

World Steel Dynamics (WSD) is a leading steel information service in Englewood Cliffs, N.J. WSD's steel experience, steel database and availability of steel statistics are the principles for performing steel forecasts, studies and analysis for international clients. WSD seeks to understand how the "pricing power" of steel companies the world over will be impacted by changes in the steel industry's structure. To submit your questions for WSD, e-mail WSD@aist.org.

The Pendulum of Trust: Smiling While Preying on the Other Side!

"The Pendulum of Trust" is WSD's depiction of the level of confidence and collaboration in steel buyer-seller relationships. When the Pendulum is at the center, the level of confidence and collaboration in buyer-seller relationships is at its highest. The longer the Pendulum remains at either extreme, the more the relationship confidence becomes strained and collaboration diminishes. The disadvantaged party is being increasingly preyed upon, and the advantaged party, in its greediness, may not be sufficiently mindful of the long-term adverse consequences.

Perception of reality often lags the change in reality in this world of psychological warfare.

(Note: This month's WSD article is authored by Pat McCormick, managing partner, in charge of WSD's Steel Stratagem Consulting Service.)

While attending AISTech 2007 in Indianapolis, Ind., I learned a number of things about the AIST organization. Some of my positive observations are listed below:

- The level of cooperation and volunteerism of AIST members to advance the steel industry was inspiring.
- Member recognition of the need to attract new talent to the steel industry was great. Discussion included the need to better advertise the career benefits of the steel industry.
- The sharing of ideas, knowledge and success stories between members and other attendees was widespread.
- A strong level of customer/seller trust was evident in the technical cooperation and interdependence between steel producers and their suppliers.

My one negative observation was that steel buyers (the ultimate customers) were not well represented at the AIST meeting. I left the conference contemplating how much more steel industry success could be achieved if the "steel mill to customer" relationships were as interactive as the "supplier to steel mill" relationships that I observed. More productive mill-to-customer relationships are needed if domestic supply chains are going to meet the growing challenge from global competition. It is critical to increase the speed of applying new steel process and product technologies to improve the cost, service or features of steel-containing products.

Many customers are still struggling with the global steel industry changes that have occurred over the last several years. Pricing power has significantly shifted into the hands of steel producers, allowing the pass-through of ever-higher and more volatile raw material costs. The planning of steel supply and steel budgets has become much more difficult. Delivery dates and quantities have become less reliable. To compensate, customers often make spot buys and double-order to assure supply is timely. The resulting supply chain conundrum



is that the competitiveness of steel-containing goods suffers, as too much attention is given to tactical issues and too little attention is given to value creation within the supply chain.

Note: In this article, "value creation" is defined as actions undertaken collaboratively by buyers and sellers independent of the negotiated price of steel. The target is to reduce the cost in either the production or application of steel products, and to find enhanced value enabling design changes or improved features of the final product.

"Pricing power" shifts between buyers and sellers are not new to the steel industry. What has changed is the length of the current run of seller pricing power – this has not been observed since the 1970s. Prior periods of prolonged seller pricing power were observed from 1947 to 1960, when mills had dominant pricing power, and from 1961 to 1979, when mills had significant pricing power. Even though prices have had mini-cycles within each of the last four years, the price trend has remained up, and the lowest price observed in each mini-cycle was higher than the previous dip. High growth rates of global steel demand, capacity rationalization and improved mill operating discipline have prolonged the shift of pricing power to sellers. The longevity of the pricing power shift to sellers is fortuitous, given the need for mills to pass on escalating raw material cost.

Raw material costs have escalated with the higher growth rate of global steel production. China continues to increase its massive imports of iron ore. In 2006, China imported 60 million more tonnes of iron ore than in 2005. This year, China has already increased its iron ore imports an additional 31 million tonnes (23.2%), January through April 2007. China's high demand of ship-borne iron ore supplies keeps the supply-and-demand balance very tight, even though additional iron ore mining capacity has already come on-line. Additionally, marginal-cost pig iron facilities around the world have been re-activated due to the increased need for metallics. This, in turn, has permitted scrap prices to reach higher peaks, in that the marginal capacity is no longer available to enter the market during price run-ups.

Steel buyers were not prepared for the magnitude, the volatility and the duration of the pricing power change to sellers. I still hear hopeful comments from customers that the current steel price environment is not sustainable. In the prior period, steel buyers had become accustomed to year-over-year price reductions, long-term fixed-price contracts, and steel availability that was seldom in question. A consequence of prolonged buyer pricing power is that successive price reductions allow some steel buyers to become complacent on value creation. It is also noteworthy that, during this period, China's steel prices were higher in comparison to North American and European steel prices. China was a net importer of steel until 2005, when its steel capacity expansion began to exceed steel demand growth.

The new pricing reality in North America and Europe is that steel prices are higher and have recently been more volatile than China's steel prices. Non-Chinese steelmaking has a much higher percentage of EAF capacity than China. In 2006, EAF steel production was 57% in the United States and only 10% in China. EAF metallic prices for pig iron, DRI and scrap (which move together) are much more volatile than annual iron ore contract prices. The net result is that North American and European supply chains struggle more with the planning of steel costs and prices. Market prices have become much harder to predict for both the buyer and the seller. During this time, China's steel prices have become lower in comparison and have become less volatile.

