

American Metal Market's Guide to Steel Futures

Part 2 of 3

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Forget the future, the time is now

The introduction of a steel futures contract has been compared to waiting for a bus. You sit patiently for an extraordinary amount of time and then three turn up.

The Dubai Gold and Commodities Exchange launched its physically deliverable steel reinforcing bar futures contract Oct. 29; as *AMM* went to press the New York Mercantile Exchange (Nymex) was about to unveil the launch date—probably early December—of its eagerly awaited steel futures contract; and the London Metal Exchange is planning to roll out its Mediterranean and Asian physically deliverable steel billet contracts April 28, although phone and electronic trading will start sooner.

Under the Nymex proposal, the exchange will introduce a financially settled U.S. hot-rolled contract that will be 20 short tons with a minimum price fluctuation of 50 cents a ton and will be listed for 18 consecutive months. The final settlement day will be the fourth Wednesday of the current contract month.

The contract, which will be listed on Nymex's ClearPort electronic clearing and trading platform, will be settled against steel prices determined by the SteelBenchmark pricing system developed by World Steel Dynamics Inc. (WSD), Englewood Cliffs, N.J., in cooperation with *AMM* and *Metal Bulletin*. ClearPort will allow Nymex to process over-the-counter, off-exchange trades for those wishing to turn them into exchange-cleared forward contracts.

With the Nymex board giving the contract the green light at the start of October, the exchange and WSD are now close to finally pushing the button. Nymex and WSD met in early November with several financial institutions that had expressed an interest in signing up for steel futures trading.

"The financial intermediaries have expressed an interest in the volume potential of steel futures. They are excited about the volume in steel futures because of the sheer size of the industry and the amount of steel and scrap-related products that are tradable," said Peter F. Marcus, WSD's joint managing

partner. "The financial intermediary SteelBenchmark transactions will be logged on the Nymex Clearport system."

Speculator involvement in steel futures trading concerns many in the steel industry as there is a belief that pricing could become more volatile and mirror some of the swings seen in base metals, such as copper and nickel.

Steel producers also have said that despite assertions that futures contracts will reduce or eliminate steel price volatility, the issue is being made moot by rapid consolidation across the industry and the ability of the remaining steelmakers to manage supply to meet demand.

But Nymex and WSD argue that the model they have drawn up will not allow for price volatility, as the hot-rolled price will be financially settled each month against a SteelBenchmark price, which is formulated through price opinions from many steel market participants.

"While the intermediary prices in the middle of the month may get driven by some speculative component, they still have to come back to that final settlement price," said Patrick A. McCormick, joint managing partner at WSD. "The financial investor liquidity will actually bridge those

timing dislocations between buyer and seller, and this is a huge step forward from where we are today with the financial swaps."

At present, there are more than 65 industry inputs into the SteelBenchmark hot-rolled price. With the settlement price relying on industry inputs, concerns have been raised in the steel and derivatives sectors over the robustness of the price because it is based on opinion rather than an average of actual transactions.

"We don't think the steel industry is going to suffer. They have so many inputs right now that the final price is so formulaically determined around its mediums that you have to have a lot of confidence that it's not being manipulated and is not subject to manipulation," Robert A. Levin, Nymex senior vice president of research, said.

WSD said it has spent \$275,000 on legal fees to make sure the contract will be regulatory compliant.

One of the tallest hurdles facing all the exchanges is convincing the steel industry to use a steel futures contract. A central plank of the resistance is a belief that the contracts could act as a barrier between producers and consumers. Lakshmi N. Mittal, president and chief executive officer of ArcelorMittal, the



world's largest steel producer, is on record as saying that steel futures are unnecessary and will not work.

But according to futures proponents, price volatility risk to profit margins continues to be an issue for steel buyers and sellers. Moreover, downstream customer price commitments, lengthy project timing and steel industry investments have more predictable returns if a fixed price of steel is available.

