

To: All members, warehouse companies, London agents and other interested parties

Ref: 16/251 : A245 : W084

Classification: Warehousing

Date: 14 July 2016

Subject: **WAREHOUSING CHARGES DISCUSSION PAPER – FEEDBACK AND ANALYSIS**

Summary

1. This Notice (a) considers the feedback received in response to Notice 16/136 : A132 : W045 (“Discussion Paper relating to LME warehousing charges, 6 April 2016, “2016 Discussion Paper”), (b) explains why the LME considered it necessary to open this discussion, (c) considers all of the questions (the “Discussion Points”) raised in the 2016 Discussion Paper, including the five potential reforms (the “Discussion Items”) which are analysed in accordance with a framework designed to ensure that the London Metal Exchange (“LME”) acts proportionately and in doing so sets out the LME’s provisional thinking on some issues, and (d) explains which of the Discussion Items the LME is proposing to consult on.

Background

2. On 6 April 2016, the LME issued the 2016 Discussion Paper which asked for feedback to a number of Discussion Points relating to possible reforms to the LME physical network, designed to address market concerns as to whether customers are treated unfairly and unreasonably in respect of the headline rates of LME rent and free-on-truck (“FOT”) charges levied by LME-registered warehouse operators (collectively, “Headline Warehousing Charges”).
3. For ease of reference, these questions and their relevant sections are outlined below in full. Where used, defined terms are taken to have the meaning ascribed to them under the revised Warehouse Agreement (the “Warehouse Agreement”) pursuant to Notice W050 (“Minor amendment to the Warehouse Agreement”, 13 April 2016), the revised Policy on Approval and Operation of Warehouses pursuant to Notice 15/372 : A359 : W121 (“Amendments to the Policy on Approval and Operation of Warehouses (implementation of LORI and QBRC) and clarification of certain points



relating to the LME's physical delivery network", 25 November 2015, the "LORI and QBRC Implementation Notice, and the 2016 Discussion Paper.

4. The Discussion Points were as follows:

SECTION 1: Background and context

Discussion Point 1: Do you agree with the LME's proposition that (i) Headline Warehousing Charges are out-of-line with the economic cost of providing the services to which those charges relate, and thus out-of-line with both off-warrant and discounted LME rates, (ii) that such charges may be unfair to customers of the market, (iii) that this may have an impact on the quality of LME pricing, and (iv) that the mechanism by which charges are set leads to the danger of an increasing degree of disparity?

Discussion Point 2: Do you believe that the LME already holds, under the existing LME Warehouse Agreement, sufficient powers to address the issue of high Headline Warehousing Charges?

SECTION 2: Key considerations in respect of the Discussion Items

Discussion Point 3: Do you have a perspective on (i) the appropriate maximum levels of Headline Warehousing Charges (options (a)-(d)), and (ii) the relative need to address levels of rent vs. levels of FOT?

Discussion Point 4: Do you have a perspective on the determination of Current Headline Warehouse Charges – per-operator or general, and choice of year?

Discussion Point 5: Do you have a perspective on the determination of Target Future Maximum Headline Warehousing Charges – location and metal granularity?

Discussion Point 6: Do you have a perspective on the determination of permissible increases in Target Future Headline Warehousing Charges?

Discussion Point 7: Do you have a perspective on the determination of Worst-Case Bilateral Warehousing Charges?

Discussion Point 8: Do you believe that a "convergence" of operators' Headline Warehousing Charges to published Target Future Maximum Headline Warehousing Charges would represent a diminution in competition?



Discussion Point 9: Do you believe that there are other key considerations which the LME should consider in the context of this section?

SECTION 3: Analysis of the Discussion Items

Discussion Point 10: Do you have any comments or feedback on the FTA Discussion Item?

Discussion Point 11: Do you have any comments or feedback on the CC Discussion Item?

Discussion Point 12: Do you have any comments or feedback on the CTG Discussion Item?

Discussion Point 13: Do you have any comments or feedback on the CBIG Discussion Item?

Discussion Point 14: Do you have any comments or feedback on the FOTC Discussion Item?

Discussion Point 15: Do you have any comments or feedback on the IB Discussion Item?

Discussion Point 16: Are there any other matters you wish the LME to consider in the context of any aspect of this Discussion Paper?

Analysis of the Discussion Items: responses and LME framework for consideration

5. In order to cover all relevant issues, as well as all the feedback received, this Notice is structured as follows:

SECTION 1: From paragraph 9
Background and context as to why the LME believes it is necessary to take action

SECTION 2: From paragraph 45
Assessment of Discussion Points 1 and 2 from the 2016 Discussion Paper section 1 (“Background and context”)

SECTION 3: From paragraph 70
Assessment of Discussion Points 3 to 9 from the 2016 Discussion Paper section 2 (“Key considerations in respect of the Discussion Items”)



SECTION 4: From paragraph 136

Assessment of Discussion Points 10 to 14 from the 2016 Discussion Paper section 3 (“Analysis of the Discussion Items”). These were the specific reform ideas outlined in the 2016 Discussion Paper. The feedback received to these questions is structured using the analytical framework set out in previous Notices (for example, the 2016 Discussion Paper). It is designed to facilitate the LME in assessing the options in a proportionate and objective manner. This framework is as follows:

X.1. Does the Discussion Item seek to achieve a regulatory, prudential or organisational objective?

X.2. Is the Discussion Item likely to have an effect on competition (noting that, for each proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

X.3. Does the Discussion Item comply with the principle of proportionality? In particular:

- (a) Is the Discussion Item capable of meeting the relevant objectives?
- (b) What are the most pertinent arguments for the Discussion Item?
- (c) What are the most pertinent arguments against the Discussion Item?
- (d) Are there any other, less restrictive means of achieving the same objective(s)?
- (e) Would the negative effects of the Discussion Item be too great to justify implementation?

SECTION 5: From paragraph 217

Assessment of Discussion Points 15 and 16 from the 2016 Discussion Paper section 3 (“Analysis of the Discussion Items”)

- 6. The structure outlined above is designed to aid the LME in conducting a thorough and in depth analysis of all the questions contained within the 2016 Discussion Paper, fully cognisant of the market feedback and comments.
- 7. As such, the LME would like to thank all those who contributed ideas, thoughts and feedback both in advance of the 2016 Discussion Paper, and following its release; the LME received 15 written responses to the 2016 Discussion Paper.



8. The LME has taken all the feedback received into careful consideration, and is today by separate Notice 16/252 : A246 : W085, (“Consultation on proposed amendments to the LME Warehouse Agreement in respect of charge-capping”, the “Charge-Capping Consultation Notice”) launching a consultation on its proposed route forward. This Consultation will run for five weeks and the LME welcomes all feedback from market participants in relation to this. Any market participant wishing to submit a response to the Consultation, or to arrange for further discussions seeking clarification in relation to the Consultation, is asked to contact Georgina Hallett at consultation@lme.com or +44 20 7113 8780.

SECTION 1: BACKGROUND AND CONTEXT AS TO WHY THE LME BELIEVES IT IS NECESSARY TO TAKE ACTION

The issue of Headline Warehousing Charges

9. In the 2016 Discussion Paper, the LME laid out its analysis in respect of the issue of Headline Warehousing Charges, including the market context and the LME’s reasoning as to why high charges represent a problem for the LME’s market. This analysis has not changed since the publication of that Notice, but is set out again here for ease of reference, and updated where necessary or appropriate.

LME warehouse reform

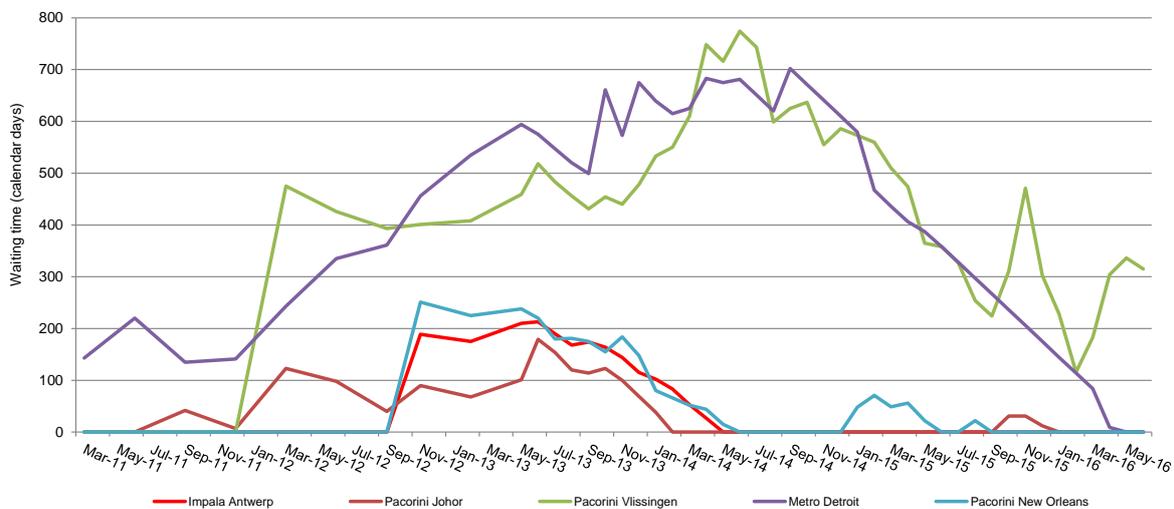
10. The LME is a “recognised investment exchange” (“RIE”) recognised and supervised by the Financial Conduct Authority (“FCA”) under the UK Financial Services and Markets Act 2000, as amended (“FSMA”). To remain recognised, an RIE must at all times ensure, and be able to demonstrate, that it continues to satisfy the requirements for RIEs under the FSMA (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (the “Recognition Requirements”). Under the Recognition Requirements, the LME must therefore, among other requirements, ensure that (a) contracts admitted to trading on its markets are capable of being traded in a fair, orderly and efficient manner, (b) the arrangements for determining the settlement price of its contracts must be such that the contract price properly reflects the price of the underlying metal, (c) there are adequate settlement and delivery procedures for the metal traded on the exchange, and (d) business conducted by means of its facilities affords proper protection to investors.



11. In November 2013, following a three-month market-wide consultation¹ (the “2013 Consultation”), the LME announced a comprehensive package of warehouse reform comprising twelve key measures (the “2013 Reform Package”). At the heart of these was the Linked Load-In / Load-Out Rule (the “LILO Rule”) which was implemented on 1 February 2015 and which requires LME-listed warehouses with queues of over 50 days to load out more metal than they load in. Eleven of the twelve items (plus additional measures such as a separate load-out rate for aluminium alloys, an increase in the decay factor under the LILO Rule and an increase in the daily minimum load-out rate) have now been implemented. Full details and copies of the relevant notices and additional documents are available on the LME website at:
<http://www.lme.com/trading/warehousing-and-brands/warehousing/lme-warehouse-reform/>
12. The LME is pleased to observe the positive impact of the 2013 Reform Package on the physical market. In particular, the LME notes that its commitment to address existing queues and prevent future queues² has led to a significant reduction in queues.
13. The graph below shows the longest waiting time in calendar days at the five warehouses which had queues on 1 July 2013 (being the start of the 2013 Consultation).

