

The ability of steel consumers to manage their price risk has up to now been tempered by the lack of a futures market – but this is set to change.

*Roderick Bruce* gauges industry reaction as four exchanges test their mettle in the race to launch a successful steel futures contract

# The pricing power battle

★ With over one billion tonnes changing hands every year, steel is the world's most widely traded commodity after crude oil. Global consumption has skyrocketed in recent years, driven in large part by the economic expansion of China. Growth in finished steel consumption has run at around 6% each year since 2000, up from a 1.2% average yearly rise in the previous three decades to 2000, according to steel analysts MEPS International. Used worldwide in the production of everything from buildings and infrastructure to automobiles, ships and home appliances, this strong and durable alloy – a mix of iron and carbon – plays a vital part in the world economy.

It's cause for concern then, that rising prices and volatility are making it harder for steel producers and consumers alike to manage their exposure to the commodity in the existing small and illiquid over-the-counter (OTC) financial swaps market. Calls are growing for steel futures contracts, and exchanges are stepping up to the mark. However, they face several barriers to success.

## Elusive tradable benchmark

One of the biggest challenges is that the many different grades of steel make it difficult to create a tradable benchmark.

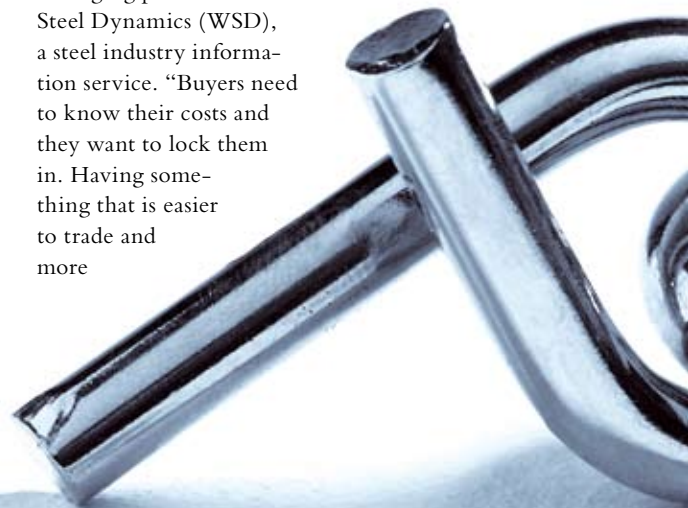
“The steel industry can be compared to the oil market, which has many different cracks and grades,” says Liz Milan, steel business manager at the London Metal Exchange (LME). “It's been very difficult for any exchange to identify where the commodity grade lies.”

The steel industry can essentially be split into two categories, distinguished by product size. On the one hand

are long products, which include scrap-based rebar, billet and wire rod, all used in construction. The other broad group consists of flat products, including hot-rolled coil and galvanised coil, intended for automotive end-use.

The two industries are quite distinct in terms of pricing fundamentals. The main liquidity, in terms of volume of traded steel, lies in the flat side, but such is the variety of flat products that previous attempts to commoditise them have failed.

Up to now, the industry has been using OTC financial swaps to hedge, and while appetite for such simple tools is growing, the perceived demand for futures contracts is even greater. “The need for futures is out there,” says Patrick McCormick, managing partner at World Steel Dynamics (WSD), a steel industry information service. “Buyers need to know their costs and they want to lock them in. Having something that is easier to trade and more



visible than OTC deals will definitely help people to achieve that.”

The recent trend of consolidation, as producers seek to bolster their pricing power by joining forces with rivals, has also had a big impact on the industry. Such mega-mergers include that of the world’s largest steel producer, Mittal, with the second-largest, Arcelor, in mid-2006.

There are currently four major initiatives to offer steel futures: two stalled launches, one at China’s Shanghai Futures Exchange (SHFE) and the other at the Dubai Gold and Commodities Exchange (DGCX); one revamped proposal from the London Metal Exchange (LME); and an all-new initiative from the New York Mercantile Exchange (Nymex). There are also two rupee-denominated futures contracts on Indian exchanges, though trading on these is limited to Indian companies and liquidity is low. A further domestic Chinese contract has also been mooted at Dalian Commodities Exchange.

