

Argus White Paper: How spot steel pricing could help European industry

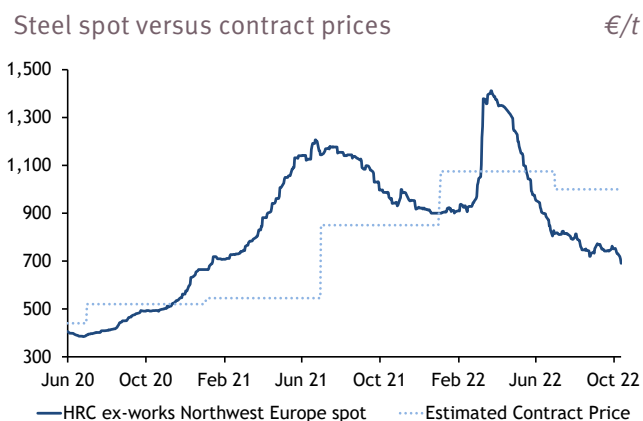


European hot-rolled coil (HRC) markets have for some time operated on a combination of long-term contracts and list prices issued by major producers. A low cost-to-bulk ratio and a lack of standardisation of grades have prevented the evolution of physically delivered futures, such as those for base metals on the London Metals Exchange (LME). This has meant a lack of price transparency and limited means of managing price risk.

Historically, this did not matter much, when the model operated in harmony with annually fixed input costs in a more stable world. But the move to shorter-term raw materials pricing combined with increasingly regular black swan events, which cause prices to spike like never before, mean that the old model becomes more unworkable every year.

Steeling for transition

How steel is priced affects the whole supply chain. As Europe embarks on an enormous build-out of renewable energy capacity, the continent's producers of wind turbines and other essential installations have been battling stiff Chinese competition and high input costs, often locked in on long-term contracts, or exposed to volatile prices over an extended period. Steel accounts for 90pc of an average wind turbine.



Steelmakers themselves, meanwhile, are struggling to fix term contracts with their huge automotive customers in an environment of rapidly moving prices, regularly leaving millions of euros on the table. Mills will embark on January-June 2023 contract talks with their service centre buyers in the next few weeks, trying to defend a rollover from July-December levels, of around €1,000/t, while spot values sit below €700 (see chart below).

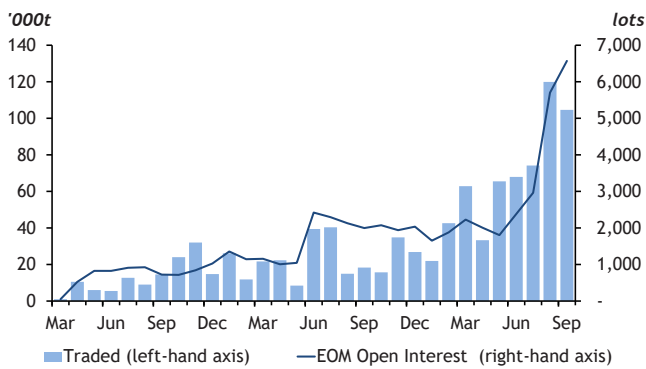
A wide range of published spot prices do exist for steel. And alongside them, a growing market in steel futures, settled against a daily index published by *Argus*, a price reporting agency (PRA).

Slowly but steadily, producers and consumers are starting to integrate spot price references into contracts as a means of absorbing price fluctuations. Greater numbers are hedging prices forward using futures. Indeed, over August and September, volumes on CME steel futures soared, in part owing to a surge in hedging activity through the wind turbine supply chain (see chart next page).

PRA's are independent companies assessing the price of key commodities through surveying market participants. *Argus* assesses its steel prices by gathering information on concluded spot transactions and other market data and calculating a final daily price based on a published methodology.

The strength of the PRA approach is particularly evident in opaque markets such as steel and its raw materials, where there is no such thing as a "pure" or standard reference product, and no traded exchange price. Steel comes in all shapes, sizes and grades. Warehousing to support a physically settled futures contract has been tried and failed. Reference prices published by industry associations risk being viewed as partisan.

European HRC futures volumes (CME)



Spot and future

The *Argus* northwest European HRC index reflects the tradeable spot price for S235 grade HRC in the Ruhr region, delivered within 2-8 weeks. More than 60 companies contribute to the daily price, which reflects the spot price of the day — a market average of transactable prices.

The futures contracts in the EU HRC space are cash-settled contracts settling against the average of the index, rather than the traditional LME contracts such as copper and zinc, which can be settled by delivery of pure metal to a warehouse. As such, a front-month, or three-month, HRC price on the exchange merely reflects market expectations of where the *Argus* spot price will average — not the price for delivery of a physical product — in that period.

Using Argus prices: Locking it in

As volatile steel prices rattle the supply chain, the simplest risk-mitigation strategy is to add cost escalation clauses to long-term agreements. These might stipulate a renegotiation or agreed adjustment should the spot index deviate too far from an agreed price.

Contracts can also directly “float” against an index, allowing the price to fluctuate in line with steel spot prices. The product in question may not be S235 grade. It may not even be HRC. But allowing a float against index, even if imperfectly correlated, means that volatility in the underlying steel price — the key variable — is captured. Differences in quality can be captured with fixed premiums or discounts.

In index-linked arrangements, negotiations become easier. Rather than trying to guess whether steel prices will soar or crater over the coming six months, discussions can focus on the premiums or value-added service. Floating contracts are less likely to require one party to attempt renegotiation halfway through the contract term, as they will follow the market.

The *Argus* northwest European HRC price is the settlement basis for two futures contracts — one on CME, settled in euros, and another on LME, settled in dollars. As both settle against the monthly average of the *Argus* index, using index-linked physical pricing — linking physical trades to a monthly index average — in conjunction with a futures position allows a perfect future hedge, effectively locking in a price (or margin) well in advance. The principle has a very familiar precedent in the iron ore market, where this practice is commonplace.

As prices fall, steel buyers should be looking at the forward curve for opportunities to secure lower input costs. Producers can take advantage of rallies to lock in higher sales prices. Traded in conjunction with iron ore, coking coal and energy futures, profit margins can be guaranteed in advance.

Mills in China and the US already have liquid futures markets and widespread indexation, as well as benefiting from cheaper energy. As Europe struggles with costs, its industry should make use of the tools available to it.

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