The memory of the worst year in Comalco's history is very fresh and has been well documented in the Annual Report and in the Chairman's Address at our Annual General Meeting.

The disastrous 1985 result — a loss of $69.1 million — followed four years of particularly disappointing performance by Comalco, and indeed by the whole of the international aluminium industry, and more generally the international metals industries. The last reasonable year for our industry and my company was 1980, and since then we have seen little to give us joy.

Without wishing to strike too euphoric a note, I should point out that Comalco has made a modest profit in the first quarter of 1986. Moreover, if metal prices for the year average around their current level and exchange rates don't move too far, then our present forecasts envisage a result for the full year which, while far from acceptable in terms of returns on funds invested, will be better than we have seen for some years.

There were four major reasons for the dramatic decline in Comalco's earnings in 1985. I will comment on each of these reasons, and will outline the steps Comalco is taking to reduce or eliminate the likelihood of their impact on future results.

Firstly, a large proportion of the loss reflected the very poor results from our investment in the Showa Aluminium Joint Venture in Japan. This contributed $31.5 million to the overall $69.1 million reported loss.

This problem which is now behind us. The company withdrew from the Showa Joint Venture on 1 April by returning its shares to its partner, Showa Denko, and at the same time acquiring the Showa Aluminium 20.6 per cent interest in the Tiwai Point smelter consortium in New Zealand. The arrangements for this withdrawal were such that no further loss by Comalco will be incurred after 31 December 1985. Furthermore, the additional interest in NZAS is a valuable asset, provided the internationally competitive position of that smelter is not undermined.

We continue to believe that the strategy behind our decision to enter the Showa Joint Venture in 1982 was correct, but by mid-1985 it became clear that it was not possible to bring it to fruition as originally envisaged and agreed with our partner. The major reason for the failure of the joint venture was Comalco's underestimation of the difficulty in bringing about major change in a complex, conservative Japanese organisation, notwithstanding our long experience in Japan and with the Showa Denko group.

In any event, withdrawal has meant that this source of major loss has been shut off. It is significant too that a number of small non-strategic operations have also been divested over the past 12 months, including a number of Comalco's South East Asian joint ventures, its commercial Architectural Fabrication operations and some other small investments. This has permitted management to focus on the Group's core businesses, including the wholly-owned US subsidiary, Commonwealth Aluminium, which promises to start contributing to our results this year and beyond.

The second reason for our poor results was the fact that primary metal prices were amongst the lowest in real terms ever recorded and equally important, were significantly lower than our expectations. And these expectations, it is worth noting, were amongst the most pessimistic forecasts of any around the world.

However, the encouraging news is that since the end of 1985 there has been a modest improvement in metal prices. With continued reasonable economic activity in the United States and the major markets of Western Europe and Japan, we believe 1986 metal prices are likely to average out at around their current level, or show some further, modest, improvement.

In response to this environment of poor metal prices, Comalco has continued to take steps to improve the cost performance of each of its alumina refineries and smelters, to lower even further their breakeven points. One impact of these efforts can be seen in the reduction during 1985 of Comalco's total manpower.
by just on 1000 people, or an overall cut of 10 per cent in our workforce. This follows a reduction of similar magnitude in 1982/83, and is part of an ongoing programme which will continue to improve productivity in all of our operations, by upgrading technology and facilities, and by changing organisation and work practices.

The third factor which contributed to our 1985 loss was the fact that our interest expenses were significantly higher than in 1984. This was partly the result of the depreciation of the A$ which increased costs by $9 million, but it was primarily because of increased borrowings to fund our rapid growth during the year.

During the first part of the 1980s Comalco increased its gearing as it moved to rapidly expand its primary metal capacity and to secure strong downstream positions in major world markets. Needless to say, this course was based upon an expectation of reasonable metal prices which, as noted, was not fulfilled in 1985. We remain confident that our moves to secure downstream positions are strategically sound and lay the foundations for improved results, as metal prices firm.

In the latter part of last year we undertook a major refinancing which consolidated most of Comalco’s floating rate debt in more efficient financing instruments, and also extended the average maturity. We also rearranged our Australian facilities to obtain greater cost effectiveness and flexibility so that overall our interest costs will be somewhat lower than would otherwise have been the case. And of course the lower US dollar interest rates now prevailing are significant help, as about 90 per cent of our total drawn debt is in US dollar floating rate facilities.

However, any major impact on our interest burden will be through progressive reduction of our debt. Some progress was made in this respect in 1985, notwithstanding the heavy recorded loss, because cash generation continued to be quite strong. Before capital expenditure and working capital changes, Comalco’s cash generation from operations was $113 million for the year. We expect further progress to be made in 1986, as capital expenditures and working capital are being very strictly controlled.