### The industry responds

Each initiative has met with its own challenges. The SHFE initiative was instigated in 2004, but the Chinese government has been slow to give approval, after previous contracts listed on the Shanghai Construction Steel Exchange and Suzhou Commodities Exchange were dropped in 1994 due to poor uptake from the industry and speculation from financial players.

However, the SHFE has now garnered support from the China Iron and Steel Association (CISA), though any launch may now be delayed until after those proposed by exchanges elsewhere as the government gauges the likelihood of success. SHFE’s efforts, galvanised only with support from CISA, emphasise a major obstacle for a fledgling steel futures market: producers are unwilling to give up pricing power.

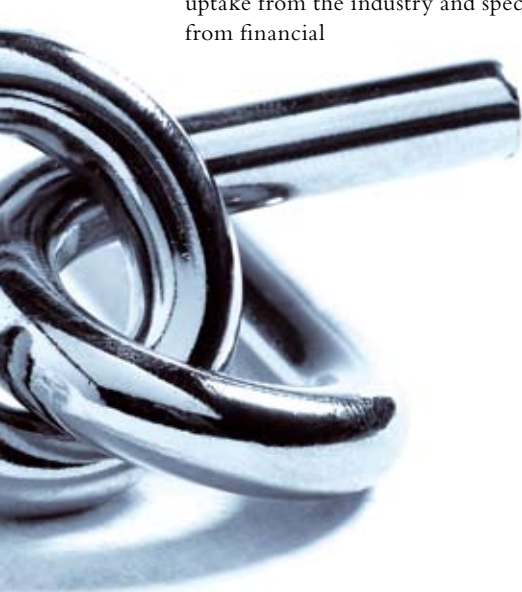
“Producers want to maintain control of their pricing and do not want to abdicate that to a financial indicator as the aluminum industry did,” says Jonathan Putman, chairman and CEO of Alabama-based OTC steel broker Birmingham Futures Exchange (BFEX).

Herwig Schmidt, head of sales at LME ring-dealer and broker Triland feels it is usually only perceived pricing power, “because in a bull market everybody thinks he has pricing power, but come the bear market such power evaporates very quickly,” he says. “However, at the moment and over the last three or four years, the producer power has been real.”

Arguably the most powerful man in the steel industry, Arcelor Mittal chief executive Lakshmi Mittal, has been uncompromising in his criticism of steel futures. At a conference in 2006 he stated that consolidation was the key to reducing market volatility, rather than financial derivatives. “We are not working for the banks,” he said. “We are working for our shareholders.” He reiterated those views in a July 2007 interview with Reuters news-wire in New York. “My personal view is that steel futures trading is not good for the steel industry... I don’t feel steel futures will be a reality in the near future,” he said, emphasising that Arcelor Mittal’s bid for LME membership was simply to buy alloys to produce steel rather than to trade futures.

*Energy Risk* contacted Arcelor Mittal for its latest views, and was told by a spokesman: “The Nymex launch won’t cause a fundamental change in our position.”

Other steel companies are equally sceptical. ThyssenKrupp spokesman Erwin Schneider says: “Steel futures are not something that we’ll be taking part in, as we are a producer of high-value steel, which is not suitable for an exchange.” He points out that around 60% of the company’s output is tied up in long-term contracts with consumers, and says ThyssenKrupp would “maybe” reconsider its stance



PhotoStock



**Liz Milan,**  
steel business manager at the London Metal Exchange (LME): “It’s been very difficult for any exchange to identify where the commodity grade lies”

when a futures contract is liquid and successful. This sentiment is echoed by Annanya Sarin, spokeswoman for Corus (now part of Tata Steel): “We are monitoring the situation with the contracts at the moment, to see how it develops,” she says.

Another indicator of producer mood comes from the International Iron and Steel Institute, a global body that represents over 190 steel producers, including the world’s 20

largest steel companies. “Two years ago our members-only Steel Futures Market Report determined that, as an institute, we would not pursue the use of steel futures,” says spokesman John Fewtrell. He refused to divulge the reasons behind the internal report’s conclusions, saying only that “there was a general consensus of agreement among our entire membership that supported the findings.”

Michael Overlander, chief executive and managing director at financial commodities, futures and options firm Sucden is, however, bullish on the influence of producers. “History shows that initially very few producers ever like the conception of a futures contract because it takes away from them what they guard very jealously,” he says. “It was the same when the LME’s aluminium contract launched [in the late 1970s], and indeed similar sentiments were expressed in relation to the oil futures markets. Producers swore blind that they would never ever trade on futures markets. Now I don’t think a minute goes by without a cross-reference from them to the futures price.”

