

focus



Power cut for Tiwai Smelter

Nearly a half-century ago, in November 1971, the then Prime Minister of New Zealand Keith Holyoake flew to Invercargill (with a small number of cabinet ministers in support), to open the aluminium smelter at Tiwai Point.

The agreement signed between the Government and Consolidated Zinc (a subsidiary of the Commonwealth Aluminium Company or “Comalco”) a decade earlier, ultimately resulted in the Government building the Manapouri power station, under a deal to sell the electricity generated, to the company.

The dam project was controversial at the time, sparking outrage from environmentalists, despite the Minister of Works and Electricity, Hugh Watt, describing it as “the most important single step in industrial development taken in New Zealand’s history”.

Fast forward 50 years and Comalco’s successor company, Rio Tinto, has given Meridian Energy (the owner of the Manapouri dam) notice on its contract to buy electricity. The contract will cease on 31 August 2021, by which time Rio Tinto expects all smelter operations at Tiwai Point to have ceased. The company has cited its lack of success in electricity price negotiations and the deteriorating aluminium market as the principal reasons for the smelter’s closure.

The announcement is a surprise given the “green” (low-carbon) credentials of the smelter compared to others owned by Rio Tinto and the high environmental rehabilitation costs (estimated to be more than NZ\$300 million), which will now be crystallised. Given recent increases in aluminium production at Tiwai, it is also surprising that Rio Tinto is not seeking a longer “ramp-down” period (in return for a lower electricity price, something it had been offered). While it is possible that the story does not end here, any other scenario appears implausible.

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In addition to the impact on the Southland economy arising from those employed directly or indirectly by the smelter, there is clearly a significant impact on the electricity sector arising from the reduction in demand for power generated from the Manapouri dam.

The smelter uses around 12% of New Zealand’s total electricity generation in an average year, with its closure resulting in 1,500GWh and 2,000GWh of generation per annum by the two South Island generators (Contact and Meridian) unable to leave Southland due to transmission constraints. However with Transpower transmission upgrades expected to be completed by early 2023 (and the smelter not fully closing for another year), this should only be an issue for a relatively short period.



Manapouri power station at Lake Manapouri Image Pseudopanax

The uncertainty arising from Rio Tinto's announcement has had an immediate impact on share prices for electricity companies, although we believe the medium-term outlook is more promising than current market sentiment might suggest. In particular, we note that as a result of the excess generation, it is likely that there will be closures of older, more expensive thermal generation plants in the North Island, which will have the additional benefit of advancing New Zealand's move to further increase renewable energy generation.



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In terms of company earnings, both Contact and Meridian will clearly be impacted in the medium-term, but over the longer-term we consider that the industry is likely to be largely better-off, once constraints are removed due to the low electricity prices that the smelter was paying are combined with the potential cessation of the high costs of thermal generation. However, across the sector, the level of future dividends will be uncertain in the short-term, with Meridian and Contact in particular likely to be directly impacted. In the case of Mercury and Genesis, the possible impact is less clear, with both companies less directly affected by the smelter closure.

Overall, our view is that the electricity sector will navigate this challenging period successfully and will continue to be a valuable infrastructure asset and an important component of investors' portfolios. Your Forsyth Barr investment adviser is available to provide you with further detailed research concerning the electricity sector, and advice in terms of your investment portfolio, at any time.



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Not a recommendation to buy or sell shares. You can access Andrew's latest research reports on Contact and Meridian through your Forsyth Barr login or by contacting your Forsyth Barr Investment Adviser. Past performance is not necessarily indicative of future performance. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and you may not get back the full (or any) amount invested.



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