

Steel Futures Rollout Draws Another Look



Proponents of steel futures trading press on despite lackluster interest among steel producers and distributors.

WITH THE LAUNCHING of steel futures trading already under way on the London Metal Exchange and in the Middle East as the New York Mercantile Exchange prepares to begin trading later this year, steel mills and service centers are taking a new look at this long-talked-about prospect and its potential effect on the way steel inventories and prices will be managed.

Top executives from steel mills operating in North America, including U.S. Steel, Nucor, AK Steel and Steel Dynamics, generally have said they are opposed to the concept of steel futures trading, favoring prices that are directly negotiated with customers rather than giving up pricing control to outside financial players. Industry leader ArcelorMittal has expressed open hostility toward the idea. But analysts who follow the sector note that these mills—as large as they are—still account for only a fraction of the global market.

"I know of several that are gearing up or are quietly supporting steel futures," says Steven Randall, managing director of Steel Business Briefing's London-based Steel Index, which compiles pricing data from more than 300 global steel industry participants. "But there are some opponents, no doubt. Resistance from a few mills

brands of steel rebar-quality billet for delivery under the contracts in 65-ton lots in Dubai, Turkey, South Korean and Malaysia.

"For those in North America, a rebar billet contract in the Middle East is not much use. I don't think we will see steel futures really take off in North America and Europe until flat-roll contracts [are

lets. I think their challenge is that they are going about it with the more traditional approach where you have physical inventories. The problem of physical inventories is the logistics of where to store them, not to mention the freight to keep that relevant to the hedging consumer if they are ever going to take a physical delivery."

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Robert A. Levin, New York Mercantile Exchange

isn't going to stop the launch of steel futures. The aluminum industry resisted for many years, and that's a much more concentrated sector."

Randall notes that five producers hold approximately 70 percent of the U.S. domestic market. Yet worldwide there are still more than 1,000 producers, and the top five command only a 20 percent market share. This globally fragmented industry and recent volatility in steel pricing make steel attractive to a growing group of futures exchanges.

The first exchange-based steel futures contracts for reinforcing bar were launched in October 2007 by the Dubai Gold and Commodities Exchange, which plans to add other steel contracts focused on the Gulf Region over time. Trading in that contract reportedly has slowed, with initial volumes of 300 10-metric-ton lots falling to 75 lots per day in recent sessions.

The LME started electronic platform trading of two billet contracts for delivery in the Mediterranean region and Far East in late February and has said that open outcry trading in the exchange's "Ring" in London would begin on April 28. The LME has approved 11

offered on the major exchanges]," Randall says.

Commenting on the LME launch, Patrick A. McCormick, a managing partner with World Steel Dynamics in New York, says "they had a pretty robust first day with over \$1 million traded in bil-

Meanwhile, World Steel Dynamics is gearing up for the mid-2008 launch of New York Mercantile Exchange trading of a financially settled contract for hot-rolled coil based on WSD's SteelBenchmarker index. Exchange officials say the contract will be for

Proponents say the recent volatility in steel pricing is driving a growing interest in steel futures. Data from the Birmingham Futures Exchange shows the dramatic shifts in the price of steel since 2004.

Hot-Rolled Price Trend: January 1980-July 2007



Source: Birmingham Futures Exchange

reference U.S. Midwest pricing of 20-ton lots of 0.2-inch-thick material from 48 to 60 inches wide.

"We haven't announced any of the details of the settlement process other than that it will be cash settled and use an index," says Robert A. Levin, senior vice president of research at the New York exchange. Launch of the contract, originally expected in the first quarter of this year, has been delayed by the Chicago-based CME Group's recent agreement to acquire the New York exchange for \$9.4 billion.

Levin and Al Getz, a New York Mercantile Exchange consultant, eventually expect hot-rolled futures contract trading to have strong participation from service centers, as well as other sectors of the supply chain. "It seems like there's a

McCormick acknowledges that only a small group of steel industry users now have much experience with or understand risk management tools. They are usually at companies with exposure to other metals such as copper and aluminum. In his past role as vice president of global steel for Emerson Electric, before joining WSD, McCormick had used over-the-counter financial swaps to stabilize the company's flat-rolled steel prices.

"The challenge is finding liquidity, in other words a counter-partner, to take the other side of the trade," he says. "When the market is rising as abruptly as it is today, to get a mill to think the other side of the hill is anytime soon can be quite difficult. What happens in times of clear movement up or down on price is

modity risk management such as Koch Metal Trading, Sempra Commodities and FC Stone Group, along with consultants like WSD, are now making efforts to help steel industry participants learn more about utilizing steel futures in their risk management strategies.