¹ See Notice 13/208: A201: W076, (“Consultation on changes to LME policy regarding the approval of warehouses in relation to delivery out rates”, 1 July 2013).

² Most recently, and pursuant to Notice 15/072 : A071 : W025 (“Discussion Paper relating to possible reforms of warehousing policy and physical delivery network”, 2 March 2015, the “2015 Discussion Paper”), through the implementation of a load-out rate increase on 1 March 2016, and the implementation of a queue-based rent cap on 1 May 2016.



*Queue development at warehouses which exhibited queues as at 1 July 2013
(data as of 30 June 2016)*

- The twelfth of the original items from the 2013 Consultation is the LME's commitment to investigate structural solutions to Headline Warehousing Charges which are, in the view of some segments of the market, too high. As set out below, considerable attention has already been paid to this topic by the LME.

Background to, and analysis of, LME Headline Warehousing Charges

- Under the Warehouse Agreement, each warehouse operator must fix its maximum rent rates and FOT charges (i.e. its Headline Warehousing Charges) annually in respect of each 12 month period commencing 1 April by notification to the Exchange not later than 1 December in the preceding year. Therefore, each year in early November, the LME Physical Operations department asks all of its listed warehouse operators to submit their proposed Headline Warehousing Charges for the next annual cycle, which runs from 1 April to 31 March.
- Warehouse operators must submit their proposed Headline Warehousing Charges to the LME by 1 December. Under the Warehouse Agreement, at any time within 10 Business Days of receiving the proposed charges, the Exchange may, at its discretion, require the warehouse to provide, within 10 Business Days, a comprehensive, written explanation of the economic circumstances which, in the view of the warehouse, necessitate the change in its Headline Warehousing Charges. However, the Warehouse Agreement does not prescribe that the LME can require that the warehouse operator reduce its charges.



17. Final Headline Warehousing Charges for the next cycle are published by the LME before 31 December each year. These are maximum charges – warehouses are always free to offer reduced rates on an *ad hoc* basis to particular metal owners in respect of particular metal storage activities.
18. As outlined in previous notices³, the LME has consistently highlighted that its market exhibits a number of features, including the process outlined above and the factors listed below, which mean that there is very little downward pressure on Headline Warehousing Charges.
19. When a metal owner places metal on warrant, they have two options:
 - (a) The metal owner may retain the warrant and eventually either withdraw the metal from the warehouse themselves, or sell the warrant bilaterally to a counterparty who will factor frictional costs of storage (including anticipated rent and FOT charges) into the purchase price. In this event, the metal owner depositing the metal will be motivated to negotiate rent and FOT rates⁴ with the warehouse company, because the costs will be borne either by the metal owner themselves, or by the buyer to whom the metal owner sells the warrant bilaterally, with a consequent reduction of purchase price that the buyer is willing to pay to the metal owner. In this scenario, therefore, the Headline Warehousing Charges are not relevant, since (in the understanding of the LME) a significant discount will be offered by the warehouse – and, importantly, the Headline Warehousing Charges are not generally used as a basis for negotiation (i.e. often the warehouse operator and the metal owner will recognise that the Headline Warehousing Charges are simply not relevant for storage under this model, and so discuss absolute rates of bilaterally-negotiated charges, rather than percentage discounts from the Headline Warehousing Charges). In particular, metal owners are not guided by the Headline Warehousing Charges in assessing at which warehouse they may achieve the lowest bilateral charges – just because a warehouse has relatively high Headline Warehousing Charges, this does not indicate that it

³ For example, Notice 15/190 : A186 : W062, (“Discussion Paper – Feedback and Analysis”, 1 July 2015, the “2015 Discussion Paper Results Notice”), and the LORI and QBRC Implementation Notice.

⁴ It is the understanding of the LME that metal owners depositing metal under this model (a) will almost universally negotiate discounted rent rates. In respect of FOT rates, owners may (i) opt to take an up-front cash incentive and then effectively repay this via acceptance of the headline FOT rate at the time of metal withdrawal, (ii) negotiate a discounted FOT rate, in which case an up-front cash incentive payment will not be available, or (iii) a combination of the two (a more modest incentive payment balanced by a less-heavily discounted FOT payment). In all cases, because any payment of incentive to the metal owner will be funded primarily by the payment of the FOT by that same metal owner at the time of metal withdrawal, the economics should balance (including the effect of time-value-of-money between incentive and FOT payments).



will be in any way uncompetitive in negotiating relatively low (and hence attractive) bilateral storage rates.

- (b) The metal owner may sell the warrant through the Exchange. Under this model, the metal owner will keep the metal in the warehouse for some period of time, and subsequently sell the metal on the LME (after which the metal may change hands a number of times before it is eventually withdrawn from the warehouse). In this case, the metal owner only bears the cost of storage prior to delivering the warrant on the LME, because the LME delivery mechanism has no adjustment to give credit to warrants which are subject to more advantageous (i.e. lower) storage costs⁵. Because negotiating lower post-delivery rent and / or FOT rates for the particular metal being sold on the LME would not affect the price achieved on the LME, the metal owner has no motivation to negotiate rent and FOT rates with the warehouse company, and will generally be content for the warehouse to levy its Headline Warehousing Charges on the new owner. Instead, the LME understands that it has become common practice for warehouse operators to offer financial incentives to metal owners to attract load-in of metal. These incentives are funded by the anticipated rent and FOT paid (at the rates set by the Headline Warehousing Charges) by the subsequent acquiror(s) of the warrant on the LME.

20. A warehouse operator looking to offer an incentive to a depositor of metal will generally model the expected economics arising from that metal during its time in the warehouse. Such economics will be a combination of (i) the expected rent, based on the daily rent level multiplied by the number of days for which the new owner is expected to keep the metal in the warehouse, (ii) the FOT, which must be paid when the metal is eventually withdrawn (although at an unknown future date, giving rise to a potential discounting effect), and (iii) other logistical and service charges which may be paid by the new owner. The expected “rest time” per item (i) has historically been increased by the presence of load-out queues at certain warehouses, although the LME’s actions to reduce the length of queues, and the introduction of Queue-Based Rent Capping (“QBRC”) which limits the rent chargeable in respect of metal sitting in queues, has significantly reduced this effect. Accordingly, the key charge in respect of setting incentives is now broadly FOT, given that this is an “exit barrier” which must be paid in order to withdraw any metal from the warehouse. Furthermore, the effect of the FOT is to “lock in” high rents – because, in order to move metal to a lower-cost negotiated rent environment, the

⁵ The only adjustment mechanism is in respect of the accrual of historical rent, not the susceptibility of the warrant to a given level of Headline Warehousing Charges going forwards.



FOT must still be paid to the incumbent warehouse, which raises the frictional cost, and may result in metal owners continuing to pay higher rents, in order to avoid paying the high FOT in order to move storage location.

21. Because of the lack of downward pressure on Headline Warehousing Charges where the metal owner intends to deliver the warrant on the LME, the LME understands that warehouse companies compete on incentives offered, rather than Headline Warehousing Charges. Such incentives may take several forms, including free or discounted shipping, cash payments or below-cost storage of the metal in the period prior to its onward delivery by the original metal owner.
22. So, in summary, the party putting the metal on warrant with the intention of selling that warrant on the LME has no motivation to negotiate rents and FOT rates; in contrast, the subsequent acquiror of the warrant on the LME has limited leverage over rents and FOT rates. Headline Warehousing Charges and incentive payments hence interact in a deterministic way, with high FOTs acting to lock in rents. The higher the rents and FOTs, the higher the financial incentives the warehouse operator can offer the metal owner. It is a self-reinforcing system. The large majority of metal loaded-in with the intention by the metal owner of eventual sale on the LME will be attracted, through the incentive mechanism, to warehouses which are able to offer high incentives (primarily, in the absence of queues, through high Headline Warehousing Charges).
23. The nature of the economic system, in the view of the LME, incentivises warehouse operators to increase their levels of Headline Warehousing Charges. In general, a charge-setting process exhibits a natural downward tension, because those businesses setting more competitive charges will tend to see a greater level of business. However, because in the LME system the levels represent maxima, setting high Headline Warehousing Charges in no way impacts the ability of a warehouse to compete for metal stored under model (a) above, in that the warehouse can simply offer discounted charges when asked by a metal owner looking to deposit metal and then withdraw it again in the future. However, under storage model (b), warehouses with higher Headline Warehousing Charges are able to offer greater levels of incentive, and hence are better positioned to attract metal from owners looking to deposit metal and then sell such metal on the LME. Accordingly, economic feedback in the system acts to drive Headline Warehousing Charges upwards.
24. This effect is further accentuated by the competitive tension between warehouses. A warehouse submitting Headline Warehousing Charges for a given rent year will, in general, be concerned to ensure that such charges are as high as possible



compared to competitors, given that this will enhance its ability to pay incentives and attract metal as set out above. If the warehouse submits lower Headline Warehousing Charges than competitors, it may find itself at a competitive disadvantage when seeking to attract metal to its warehouse, with such disadvantage lasting for the entire year, given that Headline Warehousing Charges cannot be increased intra-year. Accordingly, the inducement for charge-setting militates to “err on the upside” – in general, there is little downside to submitting Headline Warehousing Charges higher than those of peers, and significant downside to submitting charges lower than those of peers. Because the Headline Warehousing Charges are submitted by warehouses acting in isolation, with limited signalling mechanisms in the market, the logical outcome is one of an “upwards spiral”. This effect is compounded year-on-year, whereby an operator which has submitted lower increases than peers for a given charge cycle may be economically disadvantaged in terms of seeking to attract metal to its warehouse, and then attempts to compensate by submitting an “adjusting” above-market increase the next year. This process of “leap-frog” carries a significant risk of an accelerating rate of increase over a period of several charge cycles.

25. There exists an additional concern with FOTs, in that warehouses offering relatively low levels of FOT will generally suffer greater outflows of metal, in comparison to warehouses with higher levels of FOT. This is due to the role of FOT as an “exit barrier”, in that a buyer of metal taking receipt of a set of warrants through LME delivery, and looking to access some proportion of the underlying metal, will preferentially cancel warrants with lower FOT, as the frictional cost of withdrawal is lower. Indeed, even if the metal is not required for physical use, a buyer of the warrants may cancel metal in lower-FOT warehouses in order to move it to higher-FOT warehouses and benefit from the resultant incentive. This hence represents a further factor driving up Headline Warehousing Charges.
26. On the basis of the arguments above, it would at first glance seem that the LME warehouse network does not obey the general economic principle that offering goods or services at a lower price (in this case, at lower Headline Warehousing Charges) should, *ceteris paribus*, increase the demand for such services. However, the view of the LME is that Headline Warehousing Charges are simply not the venue in which competitive forces meet. Instead, the determining factor for metal owners looking to store metal and then withdraw it is the level of discounted charges offered by warehouse operators (in respect of which there is fierce competition and hence a downward force on prices, as would be expected), and the determining factor for metal owners looking to deposit metal and then sell on the LME is the level of incentive (so in this context, metal owners are effectively sellers of the right to store their metal, and rationally accept the highest bid in respect of that right).



