

## Iron ore pellet pricing structures under strain



*This year always had the potential to be a watershed for the iron ore pellet market after increasingly emboldened sellers kicked off annual supply talks with their controversial request to switch the contract price base to a 65pc Fe fines index.*

*And the ground has not stopped shifting since, with the first quarter overshadowed by Vale's Brumadinho dam disaster in Brazil and resulting supply concerns. But some analysts now warn that the seaborne pellet market might be tipping towards oversupply — particularly for blast furnace (BF) grade — as the steel market falters. Indian sales to Europe have dried up lately, Russian pellets are offered at ever-deeper discounts to headline Atlantic BF pellet contract prices, and Mideast Gulf mills are pushing to switch out as much direct reduced (DR) pellet as possible in favour of other cheaper metallics.*

*So how are conventional pellet pricing structures — solidified when seaborne trade was largely dominated by the highly structured buying patterns of Japan and Europe — coping with so many twists and turns? The answer, perhaps, is not very well. Cracks in the status quo are evident, buy-side frustration is growing and with it an appetite for new options.*

### European mills dig in their heels

Several European mills continue to push back on sellers' attempts to switch pellet contracts to a 65pc Fe fines base for 2019, refusing to follow the example of many Asian buyers. Some onlookers see them as merely delaying the inevitable, but regardless of the outcome, their resolve to keep pushing back — as late as August speaks volumes about the level of frustration at a pricing system that is perceived to increasingly empower the sell side.

Atlantic basin market participants note a gradual groundswell in favour of some shorter-term contracts going forward — potentially with volumes locked in long term but with more flexibility to renegotiate price on a quarterly or biannual basis. Some pellet producers indicate that they would be open to this possibility in 2020, if customers push for it. Atlantic pellet remains some way off from anything resembling a spot market, but a consensus appears to be gathering strength that more options need to be available and one size cannot fit all for a full year.

Those European mills that are yet to finalise their 2019 pellet pricing may now be at an advantage, as falling demand encourages some end-users globally to ask sellers for a reduction in contracted volumes for the second half of this year. A lack of resolution on price may give them a stronger hand in renegotiations than those whose terms are already locked in on all fronts.

### Once again, China drives short term spot pricing

Basis risk has always generated concern among pellet traders and mills, now potentially more than ever as the fines market navigates a period of acute volatility, arguably driven as much by sentiment and politics as by fundamentals.

Fines and pellet prices typically move in tandem, but there are exceptions. Cfr China pellet prices soared to multi-year highs in September last year, while 62pc basis indexes were largely stable.

At the time of writing, the Argus ICX 62pc Fe fines index is

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down by roughly \$40/dmt from this year's high of \$125.20/dmt cfr Qingdao on 3 July. These highs were widely seen as being created by a supply pinch, meaning they felt all the more jarring to mills outside Asia that said they turned away excess iron ore in June-July.

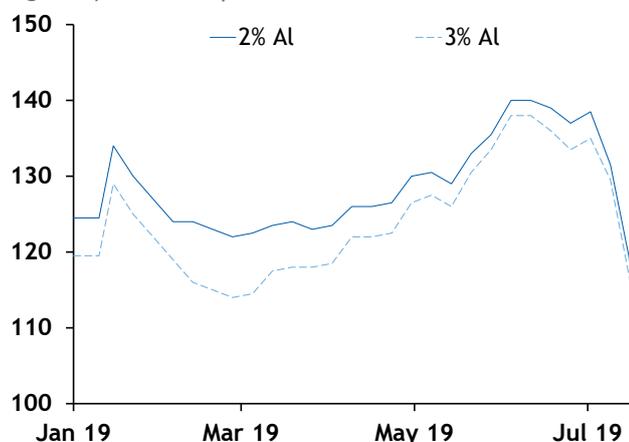
Mills globally may be relieved to see the fines indexes drop. But they are no less uncomfortable about volatility in pellet prices. China has ramped up Indian pellet imports since 2016, generating a regular pattern of trade in the seaborne market and, with it, visible spot prices. And not particularly stable ones either.

Argus offers outright Indian pellet prices based on deals, offers and bids done in the cfr China pellet market, the only relatively liquid spot market for pellet. (Since its formal launch in April, the index had an average of 11-15 seaborne deals every month.) Current data and history, including back-calculated prices for the year prior to launch, are available online, via Argus PA code PA0026271.

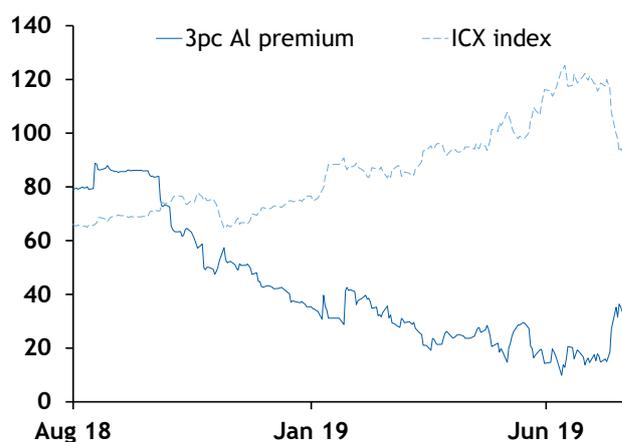
The index touched a high of \$155/dmt in September 2018, before trending downwards and hitting \$110/dmt on 22 January. However the fatal disaster at Brumadinho in Brazil, expected to take out around a fifth of global pellet supplies this year, led to a rebound in prices as demand for Indian pellet increased in China and non-traditional markets such as the Middle East, South Korea and even Europe.

