Consumers will pay as iron ore price rise hits cost of steel

The price of cars, refrigerators and buildings will rise this year after steelmakers agreed a dramatic increase in the price of their raw materials.

The latest round of iron ore price negotiations produced its first agreement yesterday when Vale, the Brazilian miner, said that it would sell to Japanese and South Korean steelmakers for at least 65 per cent more than in 2007.

Analysts estimate that this settlement, which will form a benchmark for all other talks, could lead to a 20 per cent rise in steel prices, which almost certainly will be passed on to consumers.

Prices for iron ore, the raw material for steel production, are set annually, with the world's largest consumers agreeing contact costs with suppliers. Vale, Rio Tinto and BHP Billiton control 80 per cent of the iron ore market, but deny that they operate as a cartel. BHP is trying to buy Rio Tinto in a £75 billion deal, but the possibility of a merger of the two operations has raised competition concerns over the supply of iron ore.

Other metals, such as copper, have their prices determined daily on the London Metal Exchange, but iron ore supply is controlled so tightly that the miners are able to negotiate prices with the biggest consumers only once a year.

A small quantity of iron ore is sold in the spot market, but the sector is dominated by the benchmarked agreements between miners and steel producers in Japan, China and Europe. Once one of the big three miners agrees terms with one of the leading steel producers, this becomes the benchmark price for all other buyers.

Soaring steel demand, particularly from China, which is undergoing a construction boom driven by its soaring economic growth, and constrained supply from Brazil and Australia, the leading producers, has led to this year's big increase in the price of iron ore. Daiwa Securities has estimated that the rise could lead to a 22 per cent increase in the cost of producing steel and suggested that this, in turn, would be passed on to carmakers and other steel users.

Vale's agreement yesterday was with Nippon Steel, the world's second-largest producer, and Posco, of South Korea. Its Itabira fine ore will increase in price by 65 per cent to $78.89 per tonne, while higher-grade ores will rise in price by 71 per cent.

Vale, the world's largest iron ore producer, with 38 per cent of global supply, has set the benchmark for the past six years.

Chinese steelmakers indicated yesterday that they were willing to accept the increase as this year's benchmark.

The chairman of Baosteel, the largest Chinese iron and steel conglomerate, which is leading the negotiations with ore producers on behalf of China's steel industry, said he hoped to have an agreement by the end of this month.

Rio Tinto has indicated that it may not adopt the Vale-set benchmark. The company is thought to be pushing for at least a 70 per cent price increase.

Sam Walsh, head of Rio's iron ore division, said: “We will continue to negotiate to obtain a freight premium, to reflect our proximity to Asia and our major customers.”

The price of iron ore is rising so fast that Rio and BHP want to break away from the rigid benchmarking system of previous years and sell more ore at spot prices, a market that barely existed a few years ago. At present the spot price is more than twice the benchmark level. BHP and Rio are also introducing hybrid contracts for buyers, which include some ore sold at the benchmark and some sold at the spot price.

Tobias Wörner, an analyst for MF Global Securities, said: “The Australians might look for a different approach, where both spot prices and freight differentials could feature as well. I think 65 per cent is a good starting point. It's a floor.”

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