Photo of steel coils courtesy of Bethlehem Steel

Enron: Panacea or pariah?

Giant energy concern now turns its attention to steel. The company's aggressive posture has begged controversy. Industry reactions vary from hand-wringing to open arms. Still others characterize Enron as a "non-event."

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These days, saying the word "Enron" in a room full of metals executives is like screaming "fire" in a crowded theater. For most in the steel industry, the idea of a futures market is enough to raise a few eyebrows. But when a major market maker with annual revenues of 10 times the market cap of the U.S. steelmaking industry stakes a claim (for 2000 alone, Enron logged revenues of $101 billion—that's with a "b"), a lot more than eyebrows are likely to be raised. After a bold presentation from Jeff McMahon, president and CEO of Enron Industrial Markets, at the SSCI annual convention in May (in which he accused steel mills of treating their service center customers as "annoyances"), industry leaders rushed to understand this latest market contender.

Friend or foe? Competitor or partner? These are just a couple of the questions surrounding Enron's aggressive push into the metals industry. Judging from the

service center and mill executives *Modern Metals* queried, there are as many answers as there are opinions in the industry. Reactions ranged from fear to acceptance to downright resentment. At least one mill was reticent to discuss Enron at all—still others seemed to meet the issue with unaffected shrugs. If the saying is true that all publicity is good publicity, the buzz that Enron has generated would make even a Hollywood spin doctor envious.

What's the hubbub?

Although products such as natural gas and energy—Enron's major business platform—have been traded as commodities for years, until Enron's appearance a formal forward market for steel has never existed. According to McMahon, the absence of a liquid and transparent market has resulted in "uninformed investment decisions" that have exacerbated the current oversupply situation, and left companies exposed to the hazards of price volatility.

Enron's answer is to offer a variety of financial hedging products along with forward contracts in hot-rolled, cold-rolled and galvanized (plate and long products are soon to follow), locking in prices for as many as five years out. Enron contends that it can act as a "risk intermediary" in steel transactions, ensuring healthier profit margins and lowering the cost of capital. Certain grades of steel are commodities, McMahon insists, and as such should be bought and sold on a commodity market basis, instead of the strategic relationships that now exist between the mills and consumers. Enron has been offering steel online, and via phone and fax, since November of last year.

"Before you add capacity, before you make an investment decision, you'll be able to see a three, five, maybe even a 10-year forward price of steel," McMahon stated, "and if you want to hedge that investment you can do that."

The company plans to buy steel at a floating price and then sell it to steel consumers at a fixed rate, making money on the spread. In February, Greg Hermans, VP of steel trading at Enron, reported to *AMM* that it was offering U.S.-made 10-gauge, 48-in. wide hot-rolled for April delivery in Chicago for $225 a ton. Hermans said Enron was buying the same product for April delivery at $215 a ton.

Eventually, Enron sees the development of four different market-

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places: the Northeast, the Midwest (or Chicago area), the Gulf Coast (or Houston area), and the West Coast. Enron will hedge against spot price spikes through equity and physical holdings in domestic mills. The company closed on Huntco's Arkansas-based cold-rolling mill in June.

"It's a big portfolio," McMahon said. "We wanted to put together a portfolio of supply and demand. In some cases, we'll own assets—hopefully we'll own some term contracts with domestic mills. To the extent that imports are a part of the equation, we'll be a part of that market. We may purchase capacity from somebody, not necessarily the assets, but toll slab through a hot strip mill. All of those combined is how we do our business."

Steel mills can benefit, McMahon said, by entering into a multi-year "physical off take" with Enron, thus giving steel mills a degree of certain volume and product specification. Enron would guarantee purchase of a specified amount of tonnage, and use a floating price or a floor price to guard against market shocks. Whether mills would be willing to divert capacity to the commodity grades being bought and sold by Enron remains uncertain. At least one mill executive privately said no . . . at least for now.

Nucor president, CEO and vice chairman, Dan DiMicco also sees little value in Enron's proposal. "What we need to have is stable pricing at levels where the most efficient mills can make a good return on their capital and further invest in new technologies and equipment," he stated. "I define true value as helping the industry to become stronger. It doesn't do any good to maintain a lack of price volatility at $200 a ton."

Keith Busse, CEO at Steel Dynamics, echoed that sentiment in a recent *New Steel* article. "If you're trying to get volatility out at $320 [per ton], great," he said. "But at $230, you want to stick your fingers down your throat."

