LME Steel
Providing price risk management tools for the steel industry
Why is the LME the right place for steel futures contracts?

Experience
The London Metal Exchange is unrivalled as the world’s premier non-ferrous metals market and is used as a reference price by over 98% of the world’s physical metals trading, generating an annual turnover of 8.1 trillion USD with traded volumes exceeding two billion tonnes.

In 2006, LME Turnover was over US$ 8,129 Billion (US$ 8.1 Trillion)

This equates to approximately:
- US$ 677 Billion per month
- US$ 34 Billion per day
- US$ 1.5 Billion per hr (24 hour day)
- US$ 25 Million per minute
- US$ 420,000 per second

The Exchange has proven relationships within the metals and financial communities, having successfully provided a transparent price, and a forum for price risk management, to the global metals industry for the past 130 years.

Given this enviable pedigree, the Exchange believes it has the capabilities, resources and proven relationships within the metals and financial communities, to deliver credible and market driven risk management tools for the steel industry.

A regulated environment
Providing a secure and well regulated environment is fundamental to the success of the Exchange and this would be no different for steel. The LME has a statutory requirement to ensure that business on its markets is conducted in an orderly manner; it is a Recognised Investment Exchange (RIE) providing robust protection to investors. Regulation of the market is largely carried out by the LME, while the Financial Services Authority (FSA) is responsible for regulating the financial integrity and conduct of the LME members’ business.

Worldwide participation
While the LME is based in London, it has a global reach and perspective through its member firms who are the only organisations able to trade directly on the Exchange. Trading spans all geographies, and deals are brokered by members 24 hours a day either in the Ring by open-outcry, by inter-office telephone or electronically via LME Select. As well as Europe, the LME is well positioned to cover the trading zones of the US and Asia through its position in London.

Industrial tradition
The history, structure and operations of the LME are unique in comparison to other financial exchanges and markets. This uniqueness is based on strong relationships developed with the non-ferrous metals community. By working closely with the steel industry, the Exchange is building on the success shown in the non-ferrous market, by providing a valuable service to a whole new industry which currently has no risk management tools.
The case for steel futures

Steel - a changing industry
The futures and options markets in non-ferrous metals, as well as in agricultural and energy commodities, are widely used, with prices fully accepted and embedded in standard industry practice for all parts of the supply chain. For steel, however, the benefits of a futures market; its transparent pricing, risk management tools and delivery mechanism, have yet to be realised.

Steel is a vital infrastructure component and is an industry of immense global proportions, with diverse products and applications. The specific nature of the industry creates significant and far reaching challenges for all those involved within it.

The industry has undergone radical restructuring; it has become more global, more efficient and more financially viable. Market conditions have resulted in high prices, supply disruptions and increased business volatility. The market has responded to this volatility in a number of ways, with consumers constantly looking for other ways to mitigate their price risk. These include the establishment of ‘variable cost contracts’, the use of surcharge mechanisms and the increasing use of ‘over the counter’ derivative products. But many of these options also bring with them a new set of issues and risks, which need to be considered by all concerned.

Significant portions of the steel industry now see the need for increased transparency in the discovery and publication of prices, a solution is required to provide all parties with access to tools which enable them to better manage their price risk, better manage their cash flow and therefore, more effectively predict profits.

The introduction of exchange-traded derivatives would bring all of these advantages, with the added benefit of price transparency through a forward price curve out initially to 15 months, i.e. allowing for exchange trading for more than a year forward.

The LME steel billet contract is additionally interesting as it can potentially correlate with other parts of the steel product complex, most importantly with the scrap sector.
Industry support
The LME has received support for the development of steel futures from a number of producers, re-rollers, merchant traders, the construction industry and also LME member firms.

Industry support and involvement is vital to the success of any LME contract. Unlike many exchanges, the LME designs futures contracts to address particular industry needs, and consequently, industry input and feedback plays a major part in any contract development, before and after launch.

Market Potential
Steel billet is a growing market and has experienced production growth of circa 40% since 2000, with analysts suggesting a further 32% growth on today’s annual production of 512 million tonnes by 2010.

Market intelligence suggests that merchant traded billet amounts to circa 30 million tonnes per year which, in terms of size, is comparable to some of our non-ferrous metals contracts.

How to use the LME steel billet contract

Hedging - Protection against price movements
Hedging is the process of offsetting the risk of price movements in the physical market by locking in a price for the same commodity in the futures market. In hedging an organisation is able to lock in an acceptable forward price, this may mean it forgoes windfall profits, but it equally protects the organisation against any windfall losses and enables it to decide on the amount of risk it is prepared to accept.

Hedging is a parallel activity to the physical purchase or sale of material, the on-exchange activity does not replace the industry’s normal channels for the purchase and sale of steel, indeed this is not their purpose. In the vast majority of cases it is used simply as a financial tool to manage price volatility experienced in the physical market.

For hedging to be successful, however, all pricing within the supply chain should be undertaken basis the LME price. This will achieve the most efficient hedge and support the requirements for hedge accounting standards.

Collateralisation - Receive a cash value for your stock
In times of market surplus, or with a stranded parcel of billet, the merchant or producer can, via an LME member firm, sell and deliver into the LME registered warehouse and will, within two days, receive cash, the price as determined through trading on the LME.

Alternatively the merchant or producer is able to finance his billet stock by delivering into an LME registered warehouse, via the LME member firm. On delivery an LME warrant is generated for each lot (65 metric tonnes).

