Enron Is Making Markets In

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By Jeannie Mandelker

Steel supports our skyscrapers, protects our cars, strengthens our bridges and ensures the durability of our tools and utensils. Life as we know it could not be sustained without the steel industry. But unlike other essential industries, such as agriculture and energy, the steel industry has operated without much support of its own. There is no steel equivalent of the London Metals Exchange or the New York Mercantile Exchange. Nor has any individual institution committed its own capital to make liquid steel markets — that is, until now.

In November 2000, Enron began to make markets in specific commercial grades of steel, quoting bid and ask prices for products on EnronOnline, as well as through the Enron Steel Desk. As a result, steel producers and consumers are getting supply and demand price signals for the first time.

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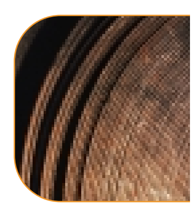
The steel group, part of Enron Industrial Markets, handles both physical and financial transactions. So far it has contracted to move more than 2 million tons of physical steel annually. Enron, as a market-maker acting on its own account, buys steel from sellers and sells steel to users. Enron acts as a principal in these buying and selling transactions, providing much-needed liquidity in the marketplace.

By making markets and developing steel risk management products, Enron has created tools to give the industry forward pricing and the ability to manage directional price risk. Enron executes its transactions on a firm — not a best-efforts — basis, so the contracts are enforceable. “The absence of a liquid and transparent market supported by firm contracts has made a challenging business even more difficult,” says Tim Battaglia, vice president, origination, Enron Steel. “We can facilitate the efficient movement of steel products in this industry.”

Commodities Are Not Catastrophic

The industry has historically resisted treating steel as a commodity for fear that it would eliminate value from prices, but that is not the case. By creating commodities out of similar commercial-grade products, Enron provides valuable pricing benchmarks for base products, against which premiums can be set for any enhanced product.

“You can’t collect a premium unless you have a base commodity product against which it can be priced,” says Battaglia. Benchmark prices, forward pricing and Enron’s corresponding price risk management tools can, among other things, help producers and their financiers make better production plant investment decisions and, Battaglia adds, “can enable industry participants to stabilize cash flows and earnings, and lower their cost of capital.”



Initially, Enron is making markets in flat-rolled steel, which includes products such as hot-rolled (used in pipe and tubing), cold-rolled (used in the automotive industry) and galvanized steel (also used in cars and appliances). Flat-rolled steel products account for about 50 percent of the $45 billion U.S. steel market. Enron's prices reflect actual market activity, offering competitive bid-offer spreads — Enron's spreads in all of its commodity markets are usually the best in the industry. Prices are real-time, which means they rise and fall as transactions occur.

U.S. steel prices are rising now, while U.K. prices seem to have crested. Everyone in the industry should examine their short- and long-term positions and protect themselves. With Enron's steel products, producers and consumers have the tools they need to manage future price risk.

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Swapping Steel

Enron's products include financial derivatives, such as caps, floors and swaps, which allow a steel buyer to set its price over the term of the contract instead of paying fluctuating market rates. “If a consumer is bullish, it can lock in its price,” explains Greg Hermans, a vice president and head of Enron's steel trading group. Enron can help producers maximize opportunities and stabilize prices, whether prices rise or fall.

These instruments ensure predictable steel prices, and therefore revenues, which makes it easier to borrow money. “With a [risk management] contract, you can show the bank a guaranteed cash flow and save money on your borrowing,” Hermans says.

Right now, U.S. steel contracts are settled against *Purchasing Magazine*'s monthly index of spot steel prices; European contracts are settled against CRU International's weekly steel price index. Battaglia says other indices may be developed. “We are working to achieve independently and highly credible indices,” Battaglia says.

Inventory Services

One of the most innovative Enron steel products is inventory management. About half of flat-rolled products are produced by mills and go directly to end-users. The other half goes to service centers and processors, which turn the steel into a customized product for end-users and original equipment manufacturers. These wholesale buyers and sellers of steel are the customers Enron's inventory services product is designed to help. (See “Inventory Help,” next page.)

Service centers and processors need steel on hand, which ties up a lot of their working capital in inventory. Enron can finance inventory to help lower the cost of carrying it; additionally, Enron can deliver the physical inventory product on a just-in-time delivery basis. As a result, “Wholesalers enhance liquidity by reducing the amount of working capital they have tied up in their inventory,” Battaglia explains. He adds that Enron helps wholesalers deal with another difficult problem: they may acquire inventory at a certain price, but then the market price falls before they sell it. Enron can manage this directional price risk for the service centers and processors, which hold so much of the inventory burden of the industry.

