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Heavy going in the steel sector

A drop in demand, an 84% slump in profit and rising costs bode badly for producer ArcelorMittal

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This is not a good year to be in the steel industry. After major producer ArcelorMittal South Africa announced less than stellar interim results last week, it spent this week renegotiating its interim iron ore supply agreement with Kumba Iron Ore's Sishen mine.

By late Wednesday it was not clear how the negotiations were going, save for terse JSE Sens announcements from both parties to indicate they were continuing.

This is the third interim pricing agreement between the parties since the first was struck in mid-2010. The government, particularly the department of trade and industry, will be watching the negotiations closely. It is determined to ensure that developmental prices for iron ore are passed through the value chain to the manufacturing industry in the form of cheaper steel.

ArcelorMittal did not anticipate any disruption to operations while talks continued, the company said in a statement on Wednesday.

The interim pricing agreement is the holding pattern under which the steel sector operates while Kumba, ArcelorMittal, the department of mineral resources and Imperial Crown Trading thrash out in court who the lawful recipient of a share of the mineral rights to the Sishen iron ore mine actually is. This share, formerly held by ArcelorMittal, formed the basis of a supply agreement that saw it receive 6.25-million tonnes of ore from Sishen at a rate of cost plus 3%. When it lapsed, the right was awarded to Imperial Crown Trading, which is now the subject of court wrangling.

An arbitration process to determine whether ArcelorMittal is still entitled to the cost plus 3% agreement is on hold until court proceedings are completed.

The interim supply agreement, which expired on July 31, entitled ArcelorMittal to the same volumes of iron ore at a price of $70 a tonne for iron ore sent to its inland steel mills and $50 a tonne for iron ore sent to its Saldanha plant.

ArcelorMittal is battling on a number of fronts, including the drop in local demand for steel products that has resulted in the company operating at only 70% capacity. During its interim results announcement last week, chief executive Nonkululeko Nyembezi-Heita disclosed an 84% slump in profit for the six months ended June 30, measured against the same period in 2011.

The cost of iron ore, along with a number of other inputs, increased by 20%, said Nyembezi-Heita. This was not exclusively related to cost increases from Sishen. Kumba's Thabazimbi mine, which continues to supply ArcelorMittal at cost plus 3%, had a number of problems, she said. "Because it's coming to the end of its life, production costs have been rising quite steeply. At the same time, the mine has been experiencing severe geotechnical problems."

The "severe" production problems pushed up the price of ore to levels that were higher than export parity prices, roughly between $95 and $100 a tonne, said Nyembezi-Heita.

In the meantime, Kumba indicated during its interim results that it was experiencing increasing cost pressures. It noted a drop in operating profit to R14.4-billion from R16.9-billion, or 15% for the corresponding period. This was as a result of increased operating expenses, attributed to company growth and increased mining activity, as well as above-inflationary cost escalations in key inputs.

Chief executive Nonkululeko Nyembezi-Heita reported a huge decrease in profits for the first six months of this year. Photo: David Harrison

"As a result of the planned increase in mining activity at Sishen mine and above-inflationary cost escalations, the unit cash cost increased by 21% from R150 per tonne at the end of 2011 to R182 per tonne for the six months," the company said.

"As with the rest of the mining industry, the group has seen above-inflationary escalations in key input costs, such as the diesel price, which has increased by 15% from R9.28 per litre to R10.67 per litre, and electricity prices, which have increased by 16% year on year."

Neither ArcelorMittal nor Kumba would comment on the nature of the negotiations, but it may be that the cost plus 3% arrangement is no longer the steal of a deal it was some years ago, particularly given the cost pressures Kumba is seeing. However, the *Mail & Guardian* could not confirm this.

Kumba's "stay in business" capital expenditure to maintain operations also increased from R597-million to just less than R1.1-billion, principally for the "acquisition of heavy mining equipment and workshop infrastructure for Sishen mine", according to its results.

The outcome of yet another round of negotiations will affect the downstream industry should the terms of the agreement change dramatically.

This is muddied by the potential outcome of the court case and a broader policy environment in which the state and ruling ANC are grappling with proposals on the role resources play in the economy.

In an attempt to insulate the broader economy from what is essentially a protracted dispute between two private giants, entities such as the Industrial Development Corporation have been examining ways to introduce greater competition to the steel industry.

However, Nyembezi-Heita said that the sector was not growing.

"We already have overcapacity in the domestic steel industry and most steel producers depend on exports in order to load their mills. The space for another domestic producer seems difficult to justify."

Earlier this year the *Mail & Guardian* reported on the unhappiness of automotive component manufacturers over the high prices, shortages and poor quality of certain steel products. ArcelorMittal 's failure to invest in local infrastructure was one of the reasons given, but this was something the company vigorously denied.

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