27. It should be noted that all LME warehouse operators also face a set of factors specific to their particular business model (e.g. long-term agreements for metal storage or captive flows of metal from parent organisations which do not necessarily require the payment of significant incentives, restricted access to financing which may constrain the regular payment of incentives) which results in each operator managing their operations to specific business models. Accordingly, it should not be supposed that all warehouse operators are motivated by precisely the same behaviours, and hence not all warehouses set Headline Warehousing Charges with precisely the same set of intentions.
28. However, there are a sufficient number of warehouse operators pursuing an incentive-led model of metal sourcing (funded by high Headline Warehousing Charges) that the highest observed Headline Warehousing Charges are driven by the analysis set out above. Because the LME market operates on the basis of “sellers’ option”, a market participant delivering warrants in settlement of an LME contract will always look to deliver the “worst warrant” – which is likely to be the warrant with the most onerous conditions attached, particularly in respect of liability for the new owner of the warrant to pay high Headline Warehousing Charges in respect of the underlying metal.
29. Accordingly, the net effect is an environment where there is a risk that Headline Warehousing Charges will be higher than the true economic cost of delivering the storage and logistical services to which these charges relate. This might be said to have at least three undesirable effects:
 - (a) Those taking delivery of warrants on the LME market may, because of the Headline Warehousing Charges, pay a set of charges (rent and FOT) in respect of metal storage and withdrawal which is higher than would be justified by the cost of providing these services, and is higher than which would be encountered if sourcing the metal through a different procurement route. While, as set out below, the majority of those taking warrant delivery on the LME market are likely to be professional merchants who will have adjusted for such frictional costs in their economic modelling, it remains the fact that one of the LME’s functions is to provide a “market of last resort” for those buying (and selling) metal. An unduly high logistical cost burden will naturally weaken the LME’s ability to fulfil this role, and subject those using the market for this purpose to a greater frictional cost of usage than would be rational in a well-functioning economic system.



- (b) In general, warrants on the LME market are taken in settlement by merchants, rather than by physical users. These merchants will factor in the logistical cost of accessing the metal they have purchased, and hence when bidding for metal on the LME market, will bid at a level below the “true” price of the metal, i.e. they will apply a discount equal to the logistical frictional costs of converting an LME warrant to metal which can be sold to an end-user (or alternatively, re-warranted with another warehouse in exchange for an incentive). Accordingly, the LME’s cash price will generally trade at a discount to the “real-world” price of metal (which is typically observed by the market as the “real-world” price of metal trading at a premium to the LME cash price).

To a certain extent, this is unavoidable in a global physical delivery network – there will always exist a discount due to the fact that a warrant delivered on the LME may be in any LME Delivery Point, and of any LME-recognised brand or shape. Historically, the existence of queues has added further to the discounting effect – although, as set out above, the LME’s reform programme is reducing queues, and consequently the impact of such queues on the LME price. However, the Headline Warehousing Charges have always been – and will continue to be – a significant driver of the discount embedded into the LME price, given that (as set out in paragraph 28) the warrants with the highest Headline Warehousing Charges will generally be seen in settlement, and hence drive the LME price. In particular, the FOT represents effectively a dollar-for-dollar discount, given that, in order to convert an LME warrant (representing the LME price) into readily-accessible metal (representing the “real-world” price), the FOT must be paid.

The fact that a greater proportion of the “real-world” price is thus represented by the premium, rather than the LME cash price, is problematic for both the market and the LME. In general, the market will hedge its exposure to metal prices by hedging the LME price. Although risk-management products do exist to hedge the premium, this is generally more expensive for users given the less liquid nature of the market. Accordingly, premium price discovery is generally conducted via survey pricing, which is viewed by certain segments of the market as less robust and reliable than the physical price discovery for the core LME contract⁶. Accordingly, while respecting the fact that fundamental market factors (in particular, regional supply/demand imbalances) will validly give rise to regional premia, the LME currently

⁶ Although the LME offers a physically-settled regional premium contract for aluminium, this has yet to gain traction in the market.



considers that reducing as much as possible the proportion of the market premium, and the changes in the level of that premium, caused by technical market factors (queues and Headline Warehousing Charges), to be a valid aim in order to ensure the reliability and integrity of the LME's price discovery arrangements and thus the orderliness of the market.

- (c) The level of Headline Warehousing Charges also represents a key tool used by warehouse operators to attract metal being deposited by owners who then intend to sell that metal on the LME, and hence (as set out further above) are looking for the highest level of incentive. While it is clearly open to any warehouse operator to set their Headline Warehousing Charges at the rate they consider most appropriate, certain warehouse operators have commented that there exists a fundamental conflict between their desire to support the LME ecosystem (which would militate for lower, more cost reflective, Headline Warehousing Charges, given the arguments set out above) and their need to avoid losing market share to their peers (which would militate for higher Headline Warehousing Charges).

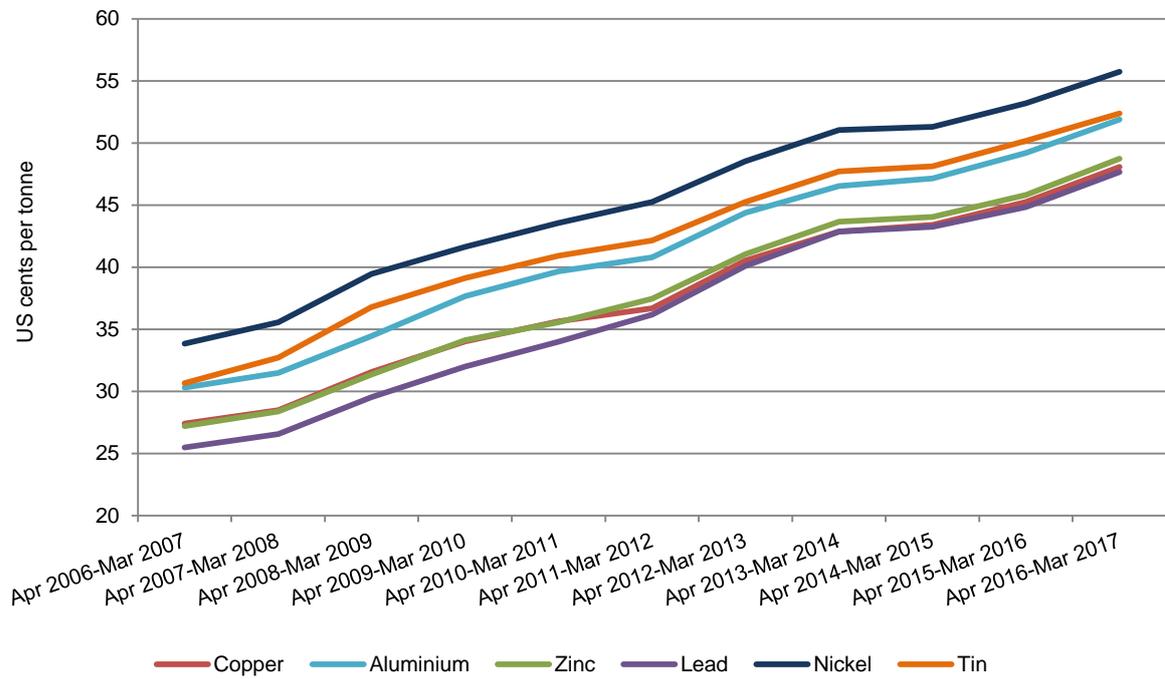
Historical development and analysis of Headline Warehousing Charges

30. The LME has previously noted the incidence of high⁷ Headline Warehousing Charges. In coming to the view that such rates are high, the LME has regard to three broad market observations:

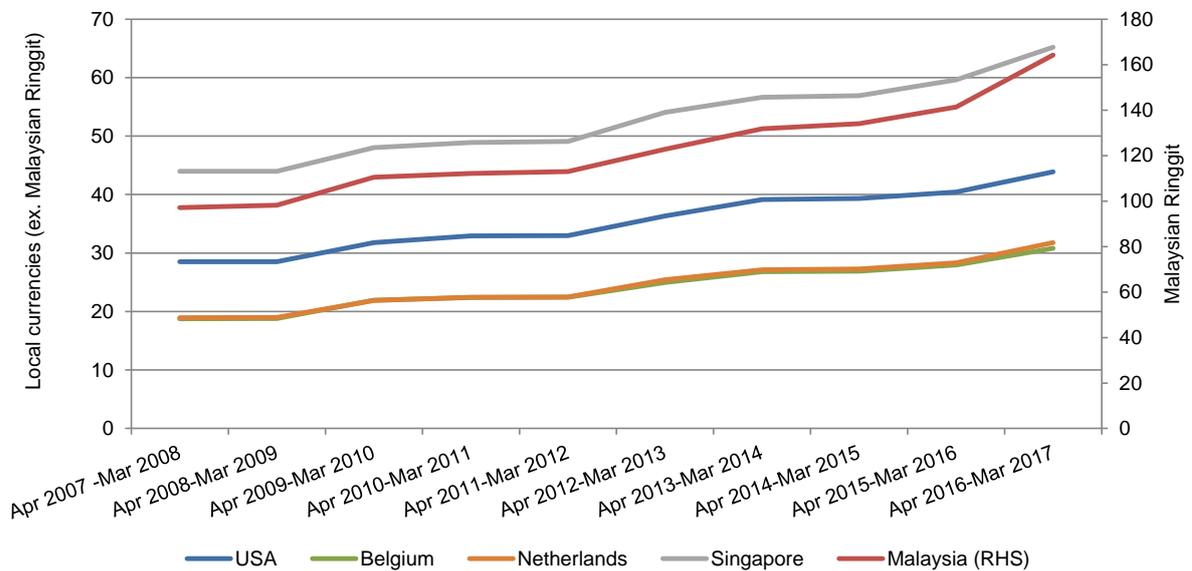
- (a) Year-on-year increases in the Headline Warehousing Charges.

Over a number of years (and starting significantly before the emergence of queues at LME warehouses), such increases have been significantly above the rate of inflation. While it may be the case that, in a particular year, specific factors (such as the introduction of new rules by the LME) mandate higher rates of increase, the persistence of such increases over a period of several consecutive years suggests that Headline Warehousing Charges may be increasing at a faster rate than the underlying economic costs of providing the services to which they relate.

⁷ From this point, the Discussion Paper will use the term "high" to refer to Headline Warehousing Charges which have, in the view of the LME, diverged from the true economic cost of delivering the storage and logistical services to which these charges relate, and which may therefore be unfair to the customers on whom they are levied.



Development of average rent per metal



Development of average FOT rate in certain key countries

- (b) Comparison between Headline Warehousing Charges and the rates charged to users on a bilaterally-negotiated basis.