"The price volatility is not going to stop. The waters are going to get choppy, and you can see that in 2007—where price volatility was less in magnitude, you had an inventory correction that mooted the ability of the market price to recover," McCormick said. "So under any kind of stable demand conditions next year, the table is set for a greater volatility in magnitude as well as frequency."

The introduction of financial swaps and steel futures contracts also could add both a feeling of security and a sense of freedom to long-term price commitments with their 18-month forward pricing opportunities, according to WSD.

"What these financial markets are providing is the ability to go after more sources of liquidity to make a trade," McCormick said. "The No. 1 complaint we get from sellers as well as buyers is that if they make a deal they don't know if it will be honored over the term. Well, if you're doing a financial swap or a steel future you are guaranteed payment by that intermediary. That is huge."

Concerns voiced by the steel industry run parallel to those of the aluminum industry when the LME was putting together its aluminum contract.

Winning over the doubters might take



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—Patrick A. McCormick

time. But as the education process gathers momentum, steel futures backers say they are confident the contracts will be accepted as they are a natural evolution to already existing over-the-counter (OTC) trading, which has been available since Koch Metals Trading Ltd. started offering OTC futures in January 2004.

"At this stage we're looking to begin a robust education process and dialogue with industry. In many instances it's individual discussions," Levin said. "It's a challenging

undertaking. A benchmark reference culture needs to develop. I think it's been growing but it's not there yet."

WSD is confident that the Nymex-listed contract will gain traction quickly, and it is already eyeing the introduction of more steel-related contracts. Cold-rolled sheet originally was mooted and is still expected to be launched once volume has built on hot-rolled. This could also come along with a scrap contract that might see prices listed for such grades as No. 1 heavy melt, shredded and auto bundles.

"Hot-rolled band will be the first product," Marcus said. "U.S.-based scrap and cold-rolled will be the next priorities. In terms of timing, we want to launch others as soon as possible. The steel scrap price changes are not only important to those who buy scrap in the U.S. but are also important to those who buy products that are made from scrap and those involved in scrap processing and trading globally."

The volatility of scrap is creating variability in the price of rebar and many fabricators are finding it impossible to cost things out six to 12 months in the future, Marcus added. "Rebar is used in long-term construction projects yet scrap prices move monthly. This extreme volatility in steel and scrap prices has always been a problem."

Nymex was more cautious, but said there was clearly an opportunity to expand the model out and include more contracts. "It's obviously our goal. But we've got to bring the first product out and build up traction," Levin said. "There is a whole suite of steel-related products and there are some other good references that are out there already for each of them." **SEAN BARRY**

So far, so good as the DGCX contract makes its debut

It's still a long way from developing liquidity, but trading of the steel reinforcing bar futures contract on the Dubai Gold and Commodities Exchange (DGCX) appears to be off to a good start, an exchange executive said after the new contract was launched Oct. 29.

There was a series of false starts earlier in the year, but the contract began trading according to expectations, said John Short, the exchange's director of steel and base metals.

"On the basis of it being the first day of trading, something that is new to banks, new to the local and international trading community, new to the local, regional and

global steel community and that DGCX is quite a new exchange, we are very pleased with the level of activity so far," he said. "We've had trades, the spread is tighter than anticipated and the price is a good reflection of the physical market basis and current forward bookings. Of course, we have a long way to go in developing liquidity in the contract, but so far so good."

There are eight approved producers for the contract: Emirates Iron & Steel Factory, Abu Dhabi, United Arab Emirates; Turkey's Diler Iron & Steel Co. Inc., Ekinciler Iron & Steelworks Inc., Izmir Demir Çelik San-

ayi AS and Kroman Çelik Sanayii AS; Saudi Arabia's Al-Tuwairqi Group and Saudi Basic Industries Corp.; and Qatar Steel Corp., Mesaieed, Qatar.

Trading is conducted on an electronic platform supplied by India's Multi Commodity Exchange, a minority shareholder in the DGCX. Trading will extend out to 12 months.

The DGCX initially planned to list steel futures in the first quarter of 2007, but postponed the launch to allow users to become more familiar with the contract.

