FIS

VIRTUAL STEEL MILL

THERMAL COAL – WARMING UP IN ASIA

A thermal coal swaps market is beginning to emerge in the Asia Pacific region as physical trade expands, fuelled by demand from China, Korea, India and Japan. Total thermal coal trade in 2013 was estimated to be just over 1 bn tonnes, though this is just a fraction of total estimated thermal coal production which just over 8 billion tonnes.

Growth in thermal coal trade over the past decade has seen a doubling of volume from around 500 million tonnes in 2005 and has helped drive demand for hedging tools from the traditional financial coal markets of Europe and South Africa, to the Asia Pacific region.

> *"Growth in thermal coal trade over the past decade has seen a doubling of volume."*

With European coal swaps trading over 2 bn tonnes per year, interest has moved to Australian and Indonesian exports and China's import market as these become increasingly important in influencing international thermal coal prices. Asia-based banks, traders, producers and consumers have been clamouring for local thermal coal based indices and with the launch of API5 (FOB Australia) and API8 (CFR South China) swaps contracts in May 2012, the regional market was finally able to take advantage of greater visibility on price trends in the region.

In addition, the Indonesian sub-bituminous coal swap contract, which is underpinned by the world's largest thermal coal export market, first traded in early 2010 and allows participants to hedge over 350 m tonnes of thermal exports.

The first independent brokerage to offer iron ore, coking coal and steel swaps, FIS is leveraging its expertise in bulk commodity derivatives to add value to the rapidly growing Asia-Pacific thermal coal swaps market.

The 12 million tonnes of API8 traded in 2013, the first full year of cleared trade, represents only about 5% of total physical thermal coal trade to China which is around 235 million tonnes, demonstrating its potential for further growth.

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CLOSE CORRELATION

Swaps activity on the newer Asian thermal coal indices is very much guided by Asian physical buying and selling activity and the two are therefore well-correlated. Importantly, a key determinant in using swaps (or using index-pricing in physical deals) is that the basis risk between the derivative and the underlying physical commodity is as small as possible.

With Asian market participants, in particular Chinese traders, increasingly using these indices against physical trades, the view is that these new indices, particularly API8, could soon challenge and even over take the API2 contract as the world's most followed and influential coal index.

Asia is the world's largest coal market, and whilst the API2 and API4 contracts have proven to be successful, it is not unreasonable to suggest that volumes could potentially match that of the European indices.

> *"Asia is the world's largest coal market"*

These newer contracts will be influenced by issues of relative value and thus opening up new trading activities, such as Chinese domestic versus Chinese import, API4 v API 8, API8 v API5 and off-spec versus on spec contracts.

API5, API8 AND INDONESIAN SUB-BITUMINOUS CONTRACTS

The cleared thermal coal derivative contracts operate as Over-The-Counter, cash-settled agreements, settled against the average of IHS McCloskey and Argus indices (API5 and API8) and the IHS McCloskey Indonesian sub-bituminous indices.

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Trades can be made on a per month, per quarter or per calendar year basis. These three swaps contracts are cleared on the Chicago Mercantile Exchange (CME), The Intercontinental Exchange (ICE) and the Singapore Exchange (SGX). The direct link to the clearing houses ensures the products are designed to meet the needs of the markets, through elimination of counter party risk and better cash management.

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