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SPECIAL REPORT

COAL

The Rise of Futures in International Coal Markets – The Asian Challenge

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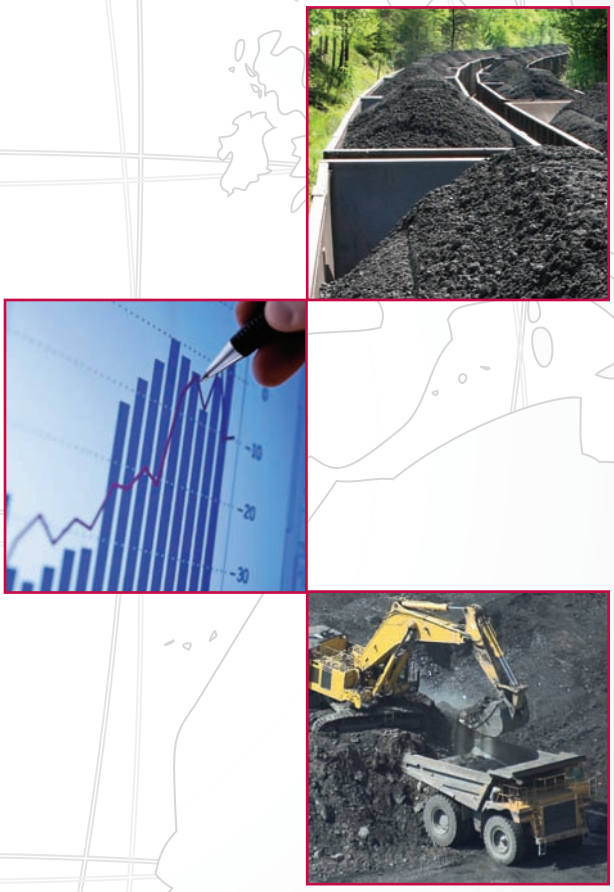


The evolution of a traded futures market in the international thermal coal sector could not have been timelier, given the global credit crisis which plunged the world into financial turmoil in the second half of 2008.

The consequent rapid fall in prices across the energy commodities spectrum meant that risk management strategies notably shifted, with credit and counterparty risk suddenly the main priority in place of price risk. The rapidly deteriorating credit environment saw many companies with exposure to coal prices, and previously happy to trade over-the-counter swaps, clamoring for cleared products.

Europe, a major trading hub for thermal coal with a firmly established over-the-counter swaps market, has been relatively quick to adopt coal futures trading. Futures have been introduced to the Atlantic coal market in a drip-feed fashion, with varying degrees of success. The European Energy Exchange (EEX), based in Germany, first listed financially settled European ARA and South African Richards Bay coal futures and offered clearing services for contracts traded in the over-the-counter coal market back in May 2006 but has had very limited take-up since then.

