

Product Profile

Playing Dirty: Competition Over Asian Coal Futures Heats Up

By Bennett Voyles

As Asian energy consumption grows, so does the global coal trade. Now, two major exchanges are betting that the market is sufficiently mature to support a coal futures contract.

In early April, the IntercontinentalExchange announced plans to launch a new Asia-focused coal futures contract later this year. ICE is collaborating with globalCoal, a U.K.-based electronic marketplace for coal, and plans to use one of globalCoal's indices as the basis for the contract. At roughly the same time, the Australian Securities Exchange announced that it also intends to launch an Asia-focused coal futures contract this year, setting the stage for an interesting battle.

As with so many commodities, the focus on Asia reflects the boom in consumption in countries like China and India, where rapid economic growth is leading to demand for coal in the generation of electricity. Japan, South Korea and Taiwan are still the largest consumers of coal in Asia, but China has moved from being a net exporter to a net importer and is expected to import about 10% of Asia's total imports this year.

"China of course is often the elephant in the room. On a percentage basis, for them, very small swings on exports versus imports have a very large effect on the international marketplace," says Eoghan Cunningham, chief executive officer of globalCoal.

An Emerging Market

Energy market participants have been trading crude oil futures for 25 years, but futures are a relatively new concept for the coal industry.

Until about 10 years ago, commodities experts say, coal was a huge but sleepy market. Power plants and mine companies would get together once a year and write an exclusive contract. "An end user would go to a producer and they would wrap a deal," recalls Rick Thomas, an industry veteran and currently the vice president for coal operations at the Newedge brokerage group in New York.

Users would typically tailor their plants to the specifications of coal dug out of the most accessible coal field. As a result, coal was almost not considered a commodity at all, since the number of must-have specifications could stretch to double digits. "They didn't think of it as a commodity that could be easily moved from one place to another. There were so many specifications that could be required...there was no fungibility," Thomas remembers.

As regulations on electrical generation pricing loosened up, the need for cost efficiency forced power station buyers to become more flexible about the kind of coal they purchased. At the time, Thomas recalls, the power company where he was a buyer shortened its list of must-have specifications from 15 to three. The shorter spec list made it possible to trade coal as a genuine commodity for the first time.

There is now a fairly active spot and forward market for physical coal, according to market observers, as well as a cash-settled coal swaps

market that has drawn in some financial players. The next logical step is to introduce a standardized exchange-traded contract, and several attempts have already been made in Europe and North America.

Back in July 2006, ICE Futures Europe introduced two coal contracts oriented to the European market. Only in the last few months have those contracts begun to get any traction, with volume averaging just over 2,000 contracts per month during the first quarter. Those two contracts are cash-settled futures based on two key pricing benchmarks—Rotterdam in the Netherlands and Richards Bay in South Africa. ICE is also planning to list a physically delivered version of its Rotterdam contract later this year in collaboration with globalCoal.

On the other side of the Atlantic, the New York Mercantile Exchange is having some success with a suite of three U.S. coal contracts, with roughly 15,000 contracts per month coming to the exchange through its Clearport OTC clearing facility during the first quarter. It remains to be seen, however, if the Asia coal trade is ready to make this step.

Coals to Newcastle

Both ASX and ICE base their proposed Asia coal futures contracts on prices for coal at the Australian port of Newcastle, a major hub in the Asia coal trade, and both contracts are using the standard contract specifications now used in over-the-counter trading.

The two contracts have some important differences, however. ASX's contract will be based on physical delivery while the contract from ICE and globalCoal will be cash-settled. In addition, ASX plans to offer options on strips of futures and it claims market makers have already offered to quote two-way prices for that product.

In March ASX circulated the details of its proposed contract and asked for feedback from industry players by the end of April. According to the consultation paper, ASX anticipates strong interest not only from producers, merchants and consumers of physical coal but also banks, brokers and investors. "The interests of financial market participants range from those seeking exposure to a new asset class; to make prices; to leverage their credit rating; to leverage their existing banking/finance relationships; and/or simply to speculate in an anonymous and centrally cleared market. This diversity bodes well for the prospects of a new futures market," ASX says.

ASX believes that the market has now matured enough to introduce an exchange-traded contract that mirrors OTC conventions. "The forward market for coal in the Asia-Pacific has grown significantly in recent years thanks to the standardization of trading agreements and screen-based trading pioneered by globalCoal and others," the paper states.

ICE's relationship with globalCoal could be an important advantage in the competition with ASX. The London-based company is owned by

big players in the global coal trade such as Anglo American and BHP Billiton. Its membership includes leading international banks and brokers as well as Japanese commodity trading firms such as Chubu, Itochu, Mitsubishi and Mitsui. GlobalCoal says it operates the largest virtual marketplace for thermal coal in the world, with more than 20.7 million tonnes of coal traded in its electronic marketplace in the first quarter of 2008. ICE and globalCoal plan to launch the contract in July, in time for the products to be cleared by ICE's planned clearinghouse in London.

