

Steel futures train starting to roll following slow start

LONDON — While steel derivatives have been available off-exchange in over-the-counter trading for nearly three and a half years—Koch Metals Trading Ltd. started offering OTC futures in January 2004—none of the world's leading metals exchanges has yet to offer exchange-traded contracts. All that is about to change.

The Dubai Gold and Commodities Exchange (DGCX) plans to launch a contract late this year; the Shanghai Futures Exchange (SHFE) hopes to have a contract up and running by the end of 2007; the London Metal Exchange has targeted April next year for a launch; and the New York Mercantile Exchange (Nymex) also is keen to offer steel futures, although it has yet to set a date (see related story, page 6). The exchanges hope to tap the financial world's newfound interest in steel, which has resulted from steel industry consolidation that has made the industry better able to impose price discipline.

In addition to the urge to merge, higher steel prices also have given rise to new demands for capital from the steel industry. But financiers want the industry to use risk-management tools to limit the exposure that greater price volatility has brought. The contracts would allow industry participants to protect themselves from price movements, gain access to cheaper and larger amounts of bank debt and find new ways to turn a profit.

Despite these benefits, the exchanges face tough jobs in ensuring the success of their contracts. Only weeks ago, for example, the DGCX delayed the launch of its localized steel reinforcing bar futures contract for the Red Sea and Arabian Gulf region until "after the summer." The DGCX contract will be trad-

ed on an electronic platform provided by Multi Commodities Exchange of India Ltd., which has already pioneered a regional steel ingot futures contract in India.

John Short, the exchange's executive director of steel and base metals, said the delay was necessary to bring the steel industry up to scratch on how to operate in the new environment. "We as an exchange and our members are completely ready to trade, but a significant percentage of the steel community that wants to trade is not yet technically able to do so," he said. "Arguably, we underestimated how long it would take for the steel community to become technically ready."

And it's not just the steel community that needs time to develop.

"When we launch depends on how quickly we can get the clearing industry to talk steel and how quickly we can get the steel industry to talk futures and compliance," Short said. "This is very new to both sides—the steel community is not familiar with things like daily margin accounts (whereby clearing members reconcile trading accounts on a daily basis) and screen trading."

The head of a large London-based trading house, which intends to trade the contract once it launches, agreed. "What (the DGCX has) developed is great, but it's very complicated," he said. "They've thought this through a lot, but the industry needs time to settle in."

Despite its complexities, the DGCX contract can offer the opportunity for a wide range of steel industry participants to hedge their steel price exposure, Short said. "We've been speaking to some regional industry guys with operations in the Far East facing the same price risk dilem-

ma as their counterparts in the Gulf—one Hong Kong operator has indicated 360-day correlations between his Dubai rebar price and his rebar price in Hong Kong in the region of 90 percent. In theory, this means that they can hedge 90 percent of their price risk using the DGCX rebar contract. We're looking at similar cases for Southeast Asia, Africa and the Indian subcontinent."

Short said that the plans of other exchanges in steel derivatives will help give the market liquidity. "In these early days for the financial trading of steel, new product introductions in aligned but not competing product markets are welcome as they bring with them arbitrage opportunities, and that breeds liquidity," he said.

LME chief executive officer Martin Abbott agreed, saying that there is potential for participants to trade the arbitrage between DGCX's contract and the LME's recently announced Near East billet contract, which has designated general delivery points in southern Italy, North Africa, Turkey's Black Sea Coast and Dubai.

Although the LME's two regional, physical-delivery-based contracts in the Near East and Far East bear some similarity to DGCX's contract, they differ in that the LME contracts will be based on the London exchange's established delivery model.

While the DGCX contract is designed on a "make/take" delivery model (whereby material is supposed to leave the warehouse 14 days after delivery) to avoid inventory buildup, the LME's model will encourage inventories, which, through its closely audited warrant system, will provide an added bonus to producers.

"The LME's warrant is a bankable document and is extremely close to cash for many financing banks. The

physical side of the LME's business is extremely well audited by PriceWaterhouseCoopers," Liz Milan, the LME's project director for steel, said.

"It will soon become apparent to producers that, with this system in place, they will be able to collateralize their output and improve their financing position," Abbott added. "Physical delivery is an integral part of what we do."

For example, by placing billet on warrant at an LME-approved warehouse, a steel producer will be able to raise loans to fund an expansion project. "There is a parallel to be drawn between the launch of this contract and the launch of primary aluminum," he added. "The (LME's) primary aluminum contract sat dormant until the collapse of the Soviet Union, which suddenly found itself with excess domestic supply, driving the contract. There is the same intramarket risk in the (Commonwealth of Independent States-Near East) billet market."

