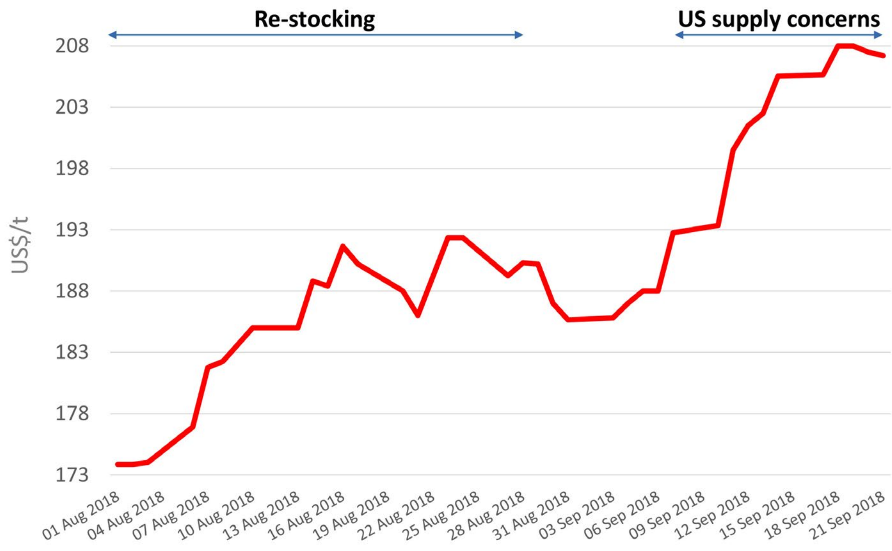
Coking coal:
Two storms in a teacup highlight cracks in the market

September brought storms to both the Chinese and US east coasts: big ones, at exactly the same time.

Typhoon Manghkut had negligible effects on prices – but Hurricane Florence brought concerns about a squeeze in supply from the US.

The impact of the hurricane added more fire to a restocking-driven run-up in prices. In the end, the weather failed to deliver on the market's worst fears. It did, however, expose a bigger storm brewing in the heart of the sector.

Argus Premium Hard FOB Australia



The coking coal market has been through a wrenching series of changes as it evolved from annual fixed-price supply contracts to shorter pricing periods, just as iron ore did before it. But, unlike iron ore, several factors make coking coal's evolution incomplete, bringing unnecessary inefficiencies into the physical market and preventing the financial market from delivering the levels of liquidity that mills and traders want to see.

For the sector to move forward, the following issues need resolution:

1. Too many indices.
Baskets rule, meaning no index has primacy. Indices often diverge and physical and paper markets are settled off different indices. This makes the market 'fuzzily opaque' and inefficient.

2. A tandem hedging solution has not concurrently evolved.
The derivatives market has failed to grow in an exponential, or even linear manner.

3. Trust in indices should be higher.
Prices differ between indices – often wildly. Which is right?

4. Market pricing is only partially transitioned.
Australian premium and some hard coals are priced off indices, while PCI and semi remain quarterly negotiated. Non-Australian supply is caught between linking to fob Australia or separate indices.

Leaving aside the lack of a wholesale move to indexation among all Australian coking coal grades, the global supply-side has not settled around a single reference location to price against. In the case of iron ore, it was inarguable that China was the location around which a benchmark would emerge. China is responsible for about 65% of global iron ore imports.

From that standpoint, it is interesting to see the resistance to Australia being the global anchor in metallurgical coal markets, given its market share is around 65% of world exports. The case for a separate 'Atlantic' market is strong, particularly given the geology-driven differences between coal types; but it is eroded by an increasing US exporter push beyond Europe, into India and Asean, bringing US material (back) into direct conflict with Australian supply. This should deepen correlations to Australian pricing, particularly as another regional supplier — Mozambique — is widely linked to Australia. Those correlations should ripple back across the Atlantic too, if US supply is disciplined, as exporters cannot allow dissonance among customers for observably differing pricing and be long-term partners.

An un-grasped nettle at the heart of this issue is that fob Australia pricing is by nature exclusionary to US, Canadian, and Mozambican (UCM) supply. While that is not in itself insurmountable, the difficulty in pricing UCM coals relative to the Australian benchmark is problematic and requires greater transparency.