The two groups are well aware of each other's plans and are keen to highlight their comparative advantages. Cunningham argues that globalCoal and ICE will be able to draw from a more global set of financial institutions to build early liquidity in the market, and claims ASX will probably rely mostly on buyers for local utilities. Cunningham, who headed commodity trading at EDF Energy before joining globalCoal in 2005, also notes that his company's existing OTC Newcastle contract is already widely accepted in the marketplace.

ASX counters that it is the "logical home" for a Newcastle-based contract and operates within the same time zone as participants in the underlying physical market. ASX adds that its market participants

include all the major international futures brokers and notes that it has installed connectivity hubs in London, Chicago, Singapore and Hong Kong. ASX also trumpets the success of its electricity futures contract, which was introduced in the fall of 2002. More than 127,000 power contracts traded on ASX in 2007, and open interest was above 40,000 contracts at the end of the year.

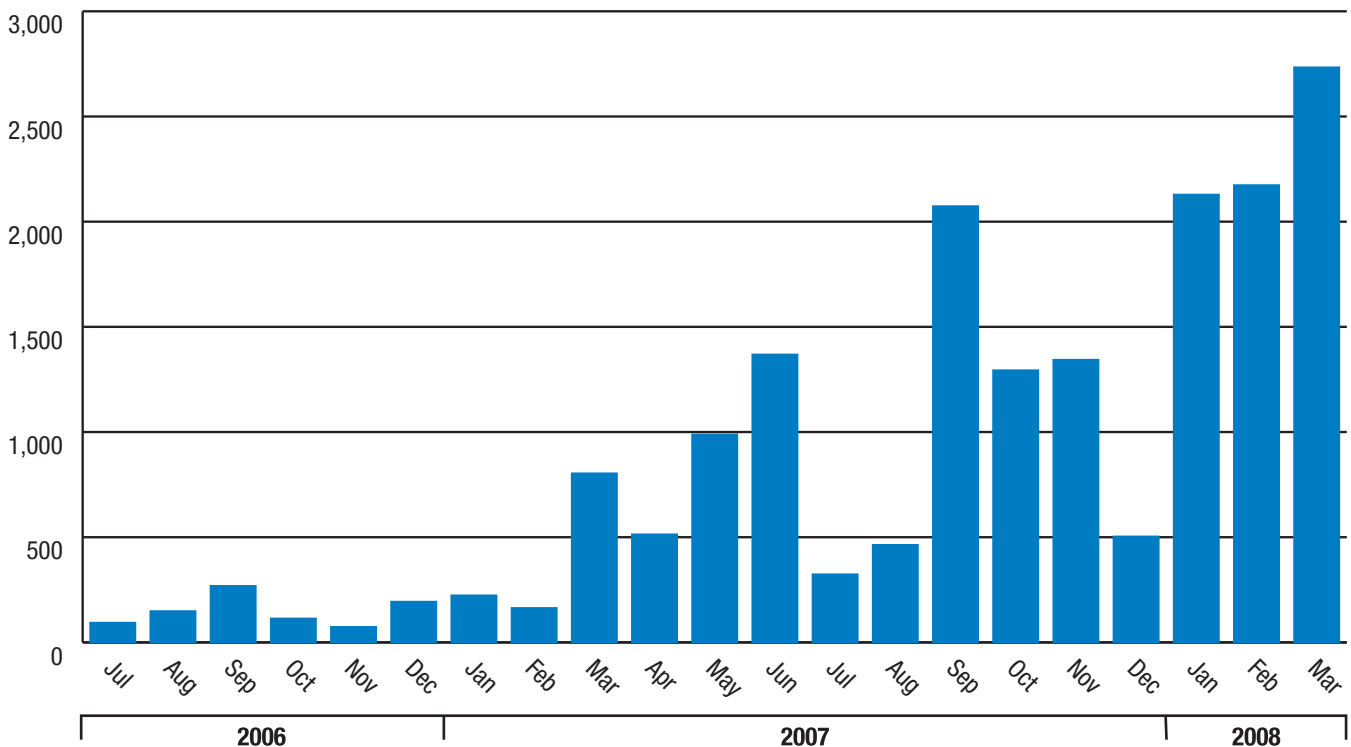
ASX also claims that its market will be seen as more independent, and questions whether users will accept a cash-settled contract based on an index managed by a single broker. "You can't be a screen and voice broker in the OTC market, competing against other OTC brokers, as well as being a quasi index provider for a futures contract and expect those same OTC brokers—who can't compete OTC on a level playing field as their trades are not included in the index—to service your futures product," asserts Anthony Collins, general manager of emerging markets for the Sydney-headquartered exchange.

"We welcome the competition," responds globalCoal's Cunningham.

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Slow Burn

Monthly volume in ICE Rotterdam and Richards Bay coal futures since launch



Source: IntercontinentalExchange