

The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

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Release Document

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Chair
CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

NEW ELECTRICITY CONTRACT FOR TIWAI POINT SMELTER

Proposal

1. This paper outlines the details of the proposed new electricity agreement between Meridian Energy Limited (Meridian) and the New Zealand Aluminium Smelters (NZAS). It seeks Cabinet's agreement to establish the appropriation required to pay NZAS the \$30 million incentive payment agreed by Cabinet on 29 July [CAB Min (13) 25/5] and outlines the basis for agreeing to this payment.

Executive Summary

2. On July 29 Cabinet agreed [CAB Min (13) 25/5] that it is in the Crown's best interests for Meridian and NZAS to enter into a revised electricity agreement, as this will provide certainty on NZAS's medium term future to the benefit of smelter employees, the Southland community and the New Zealand electricity market. To help secure this outcome, Cabinet agreed to a \$30 million incentive payment from the Crown to NZAS upon execution of the revised agreement with Meridian. Pacific Aluminium has indicated that this will be sufficient for NZAS to enter the agreement, but this is still contingent on final approval from Rio Tinto and Sumitomo Chemical's Boards.

3. In return for this payment, the Crown secures a resolution to the contract negotiations between Meridian and Pacific Aluminium. This results in:

- Greater certainty for the New Zealand electricity market and the community that the smelter operates in.
- Guarantees from NZAS's parent companies, Rio Tinto and Sumitomo Chemical until 31 December 2016.
- Continued operation of the smelter until at least 1 January 2017.
- An incentivised reduction in volume covered under the contract from 572MW to 400MW from 1 January 2017. This will allow Meridian to reduce its dependence on NZAS as a customer.
- Greater certainty for Meridian's earnings and therefore support for the proposed Initial Public Offering (IPO) process.

4. The revised agreement reflects the current stressed state of the aluminium industry. The agreement broadly reverses the pricing outcomes of the 2007 contract by returning to a price slightly below what the smelter was paying prior to the new contract (agreed in 2007), which came into effect on 1 January 2013. This will improve the smelter's viability in the current aluminium market.

5. Regardless of whether Meridian concludes the revised agreement with NZAS, or NZAS shuts down under the terms of the existing agreement, there will be a reduction in Meridian's value. [2,5,6]

We understand that Meridian will book a \$476 million gross impairment (\$343 million net of deferred tax) against its revaluation reserve when its 2012/13 financial result is announced on 12 August.

Background

6. The Tiwai Point aluminium smelter has been operating in Southland since 1971. The smelter is the largest electricity consumer in New Zealand, using approximately 5 million MWh of electricity per annum. This electricity is primarily supplied from the Manapouri power station that was commissioned in conjunction with the smelter.

7. Manapouri has been owned by Meridian Energy Limited (Meridian) since Meridian was established in 1999. The power supply agreement with NZAS was transferred to Meridian at the same time. This original agreement expired on 31 December 2012.

8. In 2007, Meridian and NZAS entered into a new agreement to take effect from 1 January 2013. The new agreement differed from the prior one in that it is a contract for difference (CFD) rather than an electricity supply agreement. Under the terms of the agreement, NZAS is a participant in the wholesale market and Meridian rebates it for the difference between the wholesale price paid and the price agreed in the contract. This has the effect of fixing the price. The price agreed averages around [2,5,6,7] in 2013, which is a significant increase on the previous power supply agreement. This contract was negotiated at a time when there was strong positive sentiment in the aluminium industry.

9. Since 2007 there have been several structural changes to the aluminium industry. An increase in Chinese smelting and a reduction in demand following the global financial crisis has resulted in a sustained fall in the price of aluminium as traded on the London Metals Exchange (LME). This has made the viability of NZAS increasingly challenging. NZAS is not unique in this situation, with a similar combination of factors also impacting a number of Australian smelters.

10. In 2011 in response to the above factors, Rio Tinto, which owns 79.36% of NZAS (the other 20.64% is owned by Sumitomo Chemical), split NZAS and Rio Tinto's other Australasian smelters into a new business unit called Pacific Aluminium, with the objective of divesting these assets. In preparation for this divestment a number of cost cutting and efficiency measures have occurred across the portfolio, most notably a renegotiation of the power supply agreement for the Bell Bay smelter in Tasmania and support from the Northern Territory Government to change the power source at the Gove alumina refinery to gas. The proposed divestment has so far been unsuccessful, with Rio Tinto unable to find an interested buyer for Pacific Aluminium.

11. In July 2012 Pacific Aluminium approached Meridian to renegotiate the 2007 electricity CFD agreement. Given the structural changes in the industry, Pacific Aluminium argued that the price under this agreement was not economic and NZAS would shut down if price reductions were not secured.