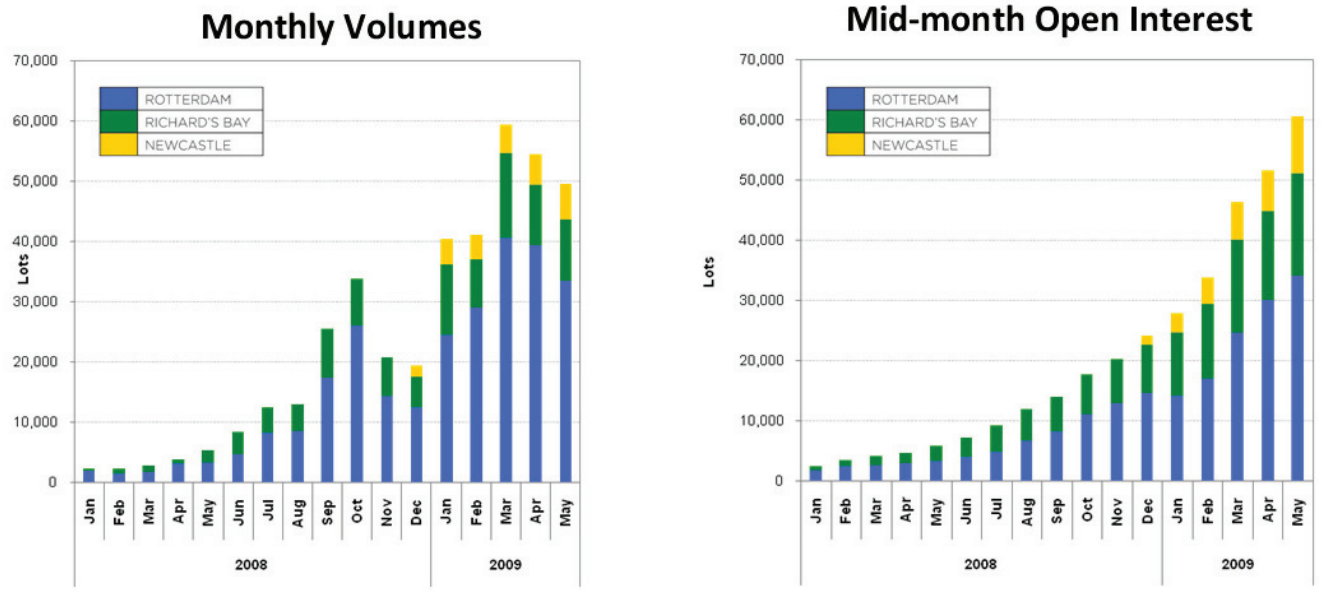
London-based ICE Futures Europe, the world's largest international energy exchange, began trading European and South African coal futures contracts that are cash settled against the API2 and API4 coal indexes just a couple of months later.

Futures hold several distinct advantages over swaps. Firstly they are netted, meaning that if a market player decides to take an equal and opposite position to an existing futures position it holds, the original position is cancelled making management of the book so much easier. Also futures markets offer price and volume transparency while guaranteeing the anonymity of market players keen to keep their trading strategies and market positions strictly confidential. The more a futures market develops, the more likely it is to concentrate liquidity, making it easier for physical participants to dip in and out of the market when they need to. But given the recent economic downturn, the biggest advantage to futures trading is that it effectively eliminates counterparty credit risk. Futures contracts traded on an exchange are guaranteed by the clearing house, eradicating the need for bilateral credit agreements between participants.

CONQUERING THE ASIAN MARKET

As a result of the price shock of 2008, traded volumes of ICE coal futures in the European hub soared as market participants strove for shelter from credit risk (see Figure 1). However, the Asia-Pacific region remains a key challenge in the development of a liquid coal futures environment and this report will focus primarily on what is being done to attract Asian players to utilize what is considered a highly effective risk management tool.

Figure 1: Coal Performance to Date



Source: ICE

Market participants generally agree that the Asia-Pacific region already has huge potential to develop and drive a thriving coal derivatives market, whether in futures or OTC contracts. It has the largest physical coal market in the world, boasting the two largest thermal coal exporters, Indonesia and Australia, and the largest importer, Japan, which is a major customer of steam coal shipped out of the port of Newcastle in New South Wales. Market growth projections for the Asia-Pacific region are impressive, with the developing economies of China and India both rapidly increasing their coal consumption in recent years. Despite these positive ingredients, the Asia-Pacific market has been slow to embrace derivatives trading, with the market still heavily influenced by long-term supply contracts negotiated by producers and end-users each year.

"There is a need for risk management in the Asia-Pacific region, but it will be a slow burner," says Eoghan Cunningham, chief executive of electronic trading platform globalCOAL. "But the Asia-Pacific region will eventually become one of the largest derivatives markets, whether futures or OTC, over the next few years."

The liberalization and deregulation of the power market at the turn of the century proved to be the catalyst for the development of a coal derivatives market in Europe. Coal buyers and sellers both realized that the consequent increase in price competition meant that they had to find new and better tools to manage their risk. However, it can be argued that no such drivers have yet been in place to effect such a transition in the Asia-Pacific zone. As a result, Europe remains the focal point of swaps and futures trading with several Asian participants conducting their trading operations from their London-based subsidiaries. There has been a slow, steady stream of Japanese coal consumers embarking on futures trading, although several of them tend to dip into the market via intermediaries such as Japanese trading houses or major investment banks.