Just as for DGCX, education will be a major factor in the success of the LME's offerings. The LME has worked hard to familiarize the steel industry with the world of derivatives, but the process is far from complete. Nonetheless, it is time to launch contracts and continue the process of education afterward, Abbott said. "The important thing is to have a product there. Once you have a definable product it is a lot easier to convince people to use it."

The LME and DGCX aren't the only exchanges planning steel futures. In China, where the steel industry opposed until recently the introduction of steel futures, the Shanghai Futures Exchange (SHFE) has drawn up physically deliverable contracts for rebar and wire rod.

(Continued on page 2)



“The applications for both products have been filed with the related government departments and we are waiting for final approval now. Once we get approval, we’ll launch (a contract) immediately,” said Huo Ruirong, the SHFE’s deputy general manager. The exchange is widely expected to begin with a wire rod contract.

Perhaps surprisingly, given the reaction of the steel industry elsewhere to steel futures, which range from indifference to downright hostility, the China Iron and Steel Association has done an about-face and now supports the SHFE initiative. But the Shanghai exchange still has a hard task in changing the majority opinion in the country’s steel industry.

“We haven’t decided yet whether we will be participating in futures trading,” a senior executive at Laiwu Iron & Steel Co. in Shandong province said. “For the moment, we don’t (even) trade forward in Shanghai.”

Many steelmakers remain unfa-

miliar with futures and will need to learn fast how futures trading works. “We really have no idea what it is,” said a sales executive at Nanjing Iron & Steel Co. based in Jiangsu province. “Our managers have never (told us about futures) or urged us to get to know futures.”

But the brokerage houses that would handle futures trading remain bullish and predict that with the right education steelmakers will come to understand the benefits. “Mills fear the unknown,” a senior manager at Great Wall Weiye Futures in Shanghai said. “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.”

Like the futures contracts already in place for base metals, the four exchanges’ proposals are likely to prove attractive to the investment community, which could look to trade them speculatively rather than use steel futures as a hedging tool.

However, this is unlikely to hap-

pen immediately and won’t have a negative effect, Abbott said. In order to bring interest and volume to its contract, the LME is looking to become established as the pricing reference for the physically traded merchant billet market and, by extension, for the rest of the billet market. Although the rest of the market won’t be traded, the contracts are intended to become the reference for the much bigger trade in finished products made from billet, especially rebar. Last year, the merchant billet market totaled around 30 million tonnes out of a total 512 million tonnes produced, the LME said.

“Using (the exchange) as a pseudo-physical market will encourage people to go on to use it for simple transaction hedging,” Abbott said. “Only when there’s a huge amount of liquidity will you see financial investment.”

Even when this happens, the steel community will have a major advantage over institutional investors, Short said. “Those in the

steel supply chain are definitely at an advantage because they have a good knowledge of the underlying steel supply chain. Whether any of the contracts are successful could take a long time to become clear. Abbott believes it could take as long as 10 years—Koch’s OTC products only recently have begun to gain traction—and during the initial period the exchange contracts are likely to evolve and foster new launches. All four exchanges have plans to launch further contracts if their initial offerings are successful.

None of the exchanges dismisses the difficulty of familiarizing the steel community with the derivatives community and *vice versa*, although the process has begun and progress has been made. But if the difficulties are overcome, given the size of the physical steel industry—the world’s third largest—it isn’t difficult to imagine volumes traded in the steel futures marketplace surpassing those for base metals.

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Views hot, cold on Nymex's likely 1st step

NEW YORK — The New York Mercantile Exchange is looking at the possibility of introducing a steel futures contract sometime this year that likely will list both hot- and cold-rolled steel coil products.

The contracts would be in 20-short-ton allotments and cash settled monthly following the publication of an index by the index provider.

"It certainly could be some time this year," Bob Levin, Nymex's senior vice president of research, said. "We just think in 2007 there is greater focus in the industry to appreciate the value of this, but there is still a lot of education that needs to be performed."

Hot- and cold-rolled contracts are the leading candidates, he said, because the exchange is familiar with them and there is already a monthly indicator established in the industry. Nymex and World Steel Dynamics Inc. (WSD), Englewood Cliffs, N.J., signed a letter of intent in December to offer the SteelBenchmarker pricing series on the exchange (*AMM*, Dec. 5). Under the terms of the agreement, contracts for U.S. hot- and cold-rolled coil would be cleared on Nymex's ClearPort platform.

SteelBenchmarker is a price discovery system developed by WSD and *AMM/Metal Bulletin*. Twice a month, confidential opinions on spot market steel prices for near-term delivery to mid-size users are offered by mills, traders, distributors and end-users.

"I am thrilled with the number of people and companies who have signed up to provide information. I feel our system is the most robust and accurate since we're getting price opinions from buyers, middlemen and sellers," Peter Marcus, WSD's managing director, said of SteelBenchmarker. "I am hoping the system will serve people as a foundation for huge trading in steel futures. And I believe passionately and logically that steel futures transactions are a triple win for the mills, the middlemen and the buyers."

