomo (most likely Waichiro Arai) at 8.30am on Tuesday 9 July. This report details the issue that PacAl will raise at this meeting, Treasury's views on these issues and advice on negotiating strategy.

Background

2. PacAl has been renegotiating its electricity pricing agreement with Meridian Energy Limited (Meridian) over the last year. The parties reached a heads of agreement recently and are now close to the point where they could close a deal. Treasury reported details of this heads of agreement in an Aide Memoire on 10 June (T2013/1507 refers). The key details of this agreement are as follows:

   - A lower price for electricity consumed by the smelter, which is to be pegged to the aluminium price on the London Metal Exchange during the first period of the contract. The lowest rate is [2,5,6,7] when the aluminium price is below [2,5,6,7] This compares to [2,5,6,7] under the existing contract, with this price escalating according to a formula based on inflation, wholesale electricity prices and aluminium prices.

   - The establishment of contract periods with changes in volume, price and guarantee obligations occurring in the second period (from either 1 January 2016 or 1 Jan 2017 - to be agreed by both parties prior to the agreement being finalised).

   - A guarantee over the first period by NZAS parent companies Rio Tinto and Sumitomo. The guarantee moves to Pacific Aluminium in the second period in most circumstances.

3. Meridian and PacAl are meeting in Brisbane on Thursday 4 and Friday 5 July to attempt to resolve a final set of commercial issues around prudential payments to the NZX electricity market.

4. In the 10 June aide memoire, we signalled that PacAl would likely seek a meeting with Ministers to ask for additional financial support from the Crown to sign up to this deal. This is the purpose of Tuesday's meeting from Pac Al's perspective.

What Pacific Aluminium Wants

5. PacAl has informed Treasury that it will seek 3 concessions from Ministers at the Tuesday meeting. These are as follows:

   1) A reduction in the price of power from the [2,5,6,7] agreed with Meridian down to their sought price of [2,5,6,7] when aluminium is below [2,5,6,7] (indicative cost [2,5,6,7] per year).

[3] The current aluminium price is approximately $NZ 2,300 a tonne at today's exchange rate

2) A reduction in transmission charges from a current average of [2,5,6,7] down to an average of [2,5,6,7] (indicative cost [2,5,6,7] per year) with the charges capped at this level (rather than escalating as per current transmission pricing rules).

3) Agreement to seek an FMA exemption from disclosing the price of power under the contract with Meridian in the offer document for the Meridian IPO.

6. In return PacAl has indicated that if these three items are agreed it can enter a revised agreement with Meridian quickly without further need to consult the respective parent companies in Tokyo and London. However, we understand from Meridian that the final deal will still need to be signed off by the Rio Tinto board on August 6. We also expect that a sign off will also be required by the Sumitomo board. To reflect this delay beyond Meridian's deadline Pacific Aluminium have stated that Sam Walsh (CEO of Rio Tinto) will offer a signed personal endorsement as soon as a deal is reached.

Analysis of Requests

Price

7. PacAl's first request is for a straight price reduction from the price it has negotiated with Meridian [2,5,6,7] down to the price that it has been seeking to pay [2,5,6,7] . PacAl was unclear in its messaging to Treasury on how this support would be delivered, however in the past the company has reacted negatively to talk of "subsidies". The total estimated cost of this would be [2,5,6,7] per year to the Crown. The subsidy would remain in effect whenever the price of aluminium is below [2,5,6,7] for the length of the contract with Meridian.

8. This is a request for a cash subsidy (although PaAl would not call it this). There would be no technical difficulties in the Crown granting it, but it would be a significant ongoing cost for the Crown as consensus forecasts do not expect aluminium to exceed [2,5,6,7] for at least the medium term. Like any other expenditure it would need to be weighed up against other priorities for Government.

9. [2,6,7]

Reduction in Transmission Charging

10. PacAl will also seek relief from the Crown for the cost of electricity transmission. This cost has recently risen significantly for all users of transmission services including the smelter, with PacAl stating that its costs have increased from around [2,5,6,7] in 2010 to [2,5,6,7] last year and [2,5,6,7] this year, and are forecast to increase by another [2,5,6,7] over each of the next two years. PacAl complained that this increase is despite the smelter reducing its average load from 620MW to 570MW (although this is an irrelevant factor). PacAl claim that this has meant the cost of transmission per MWh has increased from around [2,5,6,7] to [2,5,6,7] and this is unsustainable for the smelter. PacAl indicated that a cost of [2,5,6,7] would be acceptable. The total cost to the Crown of accepting this would be approximately [2,5,6,7] per year, increasing over time. Since Transpower do not charge on a per MWh basis this could also expose the Crown to further risk.

11. The increase in transmission costs has been caused by a significant programme of investment by Transpower. PacAl claims that this has been of no benefit to it as the majority of this spending has been in the North Island and on the HVDC link. Treasury does not believe the investment has had no benefit for the smelter, as the increased HVDC capacity provides cover for dry year risk in the South Island (such as recently occurred in March this year). [4]

12. However, granting Pac Al any relief on this is problematic. NZAS is a participant in the New Zealand electricity market and the rules that apply to it are the same as those that apply to all other participants. To grant a special deal to one participant would set a difficult precedent and would inevitably result in other participants that could make similar arguments approaching the Crown for a similar deal. Changing the rules for PacAl would also probably require special legislation.