As set out further in paragraph 19(b), headline rates are generally only charged to metal owners who take delivery of warrants through the LME settlement process. If a metal owner places metal on warrant and looks to withdraw that metal themselves, it is generally possible to negotiate significantly reduced levels of rent and FOT. This may suggest that the headline rates are deliberately set at a high level to target metal owners who do not enjoy the bargaining power to negotiate economically rational rates. Warehouses have not historically been obligated to report such negotiated rates to the LME⁸, but the LME's anecdotal experience has been that there exists a material divergence between headline and discounted rates.

The LME notes that there may be additional factors which would naturally cause discounted pricing levels to be lower than Headline Warehousing Charges. In particular, "rent deals" often require the metal owner to commit to storage for a given period of time, allowing the warehouse greater visibility over future cashflows, and (in common with most economic systems) commanding a discount in exchange for a commitment to longer-term usage of the service.

Additionally, discounted pricing levels are generally offered in exchange for the storage of a large quantity of metal by a single owner, whereas the Headline Warehousing Charges may relate to storage or withdrawal of as little as one lot of metal. However, the issue of scale is further complicated by certain of the LME's warehousing rules, and in particular the introduction of QBRC on 1 May 2016 – in this context, certain warehouses have noted that the storage of too great a quantity of metal by a given operator in a given location may give rise to scale dis-synergies, in that a simultaneous cancellation of a large quantity of metal by a number of parties⁹ may give rise to load-out queues which, under QBRC, would represent a loss of revenue for the warehouse operator. It could further be argued that discounted rate storage can avoid certain of these issues, as the warehouse operator will likely enjoy greater visibility as to when the metal will be withdrawn (e.g. at the end of the "rent-deal" period), and can plan accordingly in respect of other metal.

The position of the LME remains that it intentionally licenses a large number of Delivery Points, such that warehouse operators may establish LME

⁸ An obligation of this nature took effect on 1 January 2016, and the first reports were submitted in April 2016.

⁹ In the event of cancellation by a single party, or multiple parties acting in concert, the warehouse operator would be protected by the anti-abuse provisions of QBRC.



warehousing activities in a number of different locations, and hence avoid the need for any one location to become so large that it risks losing economics under QBRC. Arguably this may act to increase charges for LME vs. off-LME storage, as further set out below.

- (c) Comparison between Headline Warehousing Charges and the cost of off-warrant storage.

Again, there is no obligation for warehouses to report off-warrant charge levels to the LME, but the LME's anecdotal experience suggests a significant disparity in pricing between LME and off-warrant charges. While the LME accepts that the obligations associated with LME warranting are greater (for example, the requirement for LME reporting, indoor storage, maintenance of a London agent, payment of the LME stock levy, compliance with LME load-out rates, the introduction of QBRC etc), the LME is not convinced at present that this would account for the scale of observed divergence between the two sets of prices.

31. For those reasons, the LME is concerned that charges may be unreasonably high – a factor which (as set out further in paragraph 10) could affect the LME's assurance to the FCA that its warehousing arrangements are operating in a way that enable it to satisfy its regulatory obligations. As a result, and as part of the 2013 Consultation Results¹⁰, the LME committed to investigate potential solutions to high charges, including capping Headline Warehousing Charges ("Charge-Capping", or "CC")¹¹.
32. To honour its commitment in the 2013 Consultation Results, the LME undertook a review of the scope of the LME's powers under competition law to cap Headline Warehousing Charges, and published the summary of this review as the Annex to the 2015 Discussion Paper.
33. Ultimately, the LME decided to adopt a "wait and see" approach to CC following the 2015 Discussion Paper, reserving the right to implement the measure in the future should the structural issues caused by high Headline Warehousing Charges persist, rather than progressing with the implementation in the immediate term. This was in consideration of a number of factors, including (but not limited to) (a) the high level

¹⁰ See Notice 13/326 : A312 : W125 "Result of consultation on changes to LME policy regarding the approval of warehouses in relation to delivery out rates", 7 November 2013 and attached Consultation Report (together, the "2013 Consultation Results").

¹¹ The charge-capping approach was chosen for investigation since it had been the most common suggestion received to the 2013 Consultation as to how the problem of high Headline Warehousing Charges could be addressed. However, at the time of publication of the 2016 Discussion Paper, the LME had not yet reached a view as to whether charge-capping was the only approach capable of addressing this issue, hence the inclusion of five reform proposals.



of litigation and investigation risk associated with such a measure and the potentially disruptive effect such litigation or investigation could have on the market, (b) the LME's recognition of the market preference for time to allow existing reform to take effect before assessing the need for further change, (c) recognition that warehouse operators had shown restraint in recent years when setting Headline Warehousing Charges (see paragraph 35), and (d) the LME's preference to allow its warehouse operators to set the rates for their businesses themselves.

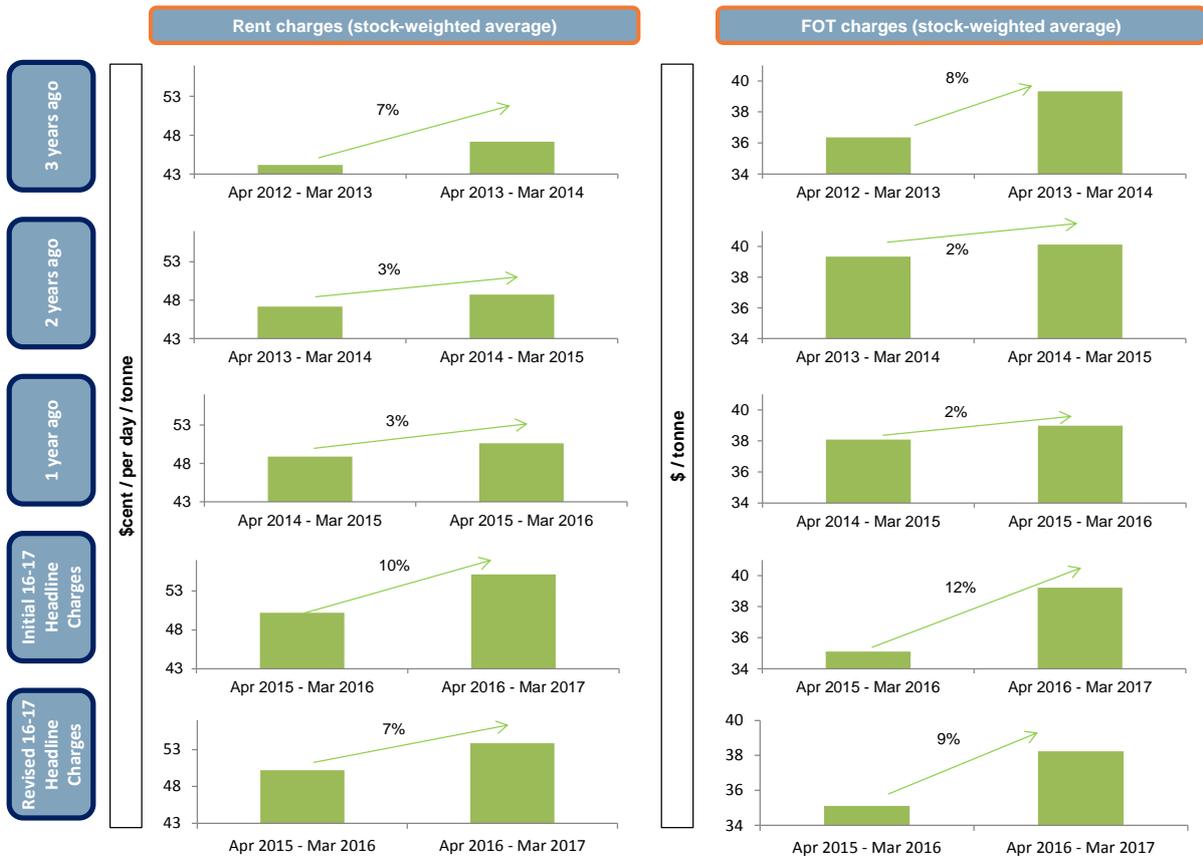
34. Given the evolving market context outlined below, however, the LME felt that it would be appropriate to further explore its options to address high Headline Warehousing Charges. This is the context in which the 2016 Discussion Paper was released, and following the results of this paper, and the wealth of feedback which supported both the LME's analysis of the problem and further reform through which to address the issues under discussion, the LME is now minded to progress with the introduction of charge-capping.

Recent developments in respect of Headline Warehousing Charges

35. Headline Warehousing Charges have increased significantly in recent years. Charge increases from 2012-2013¹² to 2013-2014 were 7% for rent and 8% for FOT (computed as a stock-weighted average to accurately reflect the real financial implications¹³). Following a call for voluntary restraint in respect of rate rises from the LME, for 2013-2014 to 2014-2015 the rate rises decreased to 3% and 2% respectively. From 2014-2015 to 2015-2016 charge increases were again 3% and 2% respectively. Most recently, however, and as illustrated by the graphs below, the stock-weighted averages for Headline Warehousing Charges submitted for the 2016-2017 cycle were significantly higher than in respect of the previous two cycles, being 10% for rents and 12% for FOTs.

¹² Years relate to rent cycles i.e. 1 April of the first year to 30 March of the second year.

¹³ For more detailed notes on the calculation methodology, interested parties are referred to Notice 15/410 : A397 : W138 ("Rent and FOT charges 1 April 2016 – 31 March 2017", 30 December 2015, the "Initial 2016-2017 Charges Notice"). Note in particular that stock-weighted averages are recalculated each year based on updated stocks and exchange rates (in the case of FOTs), and hence restated levels may not be the same as the figure for the same period when analysed in the previous year.



Stock-weighted rent and FOT increases over recent years¹³

36. The LME has always noted (e.g. in paragraphs 46(e) and 111 of the 2015 Discussion Paper), that one effect of warehouse reform may be to cause warehouse operators to increase charges – and the LME does not dispute that certain of its rule changes do place greater burdens on warehouse operators.
37. However, in the view of the LME, the levels submitted by LME-listed warehouse operators for 2016-2017 did not appear to be based on objective economic factors, even considering that 2015 saw the implementation, or announcement of future implementation, of significant levels of reform to the LME warehouse network. While this would suggest that a greater-than-inflation charge increase would be justified, as set out in paragraph 30, the LME believes that Headline Warehousing Charges have been, for many years, high compared to all relevant market comparators. Accordingly, the impact of high percentage increases applied to already inflated price levels suggests that the absolute Headline Warehousing Charges are disproportionately high. Although the LME employed its powers to query the economic rationale for such charges, this did not materially change the nature of the



submissions, which were eventually published in the Initial 2016-2017 Charges Notice.