Less-predictable mill deliveries also add to price volatility. Shipment reliability has become a key concern. Buyers have learned to order early and, in some cases, double-order steel to protect their manufacturing schedules from late mill deliveries. This practice increases the inventory build when steel buyers' orders eventually drop and when mill shipments become ready sooner. When steel inventory builds and requires correction, this compounds the reduction in demand. The eventual mill production turndown causes a drop in scrap prices. This preceding sequence of events provides a plausible explanation to the mini price cycles we have been experiencing in North America.

Steel buyers are being forced to direct engineering resources to develop and approve additional steel suppliers. Steel buyers perceive that mill consolidation has raised steel prices and has reduced delivery reliability because they have limited supply choices. The impact is that less steel buyer resource time is available to work on value creation projects with existing suppliers. It is noteworthy that some mill suppliers are showing very little interest in working on value creation projects, given the mills' strong pricing power.

The supply chain's end game to successfully serve its customers has not changed. Success is in jeopardy if too much time and effort in the supply chain are spent on transferring profit margin between the players and too little time is spent on value creation. Over time, customers will migrate to the most efficient supply chains. It has been my experience that finding constructive value creation actions in supply relationships should

not be viewed as an option, but should be viewed as a requirement. Both parties at each link in the supply chain bear the responsibility to create additional value. It is unfortunate that, in prolonged periods of pricing power advantage in favor of the buyer or the seller, value creation has a growing tendency to be ignored. It is important that all parties maintain their focus on supply chain success, since trust can often fracture during difficult times.

I believe it is time to move forward and improve relationships between the steel industry and its customers. I ask steel buyers and sellers to consider the following points:

1. Steel buyers and downstream customers need to recognize that higher mill profitability was not only required, but it was necessary. Mills going bankrupt was not a sustainable supply situation. Additionally, higher raw material costs driven by higher steel demand are likely to continue as developing countries build infrastructure and manufacturing capacity. Manufacturing capacity is typically added in increments beyond local market consumption and will likely add to global competition. Capital for these investments is plentiful. The high savings rate outside the United States allows high rates of investment with low inflation.
2. Steel sellers need to restore steel supply integrity in the eyes of their customers. The North American mill operating rate is no longer stressed. While mill lead times have reduced, the confidence in mill delivery is still a concern with many steel buyers. Delivery of the correct steel quantity within an acceptable time window needs to be consistently met by steel sellers.
3. All supply chain participants need to restore commercial integrity. Too many steel buyers and downstream customers have broken deals. Mills, too, have broken deals at times by threatening to cut off shipments unless prices were increased.

Some steel buyers feel that mills have used surcharges to unfairly increase steel prices, and then have used base price increases to keep prices high once the surcharges drop. While mills are entitled to price their products at what the market will bear, they should remain mindful that a surcharge in the buyer's definition is not intended to be a profit enhancer.

The surcharge definition that most customers reluctantly accept is: "a last-resort method to recoup unforeseen and unmanageable costs that have too much impact for the supplier to absorb."

4. Buyers and sellers should consider the advantages of using financial swaps and steel futures. These tools provide a pricing guarantee via a third party to lock in steel prices over time. An important advantage of these tools is the decoupling of the timing of securing physical steel

agreements and the timing of when one can choose to lock the price forward. Steel futures traded on exchanges will offer several advantages, such as electronic visibility of the forward-traded price curve, smaller contract quantities than are currently available, and will potentially increase trading liquidity. This should allow the use of more frequent trades to reduce price volatility by averaging forward prices.

5. Raw material price volatility is not just a customer problem. It is an issue for all the participants in the supply chain. Since global arbitrage of regional scrap markets and mill production adjustments are likely to continue to impact scrap prices, more solutions are needed to manage price volatility. More proactive mill actions with their raw material suppliers are required to stabilize raw material cost. Third-party hedging tools are another potential development to smooth price volatility. It is interesting to note that C-Com in Japan has started auto scrap futures trading, although the trading activity is still very limited.
6. Regional steel producers need to fully consider the long-term consequences of short-term pricing goals on their domestic supply chains. Solely focusing on steel buyers that are not moving manufacturing from a region may become a defeatist strategy, in my opinion. Not only is this accepting a shrinking domestic steel market, but there is no guarantee that steel buyers who aren't moving will survive. Supply chains are only as strong as their weakest link.

7. Now is the time for both the steel mills and steel buyers to renew and to increase mutual value creation activities. Mills have more investment capital today, steel process and steel product technology are advancing rapidly, and steel buyers and their customers are facing more global competition. Working together is a win-win opportunity.

In closing, it is my hope that steel buyers and sellers will find ways to increase value creation activities within their supply chains. Successful actions will strengthen relationships and return the "Pendulum of Trust" to the center, where successful buyer-seller relationships have been observed. I hope that more customers will attend the next AISTech — May 5-8 in Pittsburgh, Pa. — and share their success stories of creating value within the steel industry.

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Pat McCormick joined World Steel Dynamics in October 2006 as a managing partner. Throughout his prior 30-year career at Emerson, he was involved with the procurement and specification of steel globally. Mr. McCormick is focusing his efforts at WSD on the "buyer-seller interface." It is from this perspective that he writes this article, with the goal of providing readers with a reflection on the swing of pricing power between buyers and sellers, the danger of short-term thinking, and the opportunity to increase value creation within the supply chain. ♦

Do you have a question for World Steel Dynamics? Submit it today to WSD@aist.org.