Enron's steel business is growing rapidly. By the end of the year, the group expects to sell between 3 million and 5 million tons of physical steel annually. “We will become a huge buyer and seller. Enron also will be active in the transportation of physical steel,” Battaglia says. “As the business

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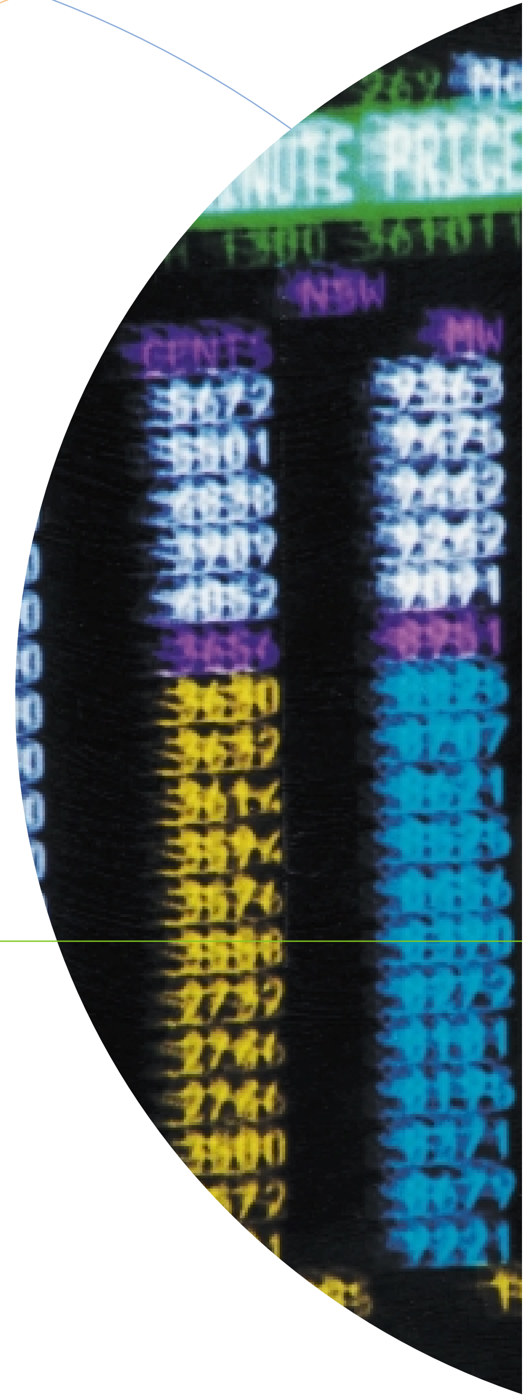
grows, we will attempt to wring out some of the inherent logistical inefficiencies."

Enron can offer all of these services because it is an experienced and successful market-maker and risk manager, but, Battaglia says, Enron brings additional value in its willingness to listen to customers to determine together with them what they need, and then fashion a solution that is responsive. "My team asks our steel customers, 'What can we do to make your business better?' Our customers are seldom at a loss for answers to that question."

For more information, contact the Enron Steel Desk at 866-327-3333, or visit us online at www.enronsteel.com.



Inventory Help

Enron is in the steel business to help companies like Huntco Steel, a U.S. steel processor and wholesaler. The companies signed an agreement on April 30 in which Enron agreed to provide price risk management, financing and other inventory procurement services. As part of the transaction, Enron gains access to Huntco's national network of steel distribution centers, which it will use as trading and distribution hubs, and acquires Huntco's cold-rolling and certain coil-pickling operations (which process the type of steel favored by automobile makers) in Blytheville, Arkansas.

Steel prices are at a 20-year low, and steel wholesalers like Huntco are caught in a pricing crosshair: they're obliged to have lots of steel on hand so they can quickly deliver steel when customers need it, but they often sell it below the acquiring price. For example, a wholesaler might pay $275 a ton and be forced to sell it at $250 if market prices drop.

Under the terms of a 15-year agreement, Enron will provide inventory price risk management services and will eventually provide more than 600,000 tons per year of hot-rolled, cold-rolled and galvanized steel products to Huntco to minimize Huntco's price risk and cut its inventory costs. Huntco "enhances its liquidity by reducing the amount of working capital tied up in its inventory," says Tim Battaglia, vice president and head of steel origination.

"Price volatility has impaired our earnings and liquidity," says Robert Marischen, president and CEO of Huntco. "Enron has offered us creative and practical solutions for overcoming these impediments to our success. This is a new beginning for Huntco Steel."