38. The level of increase caused concern for metal owners, and specifically those owners buying metal on the LME market, and hence more likely to pay the Headline Warehousing Charges stipulated by the warehouse. In particular, metal owners subjected to load-out queues (and hence compelled to pay daily rent while waiting to withdraw metal from the warehouse) were particularly aggrieved, although the LME would note that the introduction of QBRC would provide offsetting relief to a number of such metal owners. However, metal owners with load-out slots scheduled after the introduction of the new charges (1 April 2016) and before the offsetting impact of QBRC (broadly during June 2016) would indeed be subjected to a greater level of charges.
39. Furthermore, certain warehouses commented specifically on the disparity in charge levels submitted for the 2016-2017 rent cycle. In particular, certain warehouses were of the opinion that they had demonstrated restraint in the setting of charges, and that the fact that others had not done so had placed those showing restraint at a competitive disadvantage. While it is clearly for each warehouse operator to arrive independently at the assessment of appropriate charges, there exist significant perverse incentives in that those operators submitting the highest levels of charge increase (even if not objectively justified by economic factors) will enjoy a competitive advantage in terms of the ability to pay incentives and source metal.
40. As a result, the LME believed that these extraordinary circumstances justified action, and announced¹⁴ that the LME would re-open the Headline Warehousing Charges submission window for a two week period for downward modifications to 2016-2017 charges only.
41. This two week period closed on 19 February 2016, and the LME was pleased to announce on 29 February 2016 in the Revised 2016-2017 Charges Notice that two warehouse companies had taken advantage of the opportunity to reduce their Headline Warehousing Charges for the 2016-2017 period.
42. However, the LME was clear in the 2016 Charge Window Re-Opening Notice and the Revised 2016-2017 Charges Notice that such a re-opening would be an exceptional one-off event given the extraordinary circumstances, and that it did not intend to repeat this process should the problem arise in future years, due not only

¹⁴ Via Notice 16/044 : A043 : W012 ("Re-opening of rent and FOT rate window for downward modifications", 5 February 2016, the "2016 Charge Window Re-Opening Notice").



to the market uncertainty engendered by such a process, but additionally because this solution does not address the underlying problem, namely that the market will remain susceptible to this issue while the LME does not have broader powers in this respect. The LME has no reason to assume that, in the absence of any substantial change, the market will not encounter the same, or similar problem, during the next and / or future rate-setting cycles, a factor which could affect its ability to provide an orderly market. Furthermore, it is highly likely that the charge-setting process for the 2017-2018 rent year will be particularly impacted, since warehouse operators who feel disadvantaged by the disparity in paragraph 39 might submit large increases in order to avoid the possibility of again being “left behind”, thus further accentuating the “upwards spiral” set out in paragraph 24.

43. As a result, in the Revised 2016-2017 Charges Notice, the LME concluded that it would, at a minimum, explore the possibilities for implementing a longer term solution to high charges – hence the 2016 Discussion Paper. In making this commitment, the LME was mindful of the widely-held market view that the LME warehousing network has been the subject of considerable reform activity, and that it would be preferable to avoid further reform, particularly until the impact of current reform can be fully assessed. Furthermore, the LME notes the argument that issues in respect of Headline Warehousing Charges may resolve themselves over the coming years as the effect of warehouse reform beds-in¹⁵. However, in the view of the LME, the market concerns expressed around the 2016-2017 charge-setting process necessitated at least the investigation of further action to address these issues and that led to the 2016 Discussion Paper.
44. The 2016 Discussion Paper outlined five Discussion Items which were put forward as the best options to address the issues outlined above. This Notice summarises the feedback received in respect of these items and explains why, following consideration of that feedback, the LME currently considers charge-capping to be the LME’s preferred option in this respect.

SECTION 2: ASSESSMENT OF DISCUSSION POINTS 1 AND 2

Discussion Point 1: Do you agree with the LME’s proposition that (i) Headline Warehousing Charges are out-of-line with the economic cost of providing the services to which those charges relate, and thus out-of-line with both off-warrant and discounted LME rates, (ii) that such charges may be unfair to customers of the market, (iii) that this may

¹⁵ Although it should be noted that issues of high Headline Warehousing Charges have been a topic of LME market concern for a period of many years, and considerably predate the current warehousing reform initiatives.



have an impact on the quality of LME pricing, and (iv) that the mechanism by which charges are set leads to the danger of an increasing degree of disparity?

45. In general, the majority of respondents to the 2016 Discussion Paper did believe that Headline Warehousing Charges are out-of-line with market comparables, arguing variously that FOT is often (if not always) unrelated to the cost of releasing metal from a warehouse, and that these charges distort the market and are unclear, unfair, or both. One respondent also pointed out that this disparity is extreme and, given that only a few players can take advantage of it, these players are able to manipulate markets and circumvent any reform implemented by the LME. It was also seen to have a negative impact on competition.
46. However, other respondents did not agree – highlighting that, in reality, headline charges are rarely paid, that they are not always higher than the true economic costs of storing the metal, and that any discrepancy can be accounted for in a number of ways, including the plethora of additional regulation imposed upon warehouse companies by the LME, by the very real costs, which are – at times – substantial, associated with putting metal into a warehouse and storing it, and by the additional services provided by LME warehouses. Additionally, one respondent pointed out that the “significance” of discounts is subjective, that this is not always the case, and that there are also times when the metal owner will pay the warehouse to put metal on warrant. These respondents warned that undermining the value of such services (and related costs) risks undermining their value, the ultimate consequence of which could be a reduction in services and standards to better compete with off-warrant costs, or a departure from LME warehousing altogether.
47. One respondent felt that the LME was being disingenuous in arguing that rent and FOT charges are a factor in price discovery (and therefore subject to regulatory oversight), arguing that the numbers of contracts actually going to physical delivery are too low to be relevant to price discovery. They felt instead that price discovery is a combination of factors including supply vs demand, stock availability, interest rates and storage costs and that the traded future is a hypothetical lot of metal of any brand in any warehouse. This respondent did not feel that storage and financing components are likely to be material to traded price, and would be very small compared to other costs in the physical purchase price. Further, this respondent pointed out that a number of transactions occur after a warrant has been exchanged to enable the buyer to source metal appropriate to their needs and that within this broader process (which is not subject to supervision by the LME), rental charges are only a very small part.



48. This respondent was disappointed, therefore, that the LME had not chosen to include other costs which may be material to the LME price within the scope of the 2016 Discussion Paper. Further, given this distinction between the price discovery process for the first, hypothetical, lot, and the second, physically-delivered, lot (including all appropriate adjustments), this respondent felt that the LME should be focusing on the first for regulatory reasons, and the second to ensure the groundwork is in place (i.e. storage arrangements, brand management and contractual infrastructure). However, they stressed that the LME should not be trying to supervise the second – either directly or by stealth.
49. Other respondents highlighted that the LME requests an economic justification for those charge submissions which are believed to be out-of-line, a process which is often followed by a reduction; in short, that many warehouse companies work with the LME to ensure that their charges are fair. Some frustration was expressed here that the increasing disparity was the result of the lack of restraint shown by only a few operators and that all warehouse companies should not have to bear the consequences of the actions of a few. Alternatively, some respondents felt that these charges are only unfair if considered in isolation and not in conjunction with the incentives that warehouse companies have to pay in order to attract metal into a warehouse. One respondent went on to explain that, for the majority of warehouses, FOTs are a zero-sum equation in conjunction with incentives.
50. One respondent disagreed with the rationale that FOT is used to lock in higher rents arguing that it is, in fact, used to pay for moving metal to access the specific warrants required for load-out, with any remaining used to fund the empty space left behind. Funding this is considered crucial given the role of warehouses to absorb metal quickly in times of over-supply, a function that requires spare warehouse capacity.
51. Some respondents did feel that these charges are unfair or unclear to customers, although it should also be noted that many respondents believed them to be unfair to all market participants, not just customers. Customers, in fact, were seen by some respondents as sufficiently knowledgeable and sophisticated to cope with such seeming anomalies, that they frequently only own the metal for a brief period of time, in which case the charges have minimal impact, or, that customers frequently heavily negotiate the charges (especially those dealing with high volumes and / or special arrangements) and that paying a high FOT has often been offset by receiving an incentive of comparable size.
52. Additionally, it was noted that rates are transparent so they are known well in advance by all market participants, that the metal price is discounted accordingly,



and fixed over a year-long period meaning that they do not have to be hedged, and allowing customers to factor in increased or reduced costs immediately and to make decisions which take these charges into consideration. The only exception provided to this flexibility was when metal was held in queues, but, as pointed out by this respondent, this is now irrelevant given the LME's work on tackling queues.

53. Further, one respondent pointed out that a metal owner can negotiate the rent or withdraw the metal in favour of a better deal elsewhere. Given that FOT charges are factored into the price of the metal, this respondent felt that the owner has considerable leverage unless there is a queue. They also felt that the LME's analysis of incentives (specifically in paragraph 27 of the 2016 Discussion Paper), omits the fact that often the basis of LME storage is a physical flow of metal which can get disrupted through economic circumstances, prompting the metal owner to use the LME as a market of last resort. This respondent felt that metal is warranted, therefore, most often in the absence of a physical buyer, with the exception of warehouses with queues in which case the warehouse became the market of first resort.
54. More specifically, one respondent disagreed with the LME's analysis of "front" vs "back" book, arguing that it is oversimplified and flawed and pointing out that not only are market participants sufficiently knowledgeable to deal with market circumstances as outlined above, but in fact, most cancellations are driven by financial participants who have sophisticated systems which calculate when and if to cancel metal. In addition, this respondent considered that most warehouse reform has resulted in a redistribution of economics directly to these participants from warehouse operators and exacerbated issues relating to cancellations and queues.
55. For one respondent, this raised the question of whom the LME is trying to protect, pointing out that discounts arose during a time when there was an excess of storage and a few large counterparties were able to dictate terms to warehouse companies. That this has continued to present day should have meant, they believe, that the LME asks itself whether it should be warehouses that warrant additional protection.
56. One respondent argued that in fact, the participants are only at a disadvantage when rules are broken or the market does not function as it should. Examples provided of this include queues and aluminium buyers recently disadvantaged by backwardations because the spot price for warrants has been artificially inflated by the shortage of LME warrants for delivery.
57. Some respondents also agreed that high charges impact negatively on LME pricing given that the frictional costs of storage have to be factored in to LME pricing (or



premium) and if not, then the all-in price does not reflect the actual cost of the underlying metal. This risks market disorder and decreases the relevance for the LME as a pricing venue, the quality of LME pricing and creates distance between the LME and the physical market. Further, several respondents pointed out that high charges encourage metal into non-LME storage, reducing liquidity – one respondent argued that it is these conditions which has led to recent backwardations on the aluminium market, blaming both LME reforms, and the impact of financial speculators.

