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Iron ore futures can be efficient means of risk management



THE report, "BHP, Vale Move to Quarterly Iron-ore Pricing System,"which came early this year indicated that the move by two of world's largest miners to dump the four-decade old iron ore pricing mechanism signify a tectonic shift in the global markets.

While steel is world's most profoundly used metal, iron-ore resides at the heart of the global steel industry, being the primary ingredient in steel making.

Like the demand for food, world consumption of steel continues to grow unaffected by even the previous financial crisis during the last five years with a CAGR of 2.5% on the back of low per capita consumption in emerging economies. With rapid information flow into the markets and growing transparency, no wonder BHP and Vale had decided to opt for rewards while agreeing to take risks, on the back of runaway demand for ore.

As about half of our iron-ore production is being exported, there is no way the Indian iron-ore markets participated by a relatively larger number of buyers and sellers can remain insulated from this development.This is bound to keep iron ore prices in the Indian markets highly volatile largely to the benefit of intermediaries at the cost of India's competitiveness in iron ore/value added products and realization by the miners.

Historically, iron-ore prices were fixed through the obscure method of annual negotiation between mining majors and steel producers. Though iron-ore is globally abundant and widely extracted, given the capital intensive nature of its production and transportation, supply augmentation takes a longer time.

Iron-ore supplies remained restricted due to little incentive to augment supply on prices locked for a year, Besides, long-term contracts for most commodities are almost a history, possibly enticing iron-ore miners to shift to shorter-duration pricing mechanism which can better reflect the dynamics of market fundamentals.

WITH THE SHIFT IN GLOBAL IRON-ORE PRICING, THE INDIAN PRICING IS ALL SET TO FOLLOW THE CHANGING GLOBAL MARKET DYNAMICS. IT WARRANTS THE NEED FOR A COST-EFFECTIVE WAY TO MANAGE IRON-ORE PRICE RISKS

The anxiety to shift to short term contracts was possibly high as iron-ore miners remained mere witness for years together to other commodity suppliers (and even their own clients, notably steel producers) reaping the benefit of shorter-duration contracts. Thus, aspirations for higher price realisation and to provide better value to their investors prompted miners to abandon their age-old practice for a more market-determined one.

Rightly so, Credit Suisse forecast in March 2010 revealed that prices realised by Vale may increase by almost 90% for the April quarter, and another by Goldman Sachs indicated that Australian producers will make $20 billion more a year by selling products at cash levels than annual contracts.

Increasing disagreement on pricing within the big three: Vale SA, BHP Billiton Ltd & Rio Tinto Plc had also fuelled the momentum towards dynamic pricing. Moving on a flexible quarterly pricing system is widely expected to help in establishing a dynamic market reference price and promote market-based iron-ore pricing mechanism.

Despite being the world's third largest exporter of iron-ore, Indian iron-ore market is highly fragmented with a large number of small miners spread across the iron-ore geography. Hence, Indian iron-ore suppliers generally entered into short term contracts (sometimes even cash transactions) with the importers (mainly Chinese) and domestic producers. Pricing of such short-term contracts are largely influenced by other three factors; (1) the end product (domestic and international steel) prices, (2) the changes in costs of production and transportation of iron-ore such as energy, freight etc, and (3) the global iron-ore reference prices. With the announced shift in global iron-ore pricing, the Indian iron-ore pricing (with the other factors already being dynamic) is all set to follow the changing global market dynamics. It warrants the need for a cost-effective way to manage iron-ore price risks, absence of which is a glaring omission in the market where the market players are able to manage the price risk in all other segments they are exposed to, namely, steel, freight, energy, and even forex, through trading in respective derivatives contracts. Introduction of iron-ore futures in MCX perfectly times this paradigm shift in global iron-ore markets.

Not only would iron-ore futures be an efficient means for risk management but also provide an efficiently discovered and widely disseminated benchmark price from India. Which is conspicuously missing in the global markets. Importantly, as and when Indian iron-ore futures gain a threshold level of popularity, efficiently discovered prices would start to have a bearing on the global prices, unlike the current situation.

Through the discovery and dissemination of iron-ore prices discounting for market fundamentals, the evolving need for Indian iron and steel industry to operate efficiently would be fulfilled through efficient decision making and/or effective risk management.

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