For the service centers

Service centers, McMahon suggested, could benefit immediately. "The only way [distributors] are able to hedge themselves is to go out and buy inventory," he explained. "That takes capital, and cash, and space. We can offer a financial product that gives the exact same protection, but doesn't require any of the above.

"We can hold those inventories and price the steel at the time of delivery to the service centers," he continued, "so their 4- or 5- percent net margins are somewhat certain."

"I do think that Enron is providing a service for the industry . . ." commented Dave Lerman, CEO of Steel Warehouse, South Bend, Indiana. But he pointed out that "how [it] moves forward will be interesting. If they just move forward with hedge instruments . . . that's independent of whether you run your business well by having a good supplier that matches up with the demands of your customers. I think [Enron] will be a good thing for some people and a non-event for others."

Beyond hedging, McMahon pointed out, firm and enforceable contracts could become a key benefit to service centers. As one Midwestern distributor source commented, "One of the terrible things that happens in our business is that end users demand long-term pricing, beyond what anybody can foresee. When they anticipate the market is going up, or that it has hit a low point, they push harder for it—as any one would. But historically, they don't honor the deals."

In a down market, he explained, customers demand lower prices. Noncompliance can result in orders, but no releases, and a "don't call us, we'll call you" attitude from customers. The consequence for service centers, he said, are price reductions on the way down *and* on the way up. "If Enron brings integrity to both sides of this market," he concluded, "that would be a very big plus for the steel industry."

But integrity, another Midwest service center exec countered, has got nothing to do with it. In his estimation, Enron is like a profiteering carpetbagger, "trying to make a buck in between the producer and the user. That's all we need right now," he declared, "somebody trying to squeeze out a few more dollars." But, he recognized, "we're all going to have to deal with it."

Don McNeeley, president and CEO of Chicago Tube & Iron, indicated that some good could come of a heavy-hitter like Enron introducing new ideas into the industry, but acknowledged that people might be offended by somebody picking the so-called "low-hanging fruit" of the steel market in the current economy. "What do you think the mills are going to do when you come to them for just the peripheral items?" he queried. "My concern would be that the price would go up on [those items]."

McNeeley also questioned the wisdom of distributors relinquishing control of their inventories. "In distribution, 60 percent of our net worth is inventory, 30 percent is accounts receivable, and 10 percent is plant property and equipment," he related. "Our single largest asset is our inventory. If a distribution company surrenders control of its inventory to a third party, does not that distributor, in effect, surrender its own sovereignty?"

Only just begun

Questions abound regarding Enron's role as a physical supplier of steel as well. As one Minnesota-based service center exec put it, "are they ready to deal with problems?"

Although Enron has expressed interest in being a physical supplier, Dave Lerman explained, "I think that's going to be a lot more difficult to implement." Enron would have to consider specific qualities, coil sizes, nuances of chemistry, surface quality, and formability. "Most customers require better than standard tolerances," he pointed out. "These are all issues that might complicate commodity sales."

Delivery is another issue. As a physical supplier, Enron has virtually guaranteed just-in-time delivery, but as one service center source said, "the guarantee is good when the material shows up at my door. What happens if it doesn't show up? I disappoint a customer. What good does it do to sue [Enron] if I've lost a customer?"

Mill executives have questioned whether Enron is a potential competitor. "They see Enron as someone likely to buy foreign steel in order to deliver it to a U.S. customer," said Chuck Bradford, principal of Bradford Research and a long-time industry observer. He cautioned against seeing Enron as too much of a physical supplier, speculating that the future of

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Enron, similar to the LME, will be in hedging. "You may see some [physical transactions] to start with," Bradford predicted, "just to get the ball rolling. But I don't see that as the way the market will develop."

McMahon has been consistent in saying that Enron has little interest in becoming a steel manufacturer. The real value, he said, is in a transparent, liquid market. "We know the products work, we know the market wants them. Can any one particular mill or mills prevent that? We don't think so," he said. "It's not an 'if', it's a 'when'."

The jury is still out on just how soon that "when" will come, and what those effects will be for the steel industry. And for all of the debate surrounding the issue, it seems a bit soon to be hitting the panic button. As Don McNeeley recounted, "I can recall similar controversy over a speech a guy gave about 15-17 years ago. That guy's name was Ken Iverson, and he had this concept called a mini-mill. Look at it now."■