

DOW JONES' SPOT SWITCH ON INDEX LEAVES STEEL FEELING UNEASY

BY PHIL BURGERT

■ CHICAGO — Five months after launching an index based on both contract and spot steel prices, the Dow Jones Steel Index has been altered to a spot-price-only standard.

The switch, driven mainly by the interests of financial industry users of the index, does not sit well with all steel users, mills and service centres, according to observers and a Dow Jones manager.

The change to a spot basis became effective with last month's publication of the index, which showed that the index numbers represented the "volume weighted average spot transaction/base price" for coils shipped during the prior month.

Sensible split

Dow's US hot rolled coil index reported last month for August showed a spot price, without contracts, of \$695.73 per short ton. The cold rolled index was \$769.74. For July, the HR coil index, including contracts, was listed as \$630.86, and the CR index, also including contracts, was \$692.50 per ton.

Dow Jones' specifications for both HR and CR coil include all prime and non-plate tons shipped during "the indicated month" and are based on transaction prices that exclude extras but include surcharges fob mills, according to a description provided by the company.

"The only change we've made is that — after discussions with the board — we decided to separate contract from spot for the index," said Ernest Onukogu, manager of New Jersey-based Dow Jones Newswires US Indexes, a unit of Dow Jones & Co. "Now we'll continue to publish both, but the primary index will be an index that will be strictly spot."

The differences between contract and spot price were one concern raised by some market segments prior to launch of the index last spring.

"So we've been tracking the difference between the two and felt that it was prudent at this stage to make that separation," Onukogu said. "The other numbers will be available for those that are interested in seeing them. There is a market segment that likes the indexes the way they were originally."

Such a split along industry and financial community lines is usual among the index products that Dow Jones has developed. "That's generally almost always the situation in almost any industry," he said. "Sometimes various segments of the marketplace place an emphasis on what they need to see."

The changes will partially address concerns on its viability, one user of the index said. But a member of the steel index advisory board that was assembled by Dow Jones and helped with trial testing of the index from last November to April said some reaction from the steel industry to the change from contract pricing had "not been positive".

"The advisory board felt the original numbers Dow Jones produced gave a more accurate representation of what people were actually paying, since you have a blend in your purchase price," he said. "There was some conflict of interest."

Dow Jones decided that the spot numbers would be more easily tradable in a futures environment, the advisory board member said. The New York Mercantile Exchange has indicated it is looking at working with the Dow Jones Index as part of a futures contract that it hopes to introduce as early as next year.

"Basically, what they've done is modify their methodology," the advisory board member said. "Now it's a spot transaction instead of including contracts. It makes for a different number, one that apparently the financial markets had wanted."

Onukogu declined to discuss the potential of connections between the index and Nymex, while a spokeswoman for the exchange said executives there are continuing to monitor the progress of the index with the hope of basing the futures trading of steel on an index.

Evolution

Other changes in the Dow Jones steel index have also been suggested. Some in the industry have said the index tracks prices that occasionally involve purchase orders received in a particular month, although those prices might have been set when the

order was placed in a prior month.

"That's not necessarily a reflection of the market price going forward," one source said. "That just shows what you received, which could be orders three months old."

Factoring out such prior prices is not a problem, Onukogu said. "We have not had that problem," he said, adding that if there were a problem with non-reflective prices it would quickly be noticed.

"If there is no market movement, then obviously that price is not going to affect the index except for the quantity side, which skews your perception of what liquidity is," Onukogu said. "But we're not publishing volume, so the index wouldn't be affected. [The system] would flag out a huge price movement for us and we can isolate it for additional inquiries. But so far we have not had that experience."

Other changes in the steel index are under consideration, he said, but it is premature to discuss them. "There are no changes in our methodology contemplated at present," Onukogu said. "We listen to the marketplace and make sure we provide a product that the market can use. Any changes that are made will be made in light of such a philosophy."

Onukogu declined to disclose the number of subscribers from the steel industry and financial sector that have signed up to receive the steel index data or how many mills and service centres are providing data used in calculating the index. "[But] there's been a pleasant reception by the marketplace in terms of trying to get price discovery," he added. "Price discovery is something that the market welcomes and we think that we have been positively received in the marketplace thus far".

Dual purpose

Two categories of support for the index have been identified, he said. "People who trade steel have been interested in getting our index numbers because they want to track it against other numbers and against what they are seeing as well," he explained. "The financial sector is also interested in this from a purely financial aspect."

Dow Jones index products generally have to have a minimum

number of data providers in place before they are launched, Onukogu said. "We can track an index for five years if that's what it takes to have a sufficient number of people reporting," he said. "We launched the steel index in May after having tracked the indexes for a period of six months. We felt comfortable at the launch that the contributors were sufficient."

"Obviously, we'd like to have more people and anyone who is interested can become a data participant. On the other hand, it's like a sample — you don't need every mini-mill or every service centre to report in order to get an accurate index."

"If you had 10 percent of them reporting, you could still get the very same index if it's a random sample. We feel that our index is now where we're comfortable with it. We'd like to have more data participants but we feel comfortable with the number of people we have and on any given day or month we're seeing a larger participation pool," Onukogu added.

Audit plans

All data providers to the index submit confidentiality disclosure agreements that stipulate that Dow Jones can have a third party conduct audits to verify the authenticity of submitted data.

Violations of index standards found in those audits can result in removal of data suppliers from the index.

No audits have yet been performed on the steel index, Onukogu said, calling such a step "premature". "But an audit will be done," he said. "We could do five audits in a year or we could do one audit a year. There are criteria that trigger an audit. One of them is that if you feel data is being manipulated."

He described the audit clause as important to Dow Jones "because that's what we think we need in place to make sure people are compliant with their agreement to make sure they send us accurate data. The data is going to be the determining factor in how frequently an audit is going to occur. But I do expect we will do an audit between now and six months from now."