Industry Research Monitor

In Focus: The "Future" of Steel?

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Key Points:

- **Exchange traded steel futures for hot-rolled and cold rolled could make a debut this year, though physical delivery looks a long way off.**
- **Many steel producers appear reluctant to embrace steel futures, but are nonetheless preparing for their arrival.**
- **Increased acceptance of benchmark price index within terms of physical contracts key to FAS 133 hedge accounting.**

The Future is Now?

The subject of developing a steel futures market has recently come back into the limelight. An unprecedented surge in steel pricing and volatility over the last 2-3 years has pinched margins and widened budget misses among steel buyers across a broad range of industries (e.g. automotive, general manufacturing, construction), and this in turn has helped spark renewed interest in steel price risk management tools … and the exchanges are responding:

- The New York Mercantile Exchange (NYMEX) hopes to soon launch a hot-rolled band steel futures contract on their ClearPort® system that would settle based on World Steel Dynamics' *SteelBenchmarker™* pricing quotes.
- The London Metals Exchange (LME) hopes to "be able to launch (a steel futures contract) in 2007" (Dec 4th; AMM) based on a Platt's steel pricing series.
- It is rumored that the Chicago Mercantile Exchange hopes to launch a steel futures contract using CRU pricing indices (which pioneer, Koch Metal's Trading, currently uses for its "over the counter" (OTC) steel futures offerings).
- Exchanges abroad, such as the Shanghai Futures Exchange, also appear to be considering launching steel futures contracts.

Of course, the obstacles of a multitude of products and grades, associated liquidity/market depth issues and challenges of offering "physical" delivery remain. Also, many steel producers remain reluctant to see the development of a transparent exchange-based pricing system (which invites the bogeyman speculator into the equation), preferring instead to offer direct forward-contract pricing (with raw material surcharges in some cases) to their customers. Nonetheless, there does now appear to be increasing line of sight to the emergence of a financial, exchange-traded steel futures contract where settlement is based on transparent steel benchmark price indices for key product categories such as hot and cold rolled steel.

A Talk With The Experts

Given the growing interest in the matter, we sat down with…

- **Dave Rusate** - Deputy Treasurer of GE, responsible for managing about $8 billion per annum of commodity price risk across steel, base and precious metals, carbon credits and petroleum;
- **Peter Marcus** - well known steel guru, Managing Partner and founder of World Steel Dynamics and
- **Patrick McCormick** - former 30 year Emerson Electric steel guru (former VP of global steel) who recently joined World Steel Dynamics as a Managing Partner

…to try and garner some insights about the prospects and potential benefit of a steel futures market.

Q **Dave,** as a major commodities buyer and an active player in hedging activity, have you had any experience in hedging steel and are you constructive on the outlook for the development of a steel futures market?

A We hedge a wide range of commodities, energy and foreign exchange exposure with the aim of managing risk and creating shareholder value. We also help provide unbiased insights to our most valued GE customers (via our "At the Customer for the Customer" (ACFC) program) who are looking to develop or benchmark their hedging systems and metrics.

Regarding steel specifically, yes, we have had experience hedging steel with OTC futures contracts. Generally though, price risk management tools for steel are still very limited, so we naturally look forward to the further development of a steel futures market that offers greater liquidity, more hedging instruments and greater product breadth.

An important consideration will be the ability to eventually get FAS 133 hedge accounting. This is most easily attained when the index used in the physical contract is matched to the same index used in the futures contract. Thus, we think it will be important for a few key steel producers to begin to adopt such indices if the futures market is to flourish.

Q **Peter,** at the Steel Success Strategies conference back in June, many producers voiced skepticism about the merits of a steel futures market, quipping that it was really just a gimmick aimed at enriching a few players on Wall St. and possibly even boosting volatility and/or distorting the market by bringing in the speculators. What's in it for the steel producers and how essential is it that the marketplace get producer buy-in?

A **Peter:** The positives of financial (futures) transactions for the steel middleman (steel service centers, processors and traders) companies, and also steel users, seems to be well evident because, in theory at least, they will be able to lock in spreads.

Many of the steel mills, however, seem to be quite negative about this development. One of their fears – a primordial one – is that they will lose "pricing power;" i.e., that their product will become even more of a commodity.

Yet, as WSD sees it, the steel mills may prove to be the biggest winners of all. Here's why:

- For better-positioned steel mills, market share should rise since those buyers engaged in forward hedging (locking in spreads) will often want to deal with the mills that provide the most assured supply and the most consistent quality. Prices will be indexed and any fixing of price will be transacted in the futures market.
- Steel prices may be higher on individual transactions when futures are involved because there may be more discussions on spreads and reliable delivery, and less on negotiating fixed price discounts.
- When steel prices are lofty, there should be an opportunity, at times, to sell futures to price protect a considerable amount of tonnage that is either under indexed sales contracts or is yet to be negotiated.
- Only the steel mills will own the supply.
- Steel futures prices will provide a true transparency of the prices buyers and sellers are willing to settle at longer term. Steel futures transactions are anonymous. Since the previous settled prices and open interest are settled in the forward months, they provide a pricing barometer of real versus subjective market opinion. However as stated earlier, the actual physical steel prices are the ones that count in that these prices are used to settle who owes who in the steel futures transaction. Another benefit is steel futures transactions have a higher degree of security that they will be honored.
- ***SteelBenchmarker™*** prices are determined only by those in the steel marketplace – i.e., those who are buying and selling steel. Hence, unlike the key nonferrous metal markets – copper, aluminum, zinc, nickel – there will be no chance for financial investors to help to set the price. Therefore the physical market participants will have the upper hand in steel futures trading because they are closer to the physical market transactions.
- Steel mills may get better prices on their longer-term transactions with buyers since there may be less influence exerted by the offering prices at the bottom of the range. Low prices will have less of a devastating impact to the price structure. There will be more focus on the reliability of delivery and the locking in of spreads – i.e., the reduction of risk. The semi-monthly feature of our benchmark prices, rather than monthly, will cause sizable surprises to come less often. We have already observed a smoother curve of price changes versus other price indices.