58. In general, respondents who took this view also believed that the mechanism by which these charges are set does lead to a danger of disparity meaning that the LME is unable to fulfil its role as a market of last resort for those transacting metal, or that the high charges levied by some will have a knock-on effect on the behaviour of others in the following year. This process was described by one respondent as a self-reinforcing system or vicious cycle which will only further increase the delta between headline and bilaterally-negotiated charges. Finally, one respondent pointed out that the LME is responsible for this process, that warehouses are provided with no signalling mechanisms as to where charges should be, and that issues contained therein could have been resolved earlier had the LME consulted appropriately with warehouse companies and clearly defined how to calculate the rates. As a result, this respondent objected to the LME blaming warehouses, especially those who have never had, nor benefitted from, queues.
59. As a result, these respondents do feel that the LME needs to take action to address charges or risk significant inflation of rent and FOT rates, such risk meaning that that the system will no longer be financially viable for existing customers or appealing for new customers.
60. The LME notes the diversity in feedback received in respect of this question, a fact which mirrors previous market feedback, and understands that this is a controversial topic which far reaching implications for many market participants.
61. The LME is entirely cognisant of the fact that the standards and obligations for LME warehouses are significantly higher than those for off-warrant metal, and as such, agrees that these charges should be higher. The LME is also aware, and is very grateful for, the efforts made by many of the warehouse companies in its network to respect calls for restraint when setting charges over recent years.
62. The LME does not accept the argument in favour of retaining the current system made by some participants that customers are market experts able to negotiate the current system as effectively as any market operator, and that the market as a whole



has evolved to incorporate the specificities of LME rates, and rate-setting process. The LME is of the belief that, in order to promote the operation of a fair and orderly market, all processes should be clear and straightforward to implement. Moreover, the LME does not believe that the current system is unfair only to customers – in the LME’s view, certain warehouse companies may be equally disadvantaged by a rate-setting system which promotes the “leap-frogging” behaviour outlined in paragraph 24.

63. The LME notes the alternative market analysis put forward by respondents, especially regarding the relatively low numbers of contracts going to physical settlement (a fact which is not under dispute). The LME agrees that further transactions take place in order to convert an LME warrant received in settlement to one appropriate for that buyer’s need. However, the LME does not believe that it follows that this warrant, once these negotiations begin, becomes divorced from the original price discovery process. The basis for those onward transactions will be the price originally paid for the warrant on the LME, a price which would absolutely have factored in key warehousing factors such as rent, FOTs or queues. Thus the LME does not agree that these rates are outside of its regulatory ambit.
64. Thus, the LME believes that its analysis, as set out in section 1 above, is correct and that charges which are out-of-line with market comparables are unhelpful for and potentially distorting of the LME price; further, that the mechanism by which charges are set – a mechanism which is run by the LME itself – no longer provides an adequate structure or process through which warehouses are able to set fair charges which represent, as accurately as possible, the underlying cost of providing such services. Given this, and the ongoing risk to LME price discovery, the LME is minded to take action to address this issue.

Discussion Point 2: Do you believe that the LME already holds, under the existing LME Warehouse Agreement, sufficient powers to address the issue of high Headline Warehousing Charges?

65. There was a fairly even split between respondents who feel that the LME does already hold sufficient power to address the issue of high Headline Warehousing Charges, and those that do not, and one respondent commented that they would be happy for the LME to provide clarity on the rules in order to settle this issue.
66. However, even those who do think the LME holds sufficient power point to various difficulties in utilising those powers – questioning whether it would be legal or appropriate, either because the wording of such powers is too subjective (for example, terms such as “exceptional” are difficult to define), because the current



climate means that the LME's starting position would be too weak, or because, while the LME can query the economic rationale for such charges, it cannot enforce material changes.

67. Those respondents who do believe that the LME already holds sufficient powers point to Clause 9.3 ("Proper functioning of the market") and / or Clause 11 ("Principles of conduct") of the LME Warehouse Agreement. Some also believe that the LME could simply delist warehouses and / or companies which are having a distortive effect on the market – a response which some respondents would have liked the LME to take in response to those warehouse operators who increased their charges significantly at the end of 2015.
68. These respondents expressed their disappointment that the LME does not exercise their powers in this regard, or that the LME does not believe that it holds such powers. They believe that this limits the Exchange's ability to proactively address issues with warehouse companies. Some respondents also expressed their regret that the significance of this is that the LME is only able to progress using a pan-industry formal legal or regulatory approach – seen as overly lengthy and complicated given that they perceive the issue to have been caused by only a few market operators. The preference would have been to target these operators specifically rather than pursuing universal rule change; indeed, the preference generally was that the LME should pursue all those who break the rules and publicise such action. One respondent pointed out using existing powers would have negated the necessity of the 2016 Discussion Paper and reduced uncertainty caused to the market by the diversity of reform scenarios under consideration.
69. The LME recognises the disappointment felt by a proportion of respondents that the LME did not aggressively pursue those perceived as having taken advantage of, or even broken, LME rules regarding charge-setting. However, as recognised by other respondents, the LME does not believe that its existing powers provide adequate scope for the LME to pursue action against these market participants. Specifically, the LME does not believe that the powers contained in the LME Warehouse Agreement, in particular relating to Clause 9.3 and Clause 11, give the LME sufficiently clear and unambiguous authority to intervene in the charge-setting process. The LME set out in the 2016 Discussion Paper (see in particular paragraphs 52 and 53) why this is the case, and it has not seen compelling arguments from respondents to the contrary. In addition, the LME is concerned, as outlined above, that it is the process for rate-setting itself which lies at the heart of this issue and allows such a scenario as seen during the rate-setting process at the end of 2015 to occur. As such, the LME is of the belief that it would be appropriate to amend this process so as to provide a clear and unambiguous system for rate-



setting which includes both the right of appeal, and clear consequences for associated rule breaches. While the LME notes (and is sympathetic to) market concerns that LME warehouse reform has already been far-reaching and that the market would appreciate a pause in the rate of reform, this does not relieve the LME of responsibility to act where an issue exists (as appears to be the case with Headline Warehousing Charges and the process for setting such charges). This is particularly true where there exists a clear market concern that such issue may manifest itself in the near future (as appears also to be the case with the annual rate-setting process).

SECTION 3: ASSESSMENT OF DISCUSSION POINTS 3 TO 9

Discussion Point 3: *Do you have a perspective on (i) the appropriate maximum levels of Headline Warehousing Charges (options (a)-(d)), and (ii) the relative need to address levels of rent vs. levels of FOT?*

70. For many respondents, the first half of this question represented the key to the discussion on the issue of high charges.
71. A range of opinions were provided in respect of options (a)-(d). In broad terms, however, the market consensus was that (a) or (b), or a combination of both, would be acceptable to the market, but that (c) or (d) would be more likely to lead to legal action. While many respondents thought that such a legal threat should not deter the LME from taking the right course of action, there was almost no suggestion that pursuing the more aggressive routes of (c) or (d) would lead to sufficient benefits to justify such a risk, including the potential delay, disruption and concomitant difficulty in implementing such a solution were any party to commence with legal action. Indeed, the prevalent opinion amongst respondents was that (a) or (b) would be the preferred options regardless of the likelihood of any legal threat.
72. Option (a) was seen by those in favour as the least disruptive method, providing a welcome limit to price increases and preventing further deterioration. It was also favoured by those who supported a control of future increases but saw no need to address current levels, and was seen as the “least worst” option by those who do not perceive there to be an issue with the market orderliness in the current system. Additionally, it was preferred by those respondents who felt that options (b), (c) and (d), in reducing the delta between on- and off-warrant charges, would lead to a consequent withdrawal of warehouse companies (and thus competition) from the LME system due to the difficulty of balancing high operational costs in such a pricing environment.



73. However, three respondents felt that option (a) would be insufficient given that it would not reduce the delta between Headline Warehousing Charges and Bilateral Warehousing Charges.
74. Option (b) was seen as a good compromise, a reasonable measure to bring the market back to a more realistic charge comparison, easy to implement and likely to be acceptable to warehouse companies, who would have time to earn back the majority of historically paid incentives. Respondents felt that it would, in time, address both increasing charges and the delta between Headline and Bilateral Warehousing Charges without causing significant disruption.
75. One suggestion made in support of (b) was that the FOT should be frozen indefinitely with the aim that, over a significant period of time, due to inflation, this contract would eventually transition naturally into an FOT contract. An alternative suggestion was to freeze only until 31 March 2019, at which point, inflationary increases would be allowed.
76. One respondent commented that it would be interesting to see if Bilateral Warehousing Charges under option (b) rose more quickly than they might have done otherwise – although the LME notes that it would be impossible in practice to judge this, given that only one part of the data would ever be available to conduct such analysis.
77. Those not in favour of (b) felt that it would represent too slow a pace of reducing the delta between Headline and Bilateral Warehouse Charges.
78. Option (c) was supported by those who felt that it represents a reasonable compromise between a gradual reduction in the delta between Headline Warehousing Charges and Bilateral Warehousing Charges and allowing market participants sufficient time to adjust their strategic planning to incorporate the new pricing structure, but noted that it does raise the issue of what would be a reasonable rate at which to reduce the delta.
79. Those less positive disagreed, feeling that option (c) would be more difficult given the likely consequences of financial loss to warehouse operators whose ability to recoup money from historically paid incentives would decrease over time. It was also pointed out that any solution involving an immediate decrease of charges would also pose an increased risk of disruption to the warehousing market, including all-in metal pricing, and as a result, that it would carry a fair degree of legal risk and consequent potential delay – itself creating greater uncertainty.



80. No respondent proposed that the LME progress with option (d), which was viewed as the most disruptive option, potentially too aggressive, requiring a decision about what would represent a reasonable rate at which to reduce the delta, and most likely to lead to legal action – either from a warehouse company or other market participant affected by the impact on the all-in price and thus, potential future earnings. One respondent felt that options (c) and (d), i.e. the unilateral imposition of rate reductions, should be beyond the LME’s legal authority unless every LME-listed warehouse company agreed to such a measure.
81. One respondent felt that, under existing models used by warehouse companies, convergence of charges would not be desirable.
82. Another respondent suggested that the LME consider a broader set of solutions in terms of setting caps including separate accounting for rent outside the LME contract (e.g. discounts) so that these variants would not impact the LME price or for the LME to use an average net rent (received less rebated) which they felt would encourage efficient warehouses without disadvantaging the market. They did, however, point out that a risk would be that the major stockist would take their metal off warrant given there would be less incentive to store on-warrant.
83. Regarding the relative need to address rent and FOT vs. just FOT, many respondents were concerned that capping FOT only would lead warehouses to seek to recoup lost earnings through other avenues, the most likely being rents if they were not capped concurrently. Thus, the consensus was that both rent and FOT would need to be capped to protect holders of metal on-warrant.
84. However, one respondent, in support of capping FOT rates only, pointed out that decreasing FOT would automatically lead to metal leaving those warehouses with higher rental charges which would, in turn, prompt warehouses to lower their rental rates. Thus, this respondent’s view was that capping rent in addition to FOT would be unnecessary and would run the risk of increasing the likelihood of a legal challenge.
85. One respondent commented additionally that capping rents would have little impact given that rent is factored in by the market on its future pricing, so rent caps would just change the factor that the market uses to do so.
86. Finally, two respondents commented that rent levels have already been addressed through QBRC, and thus they were more concerned to cap FOT, but had no objection to both charges being included under the cap.