The subsequent gains in pellet prices were not as sharp as for 62pc indexes, leading to a narrower implied premium. Whilst the Argus ICX 62pc index climbed above \$125/dmt, the Argus 64pc pellet assessment failed to reach its previous peak, touching a year's high of \$138/dmt on 30 July before sliding sharply. The assessment stood at \$116/dmt on 13 August, with rising availability of pellet at port (anecdotally put at around 4-5m t) and a jump in domestic concentrate output putting

Argus 64% Fe India pellet indexes, cfr China



Implied cfr China 64% pellet premium to ICX 62% fines



downward pressure on prices.

Domestic pellet prices in China remain around \$7-9/dmt lower than seaborne prices after steep declines in domestic concentrate prices, dampening demand for now. However, this may not last. Tighter sintering and pelletising restrictions anticipated before China's October celebration of the 70th anniversary of the founding of the People's Republic may however lift demand for pellet imports.

With such basis risk between the standard 62pc Fe fines index and pellet prices, it is perhaps not surprising that producers are seeking to tether sales to more closely related ore grades – namely 65pc. But that still leaves a bilateral long-term premium to be negotiated on top of an illiquid spot index.

### Get on firmer ground

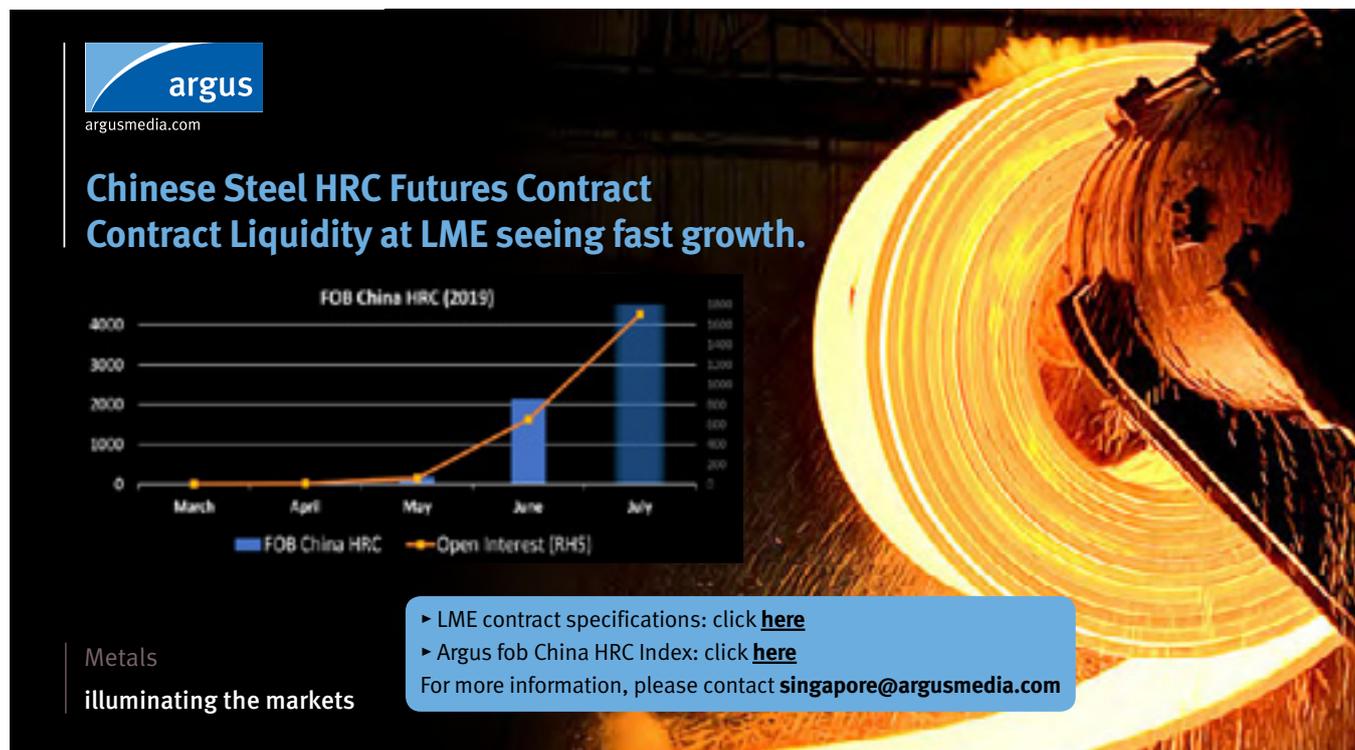
The past year's events have brought pellet pricing to an inflection point. Until recently, the underlying iron ore price was successfully captured by a liquid reference that had sufficient market confidence – that for mainstream 62pc iron ore fines – with the pellet component negotiated bilaterally. Not only have recent events now thrown supply and demand out of balance, resulting in volatile pellet premiums, but a rebasing of the underlying 62pc Fe basis to a 65pc basis has resulted in another point of contention.

Indexes may offer at least a partial solution. The Argus index for Indian pellet imports to China is already reported to being used in supply contracts between Indian suppliers and Chinese buyers. It tracks the only liquid market for iron ore pellet. Although not reflective of the mainstream grades consumed by the mills in Europe and Japan, it reflects the cost of the marginal tonne and could serve as a variable pellet component in long-term pellet contracts – with the requisite quality premiums attached.

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And while clearly some mills remain committed to the idea of keeping the 62pc Fe fines base for their contract pricing, favouring its [healthier liquidity pool](#) and the ability to hedge using the 62pc swaps market, the tide might be against them. In which case, the question moves to how best to build confidence in 65pc indexes. As discussed in a [previous Argus white paper](#), the potential for shoring up liquidity might be limited

for the time being, but using baskets — an average of more than one 65pc index — can provide users with a degree of reassurance and help to rebalance the scales between buyers and sellers.



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