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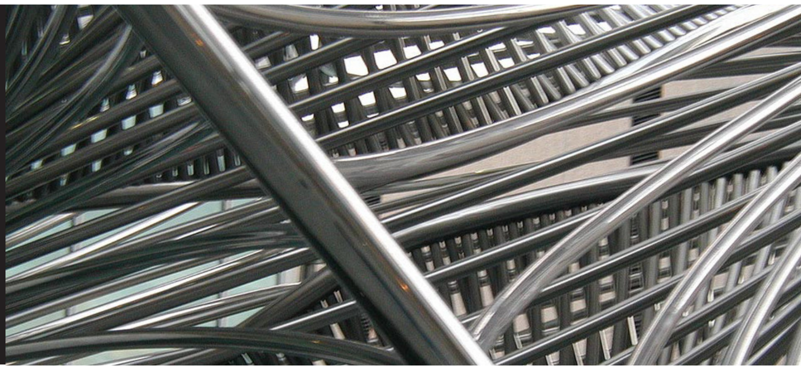
Argus White Paper:

The future of European HRC pricing



Stuck between an expensive rock — iron ore — and a hard place — the finished steel market — European steelmakers are becoming more creative and flexible in their pricing mechanisms.

European steel mills offered to transition half-year contracts to quarterly contracts over July-December, in response to the €50/t reductions sought by buyers after a substantial drop in spot prices from the fourth quarter of last year. *Argus*' headline northwest Europe hot-rolled coil (HRC) index had fallen to €474.75/t on 15 July from €535/t on 12 November 2018, as a decline in automotive demand rippled through other sectors and led to an intense bout of destocking over the first half of this year.

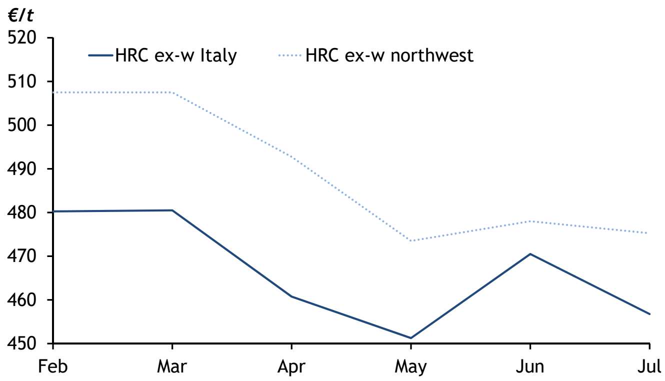
Steelmakers expect selling prices to rise in the fourth quarter, supported by production cuts, the EU's amended steel safeguard, a hoped-for normalisation in automotive demand and higher costs. The softening in steel prices and steep increase in iron ore prices has created a huge margin squeeze for blast furnace-based mills, putting them in an unsustainable position — at least €100/t has been shaved off margins since November, leaving mills in similar territory to where they were after the 2008-09 global financial crisis.

Third-quarter supply was offered at around current spot prices, plus or minus €5/t, compared with half-year contract pricing of €500/t. Ostensibly, buyers were expected to pay a premium of €20-25/t to secure supply for July-December, compared with the third-quarter offer. And most buyers acquiesced, primarily because they wanted to keep their purchasing programmes on the same terms as downstream sales contracts, particularly in the automotive sector, where original equipment manufacturers demand longer-term visibility.

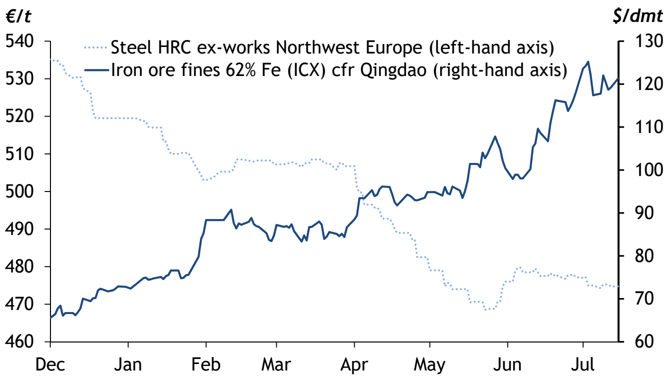
The European steel coil supply chain is heavily relationship-based, and price is not always the determining factor in negotiations, unlike in some other ferrous markets. But amid similar tension, the old annual iron ore benchmark talks quickly disintegrated to a quarterly, monthly and then spot basis, as mining firms — led by UK-Australian company BHP — realised they were leaving money on the table. And when spot prices were favourable to mills, they would renege on contractual supply and buy swing Indian product instead of their contracted volumes, or resell the latter on a spot basis, if spot prices were higher.

The European coil market has not reached its iron ore moment yet, but it has edged closer. Some customers buy on frame-

EU HRC monthly averages



Northwest EU HRC v 62pc Fe iron ore



Metals
illuminating the markets

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work agreements, where changes in monthly or quarterly contract pricing mirror the monthly change in a published index. But these are susceptible to the index not reflecting the latest developments in the physical market, either by failing to keep pace with the direction of price change or even moving in a different direction.

This has happened quite regularly in the UK ferrous scrap market, where participants focus heavily on the monthly change and often report this figure rather than underlying value.

Index-linking finished steel prices, primarily HRC, in the automotive sector would replace the raw material-linked clauses that were first signed several years ago as mills looked to pass on increasingly volatile iron ore and coal costs. These clauses meant a contract could be automatically or manually amended should costs fluctuate outside a certain range, often 10pc higher or lower. Some automakers sought to hedge their steel exposure through raw material swaps — carmakers typically buy half-year volumes on a fixed-price basis. But the correlation between iron ore and HRC is now tenuous, and this is not a perfect mechanism for pricing physical steel.

By properly linking to a physical steel index, buyers reduce risk, ensuring prices move in line with the market. Index-linked contracts make up a small percentage of European volume, according to steelmakers. But a large European mill has fully index-linked its HRC supply agreements with another steelmaker based on monthly Italian and German reference prices.

And some end-users are displaying more desire to use price indexes and avoid protracted contract talks with their suppliers — end-users are often less concerned with "beating" the market than service-centres and mills. The lengthy discussions between mills and buyers this year might also lead to some participants rethinking the value proposition of index-linking, given the man-hours lost to the extended negotiations.

The US market relies heavily on indexes, with most buying based on a discount to published reference prices. European buyers that also have operations across the Atlantic have tried to port over this practice, and say there is more openness to indexes today.

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