Since its debut in April last year, SteelBenchmarker has published U.S. prices for hot-rolled band, cold-rolled coil and plate on the second and fourth Wednesdays of each month.

But Charles A. Bradford, president of Bradford Research/Soleil Securities Inc., New York, thinks a steel contract also needs to have some type of long product. "I think there also needs to be a long product like rebar," he said. "The problem with cold rolled is that it tracks hot rolled very closely. If you look at where there is more liquidity in the market, I would have thought there was more in rebar than cold rolled."

Using an index-based system wouldn't necessarily preclude contracts from being physically delivered as counterparties can agree to settle contracts physically, Nymex said.

Establishing a global price for steel has been met with skepticism by some industry participants because of regional differences between products.

Nymex is looking to use a Midwest price for hot rolled and cold rolled. "In terms of the Midwest price, it's the one we believe the world tends to look to, so this is the one that has the best chance of success," said John Conheeny, Nymex's director of metals marketing. "Establishing a global price would depend on the product. Maybe a global price for scrap might make sense. But the price difference between Asia and the U.S. is pretty significant in hot rolled."

If the contracts are a success and volume builds, Nymex said it would look to potentially launch other products, such as rebar, billet or scrap. "There is demand to use it," Levin said. "But to begin with it's probably like any new market in the sense that there is not an overwhelmingly large amount of volume but enough interest and a growing interest to sustain it and ultimately become a very important type of instrument."

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Steel futures on growth track but impact is all guesswork

NEW YORK — Steel futures trading is expected to be launched in several venues, but how quickly the risk-management tools catch on among steel sellers and buyers is still the subject of speculation and uncertainty, according to a panel of steel traders and exchange executives at the Steel Success Strategies XXII conference in New York co-sponsored by AMM and World Steel Dynamics (WSD).

Peter F. Marcus, managing partner of Englewood Cliffs, N.J.-based WSD, who moderated the panel, asked if it was a “wildly, wide-eyed view” to expect trading of steel futures contracts between different exchanges, regions and products to vastly exceed steel production within three or four years.

“I believe sooner than expected we are going to see 30 times what’s produced in steel trading on futures exchanges. That’s 30 billion tons a year,” he said. “I am an optimist. We’ll see it.”

Martin Abbott, chief executive officer of the London Metal Exchange, said that the scenario was not one that he would put to the exchange’s board of directors, but added, “I would very happy if it

turned out to be correct.”

Abbott said the LME had identified about 30 million tons of “free-market delivery” steel that could be used in justification of the steel billet contracts the exchange has announced it will launch next April. He said the total pool of billet produced around the world was about 480 million tons last year.

“I think you are right that there is a huge appetite out there, but there is also a lot of skepticism, a huge amount of skepticism,” he added. “It’s going to take a little bit of time.”

Jeffrey M. Kabel, vice president of Koch Metal Trading Ltd., London, which has been trading over-the-counter swaps for steel risk management for several years, said his company had calculated on the basis of 100,000 to 200,000 tons of steel prices were negotiated based on indices as little as three years ago. Now, he said, that number has grown to what Koch has verified as 10 million tons of steel. “We’ve seen a heck of a lot more steel, particularly in North America, negotiated with an index price hike,” he said. “We see that growing.”

Robert A. Levin, senior vice president of the New



MARTIN ABBOTT

York Mercantile Exchange, which is eyeing the introduction of steel futures trading in the near future based on an index, also said those figures are likely to expand. “I think it’s only going to grow and it’s going to grow considerably, but it won’t all be futures,” he said.

Also seeing strong growth prospects for steel futures was Nasser Alaghband, chief executive officer of British steel trader Balli Steel Plc, who said fund interest in commodity trading could grow to \$50 billion in the next couple of years from \$20 billion. “I think the development of steel futures could be quicker than . . . people are anticipating,” he said.



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The success of the contracts depends on them being actively traded, but Alaghband was bullish on the prospects. “It’s not a question of if but when liquidity is generated,” he said. “In 1990, there were around 20,000 contracts traded in aluminum futures. In 2006, that increased nine times to almost 180,000 contracts per day.”

The steel industry should not be concerned that those who might trade steel derivatives as an investment tool could disrupt the market, according to Alaghband. “Supply and demand will still play the big role” in how prices are formulated.

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Critical info on steel futures hasn't reached the trenches

To the Editor:

I appreciated the detailed June 19 story regarding the status of steel futures. After 35-plus years in the steel industry and now responsible for purchasing steel products (flat-rolled, long, stainless, tubular), I'd like to share some comments.

Someone needs to clearly explain just what advantages/benefits hedging/futures will provide, other than "protect themselves from price movements, gain access to cheaper and larger amounts of bank debt and find new ways to turn a profit." Right now, I try to do the first item through diligent following of the industry itself, reliance on past experience and contacts, and also regular and fervent prayer.