Bob Levin, senior vice-president of research at Nymex, agrees: “Every industry where futures are now an integral part started with a range of responses. There are those that are very excited and will help lead the way, and there are those that say, ‘Hell no, I won’t go.’”

Despite the apparent rejection of steel futures by major producers, there are some who believe that sceptical public statements hide a

private interest. As buyers of steel empower themselves with OTC swaps, so producers may also be testing the water for futures by using the OTC market. “One of the advantages of financial contracts is that you’re allowed to have an anonymous position,” says WSD’s McCormick. “Some of the producing mills are experimenting in the OTC market to gain knowledge. So what is said publicly about financial contracts and what is done privately is like apples and oranges.”

Consumers make up the majority of the membership at Putman’s BFEX, and are the main current exponents of risk management techniques. Those not already involved are, like producers, watching closely. Automotive company General Motors has steel contracts of varying lengths with a number of steel suppliers, but does not hedge. “We’re looking at the different hedging tools that are being proposed, and we’re carefully evaluating the options going forward,” says GM spokeswoman Deborah Silverman.

Levin isn’t surprised by this. “There is substantial interest out there,” he says. “There is support, there is vocalised opposition, but that’s not really the issue. There is a lot of curiosity, but what you would expect from the industry is the attitude, ‘I’m going to watch this, and once it becomes liquid, I’m going to start using it.’”

### Contract conundrum

Even with producers, consumers and financial players on board, a big decision remains for exchanges trying to launch a futures contract: deciding which product to focus on, and



**Jonathan Putman of BFEX:** “The only settlement mechanism that deals with all of the issues is a steel voucher”

whether to have a cash-settled or physically-delivered contract.

It is this dilemma that faced the LME, which, after initially announcing a financially-settled contract based on a Platts prices index, has now opted to launch two physically-delivered contracts in April 2008, one for the Near East, aimed at production from Russia and Ukraine destined for Turkey and the Middle East, and one for the Far East, aimed at production for China and South East Asia. Why the change of heart?

“There are issues surrounding regulatory approval of an index price, and whether it is a robust, auditable price that isn’t open to manipulation,” says LME’s Milan.

John Short, executive director, steel and base metals at DGCX, was involved as a consultant in the LME’s steel project. “The LME realised that there simply wasn’t an index out there sufficiently robust that it satisfies the regulator as the settlement price for regulated exchange-traded futures,” he says.

Additionally, a physically-delivered contract creates a price convergence between the futures and physical markets, and because of this, hedging is possible. “It’s the model we use on non-ferrous contracts,” says Milan. “It means if the price in the physical market is out of kilter with the price in the financial market, the decision can be taken to use the exchange option to deliver.” Physical delivery is only a last-resort scenario on LME contracts. Out of a total of 87 million lots traded on the exchange in 2006, only 0.5% were delivered.

Nymex, however, has opted to take the cash-settled, index-based route. Levin is suspicious of physical delivery. “Companies produce products from the same mill that are not commercially substitutable to the extent you need for delivery,” he says. “You need the market to accept physical delivery that has undisputable par value and a specification that matches others in the industry. We are just not convinced there is a physical product that reflects that.”

The New York exchange has opted to base its regional US hot-rolled steel band contract on WSD’s Steel Benchmark index. This index is formed by price opinions sourced from 550 producers, traders and consumers of steel. “Steel traders and distributors tend to act like sellers in their price opinions,”

says McCormick. “If you add the mill and distributor percentages together it equals the percentage of end-users. We believe we have a very unbiased, well-balanced average.”

Aside from the challenges of physical delivery, Nymex chose to go down the cash-settled index route as the steel community is already familiar with the concept from OTC transactions, which use indexes from Dow Jones, Purchasing Magazine, CRU and American Metal Market, among others. “Indexes are a solution that the market has already gone towards,” says Levin. “We’re just taking it another couple of steps by focusing on the Benchmark and developing it into a futures contract.”

