

## Box B

# Iron Ore Pricing

In recent years, the prices received by Australian iron ore producers have become more responsive to shorter-term developments affecting supply and demand. This reflects a move to shorter-term contracts and a larger share of iron ore being traded at spot prices. It has resulted in an increase in the variability of iron ore export prices, which feed into Australia's terms of trade.

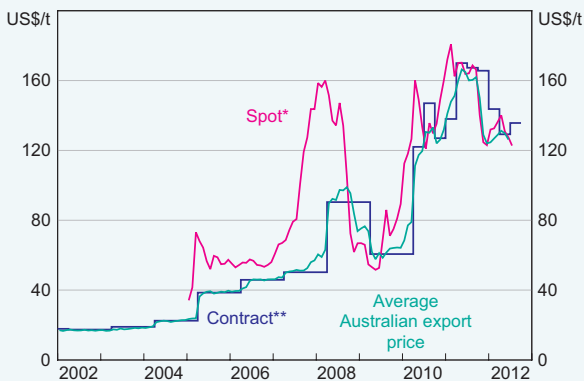
Until the mid 2000s, most trade in iron ore was based on longer-term contract prices. Hence, the average export price of Australian iron ore closely followed the annual fixed-term contract price (Graph B1). In 2007, an especially large gap opened up between the spot price and benchmark contract price as demand growth outstripped that of supply. This created an incentive for iron ore producers to sell additional supply into the spot market. Conversely, when the spot price fell below the contract price in mid 2008, there was an incentive for those buying iron ore to minimise their purchases of iron ore under contract and purchase instead on the spot market. The large

gaps between spot and contract prices also induced buyers and sellers to renegotiate existing contracts. Consequently, around this time an increasing share of iron ore began to be traded either on the basis of shorter-term contracts or in the spot market. The initial move was from annual to quarterly contracts, and over time to monthly contracts.

The gradual move from quarterly contracts towards monthly contracts, and from contracts to spot sales, has occurred for iron ore exports from Australia and other large producers such as Brazil. The move to spot sales appears to have accelerated since the end of 2011 as the sharp fall in the spot price for iron ore at that time encouraged buyers to push for contracts to be renegotiated to shorter terms.

Market reports suggest that, in aggregate, monthly contracts and spot sales now account for more than half of all Australian iron ore exports, although this share varies somewhat across producers. The remainder of Australian iron ore exports are based on longer-term contracts, many of which are quarterly, with some large Japanese steel mills reportedly preferring this pricing arrangement.

**Graph B1**  
**Iron Ore Prices**



\* Month average; iron ore fines; free on board basis  
 \*\* RBA estimate of quarterly contract from 2010 onward  
 Sources: ABARES; ABS; Bloomberg; RBA

All of these changes in pricing arrangements mean that the average Australian export price of iron ore moves more closely with prices in the iron ore spot market than in the past.

The increasing use of shorter-term price contracts has also encouraged more activity and liquidity in iron ore derivative markets as firms increase their use of hedging instruments. One example is over-the-counter iron ore swap contracts, which are derivative contracts in which one party agrees to pay the other party a fixed price in return for receiving the average iron ore spot price over the term of the swap.

According to data from SGX AsiaClear, monthly open interest on iron ore swaps – the volume of iron ore covered by swap contracts that have yet to be settled – has more than doubled over the past year, although it remains relatively small compared with physical trade in iron ore.

With iron ore currently accounting for around one-fifth of Australia's exports, the greater use of shorter-term pricing has implications for the terms of trade. In general, the spot price for iron ore has tended to move in line with developments in Chinese industrial production and steel production, although disruptions to supply can also be important. Hence, changes in the outlook for Chinese growth and steel demand are likely to be reflected more quickly in the prices received by Australian iron ore producers than in the past.