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Argus White Paper:

Daily pricing key as case for steel indexation strengthens

Indexation is surprisingly uncommon in the European hot-rolled coil market, given the price risk endemic throughout the supply chain. Where it does occur, it is usually against a price set monthly. In this White Paper, Argus explains why a daily index is the best tool for risk management — even for monthly pricing

Fixed-price legacy

Automotive companies value stable input costs. Long after the transition of iron ore to a spot-based index price, mills continue to sell long-term fixed-price steel into the automotive supply chain, sometimes even in the absence of raw material escalators. Some may hedge their raw material exposure in future markets, but by no means all.

Automotive tier-suppliers often buy on an index-linked basis from their suppliers, but then sell to original equipment manufacturers on fixed-price terms, providing another price risk choke point.

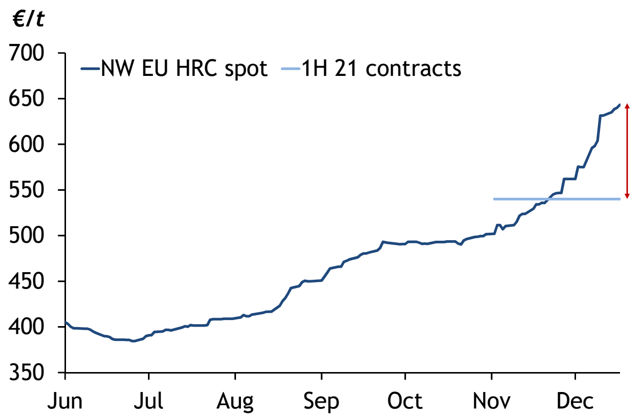
Under stable market conditions this may not matter. But soaring spot prices in the past few months have exposed tensions, showing parallels to the trends that ushered in indexation in steelmaking raw materials a decade ago.

Fixed-price steel supply contracts that were signed in November between mills and service centres/cold rollers for January-June 2021 look incredibly cheap – equivalent to €100/t below the *Argus* Northwest Europe hot-rolled coil (HRC) benchmark. At least one major European steelmaker is now trying to renegotiate recently struck fixed price automotive contracts, citing the rapid escalation in raw material costs.

Indexation in the south

The more volatile Italian market sometimes references index prices. But these are often set monthly, obscuring the often-large intraday price swings during the month, while affording too much influence on a single published index for the period.

Missed upside



Argus' daily Italian HRC index has jumped by more than €150/t since the start of November, with multiple large daily increases. The daily northwest European HRC index has strengthened by more than €140/t over the same period. Daily moves have come close to touching €30/t. With such volatility, even a price published weekly would struggle to keep pace, let alone monthly.

Indeed, a price set monthly can often end up offering little more security than a fixed price. So it is unsurprising that in Italy a few months ago one large producer cancelled most of its monthly index-linked contracts as supply tightened and it became clear that spot market momentum was building. If the contracts had been linked exactly to the *Argus* monthly average for December, for example, the mill would be €58.50/t better off than using the monthly index. Buyers would be paying more, but not scrambling for supply after contracts were cancelled.

Daily averaging: Spread the risk

The benefits of using an index lie in averaging daily prices across a period of volatility. The average could be calculated weekly, monthly or even quarterly. But this captures all daily movement and limits the impact of any day's published index, instead averaging the final settlement across the number of pricing days in that period. There may be no obvious winners, but also no clear losers.

Under any agreement there is always a risk that the buy- or sell-side will renege on a contract. It is European steel's inherent hedge. But should the contracts be linked to the monthly average of a daily index, this risk is reduced. Provided indexation occurs using the right market average, it enables trade to continue in rising and falling markets. It facilitates strong relationships between buyers and sellers as it reduces the need for protracted negotiations that ultimately lead to a lot of time that could have been better spent elsewhere.

Using an index itself reduces risk to an extent. Most service centres are concerned that the high-priced tonnes they are buying now will arrive in a weaker market, immediately meaning a loss that they have to offload at cheaper sheet prices. Rather than buying at a fixed price, they could purchase against the monthly or quarterly average of *Argus*' index. Material booked for April, for example, could be priced at the index average for the month of delivery. Should the market weaken, buyers have not thrown away money at today's expensive spot prices. Should it increase, they still get their material.

Futures: Next-level hedging

Averaging against a daily spot index is a simple hedge that guarantees an average market price for the given period. For experienced procurement or sales managers priding themselves on their ability to find the best prices, this may sound deeply uninspiring. Here, there are two points to be made.

The first is that index-linking can be done as little or as often as appropriate, applying to the entirety of a book or just a small proportion. It does not mean the end of the art of negotiation – simply additional optionality. If a buyer needs to secure tonnes but thinks prices are headed south, buying at the delivery-month index average might be better than waiting to call the bottom. And if spot prices appear to be rising, a fixed-price deal might be preferable.

The second point is that there are now financial tools available that offer opportunities to lock in attractive forward prices when buying or selling against an index. CME Group offers a cash-settled futures contract that settles against the *Argus* index for northwest European HRC. Using the same index to price physical cargoes would mean a perfect hedge and enable forward visibility for as-yet-unsettled transactions (for example, if cargoes are priced against a January or February arrival month index average). Choosing the right future price to lock in is still a skill requiring market know-how.

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