Jonathan Putman of BFEX is not convinced by either of the proposed steel futures contracts from Nymex and the LME. “They are both better than nothing, but if steel producers maintain an independent pricing policy then the consumer will be exposed to a substantial basis risk when settling a hedge with an opinion-based index like Nymex or a physical contract from the LME,” he says. “The only settlement mechanism that deals with all of these issues is a steel voucher.”

Putman is currently “signing documents



**John Short,**  
executive

**director, steel and base metals at DGCX: “There is an element of education required. We have to engage people over many months to come”**

**“History shows that initially very few producers like the conception of a futures contract because it takes away what they guard very jealously”**

**Michael Overlander, Sueden**

with a well-respected financial house” that will offer the voucher platform for trading (see box on next page). “The next step is to get steel mills to sell vouchers, and I have one significant mill that has expressed interest, and I’ve met with several others.” Putman hopes to have the system up and running in the US

within six months, and is looking at other products and regions to expand into.

### Education and preparation

One challenge that faces all exchanges launching products into the steel space is the ability to educate the industry about hedging with futures. Though experimentation with derivatives has started in the OTC market, it is still embryonic.

Triland's Schmidt draws attention to the LME's recently-launched plastics futures contracts, which so far have failed to take off due to a lack of understanding of hedging fundamentals in the plastics industry – and also a lack of infrastructure. “One better omen for steel contracts is that there are quite a few consumer companies that already trade futures,” says Schmidt. “They won't need to do an entire revamp of their

whole management, booking and accounting systems and practices.”

Milan is unequivocal about the need for education. Her three-person steel team, with the resources of the LME and its members, have



### The BFEX voucher solution

The BFEX Steel Voucher Exchange (SVE) is designed to provide vouchers from its member mills as a proxy for steel coils in the financial marketplace, without the related costs of transportation, storage and deterioration associated with physical delivery. End-users will be able to select their specific mill of choice and have the steel produced to their exact specifications.

Hedge positions will have high price correlation (100% correlation if final purchase is from the SVE mill). These vouchers will accurately convey the current value of base metal at the individual SVE mills because they can be used in lieu of cash for settling open invoices, thereby creating a guaranteed market made up of all the mill's active customers. If the voucher price should begin to fall below the current invoice price, customers will begin to buy them for use in settling their open payables. This will apply upward price pressure until the voucher once again approaches current value.

In addition to pricing differences, the variation in individual mill voucher values will also reflect the marketplace's evaluation of quality, location and reliability of delivery. The weighted average of all outstanding vouchers will yield a current market price for generic domestic steel. This price will be used to publish the Steel Voucher Index (SVI), providing the benchmark for US steel prices on a daily basis.

set out to educate the industry in preparation for the contract launch. “The lack of understanding is vast in many areas,” she says.

A lack of knowledge and trading infrastructure is precisely what has delayed the DGCX steel contract, originally intended for launch in June, but now launching “after the summer”. “The delay was 90% caused by a lack of technical ability to trade,” says Short.

Specifically, a lack of clearing accounts and margining facilities (and, for those intending to become broking members, compliance officers) among those companies seeking to trade steel caused concern. In addition, Short observes that “many of our potential clients have only just learnt how to trade a uniform contango, so there is an element of education required. We just have to engage people over many months to come.”

### The future for futures

The regional variations of steel products mean that futures markets will be regional too, with several benchmarks required. “The price of rebar in Dubai has nothing to do with the price of hot-rolled in Chicago,” notes Short.

DGCX has plans to offer a suite of four contracts in both stainless and carbon steel, should its initial offering be successful. It also hopes to launch freight futures, as steel – including iron ore and coking coal – makes up almost half of global dry bulk freight.

The LME, too, plans other steel contracts, while Nymex, meanwhile, is “very open” to the idea of extending its futures coverage in Europe and China based on the WSD index, with India and Brazil also on WSD's radar.

Clearly there is massive potential for regional contracts, should all the obstacles be overcome. “All these guys know that this is a prize that will be very valuable for the exchange that comes up with a successful formula,” says Overlander. “I believe the LME has got a better chance than most, but it is still a bit of a lottery. Any embryonic market is in the hands of the gods in many respects. Time shall tell.”

The overall mood for steel futures appears to be one of cautious optimism – with a long-term view very much in evidence. As Milan observes: “Volumes on our aluminium contract only increased after the eighth year, so we're in this for the long haul; it takes time for a market to mature.” 