The fourth major reason for our poor results last year was the depreciation of the A$ against the NZ$ and the US$. This significantly increased costs, particularly in the production of metal in New Zealand, and, equally important, it caused a major increase to $71 million in the provision for amortisation of unrealised exchange losses on foreign currency debt.

The increased provision for amortisation of exchange losses on debt resulting from the devaluation of the Australian dollar, completely offset the gains it generated in terms of increased revenue, so that overall the impact of the devaluation on Comalco was neutral, even though the company’s costs in Australia had suffered from the substantial inflation which has accompanied the devaluation. In New Zealand the appreciation of the currency had a most adverse impact on costs and revenue.

It should be noted that approximately 40 per cent of Comalco’s total debt may be notionally aligned with the company’s US dollar denominated assets, so that in balance sheet (but not earnings statement) terms, exchange losses due to devaluation of the Australian dollar are offset by gains in the value of those US assets. Of more significance in cash terms is the fact that Comalco’s revenues are predominantly in US dollars, whether from the US operations, or from its sales of raw materials and metal in the international markets. Thus, over time, its revenues provide a substantial internal hedge against exchange losses on foreign currency borrowings, notwithstanding timing differences and taxation effects.

The announcement by the Treasurer on 18 February last, that exchange losses on foreign currency debt after that date will be tax deductible is of real importance. Steps are in progress to ensure that all of the company’s Australian domiciled foreign currency debt is rendered tax effective in terms of the Treasurer’s announcement, and this will provide substantial protection against future possible devaluation of the Australian currency.

Despite the heavy loss in 1985, Comalco made a major step forward in its long term strategy and in securing its future, by acquiring and consolidating a substantial position in the US market. The Lewisport Rolling Mill of Commonwealth Aluminium operated profitably in 1985 after interest on working capital, in a difficult market period. In the first quarter of this year, shipments from Lewisport have run about 20 per cent ahead of last year. The mill has an enviable position in the general sheet and plate market in the United States, and has an overall 10 per cent market share in the non-can sheet rolled products business. This is concentrated in particular niches, in each of which it is one of the leading suppliers, and it continues to build on this strength. Comalco has committed capital investment to ensure that the mill remains amongst the most modern in the US, particularly in terms of...
maintaining the quality of its products at the forefront of the industry.

At the same time major improvements have been achieved in the operation of the Goldendale smelter which is now at about breakeven cash levels, even though it is operating at only 57 per cent of capacity. The future of Goldendale depends substantially on power price and labour costs, both of which will be determined by developments in the US which are currently in train and which will be finalised by August of this year.

I will now turn to where Comalco is today and where it is heading. Our 1985 financial statements have just been released, and confirm the rapid growth over recent years, which has increased gearing to the point where long term debt is almost equal to shareholders’ funds. Whilst around 90 per cent of that debt is floating rate and denominated in US dollars, some 75 per cent of it matures in or after 1989, and the maturity of the balance is spread quite evenly over the years before then.

Our business is structured into six divisions, each of which is under the charge of a Managing Director with a high degree of delegated authority and accountability for the return on the assets under his control, and for the further development of his segment of the business. Corporate services are shared with CRA, and a small corporate group maintains an overall perspective.

A list of our major facilities shows that we have a strong integrated core business from Weipa bauxite through alumina refining at QAL, aluminium smelting at Bell Bay, Tiwai Point and Boyne Island, to semi-fabricating in Australia and the USA. All of these operations are highly competitive in world terms, and will be kept that way. We regard it as critical for Comalco’s future that all our core operations remain in the lowest cost quartile of the world supply/cost curve, given our distances from the major northern hemisphere markets.

We have two peripheral operations which we regard as special cases — the Eurallumina refinery in Sardinia, and the Goldendale smelter in the United States. Each of these is less competitive internationally than our core business, but each is amongst the most competitive in its geographical region — Eurallumina, amongst the alumina producers of Western Europe and Goldendale amongst the smelters of the United States. Each sells into its regional markets and is able to command premiums for substantial parts of its output, and thus can be a profitable enterprise.

A significant factor for Comalco is the balance of supply through its system. More than 50 per cent of the capacity of Weipa is committed to QAL, with the balance of its sales being under medium and long term contracts to other customers overseas, including Eurallumina. Weipa’s external sales have come under threat in recent years, and have declined as a result of the progressive closure of the aluminium smelting industry in Japan, and of the great increases in freight rates from Australia to Western Europe. Nonetheless, Weipa continues to provide a secure cash flow base for the Comalco group.

Comalco’s entitlements from QAL are used to supply all of the alumina for the smelters at Tiwai Point and Boyne Island, in which the consortium partners in those plants purchase all their raw material requirements from Comalco under long term contracts.

