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Iron ore prices start to turn on the spot

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Without doubt, 2009 was a bad year for the longstanding benchmark system for setting the annual prices of iron ore and coking coal, the main ingredients in steel.

After an acrimonious months-long battle between China, the world's largest iron ore importer, and the miners Vale, Rio Tinto

and BHP Billiton, Beijing rejected a benchmark deal for a 33 per cent cut in prices for the 2009-2010 contract year that the miners had already agreed with customers in Japan, South Korea and Taiwan. China had wanted a bigger cut.

The rebuff was unprecedented because under the traditional system the first deal between a miner and a major steelmaker set the benchmark followed by the rest of the sector.

In spite of the disagreement, ore trading continued to flow without big problems, with prices moving on to spot rates. This has raised serious questions over whether the 40-year-old annual benchmark system is still necessary in a commodities world that is mostly driven by spot pricing mechanisms.

BHP Billiton - a proponent of the use of spot prices - already sells about half its production outside the traditional benchmark system. Vale and Rio Tinto have also sold a significant chunk of this year's production on the spot market.

With annual negotiations about to begin at the China International Steel and Raw Materials conference in Qingdao this week, the benchmark is likely to suffer further in favour of contracts linked to the spot market. Most executives and analysts, nonetheless, say it will continue to play a role in the contract year beginning April 1 2010.

"The benchmark system has a stake through its heart," says one industry insider, predicting that its demise is only a matter of time. Others say that, for this year at least, it will continue. Xu Zhongbo, of Beijing Metal Consulting, takes the consensus view among the analysts: "The big Chinese mills like the benchmark system and the Japanese like it. If the main steel producers in the world still like the benchmark, then it will survive, at least for the next three years or so."

China's big mills - including Baosteel, China's largest mill, which is expected to be the power behind the forthcoming negotiations - want a benchmark because of the security of supply that it promises. And the China Iron and Steel Association - the group staffed with former government bureaucrats who led the abortive talks earlier this year - is devoted to the benchmark.

"For Cisa, benchmark pricing is existential," says one industry insider. "They are unreconstructed central planners who can't get used to the idea of not dictating prices."

Even if the benchmark survives another year, the original function of the negotiations - to be a "price discovery" mechanism - has already moved to the spot market, mining executives say. In the past, when miners and steelmakers met to discuss annual contract prices, they had no outside information about the market. The negotiations were, in essence, a discussion about where the price was: a price discovery exercise. Today, however, when miners and mills start talking on the sidelines of the Qingdao conference, they already have a reference: spot prices.

"The price discovery function is no longer in the negotiations," says one mining executive. "We know where the price is today and also know the forward prices for six months. The discussion has a starting point."

Iron ore is currently trading on the spot market at about \$85-\$87 a tonne, brokers say. Excluding freight costs from Australia to China at \$8-\$10 a tonne, the spot price is 30 per cent higher than the benchmark settlement of \$60 a tonne for 2009-10.

The spot price reference should help the negotiations, miners say, as everyone has an indication of price levels. Indeed, this year's settlement with the Japanese mills was near the spot market, suggesting both sides were using the same yardstick.

The miners are likely to focus on pushing the benchmark near to spot market levels, seeking a deal with Japanese customers which can be presented later as a fait accompli to the Chinese. For some, the discussions with China will be just a time-killing exercise while waiting for a deal with Tokyo.