However, until someone does a "Steel Hedging for Dummies" most of us (buyers and producers) will be left with the impression that someone will make lots of money in this endeavor, but it ain't likely to be us buyers and producers. Remember, this has to be something that I/we can take to senior staff and say, "This can save us X amount of money each month," rather than

"This may help us control steel costs," to which the question would reasonably be asked, "Isn't that why we hired you?" I loved the comment from a Nanjing Iron & Steel executive: "We really have no idea what it is."

Credibility will need to be not only established but guaranteed. Who or what makes sure that X amount of steel product is deliverable at X price? And how do things like *force majeure* impact the arrangement?

The last thing I need is to have extensive legal counsel involved just to participate (would I have to bring up that cost as well to senior staff?). Hedging/futures for steel still smacks of the Wild West (or East/Mid-East?) at this point. As you point out in the story, "... the (Dubai Gold and Commodities Exchange) faces a tough job in ensuring the success of their contracts." And they delayed the launch of their localized steel reinforcing bar futures contract. My, that gives me a warm, fuzzy feeling.

This sounds like a derivatives/financial trader's dream come true: money to be made by arbitrage, no physical commodity

required and no other selling points other than "improved liquidity, less volatility, pseudo-physical market, etc." Again, it sounds like a "bird in the hand" for traders and "you find if there are any birds in the bush" for the steel buyers and producers.

In summary, this looks like it has a long way to go and many details to iron out (I didn't even mention things such as "the applications for products have been filed with the related government departments and we are now waiting for final approval." Great. Individual governments will be involved as well. Yes, I know I should have guessed that). In the meantime, though, I suppose I will be hearing comments from senior staff regarding the sexiness of steel futures and "Why aren't we doing this?"

As for now, my thinking simply echoes the proverb: "Change is great. You go first." I want to see some concrete dollars and cents and real steel products being delivered (in this decade) per contracts and why this makes total cost sense before ponying up the company's shekels.

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Futures contract could soften blow of steel pricing volatility

To the Editor:

Please allow these comments to serve as a response to Barry Lauer's Letter to the Editor (*AMM*, June 22) on hedging steel prices with financial contracts.

Prior to 2004, the lawnmower manufacturer with an annual contract with Wal-Mart, the automotive door panel provider with a model-year contract and the contractor bidding on the construction of a new office complex all locked down their steel costs, either directly or indirectly, through long-term pricing agreements with steel mills.

This process began to unravel when hot-roll prices doubled in the first half of 2002 because of the threat of 15-percent Section 201 import tariffs drying up the foreign steel pipeline. Steel mills gave back some purchase orders and failed to deliver others in an attempt to avoid missing out on the much-needed increase in revenues.

The death blow for contract pricing with a mill came when hot-roll prices tripled from the fall of 2003 to the fall of 2004 because of China's enormous increase in consumption. U.S. mills boldly added surcharges to their contract prices to achieve this dramatic price increase, all the

while maintaining they had honored their original contract agreements. This caused enormous cost overruns for steel users committed to providing a fixed-price product to their customers.

Steel consolidation has given the mills the backbone to say that they will no longer bear the risk of long-term price agreements without a built-in adjustment for cost fluctuations. The net result has been to leave steel users without a viable means to lock down total steel costs for extended periods.

Steel hedging provides steel users the ability to offer fixed-price contracts to their customers. Utilizing futures for any other reason is not hedging, it is simply speculating on the part of the buyer, betting that they can out-guess the market. If your customers don't need their prices tied down, don't play in the futures market.

Craig Bouchard, Wheeling-Pittsburgh Corp.'s vice chairman and president, is correct when he says, "There has to be an underlying piece of steel somewhere. The underlying component adds the tangible, measurable guts to a product that is traded across the world. And a synthetic can be manipulated with bad information.

The synthetic, I don't think, will have the confidence with the real derivative players." This was most evident in November 2004, when CRU International Ltd. and *Purchasing Magazine*, two of the world's most respected steel indices, published hot-roll prices with a \$74-per-ton difference. This became a \$740,000 difference of opinion on a 10,000-ton hedge.

The only way to avoid this problem is to base all transactions on only one index. This is essentially what the aluminum industry has done with the London Metal Exchange. Virtually all purchase prices are based on LME plus or minus some factor. That is why Nucor Corp. chairman, president and chief executive officer Dan DiMicco says steel futures will allow the financial markets to set steel prices rather than steel mills.

Lakshmi Mittal, ArcelorMittal's president and chief executive officer, is absolutely correct when he says that steel futures will not curb price volatility. They won't. They might even make it worse. They simply will allow users the opportunity to avoid the impact, plus or minus, of that volatility. That is a benefit worth pursuing.

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