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Iron ore pricing enters a new era

Iron ore markets have been on a rollercoaster ride over the past decade, with the pricing system undergoing major changes. It would be a mistake to think that this is a market settled into its final state. More change lies ahead, and as we begin 2018 the market finds itself at a series of crossroads: between linking term contracts to open or closed systems of index data gathering and between seaborne and portside pricing. Pricing methodologies are again coming under scrutiny. This article highlights where the industry currently stands, where it might go, and how Argus updated methodology and coverage to serve market needs articulated by both buy and sell sides.

Before we begin, a recap...

In the early part of the millennium, surging Chinese demand, outpacing what traditional iron ore suppliers could satiate, created a vibrant spot market as Indian suppliers plugged the gap. The discrepancy between annually set “benchmark” prices and increasingly volatile spot prices led in 2010 to a shift to contracts based on daily spot indices.

With both the fundamental way the product was priced and the main consumer changed production surged and an already international product became an overwhelmingly exported one (see chart).

Futures markets sprang up in 2009. Volumes proved to be as effervescent as the physical market, rising to exceed the size of the export market (over 1.7bn tonnes in 2017) in just eight years.

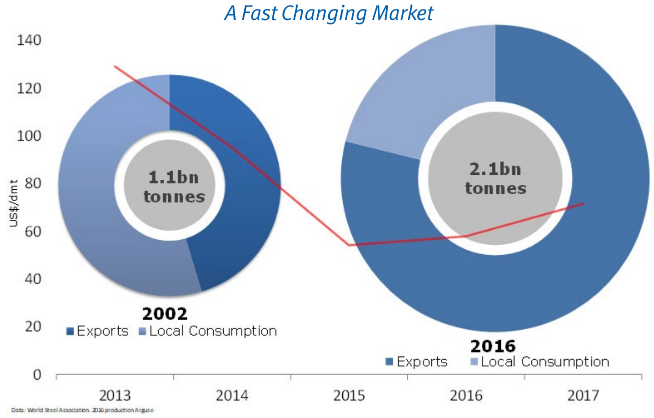
Amid all this change, there was huge churn. Now, supply has re-consolidated, as have traders, where scale is key. Buyers are also starting to combine – the steel sector has seen several large-scale mergers, with more to come. Prices have moderated, and the exuberance in the paper community has calmed down. 2017 saw the emergence of a healthier steel market. Rationalisation of capacity in China saw a resurrected buy-side posting higher margins, even as iron ore prices rose, despite abundant supply.

The China-driven ore market probably best personifies the commodity mega cycle story, but is now ‘re-maturing’ and finds itself at a crossroads. Will it tread the path of oil? Or will it continue to blaze new ground, as it has done for over a decade?

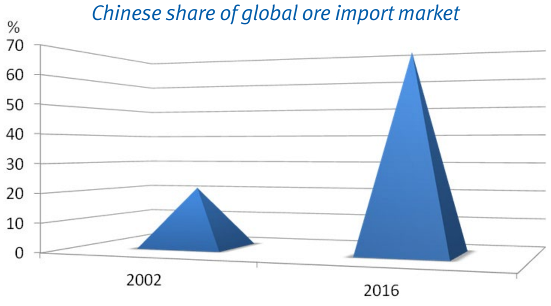
Why all the fuss now?

A decade after the index pricing system was initiated, the market is taking a second and harder look at how the indices against which term contracts are priced are formed. Rising consumer pricing power, as well as a reduction in choice following consolidation of two key indices, has triggered fresh debate in the market. The market seems trapped at present between indices that don’t take in the full range of available data or only take in limited market activity within a narrow time window. But the potential data for price discovery has broadened into floating basis, platform and even portside trade. The growth of secondary (portside) markets in mainland China, has contributed further food for thought as to where the market might go.

A Fast Changing Market



Chinese share of global ore import market



A unique and complex iron ore ecosystem has grown organically over the last decade, with electronic platforms in China and Singapore, a seaborne and portside market and a myriad of paper players, brokers and exchanges providing risk management to an industry that has a plethora of information available to it from a well-supported physical spot market for mainstream fines. Now a fork in the road beckons for the seaborne market.

Either it continues to forge its own destiny, with price formation occurring within the self-constructed environment, or it submits to the development path of other unrelated markets, such as oil. As the world’s second-largest commodity market, the path ahead deserves consideration.

Indeed, imposition of either a single solution, or “oil-style” pricing at the expense of a pre-existing system, may already be meeting resistance. Primary consumers and producers now appear to be actively pushing back, with both looking to diversify indices against which they price.

Further murmurings as we enter a new year concern the very nature of the pricing point itself. Port stock prices in China have increasingly become seen as leading indicators for seaborne prices. Liquidity is greater at the ports, particularly for sub-60pc Fe products, which rarely trade in the seaborne market. Miners are now looking at ways to sell directly to their Chinese customers from ports in China. Some argusmedia.com

are making sales in yuan. These trends will only raise the appeal of portside pricing going into 2018.

