

Industry Outlook – “Iron Ore”

Iron ore market had seen a paradigm shift since 2000 with emergence of Chinese industrial demand. In the first decade of the 21st millennium, China emerged as the largest producer of steel and consequently became the largest consumer of iron ore. Steel production dropped marginally in 2008 and about 8.1% last year on account of global slowdown. The demand, however, picked up this year once again due to China and it is estimated China alone needs more than 650 million tons of imported iron ore this year to feed its ever growing steel industry. Chinese demand benefited largely global exporters of ore as China's inland production is not enough to meet the demand both on qualitative and quantitative terms. Along with large players like BHP Billiton, Vale Group and Rio Tinto who together control 70% of total iron ore exports, India is the third largest exporter of iron ore. Growth in Indian iron ore exports attracted several criticisms too such as environmental damage due to illegal mining, issue of licenses and the very rationale of exporting a crucial raw material. However there has been divergent views on the issue. While Karnataka government imposed a ban on iron ore export following reports of illegal mining activities, central government responded by rejecting such stance. While views on the issue of illegal mining converge, central Govt. did not support such blanket ban on ore exports.

Volatility in iron ore prices continues to create major concerns for world's leading consumers like China and Japan. Until last year, iron ore price fixing was done on yearly basis. Huge swings in output prices and consolidation among iron ore suppliers lead to a change in iron ore pricing mechanism from yearly to quarterly basis during 2010. The change in pricing mechanism is seen to increase volatility in iron ore prices. We discussed these issues with industry experts and have summarized the key points.

Change in pricing mechanism has driven the recent volatility

Iron ore price volatility is one of the major challenges faced by global steel makers. According to FIMI Secretary General, Mr.R.K.Sharma, it happened because of “the insistence of China for a certain price level and the resistance of Big Three — Rio, BHP Billiton and Vale to agree to it.” On behalf of Iron Ore and Steel Derivatives Association (IOSDA), Mr. Pedro Cotait cited the same reason. According to him, the basic idea “is to look for prices that correspond to the change in the demand/supply equation in a timely manner.” IOSDA informs that despite officially agreed quarterly pricing system, industry players may have started talking of monthly average settlement in China. BHP Bilton is expecting a shift toward monthly pricing as, , it would project the market better. But its

rivals Vale and Rion Tinto are not favouring the concept at present. So iron ore traders are searching for better pricing mechanism over the prevailing one. Some industry experts are apprehensive of this move as well, as they fear this move will increase the chance of Chinese steelmakers defaulting on contracts. However, FIMI believes that quarterly benchmarking will give better flexibility to buyers and sellers on pricing their products. MMTC, India's leading export house, is also convinced with the present pricing mechanism. Mr. V.P. Mehta, General Manager (Minerals), MMTC Ltd. said, "The benchmark prices have become index-based and are more or less at par with the international prices. This has resulted in more transparency in the prices and the suppliers are also benefitted. This is good in the short term however its impact is to be seen in the long run."

Managing price risk is key to managing cash-flows

With increasing uncertainties, mining has become much more prone to volatility. Hence, managing risk is very crucial for every mining company to manage cash flows and investors' expectation. Usually in other commodities miners either are integrated with processing companies, or are under a fixed price contract or have hedged their exposures using market instruments. Forward market is not fully developed in case of steel or iron ore. Iron ore & Steel Derivatives Association (IOSDA) is in favour of developing effective swap derivative or other forward markets to provide platform for companies to manage volatility and they are highly optimistic about forward market in iron ore and that, it will develop at a brisk pace. According to Mr Pedro, "The quarterly pricing is just a transit period for the adoption of spot index. In spot market derivatives such as swaps are very important for a company to manage volatility, protect profitability and have smoother cash flow in the long run." He cited the example of swap contract on iron ore that was started by a Singapore exchange. He is pretty happy with the kind of development since the launch of the contract one and half years ago and is optimistic that the demand for such contracts will increase at a brisk rate with changing market of iron ore. According to SGX data, total 4,436 lots were traded in swaps in April for a volume of 2.2 million tons. However, it dropped to 2,683 lots to 1.3 million tons last month on short- term liquidity problem. **They appreciated ICEX's effort to initiate Indian rupee denominated forward contract in iron ore. According to them, it would help Indian companies to manage their risk better since the contract will reflect their trades.**