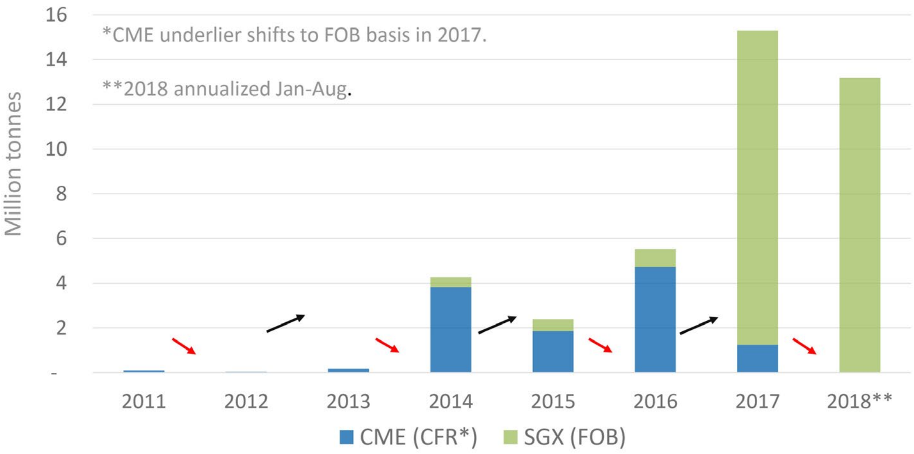
Stuttering: stalled derivatives growth not yet arrived

The "will they, won't they" nature of stuttering derivatives uptake in coking coal markets is wearying for most. The market would broadly welcome a clear upward direction in trading volumes, but is fatigued by a market that was heralded as "arriving" in 2011, 2013, 2014, 2016 and 2017. During this time, volumes have waxed and waned across two exchanges (CME and SGX) as well as across two different price points (cfr China and fob Australia). The latter battle also played out across physical argus

argusmedia.com

Volume evolution: mixed signals

Growth unsustained in consecutive years since 2011. Changing index origin points, indexes used, and exchange venues have not helped.



markets as competing pricing points battled for primacy.

Prima facie, volatile coking coal prices should provide fertile ground for financial contract development. In practice, high volatility in embryonic derivatives markets has proven to be enormously expensive, if on the wrong end of a position unmatched by a physical cargo. Even pure physical market players have seen scalps taken by sudden trend reversals brought out by either weather or (Chinese) policy developments.

Add in deep market uncertainty over which exchange and price point would win out, as well as "musical chairs" over which index is being used to link physical supply to, and years of "failure to launch" suddenly do not seem so surprising.

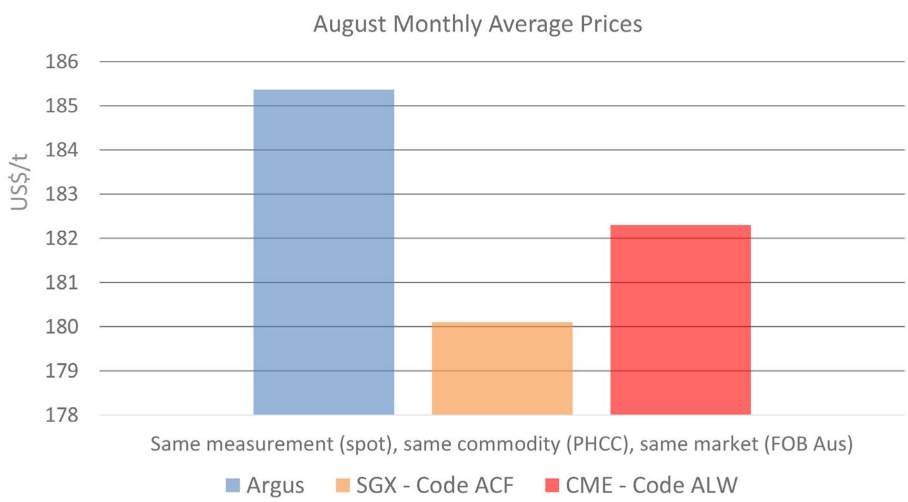
The changes in cfr vs fob benchmarks introduced a third complication: a split "benchmark index". While iron ore markets have proven that a physical and financial benchmark do not have to be based on the same index, they did so on the caveat that they could be - if correlations were tight.
The fob/cfr battle took place because of differences in pricing, so while directionality was broadly congruent, magnitudes of changes were variable and unmatched.

The upshot was that a twin, or even three-track, system was in place for some time. Paper trades were conducted on one index, while the physical market moved to two others (Argus being one). Then the basis of the dominant paper trading instrument switched from cfr to fob, with a large overnight swing in nominal value, negatively impacting half of the holders of open positions.

That proved decisive on which exchange would win out in market share, for now. In its wake, though, is a physical market left inconclusively split among three indices.

Same, same, same. But different monthly averages.

Daily differences between Argus and the SGX underlier almost breached US$11/tonne: the mean was $4. That adds needless tension and uncertainty.



The price is right – or is it?