NEWCASTLE FUTURES PRODUCT OFFERINGS

Two distinct powerhouses have emerged in the drive to establish coal futures in the Asia region. GlobalCOAL was first off the blocks, launching a Newcastle future product in December 2008. Contracts are traded on the ICE platform and through a range of brokers in lots of 1,000 mt, with a minimum contract size of 5 lots. They are cash-settled against the globalCOAL Newcastle monthly index, which in turn is the average of each weekly Newcastle index falling within any one calendar month.

The globalCOAL Newcastle contract has enjoyed steady growth over the last seven months. According to the latest available statistics from ICE and globalCOAL, open interest positions for the contract increased by 25% during the month of May and stood at 9,070 lots, or 9 million mt on June 5. Trading volumes for the contract grew by 18% month-on-month to surpass 6 million mt in May, with most of this growth occurring in calendar year contracts.

Meanwhile the Australian Securities Exchange (ASX) has earmarked a launch date of July 7 for its Newcastle future. The contract had been scheduled to begin trading in April but the launch was hampered as the exchange waited to secure the necessary regulatory clearance from the Australian Securities and Investments Commission.

In contrast to the globalCOAL offering, the ASX contract is physically settled. The contract will trade in lots of 1,000 mt and between 1% and 5% of trades are expected to go to physical delivery. It will trade over four forward calendar years and options over three quarters and four calendar years, with prices settled at 4.30pm Australian Eastern Standard Time on week days. The first traded contracts will be for October delivery. The contract specifies a minimum calorific value for Australian thermal coal of 5,650 kcal/kg NAR, maximum ash of 17% and maximum sulfur of 1%, slightly different from its original parameters which specified 6,000 kcal/kg NAR with maximum sulfur of 0.6% and ash of 13%.

Anthony Collins, general manager, energy at ASX says the foundation of the product offering "is that it's deliverable, sustainable and not dependent on editorial indices or globalCOAL's broker platform. It's not proprietary, it's an index that anyone can use, and there are no restrictions on brokers being able to screen-broke as well as voice-broke the product."

While the new ASX contract's physical deliverability has attracted the interest of Japanese traders, some players in the market say it could prove to be a stumbling block to its utilization by new market entrants with a non-physical coal trading background because they do not want to be involved in physically-settled coal contracts. "Early adopters of the contract such as traders and banks may be reluctant to allow physical settlement," says one market participant.

Both globalCOAL and ASX remain optimistic that the Asia-Pacific region will in time develop the largest coal derivatives market, but skeptics have warned certain obstacles remain. They point out that not only will Asian buyers and sellers take a lot of convincing to accept the risk management benefits of futures trading, but also that they will want to see a certain amount of liquidity in the market before getting involved.

One European coal market source who did not wish to be named says that liquidity remains a vital issue in the Newcastle futures market, because new entrants want to be assured that they can enter and exit it without restrictions. "There's much more traction in the European paper market, but people's biggest concern with the Newcastle market is that they won't be able to get out of big positions quickly," he says.

FUTURE INITIATIVES

The international coal market is not short of upcoming product offerings for futures. GlobalCOAL and ICE are also planning the launch of a physically-settled coal futures contracts for delivery of thermal coal to the Amsterdam-Rotterdam-Antwerp region. This contract is currently being developed and is expected to be introduced on the ICE platform later this year.

The next cab off the rank for the ASX in terms of coal is a FOB Richards Bay futures and options contract which will also carry the option of physical delivery. Meanwhile, Sydney-based futures exchange, the Financial and Energy Exchange (FEX), is working on its license application for a proposed Newcastle futures contract for which it has yet to announce a launch date.

Despite the severe impact of last year's credit crisis and the resultant reduction in the volumes traded in OTC markets, trading volumes of coal futures are expected to keep on growing over the coming months and years. Last year's rush to credit saw the European coal trading community comfortably get to grips with this useful risk management tool, but it still remains to be seen whether their Asia-Pacific counterparts will follow suit.

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