The alumina requirements of the Bell Bay and Goldendale smelters are purchased off the market, although, if necessary, Bell Bay can be covered by swap arrangements from Sardinia. This means that Comalco is a net purchaser of alumina, and intends to maintain that position into the future as we foresee a further period of excess capacity in the international alumina industry, and consequently competitive pricing for short and medium term supplies.

In general, we would like to see the three Australasian smelters covered by captive alumina capacity, with the Goldendale smelter supplied by market purchase from third parties so that it has maximum flexibility to vary its production rate according to world demand, and so that it can remain competitive with other marginal production smelters in terms of this important cost element.

Comalco has a relatively low degree of integration between its primary metal capacity and its downstream operations which makes it a substantial seller of primary aluminium ingot in the world markets. We seek to maintain a reasonable geographic distribution of primary metal markets around the Pacific Basin, with emphasis on Japan and the USA, but with Asia and the People’s Republic of China also significant.

Our longer term strategy calls for a continuing progressive increase in our degree of integration, building particularly on the base we have now established in the dominant US market.

At this point, Comalco ranks number eight amongst the world’s aluminium producers in terms of its primary metal capacity, but one of the least integrated among that group of eight. Whilst we have a strong
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growth objective, it is an objective of profitable growth rather than growth at any cost. We do not regard primary metal capacity as an objective in itself but rather as a source of overall profitability.

Perhaps Comalco’s greatest strength is the balance of its productive capacity through its integrated system to the primary metal stage, combined with the pre-eminent ranking of each of its core bauxite, alumina and primary metal operations. This position gives the company the ability to maintain maximum production rates at its core facilities, through virtually the full economic cycle. This means that Comalco’s competitive operations can generate cash profits, even in times of low metal prices, in contrast with the great majority of world producers who would at that time be in cash deficit positions. Comalco is determined to maintain this position, and build on it, whilst securing downstream positions in major markets to ensure that, regardless of price and demand conditions, volume outlets are available to maintain the company’s operating rates at full capacity.

Comalco today is generally regarded as one of the world’s low cost producers of primary aluminium, with perhaps the strongest and most cost effective resource and raw materials base in the international industry. It has a good mix of pricing mechanisms in its portfolio — largely cost plus pricing in the raw materials area, terminal market pricing in the primary metal area and consumer market pricing in the downstream areas — which give it a reasonable degree of earnings stability relative to its competitors. Over the past six years, when adjusted to a comparable basis, its performance has been at least as good as the average of the major North American aluminium companies, in terms of return on investment and in consistency of earnings.

Any assessment of Comalco must be made in the light of assumptions about what lies ahead for the aluminium industry. Looking at the industry’s prospects for 1986, the major unknown in making any forecasts is, of course, the exchange rate of the Australian dollar in relation to other currencies, and in particular to those of the United States, and to a lesser extent New Zealand.

In making our forecasts we have assumed a modest devaluation of the Australian dollar from its present relationship to the US dollar, the impact of which would be small for Comalco. However, we recognise a significant risk of a more substantial downward adjustment before the end of 1986, and such an outcome would have adverse consequences for Comalco’s results.

The most significant factor for Comalco in 1986 and in future years will, of course, be the level of international primary aluminium prices. In recent years we have cautioned publicly that one cannot expect international prices to regain the trend levels generally forecast even a year or so ago. Developments in the last 12 months have borne out this view, and more and more analysts appear to be accepting that this is the case.

It continues to be Comalco’s view that the long term trend metal price, expressed as the LME spot price, over the next 5-10 years will be around US$1,400 per tonne in 1985 dollars. This forecast assumes reasonable world growth over the period, some restoration of oil prices, and a continued climate of low growth in primary aluminium consumption — averaging around 1 per cent per annum.

Whilst these forecasts are pessimistic in comparison with those of most analysts and the majority of aluminium companies, we believe them to be realistic, and are tailoring our strategies to take account of them. Indeed, we are convinced that Comalco can prosper with these conditions, and show acceptable returns to its shareholders.

We have responded to the changes in the world environment for aluminium, and have been adjusting our business to meet these changes. Our operations are modern, world-scale and operate at the lower end of the cost curve.

Although we are not spending capital to expand, or constructing new capacity, we are spending whatever is necessary to maintain our market position and the competitiveness of our facilities. Our aim for the future, which we have already gone some way to attaining, is to have a better balanced business, shifting the balance of our operations downstream with an increasing percentage of our own metal output going through our own semi-fabricating operations, here and in the USA.

Our business is becoming a lot more focussed, and there will be continued heavy concentration on the performance of all our assets.

We have been through the worst, and survived, and I believe we have come through as a leaner and stronger organisation. We are confident that our outlook is sound.