An LME warrant is a bearer document of title, globally recognised in the financing world as a completely reliable, robust and secure document, which finance banks are consequently able to use as the basis for finance terms. The LME warehouse system is regularly audited both by the LME executive and by third party auditors to ensure that its integrity is maintained.
Price correlation - Able to offer long term fixed-price contracts

The LME has researched publicly available price correlations on CIS, Turkey billet, rebar and scrap which suggest a 95%+ price correlation over a ten year period. Publicly available figures also suggest a similar level of correlation can be found in the Far Eastern contract.

This level of correlation suggests that it would be possible for merchants/traders to hedge their scrap, billet and rebar purchases against the LME benchmark billet contract. The potential for such price-risk hedging creates the possibility for offering fixed-price contracts to their customers. This practice is common in the non-ferrous industry.

In specific relation to rebar, the ability to hedge price risk could create for merchants/traders the potential to offer long term fixed-price contracts to their customers in the construction industry, which could create an opportunity to tender for long term construction projects well beyond the current three month model.

Benefits of hedging for a Merchant / Trader:

- protection against price movements
- ability to offer long-term fixed price sales
- the opportunity to swap physical material on a location and brand basis
- the chance to gain a competitive edge
- protect physical stock against a fall in price
- better forecasting of costs and profits
- collateralisation
- access to a transparent reference price

The LME core services

Pricing - Real transactions creating a transparent and credible price

One of the principal functions of the LME will be the discovery of prices which the steel industry can use as a reference when pricing physical transactions. The LME does not control or fix the prices which it publishes, and nor does it seek to. In fact, LME prices are the result of daily trading activity on the Exchange, channelled through the LME’s member firms, and therefore representative of real transactions between buyers and sellers.

The LME has no material interest in whether prices are high or low, its primary concern is that they are discovered in an orderly and transparent manner, in accordance with the Exchange’s strict market regulation. In its simplest form the LME’s function is to help to find the price at which one party is prepared to buy, and the price at which one party is prepared sell.

One of the most significant differences with an LME price, compared to a poll-based price reference currently used by the industry, is that LME prices are based on real transactions, not simply a perception of where prices are or might be in the future.

Another key difference is the concentration of liquidity, which means the number of buyers and sellers in the market. As with most other markets, the most accurate prices are generally those which involve the greatest number of buyers and sellers, and which are most representative of the supply and demand dynamics for that particular commodity.
The option of physical delivery - Aligning the Physical market and the LME price

The option of physical delivery plays an important role in creating price convergence between the LME price and the physical market price. This effectiveness of this mechanism means that if the LME price appears too high or too low, those in the market will see a favourable pricing opportunity and make use of the delivery mechanism, ensuring that the LME price is always in line with the physical market price.

The market does not replace the normal channels for the buying and selling of metal, and only a very small proportion of contracts actually result in delivery.

As the LME delivery system relies on a user being guaranteed a specified quality of material, wherever they take delivery in the world, the Exchange also approves brands of metal. Approved brands can then be delivered against an LME contract.

In order to support the delivery mechanism, the Exchange has a unique, international network of warehouses that it does not own but, which work to the exacting and uniform specifications of the LME, regardless of where they are located. It is the LME’s deep knowledge and experience of international physical delivery, built up over its 130 year history, which makes it the most viable of Exchanges for a steel contract.

Access to the LME

Any organisation wishing to access the risk management or delivery services of the Exchange must do so through an LME member firm. There are various categories of membership and an organisation’s choice will depend entirely on the services required and the desired level of interaction with the market.

The LME provides the flexibility of three trading platforms, which operate side-by-side:

Ring trading
1145 to 1700 hours, London Time
Open-outcry is the oldest and most popular way of trading on the Exchange. It is central to the process of ‘price discovery’, a term used to describe the way LME official prices are established. These prices are derived from the most liquid periods of trading: the short open-outcry ‘ring’ trading sessions, and are most representative of industry supply and demand. The official settlement price, on which contracts are settled, is determined by the last offer price before the bell is sounded to mark the end of the official ring.

LME Select
0100 to 1900 hours, London Time
LME Select is the official Exchange-operated electronic trading platform. LME member firms are connected to the LME Select system which allows accredited traders to execute trades electronically. It allows for straight-through processing in which LME Select trades are automatically sent to the matching and clearing systems operated by LCH.Clearnet. The system also enables LME members to connect their clients directly to the LME Select trading system via third party applications, a process known as ‘order-routing’.

Telephone trading
24 hours a day
The Exchange also supports an inter-office telephone market between LME members which operates 24 hours a day.
How do I get involved?

For those interested in getting involved, there are a number of next steps an organisation can take:

**Contact an LME member firm directly**

LME member firms are very familiar with the process of opening new client accounts and will guide any prospective users smoothly through the various processes. A list of LME members is included at the back of this brochure and available on the LME website at [www.lme.com](http://www.lme.com)

**Contact the LME Steel Team directly**

- Liz Milan – Steel Business Manager (liz.milan@lme.com)
- Lotta Ulfsdotter – Steel Market Executive (lotta.ulfsdotter@lme.com)
- Martin Evans – Steel Analyst (martin.evans@lme.com)

Email: info@lme.com
Tel: +44 (0)20 7264 5555
Fax: +44 (0)20 7680 0505

The London Metal Exchange Limited
56 Leadenhall Street,
London,
EC3A 2DX, UK

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[www.lme.com](http://www.lme.com)

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