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Q Pat, steel futures have been discussed for many years … yet you've recently joined WSD as a steel futures evangelist of sorts, after having been head of global steel purchasing of a major industrial company for more than two decades. What's changed that makes you think prospects have improved for developing a steel futures market?

A Pat: OTC (over-the-counter) steel financial trading has already been with us now for several years. During this time, the need for steel price risk management tools has increased because of an increase in market price volatility and the practice of mills offering shorter-term pricing contracts to their customers. The increase in market price volatility has resulted from changing regional market pricing tendencies as consolidated markets are managed for price support by reducing production output in contrast to the Chinese market which is competitively price driven by a growing and fragmented supply base. The need for price risk management tools is further highlighted by the recent requests of the automotive companies for steel futures to be supported by commodity trading exchanges.

It is common in the development of futures contracts that the OTC market form first and then futures trading. We are told by one of the OTC providers that their steel financial trading has increased four-fold in 2006. We now have the NYMEX and LME showing real interest in offering steel futures contracts in 2007/2008. The arrival of a steel futures product will be a significant advancement to steel financial trading. Several of the current constraints from my experience have been the size of the trading contract (too large today for granular trading schemes), lack of fluid visibility of the forward price curve (manually quoted on request today with no assurance you can trade at this price), and liquidity is still erratic based on the perceived strength of the steel market.

We are told that many steel producers are experimenting with OTC steel financial transactions, despite several mills having a negative public stance. A comment received from an OTC steel trader is mills are being prudent in understanding these price risk management tools because they now accept they are very likely to happen with the weight of automotive behind them.

Some of the benefits of steel financial trading with OTC and steel futures:

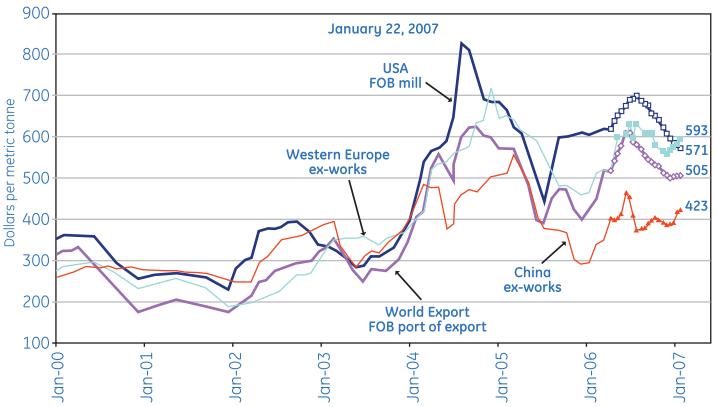
- You can decouple the physical steel commitment timing from the financial fixing of price
- Steel futures contracts have stronger integrity
- Steel futures will give a real traded view of the forward price curve versus buyer-seller opinion
- Your transactions are confidential from the physical steel market. Examples of this point are: mills trying to remain publicly optimistic on price while laying off their risk financially, or buyers remaining pessimistic in their pricing stance while protecting their cost at a higher price point.

In summary, the need for steel price risk management tools is clear. Market interest and trading exchange interest appear to be in place, it is now just a matter of moving steel futures contracts into market participants' hands. Steel futures product offerings, dealmaker involvement, and trading education are the next steps to the road of steel futures success.

***Steel Benchmarker* HRB Price**

USA, China, Western Europe and World Export

(WSD's PriceTrack data, Jan. 2000-March 2006; SteelBenchmarker data begins April 2006)



Q Pat, what makes a good pricing benchmark and do you feel *"SteelBenchmarker"* is there yet?

A Pat: The *SteelBenchmarker* is already a good market price benchmarking system in several commodities and in several markets. There are several significant attributes that make the *SteelBenchmarker* a preferred choice. It has "safety in numbers" in that we require a significant amount of price opinions to be received that pass the validation process before a price opinion will be aggregated and published to the market. In the case of hot-rolled band, we are already up to 60, and we are just starting to scratch the surface. Price providers come from all sides and the middle of the buying-selling equation, i.e., steel mills, steel service centers, processors, traders and steel users. This mix tends to blend out biases, i.e., buyers want a low price and sellers a high one. Statistical analysis shows a very normal distribution of pricing inputs. Finally, it has fair and easy internet access that allows any participant to be a price opinion provider.

We believe the *SteelBenchmarker* has a head start using its current price assessment methodology, and it can also be tied to WSD's prior Price Track history. This is a very important advantage since historical price correlations will be required by steel futures' users to confirm their historical pricing relationships to the index.

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