. MMTC Ltd.kept mum on the issue of derivative contract as an appropriate hedging instrument. Mr.V. P. Mehta said that they are "following benchmark price mechanism for exports of iron ore to Japan and S.Korea. The exports to China are based on spot prices. MMTC is taking forward cover to hedge currency exposures."However MMTC Ltd. does

believe that iron ore forward contracts have good future considering the increase in iron ore trade, though it has not used the product as yet.

Indian iron ore market

India has emerged as the fourth largest miner and the third largest exporter of iron ore. India has currently estimated iron ore resource of 25 billion tons. IOSDA expects India to definitely strengthen its position as a major ore producer. However, it foresees moderation in iron ore exports from India going forward. With a number of steel projects coming on stream in the next one year, IOSDA anticipates a steep increase in internal demand for iron ore. It also opines that India needs to invest in infrastructure in order to develop the industry from a long term perspective.

Mr. Pedro expressed similar views as he asserted that Indian iron ore miners face high political risks. Uncertainty regarding future policy direction affects capital flows, efficiency and productivity. On logistical ground, rail movement and poor port facilities pose serious scale-up challenges.

Agreeing on the need to develop infrastructure, MMTC called for policy changes in iron ore export so as to make it more competitive. MMTC feels that there is a need of removing export duty on iron ore and rationalization of railway freight. Besides, facilities like rakes, good roads and ports capable of berthing large size vessels are urgently needed.

Is there a case for banning iron Ore exports?

While Ministry of Steel is very much vocal against the export of iron ore in order to support the domestic steel industry, exporters have a strong case in defense. According to them, steel majors like Tata Steel and Sail have their own captive resources. Others are getting ore from domestic miners. Indian iron ore production has always been higher than the steel mill's capacity to consume. Besides, surplus remains even after exports. Goa sector (which is of low grade ore) constitutes about 40% of the total iron ore exports from India and cannot be used by domestic industry. So what purpose would a ban on iron ore exports serve?

Hike in Export Duty –Impact on Industry

Recently, Assocham, an industry body, recommended imposition of 20% duty on exports of iron ore fines from current 5% level. Mining industry disagreed with this proposition stating “Indian steel industry is predominantly based on lumps as raw material input. In

view of huge demand of lumps in India, the export of lumps from India has declined over the years. Iron ore fines are produced while producing lumps. If export of fines is restricted, it will escalate lumps cost.” So discouraging iron ore fines exports will ultimately lead to increase in steel product prices. Furthermore, since domestic steel industry does not have adequate sintering capacity, dumped fines will cause huge environmental problems. On development issue, they feel that banning iron ore fines will create not only socio-economic problems like unemployment, non-utilization of infrastructure etc. but would also result in huge loss of foreign exchange for the country.

Need of iron ore and steel derivatives:-

Though FIMI and MMTC have not clarified at length on the utility of derivative contract on iron ore like IOSDA, but both have passively supported the international iron ore forward contracts. While MMTC believes that the swap contract has good future given the increase in iron ore trading volumes, FIMI feels the need of such instruments to contain price volatility. Earlier in July this year at the FIMI conference held at Bali, Indonesia, stakeholders across the industry appreciated and welcomed ICEX’s initiatives towards introducing iron ore future contracts in India. This was echoed during the presentation made by ICEX at the recently held Annual General Meeting of FIMI at New Delhi. IOSDA has been conducting relentless awareness programmes to let people know and use these financial tools to counter the risk arising out of high volatility. IOSDA greeted the initiative of ICEX to launch Indian rupee denominated forward contract in iron ore.