87. The LME agrees with the majority of respondents that this issue of the LME's position on options (a) to (d) lies at the heart of the discussion on any charge-capping measure – and notes that four of the five Discussion Items in the 2016 Discussion Paper would require a decision on exactly this point.
88. In considering its options, the LME is cognisant of the wealth of responses received in respect of the 2016 Discussion Paper which outlined the general level of market fatigue with reform of the LME physical network (fully outlined below from paragraph 227). The LME itself agrees that the pace of reform over the last few years has been significant and as such, is aware that the benefits of further change now have to be weighed against the possibility of further market disruption.
89. As such, the LME remains concerned that (c) and (d) have the potential to cause significant disorder, including an undue level of legal risk. As a result, the LME notes the preponderance of responses towards (a) and (b), and is in agreement that these two options represent the more reasonable, proportionate and fair compromise between the views of various sectors of the market. In considering which would constitute the most appropriate position for the proposed implementation of charge-capping, the LME is also minded that it has to take into consideration the practicalities of implementation and ongoing administration.
90. The LME is grateful for the thought that some respondents put in to considering other structures; however, the LME is not persuaded that an average rent and a separate accounting model would be feasible, given the potential difficulties caused to all market participants in making significant changes to the mechanics of rent pay-up and the levying of other warehousing charges.
91. With regard to capping both rent and FOT vs. capping FOT only, the LME shares the concern of some respondents that if only FOT charges were capped, the easiest way to recoup lost FOT revenue would be to raise rents and as a result, the “leap-frogging” of charges witnessed in previous years would continue. Thus the LME considers that it would be preferable to cap both charges rather than just one, in order to maintain consistency and an orderly process.

Discussion Point 4: Do you have a perspective on the determination of Current Headline Warehousing Charges – per-operator or general, and choice of year?

92. Many respondents felt that it would be most appropriate to start with 2015-2016 charges given that the 2016-2017 charges were generally viewed as excessive.



93. It was acknowledged that applying 2015-2016 levels would have the effect of immediately reducing charge levels (a *de facto* – although mild – transitional floor, or option (c)) and opinions were mixed about the legal risk associated with this, with some respondents still preferring to implement on the basis of 2015-2016 levels, one respondent feeling that 2016-2017 charges would be safer, and another suggesting basing caps on those rates which will be submitted at the end of 2016 for the 2017-2018 cycle.
94. One respondent recommended next years' rates (1 April 2017 to 31 March 2018) be set at the weighted average of the charges across all warehouses as at 1 April 2016 which would mean no net increase but level charges across all warehouse companies.
95. Almost all respondents supported a general or per-Delivery Point application of Headline Warehousing Charges as the only fair way to avoid distortion or economic imbalance caused by locking in potentially disadvantageous levels between operators – causing some to be more expensive than others. These respondents disagreed, however, as to whether this should be the average per-Delivery Point, or the current highest per-Delivery Point.
96. One respondent felt a regional approach would be preferred given, for example, the North-Europe region (consisting of Antwerp, Rotterdam, Hamburg and Vlissingen) and South-East Asian region (consisting of Singapore and Johor). These locations serve the same market with similar conditions and the respondent felt that it would be undesirable if one location were favoured over another. Similarly this respondent was also anxious to avoid some operators being able to pay higher incentives, so recommended choosing the highest rate in a delivery point region in the chosen year to ensure a level playing field and minimise legal risk.
97. As to the choice of basis year, the LME does recognise that choosing 2015-2016 charges could be viewed as a *de facto* charge reduction; however, the predominant opinion here suggests that the market is dissatisfied with the excessive increases contained within some of the charges submitted for 2016-2017, and would prefer to revert to 2015-2016 levels as a more reasonable basis. Accordingly, and in order to balance the reasonable views of all stakeholders, the LME's present view is thus that any measure involving the capping of charges would be most appropriate if levied starting from the average of maximum 2015-16 and maximum 2016-17 levels.
98. In respect of the geographical basis, the LME agrees that locking in discrepancies between operators, regardless of basis year chosen, would be unfair to those operators who had consistently shown restraint in rate-setting. As such, the LME, as



outlined in the 2016 Discussion Paper, considers that a general approach would be more appropriate.

99. Although the LME notes that many respondents preferred a per-Delivery Point charge, the LME's analysis suggests that this would still have the disadvantage of locking in rate discrepancies, for example, low rates at a particular location within a country where rates are, typically, higher. As such, the LME believes that it would be appropriate to base the Current Headline Warehousing Charges on the mean arithmetical average of (i) the highest of 2015-2016 rates in a given country, and (ii) the highest of 2016-2017 rates in that same given country.

Discussion Point 5: Do you have a perspective on the determination of Target Future Maximum Headline Warehousing Charges – location and metal granularity?

100. Although, as one respondent pointed out, it is recognised that one of the strengths of the LME is the global nature of its contracts – and that maintaining this global following is important – in general there was acknowledgement that FOT rates would need to be set to reflect the local cost of conducting warehousing operations. This is especially true, according to one participant, if the FOT does mean that the LME price trades lower than the physical market.
101. Other respondents pointed out that a global FOT charge could result in some locations being perceived as “lower cost” leading to metal flowing into these locations as the expense of other, higher cost locations.
102. Additionally, it was also recognised that different metals have different storage requirements.
103. As such, the broad consensus was that charges should be per-metal and per-location / Delivery Point (or on a regional basis) to ensure that they reflect the underlying costs of operations and to be seen as reasonable by the market. Ensuring this was seen as being both cost- and time-intensive, but necessary.
104. The LME is entirely in agreement with these views and would be concerned that a global charge would fail to reflect local, or even regional, differences, resulting in some Delivery Points being seen as “cheap” in comparison to others, an outcome which could result in a distorted distribution of metal across the LME physical network e.g. a disconnection with trade flows or supply and demand factors. Similarly, the LME is anxious that charges reflect underlying cost, and understands that some metals, specifically cobalt and molybdenum, have higher associated



storage costs. As such, the LME believes that it would be appropriate to apply charges on a per-metal basis.

Discussion Point 6: Do you have a perspective on the determination of permissible increases in Target Future Headline Warehousing Charges?

105. Views on this were mixed, with proponents stating exogenous data points would be the most straightforward, objective, easy to repeat on an annual basis, and would remove sensitivities from the process. However, some expressed concerns that it would be unlikely to cater to the specifics and idiosyncrasies of the LME market, or to regional differences. As a result, some respondents stressed that there should be adequate provision for warehouse companies to provide evidence and justification for costs above the exogenous data points, or a process through which they would be able to agree one-off changes in a location should LME rules change over that year.
106. One respondent was concerned that using the inducement and charge reports (endogenous data points) would not be objective and that this data would not represent an accurate portrait of the cost of warehouse operations. This respondent felt that the most important drivers of discounted rates are spread tightness, interest rates and client economies of scale. Another respondent commented that charge increases should be based on cost increases which include local handling and storage costs, LME regulatory changes and variations on foreign exchange and local risks.
107. As with exogenous data points, using an external consultant was understood to be fair, able to negotiate the complexity and potential contentiousness in determining permissible increases, and as the most defensible option for the LME. However, it was also considered that the consultant would be likely to require significant access to both LME staff and LME data to ensure adequate understanding of the market resulting, ultimately, in them submitting a report of the LME's work. Using someone with existing knowledge of LME warehouses would run the risk that they would not be seen as objective and one respondent questioned whether an appropriate consultant could be found. Additionally, data used by the consultant would be likely to include the inducements and charges reports which were considered to be relevant but not a leading factor in the current determination of charge levels in the market. Finally, there were concerns about warehouse operators bearing the cost of this process, given that they would, in effect, be paying to cap their own income thus providing them with a valid argument to increase charges.



108. Ultimately, many respondents felt that this would be a process best conducted by the LME, given the Exchange would also be aware of current charge-setting procedures. The LME already has access to all the data sets involved in an exogenous and endogenous process, as well as being well versed in market developments and warehouse operator concerns. However, respondents did raise the risk that the LME would not be seen to be independent.
109. Finally, one respondent stressed the need for any approach to involve input from warehouse companies, considered crucial to ensure all relevant variables are taken into account while setting charge levels, and would also mean that warehouse operators were less likely to object to charges set.
110. The LME, for the most part, is in agreement with respondents on the issue of how to determine future permissible increases and is alive to the need to balance a sensible use of time, resource and effort with the need to provide caps which are fair, reasonable and proportionate and reflect the interests of all sections of the market. As such, the LME would be minded to use an exogenous data series which would be straightforward and objective to implement, and would not materially increase the administrative burden of either warehouse companies or the LME in submitting and / or collating charges on an annual basis to produce a more tailored index against which rates could be set.
111. The LME is aware that this option carries greater risk that the index is not a specific match to the cost of warehouse operations, but an inflationary-linked index would mean that the cost of warehousing did not exceed the permissible increases and would thus seek to ensure that warehouses were not economically disadvantaged by caps set on this basis. Additionally, the LME respects those concerned that the LME should provide sufficient provision for appeal should warehouse operators be concerned that caps set were not reflective, and agrees that it would be necessary to implement such an appeal process to afford warehouse companies sufficient time and ability to raise queries should that be necessary.

Discussion Point 7: Do you have a perspective on the determination of Worst-Case Bilateral Warehousing Charges?

112. Those that responded generally echoed their response to the previous question, stressing that consistency would be appropriate – thus those that preferred the external charges consultant route in Discussion Point 6 also supported it for Discussion Point 7.



113. Two respondents commented on how challenging, time consuming and expensive the process would be to determine which changes render a business viable without having a guaranteed revenue (which the LME does not currently do). It was pointed out that any charge linked to tonnage would also provide variable revenue depending on stock levels, and would be unlikely to cover costs when stocks are low or zero. The LME was urged to ensure it was adequately resourced to conduct this process.
114. One respondent felt that this question only applies if convergence is the objective but preferred that this issue were left to the market.
115. The LME is presently minded to agree that consistency across this process would be beneficial to the market. Similarly, the LME considers that consistency would also be beneficial for determining Target Future Headline Warehousing Charges. However, the LME does not believe that it can, or should, guarantee revenue for any company, warehouse or otherwise, which operates within the LME ecosystem. The role of the LME is absolutely to provide a fair and orderly marketplace; however, how companies choose to operate within that, provided that they abide by LME rules and regulations, has to be the prerogative of the company in question. The results of those operations, financial or otherwise, are the purview of that company alone.

Discussion Point 8: Do you believe that a “convergence” of operators’ Headline Warehousing Charges to published Target Future Maximum Headline Warehousing Charges would represent a diminution in competition?