"I think it just behooves everyone to get themselves educated," says Jonathan Putman, chairman and chief executive officer of Birmingham Futures Exchange, an Alabama-based over-the-counter risk management broker. "Then the next step is to establish a relationship with a firm that can actually assist in their education and can position them to do transactions when it is in their best interest."

Putman's company and Iowa-based FC Stone are planning a seminar on steel industry hedging in Kansas City on May

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lot of upside here," Levin says. "Service centers are in the middle. They buy and they sell. They, as much as anyone in the steel industry, have to ride waves of price volatility."

Futures will help service centers manage volatility better, Levin explains. Companies with inventory that want to protect their steel's value can lock in a price by selling in the futures market. "If you were worried that a price might go up in the future and you would miss out on an opportunity, then you could buy futures and you would benefit if the price did go up," he adds.

Contracts would allow service centers to take hedges on their inventory value rather than having to move product at a loss to generate cash in times of falling prices, or writing down big losses in inventory valuation, McCormick says. "They would be receiving payments from the exchange or a counterparty in a financial swap vs. having to liquidate inventory at a loss. It's a big deal for middlemen, from where I sit," he adds.

that you're either long on selling liquidity and short on buying liquidity, or vice versa."

This presents a situation where the promise of getting steel futures trading onto an exchange starts to offer an advantage, since financial investors and speculators can help fill that timing void, McCormick says. "They actually serve a very positive and constructive purpose," he adds, noting that on the New York Mercantile Exchange the use of a price index would allow only actual buyers and sellers of steel to determine settlement prices.

"A lot of people looked at the last couple years in steel and said that volatility was becoming something less," he says. "Well this year is a reminder that it's not. Having effective tools that help you manage this volatility and help you stabilize your cost and your prices is a good thing. The challenge is to learn how to use them."

Brokers already involved with over-the-counter steel swaps and com-

12 to educate potential users of steel futures on how hedging works and the steps they must take to get involved in steel futures trading. Those steps include setting up brokerage agreements, which involve numerous documents, board of director approvals, authorizations for trading and other measures.

"It takes a healthy piece of time and effort to get it all set up appropriately," Putman says. "By educating themselves and putting in the time and effort, they can take advantage of the Nymex, LME and Dubai contracts, as well as over-the-counter contracts. I think everybody in the steel business should position themselves to be ready to make a move. That requires establishing a relationship with a firm that can do transactions for them, if they choose."

Most service centers continue to harbor a wait-and-see attitude toward futures trading. Executives at Steel Warehouse in South Bend, Ind., have taken some steps to learn about the process, but are not yet convinced it's

necessary. "We haven't done a full detailed study yet, and we haven't participated in hedging because we haven't seen the value of it at this point," says Marc Lerman, purchasing vice president. "In order to really be successful, it's going to take a lot of the industry to accept and believe in it."

Dave Lerman, Steel Warehouse chief executive officer, personally dislikes the idea of steel futures. "I think it just adds another degree of speculation into the marketplace," he says. "All you'll do is introduce a whole bunch of traders into the market who add no value. They'll magnify any change and any fear, and run the price up extra high, then run it down extra low."

Michael D. Siegal, chairman and chief executive of Olympic Steel in Bedford Heights, Ohio, says his company has not yet participated in any forward contracts. "It's a very costly risk mitigation device," he says. "If you have good working capital turnover, steel futures become just an

insurance policy against severe short-term drops or rises of price. Steel futures are like any financial swap. It's an insurance policy."

Siegal describes the steel service center industry as already a type of steel futures business, aimed at helping customers to manage steel costs. Like Lerman, he also questions whether speculation in steel futures might add rather than ease price volatility.

Lourenço Gonçalves, chairman, president and chief executive officer of Metals USA in Houston, says he is "completely not interested" in getting involved in steel futures trading, despite past experience using natural gas and energy futures while heading a steel rolling mill. Price stabilization and decreased volatility are being accomplished through steel industry consolidation, he says.

"We do not need futures. In fact, the only ones that really need futures are the ones trying to make a living trading with futures. It's just a way that financial guys

are trying to get into our business and to profit from that. Trying to sell steel futures as something that will be helpful or will curb volatility is, to use a polite word, silly," Gonçalves says.

If the argument for futures were correct, there would be little or no volatility in aluminum, nickel and other nonferrous metals, Gonçalves points out. "In fact it is the other way around. The very existence of these contracts is one of the causes of this volatility. When you have futures you have speculation, and speculation brings volatility."

Bill Jones, chief executive officer of O'Neal Steel in Birmingham, Ala., says his company has used nonferrous hedging from time to time to protect its price, but does not use hedging for speculation. "We use it to minimize speculation. It's just not a big issue with us. We prefer to spend more time working closely with our customers and suppliers to manage inventories." ■