Scrutiny of the underlier for the SGX financial contract is rightly acute. An index is just a gauge of spot prices, but this market has three gauges, all measuring the same thing (price), in the same market (fob), for the same commodity.

But these gauges have been giving different readings, all at the same time. This matters because physical and paper positions are being settled off them. Either type of user would have cause for complaint, but it matters even more for those who are engaged with both. Their hedges have become less effective, or 'dirtier'.

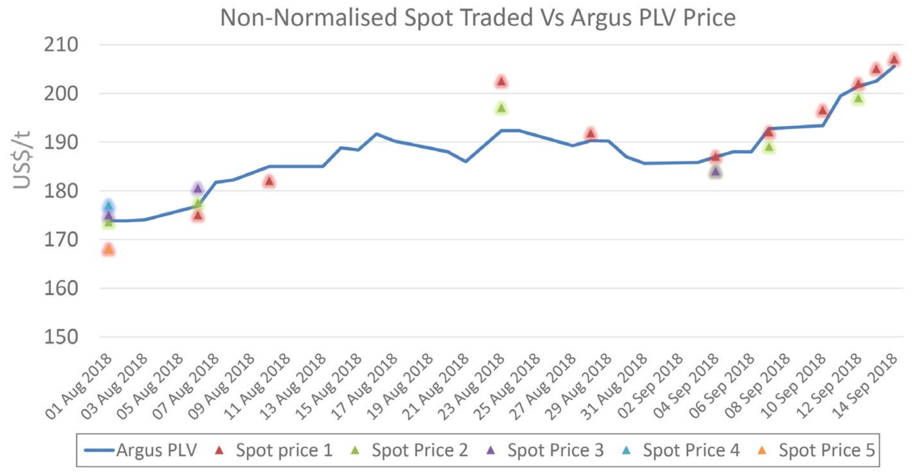
What happened over this period? Well, there was not a lack of spot activity. Comparing un-normalised spot transactions (there is no art to scatter-plotting data points) against the Argus index, it is easy to see how the index shape was formed. Normalisation simply tightens the displayed fit.

But normalisation is important in this industry, as coal brands have significantly different price outcomes, based on their characteristics.

But looking at normalised values simply reinforces the view of how well

Even pre-normalization: premium coking coal spot trades clearly sit around the Argus index!

Leaving aside bids and offers...With up to 5 spot transaction per day over this period there was ample liquidity.



supported index formation was by underlying transactions and deepens the mystery of divergence.

Before cynical buyers congratulate themselves on saving money on an uptrend, it is worth remembering that curious performance one way can easily be repeated in reverse.

Overall, the sector would benefit from a derivatives market that flourishes and a more cohesive global pricing system emerging. The chances of that happening are greatly improved if a few fairly reasonable conditions are met.

- **The physical and paper markets solidify around a single fob premium hard Australia benchmark.** Even two numbers is better than three: but ideally, the market needs one number to focus one.
- **Spot volumes should increase.** Mills and mining firms should take some volumes off long-term contracts. Supply is plentiful and index pricing is well embedded. Buyers felt the effects of Cyclone Debbie whether buying spot, or index-linked. I.e., they are exposed to supply-shocks either way, so should not fear participating in spot markets. Doing so will provide more price points, raise transparency and make the market more comfortable about what is underpinning indices.
- **The paper market needs another sustained push from a committed market maker,** to cement the growth story. There is a wider group of participants than ever before, but a catalyst company is needed to normalise the next stage of liquidity.

Paris in the Spring – Vienna in the Winter?

The first point is crucial. Less is more: there is clear value in physical and derivative markets talking about a lone benchmark that is broadly agreed to be representative. Preferably that should be one index, but even a composite is superior, as it focuses attention around a single number, even if drawn from two.

If not, this car is going nowhere fast as it pulls in different directions. But the market seems to be already moving to remove some confusion. Basketisation of indices was an industry response intended to hedge risks amid uncertainty over precisely which reference should be used. But with two readings coming from the same dashboard, questions about the effectiveness of that 'hedge' have been widespread and persistent.

The global coking coal market has been divided for at least five years over which gauge to use. But it has also had at least five years to get familiar with indices. To develop further, it needs to reach a consensus conclusion about which one – or ones – it will use.

At a minimum, the least effective instrument should be dropped. Which that is, is for the industry to decide – but there are a number of events in the fourth quarter at which the sector can chew that question over, together. Mills, traders and mining firms should come together to reach a consensus solution: to improve the efficiency of pricing their own industry for the benefit of all involved.

For more information. contact us at:

Argus Metals Business Development

Tim Hard – Singapore
tim.hard@argusmedia.com
+65 6496 9894

Oscar Tarneberg – Shanghai
oscar.tarneberg@argusmedia.com
+86 1397 1884 804