PHILIP PRICE

BFEX and FCStone hope to move forward with a platform early next year. But to date, BFEX hasn't identified any mills willing to issue the vouchers.

When the voucher bell rings, will steel open the door?

Plans for a voucher system are piquing interests in steel, but the jury's still out on the potential for success.

Steel buyers, traders and analysts said they are interested in learning more about plans to develop a steel price hedging platform based on steel vouchers, but many also expressed doubts on whether the concept will work.

Of more than a dozen executives interviewed after a session on steel futures and price risk management at CRU International Ltd.'s inaugural steel conference in Chicago, only a few acknowledged being informed enough to comment on the concept from Birmingham Futures Exchange (BFEX) Inc.

The Birmingham, Ala.-based over-the-counter steel risk management broker recently agreed to develop the hedging platform using its voucher concept with middle-market commodity risk management firm FCStone Group Inc., West Des Moines, Iowa. The two companies said the platform could include forward sales, options and over-the-counter swaps based on the BFEX, and Jonathan C. Putman, BFEX chairman and chief executive officer, is talking with a futures exchange about eventually offering futures based on vouchers.

The vouchers have been described as similar to prepaid coupons issued by steel mills as payment for base steel, including surcharges, which could be hedged as a proxy for deliverable steel products—initially hot-rolled, cold-rolled and galvanized steel—while allowing steel producers to continue to set their own base price.

So far, BFEX hasn't identified any steel mills that might be willing to issue the vouchers. Putman said in an interview at the CRU conference that he is still working to line up mills and answer questions being raised by other potential partners, but BFEX and FCStone hope to move forward with the platform early next year.

John Conheeny, marketing director of the New York Mercantile Exchange

(Nymex), acknowledged that his commodity exchange was among those that would be following the development of vouchers. The exchange is expected to launch its own financially settled hot-rolled futures contract before the end of the year.

Vouchers are “going to be one of many developments that we think could contribute to the development of steel futures trading,” Conheeny said, adding that steel mill acceptance of the contract will be crucial. “The industry’s reaction will determine whether we will embrace it.”

London Metal Exchange executives at the conference said they were less interested in the BFEX concept, noting that they were moving ahead with plans for deliverable physical contracts rather than financially settled contracts similar to those planned by Nymex and BFEX.

The concept could have advantages, according to one analyst who said he had only just started to study the voucher concept. Many steel buyers now struggle to meet margin commitments involved with futures trading, he

‘There is an appeal to this approach to steel futures. Guaranteed payment to the terms of the deal is an attractive thing to offer. How practical it will be to administer is another question.’

—Analyst

said, and purchasing vouchers could provide a much lower-cost method of guaranteeing future supplies of steel.

On the other hand, questions remain about whether mills would always fulfill their voucher obligations to all buyers when demand increases sharply and major buyers start expecting first access to a mill's production, the analyst said. “When the OEM (original equipment manufacturer) dinner bell is ringing purposefully, the mills are sometimes slow to supply distributors.”

However, “there is an appeal to this ap-



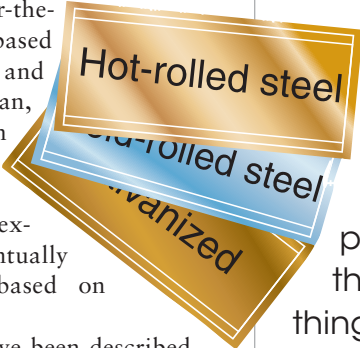
BFEX' Jonathan C. Putman points out the vouchers, or prepaid coupons, can be hedged as a proxy for deliverable steel products while still allowing mills to set their own base price.

proach to steel futures. Guaranteed payment to the original terms of the deal is an attractive thing to offer. How practical it will be to administer is another question,” he said.

Several other analysts, buyers and traders at the conference also expressed doubts about how well the voucher concept would work. “I can't see it,” Jean-Luc Fiorenzoni, head of steel price risk management at Stemcor Holdings Ltd., London, said. “Coming from other commodities markets, I can't see that it would work.”

