Iron ore price negotiations - China bet on spot iron ore makes steel puzzle

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Reuters reported that China first tentative steps away from the 40 year old iron ore benchmark open a vexing question for its mills how to convince new customers to adopt free market steel prices when it needs more long term contract clients.

Touting its presence as the world's biggest buyer, China has sought a deeper iron ore price cut than the 33% reduction its Asian rivals had won, betting they can switch to the spot market if their demands were not accepted. They have also signaled a readiness to price sales on a quarterly or twice yearly basis. While such a change would allow them to benefit from any backslide in prices rather than paying higher rates for a full year it also opens up more uncertainty for its costs ironically, just when Chinese mills are trying to secure more long term contracts typically priced annually.

Passing their cost instability onto clients would be a tough sell against more profitable global rivals such as Nippon Steel that have thus far stuck with the benchmark.

Mr Atsushi Yamaguchi UBS analyst said "If Chinese mills move to purchasing based on spot prices, it would bring a risk that material prices could become unstable. Then the system of annual steel product price negotiations would need to be changed which would not be well received by clients."

As commodity prices rose for most of this decade, China mills enjoyed an advantage over their more traditional rivals by selling more of their steel products on a spot market basis while paying for their iron ore at an annual price which had typically lagged behind rising free markets.

Unlike Japanese and South Korean mills, Chinese steel makers do not have high levels of contract sales and depend more on the volatile spot market to sell their steel products. But with insufficient and expensive domestic reserves to feed an industry that produces nearly 40% of the world's steel, even their bread and butter products have become less competitive this year forcing it to become a net steel importer.

Mr Kim Hyun-tae a Hyundai Securities analyst said "Chinese mills are already less cost competitive than their counterparts in Japan and South Korea and that explains part of the reason why their steel export prices are higher than regional prices."

Against this backdrop, sourcing iron ore in the spot market, which is now trading just above this year's benchmark prices and does not guarantee stable long term supply would create a conundrum to China seeking to boost exports to get rid of soaring output sharply in excess of its demand growth.

Despite its warnings that steel output should drop 8% this year, China's daily production hit 2009 high of 1.522 million tonnes between June 11th and 20th equivalent to an annual output of a record 555.5 million tonnes more than 10% above 2008 level.

Various measures including tax benefits have failed to boost exports, as Chinese export prices continue to remain higher than regional prices.

(Sourced from Reuters)