What is Argus doing?

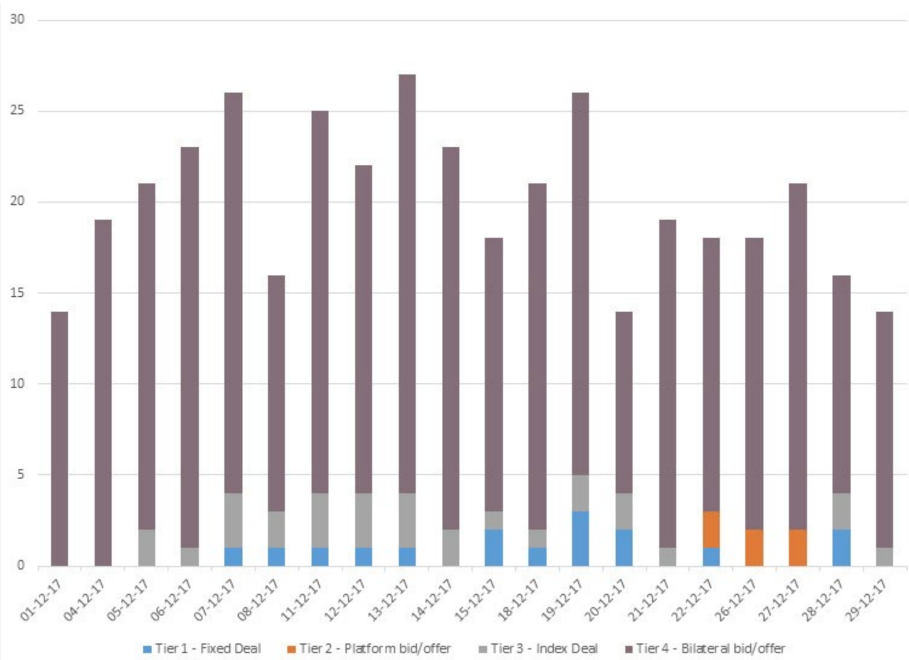
After extensive buy and sell-side consultation, it is clear that the market – as well as best practices in commodity pricing - favour indices based on physical spot trades, with greater confidence being created wherever there is greater depth of information and transparency in how this information is handled.

Argus has evolved its methodology accordingly, to transparently work with the industry and accurately reflect daily spot markets. Index-price formation has been optimised by employing the widest possible cross-section of data and using a volume-weighted average, with variable weighting based on quality according to a published hierarchy (closely matching IOSCO principles and best practice). A breakdown of the usage and weighting of all information is published daily in a rationale, along with captured iron ore transactions. The sensitivity of commercial data is respected, with no counterparties named in the process.

After December's methodology update, a data audit shows a minimum of 14 and an average of 20 data points going into the Argus ICX™62pc iron ore index daily, which can be seen as a solid foundation for an index based on averaging to offer to the iron ore market. Bids and offers are only included as pairs, while a statistical check removes extreme highs and lows.

In summary, Argus has boosted its data collection, processing and weighting system to best reflect the spectrum of data available to the market, providing the index with the broadest possible foundation. Simultaneously, new levels of clarity and transparency are being provided on both the process and inputs to the index.

Argus ICX(TM)62pc Data Capture



An increasingly competitive market

With negotiations for long-term contracts for Q2 2018 already underway, the market faces a choice as to which pricing mechanisms it would like to use.

That choice largely comes down to whether to use indices built around providing value-added services to spot market data created by the industry, or to use indices based on information prioritised by ownership of that data, within a narrow end-of-day time window.

It also comes down to whether to price off one single index, or introduce diversity by implementing a basket price formula. In either scenario, prioritising indices based on robust data depth, width, transparency and clear calculation procedures makes sense. And as the market evolves in a competitive market, the availability of different methods of pricing will ultimately be beneficial for its ongoing evolution.

Volume-weighted averaging: the case for iron ore

Iron ore is traded in a non-standardised manner and cargos are not necessarily fungible, so a volume-weighted averaging approach aids the market in smoothing out the inherent cargo- and contract-specific differences. Averaging minimises the impact of any single transaction or indeed contributor, and avoids a scenario where a standalone bid or offer, or even a single transaction, can set the entire market price.

Every market shares the desire to fully understand how the published price on any given day is calculated. The refreshed Argus ICX index methodology is a direct response to industry wide feedback: a clear, consistent, transparent and robust process limiting subjectivity, coupled with detailed market reporting and rationales.

For a more detailed look at the Argus approach to iron ore markets, click **here**.

The detailed Argus approach to iron ore is laid out from page 7 of our methodology document **here**.

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