12. NZAS is by far Meridian's largest customer and accounts for approximately 41% of Meridian's output and 14% of New Zealand electricity demand. The consequences of NZAS shutting would be very significant for Meridian and the New Zealand electricity market as a whole, especially if shut down were to occur suddenly, as there may be insufficient transmission capacity to move all of the newly available electricity to other customers.

13. Pacific Aluminium is prohibited from closing the smelter straight away by the terms of the 2007 contract. The contract prohibits notice of closure until 1 January 2016 and is then subject to ramp down provisions. Shut down can occur sooner than the full ramp down period, but under the terms of the agreement this results in penalties that NZAS is required to pay Meridian.

[2,4,5,6,7]

15. Given these factors Meridian agreed to renegotiate the contract with NZAS. After a year of negotiation Pacific Aluminium and Meridian reached final positions on revised terms.

Revised Agreement

16. Under the proposed agreement, NZAS will pay a lower price of [2,4,5,6,7] for electricity while the aluminium price remains under [2,4,5,6,7]¹ per tonne. This price is higher than the [2,4,5,6,7] requested by NZAS, but is slightly lower than the price paid under the previous contract (pre 1 January 2013). NZAS also benefits from improved conditions in the contract including Meridian bearing the prudential risk that NZAS incurs from being a participant in the wholesale market. Under the current contract NZAS has significant exposure to market conditions, which can require it to post significant collateral with NZX. It did not have this exposure under its previous contract as this was a supply agreement rather than a CFD.

17. In return for the concession on price, Meridian receives Rio Tinto and Sumitomo Chemical guarantees over the contract for the first period (until 31 December 2016) and the benefit of the smelter accepting a reduction in volume (to 400MW from 572MW) from the start of the second period (1 January 2017). The reduced volume is financially beneficial to Meridian as it is likely to be able to sell the 172 MW difference more profitably on the wholesale market, and it also reduces Meridian's dependence on the smelter as a customer. If the smelter does not accept this reduction in volume pricing reverts back to the rates under the 2007 contract. These arrangements will reduce the wider economic impact should the smelter close at a subsequent date.

¹ The current price of Aluminium on the LME is \$US1769 per tonne. On current exchange rates this amounts to around NZ\$2,260.

18. Following the reduction the smelter has the option of either reducing its production to allow for the lower volume of electricity, or contracting with another generator for the 172MW difference. The smelter is also entitled to elect to move to this reduced volume earlier by giving 1 years notice from any date after 1 January 2014. It is therefore possible that the smelter moves to 400MW from 1 January 2015.

Implications for Meridian's value

19. The approach by Pacific Aluminium to Meridian had significant implications for Meridian's value regardless of whether an agreement is reached or not. Due to the significance of NZAS as a customer, Meridian is exposed to world aluminium prices, and therefore was always likely to suffer a significant fall in value when the aluminium market deteriorated so significantly, whether by reaching a new agreement or as a result of the smelter exiting.

20. In negotiating a revised agreement Meridian has done detailed modelling work of all possible scenarios. The agreement with Pacific Aluminium represents its point of indifference, where on a base set of worst case assumptions the company is no better or worse off over the long term between the revised agreement and the smelter leaving. Meridian is not prepared to offer any further concessions to Pacific Aluminium, especially on price. [2,4,5,6,7]

21. Meridian will take a write down as a result of the new contract. This will be announced as part of its annual result on 12 August. We understand that Meridian's write down will be \$476 million gross (\$343 million net after deduction for deferred tax). This write down will be charged to the revaluation reserve and therefore will not have an impact on Meridian's profit.

[2,4,5,6]

Implications for the proposed IPO of Meridian

23. Entering into a revised agreement with NZAS will provide greater certainty for Meridian's earnings and therefore supports the proposed IPO process.

[2,4,5,6]

25. In addition to the impacts on the valuation of Meridian, resolution of the contractual arrangements will provide certainty of outlook to all other participants in the electricity sector.

Approach to Government

26. Pacific Aluminium has approached the Government twice for additional support for NZAS. The first approach was in March just ahead of the Mighty River Power offer period. At this time an offer was made to Pacific Aluminium by the Government to cover some of the gap that existed between Pacific Aluminium and Meridian. This arrangement would have supported an orderly transition. This offer amounted to [4,5,6]

Pacific Aluminium rejected this offer at the time due to not having reached a satisfactory position with Meridian on the agreement. Since then Meridian has made no further concessions on price. Meridian has however agreed to bear the prudential risk that NZAS incurs from being a participant in the wholesale market.

