

Clearing move puts pressure on iron ore pricing system

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The development of the iron ore spot market was boosted yesterday after LCH.Clearnet, Europe's largest independent clearing house, said that it would start clearing ore contracts.

It is the latest sign that the iron ore market is moving away from the traditional system of annual price negotiations, known as the benchmark, between miners Vale of Brazil, Rio Tinto and BHP Billiton and Chinese steelmakers.

The secretive annual talks have become acrimonious and this year both sides missed an April 1 deadline for agreeing the price for 2009-10. The Chinese side is asking a 40-50 per cent cut, but the miners are holding out for about 20 per cent.

The annual price negotiations have a great influence in the global economy as the cost of iron ore filters down into steel prices and ultimately into goods such as cars. A move away from the benchmark prices to long-term contracts based on spot prices could lead to more volatile prices for steel and other goods, analysts say.

LCH.Clearnet's move follows a similar one by the Singapore Exchange.

The launch of clearing systems for spot ore puts "more pressure on the benchmark system," said Michael Gaylard, strategic director at Freight Investors Services, a London-based iron ore broker. "This is a turning point for the iron ore market."

Until now, buyers and seller of the private, bilateral over-the-counter iron ore swaps bore the risk of their counterparties defaulting, deterring some companies from participating. Now that risk would be offloaded onto the clearing house.

LCH.Clearnet said that clearing iron ore was a natural extension of its business clearing freight derivatives. The contracts will be monthly cash-settled swaps, starting this month, based on industry published reference prices.

Traders said that interest in the nascent spot market has jumped fivefold since Singapore Exchange launched the first clearing system last month, with the seller-buyer price spread falling to \$1-\$0.25 from \$3-\$4 because of better liquidity. Wall Street's banks are also getting more involved in spot ore, following the lead of Deutsche Bank and Credit Suisse, traders said. Commodities trading houses such as Cargill are also active participants in the iron ore market.

Mark Lyons, trading manager of iron ore at Cargill, said that the availability of an exchange cleared contract would "result in improved transparency".

BHP Billiton has been a strong proponent of abandoning the current benchmark system in favour of long-term contracts, with prices based not on annual negotiations but "market clearing" prices aggregated in indices.

Alberto Calderón, chief commercial officer at BHP, said that so far, indices had largely represented the physical iron ore markets. But he expected that over time that the iron ore market would "follow other commodities such as oil, coal and metals" with the development of a cash-settled market.

Rio Tinto and Vale have been strong supporters of the benchmark system in the past, but more recently have softened their opposition to spot pricing.