BFEX and FCStone appear to be trying to do too many things at one time with the concept by combining the possibility of physical delivery and options, he said. “I understand that you buy a voucher and when it comes to expiring you want to take delivery on that,” he said. “This is basically giving away an option. If you issue an option, you need to get some money for it,” providing coverage if an option is exercised against a position.

Also expressing skepticism was Joseph P. Reinmann, president and chief executive officer of Metal Resources Inc., Chicago, who chaired the CRU futures panel. “I understand it's like any other kind of physically settled forward call,” he said. “It's still questionable how it will develop.” **PHILIP BURGERT**



In the Far East, exchange-based trading is going nowhere fast, stalled by underwhelming government interest

Chinese plans for steel futures run into a great wall

The Dubai Gold and Commodities Exchange (DGCX) might have won the race to launch steel futures when it began trading reinforcing bar futures in late October, but it is the world's two most influential metal exchanges—the New York Mercantile Exchange (Nymex) and the London Metal Exchange—that are getting most of the attention as they put the finishing touches to their own steel contracts.

But as recently as 2005, many global steel watchers were looking further east for leadership in steel futures. Chinese steel output was booming, and two of the country's top exchanges, the Shanghai Futures Exchange (SHFE) and the Dalian Commodities Exchange (DCE), were planning to launch steel futures.

Fast forward two years, and while China's steel production continues to outstrip expectations, a Chinese futures contract appears no closer to getting off the ground. According to market participants, a combination of changing government priorities and a mixed reaction from the steel industry itself has stymied attempts to launch a futures contract, a situation that might not change for some time to come.

The SHFE, China's top commodities exchange, already lists futures contracts in aluminum, copper and zinc, among others. The exchange applied to list a futures contract in rebar in 2005 but still has no timetable for launch, an SHFE official said in the exchange's last public comment in September.

The SHFE is waiting for the approval of the State Council, a cabinet-level political body that includes China's president and prime minister. The State Council is believed



to have the final say on all new financial products introduced by major institutions in China, including metals futures.

The Shanghai exchange was given approval to list zinc futures in early 2007, allowing it to launch its first new futures contract in several years, but its application for steel futures is still pending. "We've got everything (in place), from contract (specifications) to an electronic system prepared by the exchange. . . . The only thing we need is approval from the government," SHFE deputy general manager Huo Ruirong said in April.

Market participants have cited several possible reasons for the government's reticence. Beijing might be concerned about the risk of introducing a relatively complex new financial tool into its fragmented steel industry, especially at a time when it is trying to rein in price volatility and consolidate the sector. It also might be concentrating on launching stock index futures, which would be the first non-commodity futures contract to be traded in China for almost a decade. A new financial derivatives bourse, the China Financial Futures Exchange, was inaugurated in September 2006, but full trading has yet to begin.

The long wait for government approval has already forced the DCE out of the running for steel futures. The northern Chinese exchange, which mainly lists agricultural products, last year dropped its planned wire rod and rebar futures contracts in favor of a plastics contract. Market sources said the lack of any positive response to the DCE's application for steel futures might have played a role in its decision.

It's not just the government that seems underwhelmed by the idea of steel futures. Although the China Iron and Steel Association reversed its long-standing opposition to steel futures in the summer, executives at some of China's top steelmakers are yet to be convinced.

Other industry executives said they feel they lack enough information to make a judgement. "We really have no idea what it is," said a sales executive at privately owned Nanjing Iron & Steel Co. Ltd. in eastern Jiangsu province.

In another reflection of the situation in the West, the financial community is a bigger cheerleader for futures than the industry they are meant to benefit. "The mills here fear the unknown," an executive at Great Wall Weiye Futures Brokerage Co. Ltd. said in June. "If they get better knowledge, just as the copper smelters are doing in the copper futures market right now, they'll find it is very helpful."

Whether that will be enough to break the government's silence remains to be seen, but as Nymex and the LME gear up to launch steel futures, it looks as if this is one area of the steel industry in which China's influence will be limited for the time being.

KEVIN FOSTER

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