13. [4]

14. Treasury expects that in evaluating a deal PacAl will focus on the delivered cost of electricity to the smelter. Therefore concessions on price and transmission charging are likely to be fungible with the total concession across the two being what will be evaluated by PacAl choosing to accept or reject a deal. Therefore, PacAl would probably accept a further price based subsidy in lieu of addressing the transmission issue directly.

15. The total cost of what has been requested is in excess of [2,5,6,7] per annum with a term potentially as long as the full power supply contract (out until 2025).This equates to roughly [2,5,6,7] on an NPV basis using the public sector discount rate of 8%.

Exemption from disclosure of price in the offer document

16. PacAl has also requested that the Crown seek an exemption to the requirement to detail the price agreed in its contract with Meridian in the offer document for the proposed IPO, on the grounds of commercial sensitivity. PacAl has been advised by Treasury that an independent body, the FMA, would need to make this judgement and the Crown cannot guarantee that it will be granted. In response, PacAl indicated that a good faith undertaking from the Crown to seek the exemption would be enough for them to agree the deal (signalling, we think, a view on their part that the exemption will be granted if applied for).

17. [8]

In respect of other FMA exemptions across the MOM programme, the principle the Crown has adhered to is to apply for them only when there is already precedent for the exemption.

18. Of all of PacAl's requests this would be the easiest to grant [4]

This perspective is mitigated by the long standing confidentiality provisions that have existed around the power contract with the smelter for a number of years and the precedent for exemptions of this type.

Framing Advice

19. As previously advised (T2013/801) Treasury's view is that there is no economic rationale for a long term government subsidy for the Tiwai point smelter. The smelter already enjoys a significant commercial discount on power relative to other participants in the New Zealand electricity market and this will be extended further if the current offer from Meridian is accepted. In the long term the smelter shutting would result in higher value uses for the electricity and be of benefit to the New Zealand economy.

20. We also previously advised that there would be significant transition costs in the event of a shut down scenario, especially to the Southland economy and the wider electricity market. Therefore a short term subsidy [4,6] might be justified if this provided certainty [4,6]

21. In March, the Prime Minister offered Rio Tinto and PacAl [2,5,6,7] over six years to support them entering into an agreement with Meridian. This offer was rejected on the basis that Rio Tinto were not given enough time to properly evaluate it and they had not reached a satisfactory position in their negotiations with Meridian.

22. In the context both of the lack of an economic rationale for a subsidy (a point that has been clearly communicated to PacAl), and of the scale of the Prime Minister's previous offer, the ask by PacAl is [4,5,6] not something we can recommend Ministers accept.

23. [4,5,6]

[2,4,5,6]

[2,4,5,6,7]

[2,5,6,7]

[4,5,6]

32. However, recent press speculation has suggested that Rio Tinto might be rethinking its current planned divestment of PacAl. The company is currently being pressured by investors to look at divestment of its entire aluminium operation, which may involve the reintegration of PacAl back into Rio Tinto Alcan. It is hard to know what the implications of this might be. However, it might explain recent slow decision making at Rio Tinto in relation to this deal.

33. PacAl management indicated in their conversation with Treasury that even if the current proposed deal was accepted by the Crown, the smelter would be losing money while the Aluminium price remained under [2,5,6,7] (the current price is just under $1800 US a tonne). [2,5,6,7]

34. If PacAl can get to a breakeven point we believe that it is rational for them to continue to operate. The aluminium market is currently highly stressed and a number of participants are likely to be losing money. However, forward forecasts predict a modest increase in prices, and given the costs associated with closing, this would appear to be the rational position for the company to take.

Negotiating Strategy

35. [4,5,6]

36. We therefore suggest that the best approach is to communicate the following points to PacAl:

- You have negotiated so hard with Meridian that it is at its point of indifference.
- A subsidy to the smelter makes no economic sense for New Zealand
- [4,5,6]
-
- Meridian, with the Crown's blessing, has set a deadline of 19 July at which point it will withdraw its offer – this has been well signalled and will be followed through
- The Crown will not be offering any additional financial support
- However, the Crown will apply or support Meridian applying for an application to the FMA for an exemption to allow the contract price to be withheld
- We therefore suggest you take the deal in the next ten days while you still can.

37. As a variant of the above, if Ministers felt that it is hard to remove the [4,5,6] previously tabled, this offer could remain as the sole offer the Crown is prepared to make with the remaining messages essentially the same. However, [4,5,6] is insignificant in the context of what PacAl has requested, so it is substantively the same as offering nothing. [4]
[4,5,6]

38. Additional points that may be useful in the conversation include:

- PacAl have secured at least [2,5,6,7] of value from Meridian.
- We are unable to intervene in the transmission pricing regime as this would set a precedent for other users. We recognise that the regime is not perfect, but also note that the independent Electricity Authority has a programme of work underway to reform the pricing regime and the outcome of this may beneficial to NZAS.

[2,4,5,6,7]