27. In early July, Pacific Aluminium approached the government again seeking support for the smelter to allow them to agree to the terms on offer from Meridian. This request consisted of three components:

- a. Support to cover the difference between the price agreed with Meridian [2,4,5,6,7] and NZAS' desired electricity price of [2,4,5,6,7] at an approximate cost of [2,4,5,6,7] per year.
- b. Relief from growth in transmission charging by capping the price paid by the smelter at the equivalent of [2] at an approximate cost of [2] in 2013/14 growing to [2] by 2018/19, assuming current transmission charging policy remains in place. We estimate that the total cost of this request over the life of the contract would have a net present value (NPV) of [2]
- c. Agreement to seek an exemption from the Financial Markets Authority (FMA) to withhold the price agreed under the revised agreement as part of the Meridian IPO process.

Government Offer

28. Cabinet agreed on 29 July that the Crown could not support the first two requests from Pacific Aluminium. It is not appropriate for the government to provide a commercial entity with a subsidy for either the price of electricity or the price of transmission. This is especially true of the latter as it would set a difficult precedent with other electricity users. The third request is easier to agree to and Meridian has made an application to the FMA to withhold the price, with the support of the Crown. There is established precedent for commercial details such as this being withheld in offer documents and such an application therefore is common practice, though it is not guaranteed to succeed, a point which Pacific Aluminium acknowledges.

29. In our view it is unlikely that Pacific Aluminium would enter the new agreement without any financial support from the Crown, especially following the previous offer made in March.

30. In light of this and given how far the negotiations between Meridian and Pacific Aluminium have come, we have made a counter proposal to Pacific Aluminium. This is that the Government will pay a net \$30 million incentive payment to NZAS on execution of the revised agreement with Meridian. This amount approximates the initial offer that

was made to Pacific Aluminium in March, but is structured as a lump sum rather than an annual subsidy, and with no connection to power prices or transmission prices. Cabinet agreed to this proposal on 29 July.

31. The purpose of this payment is to provide an incentive for negotiations between Pacific Aluminium and Meridian to conclude on the terms currently negotiated. This provides the benefit of greater certainty over NZAS's immediate future to the benefit of the employees of NZAS, the wider Southland community, and the New Zealand electricity market.

32. This payment is subject to the condition that no review of the ongoing viability of NZAS is publicly announced before 30 June 2015. If this condition is breached the \$30 million payment is to be refunded to the Crown. A decision from NZAS to reduce volume to 400MW in accordance with the terms of the contract will not be treated as a review of ongoing viability for this purpose.

33. Pacific Aluminium has accepted this offer in principle, subject to the approval of NZAS's two parent companies' (Rio Tinto and Sumitomo Chemical) boards, who will consider the revised contract with Meridian and the Crown offer as a package. We expect that a decision will be made on 5 August by Sumitomo Chemical and 6 August by Rio Tinto.

Tax Treatment

34. In accepting the offer Pacific Aluminium has indicated that its understanding is that the amount offered is net of tax. Initial advice suggests that the tax treatment of the payment is unclear. Given the timeframes associated with this offer there is not time to clarify the tax treatment by seeking a binding ruling from IRD. We are willing to make the payment on a net basis, and consequently the Minister of Finance will provide an indemnity to cover any tax expense incurred through the payment of the grant.

35. This is consistent with how the Government addresses uncertain tax consequences in other negotiations such as Treaty of Waitangi settlements. If the indemnity is called on it will be funded by an existing permanent legislative authority and will have no net cost to the Crown as any tax obligation will be returned to the Crown as revenue.

36. NZAS considers that the payment is subject to GST and as a result will issue a tax invoice for \$30 million plus GST. GST will be returned to the Crown in NZAS's next GST return. Consistent with other payments made by Government the amount of GST does not need to be appropriated.

Financial Implications

37. The operating expense associated with the Government signing incentive to NZAS will need to be appropriated. The \$30 million cost will be charged against the between budget contingency and will be classified as a non-departmental other expense in Vote Finance.

Regulatory Impact Analysis

38. This paper is exempt from regulatory impact analysis.

Publicity

39. The revised electricity agreement between Meridian and NZAS and the Crown support for the deal will generate significant media interest. The deal will be announced publicly following the approval of the parent company boards around 8 August. Meridian will take the lead on the announcement, and no public comment will be made by Ministers before Meridian's announcement, due to the continuous disclosure requirements that result from Meridian having debt listed on the NZX.

