REUTERS

HD UPDATE 1-China trims long-term iron ore contracts as glut hits market

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(Updates iron ore price)

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SINGAPORE/SHANGHAI, May 30 (Reuters) - Chinese steel mills are cutting back on long-term iron ore contracts in favour of cheaper spot cargoes, confident that beaten-down prices are unlikely to rebound amid the first global ore surplus in 10 years.

Miners in Australia and Brazil, who for years have earned massive profits from China's insatiable demand for iron ore, are ramping up production at a time when steel demand growth is slowing, pushing prices down 28 percent so far this year.

Market talk is swirling that some Chinese mills have cancelled iron ore cargoes, with several traders saying up to four million tonnes have been rejected, although this could not be verified by Reuters.

Iron ore demand in China is still near record levels - April imports of 83 million tonnes were the second-highest ever - but miners such as Vale, Rio Tinto and BHP Billiton are boosting production even faster.

"For the first time in 10 years, supply is greater than demand," Jose Carlos Martins, head of Vale's ferrous metals division, said late last month. "At the same time, demand has risen slower than expected."

Shipments from dominant producers Australia and Brazil are expected to grow by 40 percent over the four years to 2017, when annual exports will reach 1.27 billion tonnes, according to Australia's Bureau of Resources and Energy Economics.

Australian miner BC Iron said some of its customers have asked for small discounts or more flexible pricing periods, but it has not seen any cancellations.

"We certainly haven't had any even whispers of that as far as our product goes," managing director Morgan Ball told Reuters.

Most big steel producers in China such as Baoshan Iron & Steel secure their supply of iron ore via long-term contracts with major Australian and Brazilian miners.

The cargoes are usually priced based on the average iron ore price index for a particular period, such as the monthly average, so with spot prices falling, it is cheaper for buyers to purchase spot cargoes.

Iron ore <.IO62-CNI=SI> fell below $100 last week, hitting $95.70 a tonne on Thursday, its weakest since September 2012.

A senior executive at a leading Chinese steelmaker said the firm has cut the volume of iron ore it buys via long-term contracts by about 10 percent this year, noting that some of its contracts with miners gave it an option to reduce volumes.

A second official who buys iron ore for a mid-size steel mill in northern China said the company was now relying totally on the spot market.

"We used to go with annual term supply but we have stopped doing it from this year as the market outlook remains weak," the official said.

One trader told Reuters six midsize mills in northern **China** had walked away from contracted **iron ore** cargoes this month totalling around 4 **million** tonnes - equivalent to more than 20 capesize vessels.

"They're rejecting these cargoes because there's too much supply in the market and they're not afraid to do it because they know the miners need them for future shipments," said the trader, who said he was offered some of the cargoes.

COST PRESSURES

Chinese steel mills are under pressure from poor demand growth due to slower economic growth, as well as an anti-pollution campaign launched by Beijing.

With cashflow already squeezed by weak margins and tighter access to credit, mills are looking to slash costs to help find the funds to meet stricter environmental rules.

A Xiamen-based **iron ore** buyer for a **Chinese** steel mill told Reuters he was negotiating to delay deliveries of **iron ore** shipments under long-term contracts that amount to 5 **million** tonnes a year.

A growing number of steel mills are running down their inventories, selling **iron ore** cargoes back to the market, often even before they arrive.

"There are more **Chinese** steel mills reselling their long-term contract cargoes this year and they prefer to buy from port inventories at lower cost," said an official at a state-owned **Chinese** steel producer.

Mills seeking short-term supplies can buy **iron ore** stocks sitting at **Chinese** ports for about $5 a tonne less than seaborne cargoes, on average, said a trader in Shanghai.

Stockpiles of imported **iron ore** at 44 **Chinese** ports hit a record high 113.3 **million** tonnes as of May 23, according to Steelhome, which tracks the data. <SH-TOT-IRONINV>

Goldman Sachs expects a seaborne **iron ore** surplus of 72 **million** tonnes in 2014, rising to 175 **million** tonnes in 2015.

Big miners, however, argue that as prices fall, imports will replace high-cost **Chinese** producers who will be squeezed out.

The latest fall in **iron ore** prices reflected a rapid rise in seaborne supply, but wouldn't necessarily have a long-term price impact, said Australia's Atlas **Mining** managing director Ken Brinsden.

"It'll just take a little while for these tonnes to find a natural home," he said, adding that Atlas' customers have been performing according to contract terms. (Additional reporting by Sonali Paul in MELBOURNE; Editing by Richard Pullin)

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