The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

www.treasury.govt.nz/publications/information-releases/nzas

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information, or who is the subject of the information

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

[4] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[5] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[6] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[7] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[8] 9(2)(h) – to maintain professional legal privilege

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [3] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.
Treasury Report: Recent market commentary on Rio Tinto or the NZ Aluminium Smelter

Date: 6 December 2012  Report No: T2012/3170

Action Sought

<table>
<thead>
<tr>
<th>Position</th>
<th>Action Sought</th>
<th>Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minister of Finance (Hon Bill English)</td>
<td>Note contents</td>
<td>None</td>
</tr>
<tr>
<td>Associate Minister of Finance (Hon Steven Joyce)</td>
<td>Note contents</td>
<td>None</td>
</tr>
<tr>
<td>Minister for State Owned Enterprises (Hon Tony Ryall)</td>
<td>Note contents</td>
<td>None</td>
</tr>
</tbody>
</table>

Contact for Telephone Discussion (if required)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Telephone</th>
<th>1st Contact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Juston Anderson</td>
<td>Senior Analyst, Commercial Transactions Group</td>
<td>04 890 7211 [1]</td>
<td>✔</td>
</tr>
<tr>
<td>Chris White</td>
<td>Manager, Commercial Transactions Group</td>
<td>04 890 7256 [1]</td>
<td></td>
</tr>
</tbody>
</table>

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
<table>
<thead>
<tr>
<th>Source</th>
<th>Date</th>
<th>Subject of report</th>
<th>Relevant commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morgan Stanley</td>
<td>4 Oct</td>
<td>Rio Tinto</td>
<td>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.</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>14 Aug</td>
<td>Rio Tinto</td>
<td>To many investors, Rio Tinto’s aluminium division is something of a black sheep generating very low return on assets, prompting the recategorization 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 Aluminiun). 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].</td>
</tr>
<tr>
<td>Deutsche Bank (Australia)</td>
<td>3 July</td>
<td>Australian mining sector</td>
<td>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.</td>
</tr>
</tbody>
</table>