Recommendations

40. It is recommended that the Economic Growth and Infrastructure Committee:

- 1 **note** that on 5 August Cabinet granted the Cabinet Economic Growth and Infrastructure Committee power to act with respect to this paper.
- 2 **note** that on 29 July Cabinet [Cab Min (13) 25/5]:
 - 2.1 **noted** that the aluminium industry has been in a sustained downturn with low prices and a strong New Zealand dollar threatening the viability of production in New Zealand;
 - 2.2 **noted** that Pacific Aluminium, a business unit of Rio Tinto (the majority owner of the New Zealand Aluminium Smelter (NZAS) at Tiwai Point), has approached Meridian Energy Limited (Meridian) to renegotiate the electricity agreement between the two parties;
 - 2.3 [2,5,6,7]
 - 2.4 **noted** that, following a year of negotiation, a revised agreement has been reached between NZAS and Meridian Energy that significantly reduces the price paid for electricity by the smelter from approximately [2,5,6,7] to [2,5,6,7] ;
 - 2.5 **noted** that in return for the reduction in price, Meridian receive guarantees over the contract from NZAS's parent companies, Rio Tinto and Sumitomo Chemical, an extension of the earliest possible smelter exit date to 1 January 2017 and a reduction in contract volume from 572MW to 400MW from either 1 January 2017 or 1 January 2018;
 - 2.6 [2,5,6,7]
 - 2.7 **noted** that Pacific Aluminium claims that this reduction is not sufficient to return the smelter to viability, and that as a result Pacific Aluminium has approached the New Zealand Government for further support to reduce the price of electricity and the cost of transmission;
 - 2.8 **agreed** not to support NZAS with a price or transmission based subsidy;

- 2.9 **agreed** that, for the purposes of providing certainty to NZAS workers, the Southland community and the New Zealand electricity market, it would be desirable for NZAS to enter into the revised electricity agreement with Meridian;
- 2.10 **agreed** to fund a sign-up incentive to NZAS of \$30 million on execution of the revised agreement with Meridian to encourage NZAS to enter into the new agreement with Meridian;
- 2.11 **agreed** that a condition of the payment to NZAS is that NZAS will repay the \$30 million lump sum in full if an on-going review of the viability of the smelter is publicly announced before 30 June 2015;
- 2.12 **invited** the Ministers of Finance and State Owned Enterprises to report back to Cabinet to seek agreement to the details of the payment and the communication of the payment by the 7th of August;
- 3 **note** that since 29 July, NZAS has elected that the reduction in contracted volume from 572MW to 400MW will occur on 1 January 2017;
- 4 **agree** to establish a new Non-Departmental Other Expense appropriation "New Zealand Aluminium Smelters – Electricity Agreement Incentive Payment" in Vote Finance;
- 5 **agree** that the scope of this appropriation be "This appropriation is limited to the provision of an incentive payment to New Zealand Aluminium Smelters on the execution of a revised electricity agreement with Meridian Energy Limited";
- 6 **approve** the following changes to appropriations to give effect to the policy decision agreed by Cabinet on 29 July, with a corresponding impact on the operating balance:

Vote Finance Minister of Finance	\$m – increase/(decrease)				
	2013/14	2014/15	2015/16	2016/17	2017/18 & Outyears
Non-Departmental Other Expense: New Zealand Aluminium Smelters – Electricity Agreement Incentive Payment	30.000				

- 7 **agree** that the proposed change to appropriations for 2013/14 above be included in the 2013/14 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply;
- 8 **agree** that the expenses incurred under recommendation 4 above be a charge against the between-Budget operating contingency, established as part of Budget 2013;
- 9 **note** that Pacific Aluminium has also requested that an exemption from the requirement to disclose the price it pays for electricity under the revised

contract in the offer document for the proposed Initial Public Offering (IPO) of Meridian be made to the Financial Markets Authority (FMA);

- 10 **note** that Meridian has requested the exemption from the FMA on the basis that this is common practice;
- 11 **note** that the amount offered to NZAS is a net amount and that as the tax treatment of the payment is unclear the Minister of Finance will grant NZAS an indemnity over any tax expense incurred as a result of the payment;
- 12 **note** that a condition of the incentive payment is that NZAS's owners will not announce a public review of NZAS's viability before 30 June 2015;
- 13 **note** that Pacific Aluminium has indicated that the offer of an incentive payment will be sufficient for it to accept the revised agreement with Meridian, but this will be subject to final approval from the Sumitomo Chemical and Rio Tinto Boards on the 5th and 6th of August respectively; and
- 14 **note** that Meridian Energy will take the lead on media enquiries relating to the underlying electricity agreement, beginning by meeting its continuous disclosure obligations to the NZX once an agreement is concluded.

Hon Bill English
Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

Date: