

End of power subsidies fried smelting sector

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A plant closure reveals aluminium manufacturing is struggling, and not just because of the prices, writes Tony Wood

Almost 350 workers at the Kurri Kurri aluminium smelter in NSW have become pawns in the shouting that masquerades as public policy debate in Australia in 2012.

The facts of the smelter's closure and the cost pressures that this and other Australian businesses face are reasonably clear. Interpretation of the facts and the overlay of politics make things less clear, and shining some light might be useful.

Aluminium smelting in Australia, like other light metals manufacturing, has been politically charged for decades.

Electricity costs are the major driver of aluminium smelter plant profitability and location decisions.

Most Australian producers have generally had low costs by global standards because the price they have paid for electricity has been low and has also been subsidised by legacy state government contracts.

An example of such subsidies was the decision to support Alcoa for Point Henry and Portland, made by the Liberal government in 1979.

In 2009, Rob Maclellan, who was in cabinet for the decision, described it as a "collective moment of insanity". This deal was inherited by new private sector owners of generation assets and added \$2.45 to every MWh sold in Victoria.

As these contracts have approached their end dates, the smelters have found it difficult to negotiate new contracts, as the Kurri Kurri operation found in its negotiations with Delta Electricity.

Moving to commercial electricity prices would add about 50 per cent to the average wholesale price applying to these smelter contracts, the Grattan Institute estimated in a report in 2010.

A further and pending cost pressure is the impact of export parity pricing for thermal coal on domestic supply contracts with generators. These contracts were negotiated at the time of vertical disaggregation by governments and effectively protected households and businesses from volatility in global prices while they were in place.

Their unwinding in the next few years has been highlighted in submissions to the NSW regulator, the Independent Pricing and Regulatory Tribunal.

These cost increases will have a material impact on the competitiveness of Australian aluminium smelting businesses.

At the same time, new smelting centres have emerged in southern Africa, Iceland and the Middle East with very low-cost electricity. This has eroded efficiency advantages that Australian smelters had once held over plants in the United States, Europe and Russia.

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The position is also complicated by Chinese producers, which have been accused of dumping subsidised aluminium on the world market.

An assessment of these market forces suggests that Kurri Kurri becomes a very high-cost producer, independent of a carbon price. The owner of the Kurri Kurri smelter, Norsk Hydro, has acted on this position, presumably judging that it is unlikely to improve.

Full carbon pricing would probably result in most Australian aluminium production moving overseas. In the medium term, with the exception of Tasmania's Bell Bay, this would probably cut global carbon emissions, since Australian smelters emit more greenhouse gases than the International Aluminium Institute global average.

New global capacity is also likely to have even lower emissions, locating in countries where electricity is produced from hydro, nuclear or geothermal energy.

In some cases, such as the Middle East, Canada and Iceland, there are few alternative uses for this electricity, making it relatively cheap.

An example closer to home could include the sort of large-scale hydro generation envisaged by Origin Energy for Papua New Guinea.

The owners of the Kurri Kurri smelter have indicated that "the carbon tax is not a major issue compared to other factors", and the above assessment would support such a view.

It is equally clear that longer-term carbon pricing will be a global consideration for all big aluminium producers when locating new capacity. The short-term impact of the emissions trading scheme is not trivial for aluminium smelting and will add to other pressures.

In the absence of the basic loss of competitiveness from non-carbon factors, Norsk Hydro may well have waited to see the outcome of the next federal election and the approach that a possible Abbott government might take to climate change. However, the immediate bleeding of cash made the decision a no-brainer.

In the context of such pressures, and taking a long-term perspective that carbon pricing will be a reality beyond current political positioning, this decision is unlikely to be the first of a kind.

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