116. Most respondents disagreed that a charge cap would diminish competition between warehouses, although many agreed with the LME’s analysis that the setting of caps for rent and FOT charges would be likely to lead to warehouse charges “floating up” to the maximum charge allowed, ostensibly representing a diminution in competition.
117. However, most respondents did not think that competition would be restricted as a result, pointing out that competition in this market is not reflected in headline charges but is often found in other areas, for example, on discounted rates offered for metal destined for longer term warranting.
118. Instead, most respondents said that they consider that charge-capping would actually increase competition as it would eliminate unfair advantages – for example, “larger companies who can fund sideways through their ownership of warehouses”, or those who could offer higher incentives having submitted higher than average increases during the rate-setting cycle. Charge caps would mean warehouse companies would then compete by offering incentives and discounted rates beneath



the headline charges, and thus warehouse companies would be operating from a relatively level playing field.

119. Two respondents pointed out that the concomitant reduction in the overall incentive “pool” would result in greater competition in the metals market as a whole and thus, despite appearances, such a convergence of charges would actually represent greater competition in the market. One felt that a reduction in warehouse costs would result in the LME system eventually reverting to acting as a market of last resort as opposed to acting as price driver for regional premia.
120. One respondent pointed out that, while incentives based on FOT are more a measure of costs and desired profit making, this is not the case for rents which are negotiated based on forward profitability for metal returns (contango) and their ability and willingness to pay rent and interest rates amongst other things. So actual storage costs would not stay the same regardless of any maximum charges, but would follow the market and increase if the commercial opportunity arises.
121. However, some respondents did have concerns – warnings were issued that in some circumstances, such as when metal is not financed or there are fewer operators (or only one interested operator), there will be less reason for warehouses to compete on charges. One respondent expressed concern that fixing prices would mean less incentive for warehouse companies to compete, or that the fixed charge may benefit certain warehouses against others.
122. One respondent also pointed out that implementing a charge cap would represent a significant increase in the LME’s own powers in the market.
123. The LME is presently minded to agree with the majority in this instance – that although a charge cap might have the appearance of reducing competition, in reality the system will continue to operate as per current practice, where warehouse operators do not compete on the level of headline charges (hence why these continue to increase out-of-line with market comparables, as fully outlined in the 2016 Discussion Paper) but on incentives and discounted rates offered bilaterally. Furthermore, the LME notes that, in the absence of a charge cap, headline charges would be likely to keep going ever upwards unchecked, so that even just looking at the impact of charge-capping on headline charges, and even if capping leads to all warehouses adopting the same (maximum) level, that is in principle less restrictive of competition than the position in the absence of a charge cap. Therefore it currently appears to the LME that a charge cap, regardless of the approach taken to permissible increases, would have the primary impact of creating a more orderly annual rate-setting process.



124. The LME acknowledges that it does not currently have the power to set such caps, and that as a result, this would represent an increase in the LME's powers.

Discussion Point 9: *Do you believe there are other key considerations which the LME should consider in the context of this section?*

125. One respondent asked the LME to consider the potential negative impact on spreads likely to occur as a result of tilting the market in favour of consumers. They see the risk of an increase in backwardations caused by the ability of large position holders to dominate the market. The repercussions were seen as damaging price transparency and further distancing the LME from the physical market.
126. Two respondents felt that the LME should consider simplifying or rescinding recent rules if a charge cap were implemented, one asking if QBRC would still be necessary if queues had gone. A third commented that the more prescriptive and complex the LME rules become, the more it will encourage warehouse operators who game the system, and discourage smaller independent operators who do not have the resources or the appetite to find and exploit loopholes.
127. One respondent objected to the LME's rationale that the listing of a large number of Delivery Points offsets the effects of QBRC, arguing that licensing warehouses outside of natural trade flows encourages metal into inconvenient and expensive off-site locations and that it would have been more helpful for the LME to address the problems which led to the need for QBRC.
128. The LME notes the concern about the balance of power in the LME ecosystem, but does not presently believe that any of the reform ideas contained within the 2016 Discussion Paper would materially benefit one group of LME users at the expense of another. Indeed, the aim of the 2016 Discussion Paper was to garner feedback on what the market views are on this problem – if the market views it as a problem at all – and ascertain a route forward, if necessary, that would work for all parties. The LME has received as many, if not more, comments from warehouse operators requesting a change to the current rate submission system as it has from market consumers.
129. Similarly, when undertaking any reform the LME is highly aware of the risk that such reform will result in unintended consequences or create loopholes in regulation which market participants can seek to use to their advantage. The LME spends considerable time and resource in thinking through all possible outcomes of any decision to implement reform, and acts to mitigate those which it views as negative. However, the LME remains cognisant that not all these outcomes can be anticipated



by the LME alone and it is a key function of any discussion process to elicit other views which may have seen alternatives. Ultimately, the LME has to make a decision of risk vs. reward, and then adapt to address any consequences which may emerge.

130. One respondent felt that the emphasis of the 2016 Discussion Paper should have been to answer the question as to why such a disparity in charges exists. They believed that all the reform proposals outlined in the 2016 Discussion Paper, either individually or in combination, could work if applied correctly and in a timely and collaborative manner, but stressed that this would not answer the question as to, if the parameters are the same for all operators, why the charges are not aligned at present. They requested that the LME grasp this opportunity to take all aspects of warehouse operations into consideration, including economic, geographical and operational, and reassess them to ensure that any reform is introduced with as few loopholes as possible and in a sufficiently simple way as to restore confidence to the market while managing expectations of those outside the warehousing functions as to what is feasible to achieve.
131. The LME agrees that this is an important question, and its analysis of the causes and impact of high charges (and the discrepancy in such charges) is fully laid out in the 2016 Discussion Paper and above. The LME hopes that its reform process, started in 2013, has taken all aspects of the market into consideration and as per the above, endeavours to ensure its rules represent best practice. The LME welcomes and encourages feedback on the reform proposed today in Notice 16/252 : A246 : W085 exactly for the purpose of identifying loopholes and addressing as appropriate.
132. One respondent noted that the 2016 Discussion Paper commented that the LME had not raised the stock levy in recent years, but did not mention increased costs to warehouse operators through stock audits, QBRC regulations and incentive reporting costs.
133. The LME is aware that increased regulation on the part of the LME has created an increased administrative burden on its warehouse operators. However, as one respondent noted, such costs are represented in the charges levied by warehouse operators and are arguably one of the reasons that Headline Warehousing Charges have increased significantly over recent years. However, the LME continues to believe that these costs are out-of-line with market comparables and that, unchecked, these will continue to risk causing distortions to LME pricing.



134. One respondent questioned whether the fact that the incentive structure does not apply to all LME material should mean that the rules be changed for all metals.
135. The LME has only recently had access to data pertaining to how the incentive structure works so is unable to comment on whether incentives are applied to all metals. However, the LME operates a global market and any rule changes should thus be applicable across such a market, in order to avoid regional or material distortions. Were some metals not subject to the same rules there would be a risk that these metals would be treated differently, be subject to discounts or premiums that would not be represented in the LME price, and would thus risk devaluing the reliability of that price and the LME price discovery process.

SECTION 4: ASSESSMENT OF DISCUSSION POINTS 10 TO 14 (THE DISCUSSION ITEMS)

Discussion Point 10: Do you have any comments or feedback on the FTA Discussion Item?

136. Four respondents commented that they felt the FTA item was worthy of further consideration and could work, with a further three respondents providing mixed feedback, with some specifying that this would be contingent on the evaluations being conducted by the LME and any disciplinary action subject to ratification by the Warehousing Committee. Other respondents felt that the ongoing compliance requirements would be useful and promote good behaviour; indeed, that any measure which promotes transparency and accountability measures would be welcome and that the LME should take all possible steps to ensure that warehouse behaviour meets market expectations and the principles of supply and demand. One respondent commented that they have always considered that the right to operate as an LME-listed warehouse should be revoked if a company fails to operate correctly within the guidelines and rules of the LME.
137. It was commented that the LME would need to be clear about its expectations in respect of appropriate behaviour and that the terms would need to be defined in advance with a clear appeals process. In respect of this, one respondent suggested that the LME publish a charter or code of conduct in order to outline the behaviours expected of warehouse operators which could then be used during the reviews to ensure warehouses meet expectations.
138. Respondents in favour did acknowledge that the consequences of failing to comply would have to be strong in order to be able to enforce an FTA system, and that there



was a risk that warehouse operators would leave the LME network as a result. However, it was felt that the barriers to exit would be significant – especially if warehouse companies had to bear the cost of shipping existing metal to a new location which could potentially be very high were there no alternative availability at the current location. One respondent did not view the risk that short sellers would be unable to deliver into their preferred location at short notice as significant given that this is already an accepted risk under QBRC, commenting that most metal owners make arrangements pre-shipment, especially if delivering to an illiquid location. Their view was that this is the seller’s responsibility and would remain so.

139. One respondent queried who would bear the financial burden for conducting the FTA reviews, pointing out that if this should be the warehouse companies, this would provide additional justification for raising rates. Either way, they felt that the Warehouse Agreement and charges should be linked rather than reviewed, discussed and agreed separately.
140. As an alternative to an FTA system, one respondent suggested that the LME introduce other measures to ensure warehouse operator compliance, for example, fines or mandated future year rate reductions (in addition to any maximum charges) which could act as “enforcement clauses” in the relevant LME policy documents.
141. However, six respondents were against FTA, feeling that it would be unnecessary, especially if charge-capping in some form was also introduced. This was echoed, in particular, by one respondent who commented that while an FTA system could be useful to review warehouses in respect of queues, incentives, high charges etc, if the LME’s aim was to deal with high charges then it should pursue this directly through a charge cap, rather than indirectly. They felt that it would be an unnecessary complication of the LME’s regulatory environment and would run the risk that operators ignore the FTA and challenge any refusal of re-authorisation, thus creating even more uncertainty. In short, their view was that an FTA regime was impractical, complicated, non-transparent and potentially very dangerous.
142. Other respondents agreed, feeling that FTA was draconian, inappropriate and would likely have the dual impact of being an existential threat to existing warehouses, and a deterrent to any new warehousing activity – especially given that the review would be used to terminate LME status for those warehouses deemed to be charging too much. It was pointed out that any contract termination would likely lead to a potentially disruptive period while any stocks were transferred to another LME warehouse operator. It was also seen as adding to the burden of both the LME and warehouse operators in terms of cost, administration and, potentially, negotiation, while adding little transparency given that these reviews would need to be



confidential. One respondent considered that the LME would be likely to face legal challenge were an FTA regime to be implemented.

143. Further, these respondents pointed out that one, or even two, year reviews would not be conducive to warehouse companies building long term relationships (either with customers or with shed leases) and would represent too short a period of time for adequate long term strategic planning, meaning that investment would be hampered, creating uncertainty for operators and other participants and potentially creating significant distortions within the warehousing system. It could also mean that warehouse companies attempt to recoup all costs within the stated time frame (likely to mean significant cost rises) or make no investment in a warehouse – neither of which would benefit the LME. It would also deter new warehouses from joining the LME, given that they would likely be unable or unwilling to enter into leases for longer than the stated review period.
144. Instead, respondents felt that the market needs confidence that warehouse companies are already compliant with all LME requirements and will continue to meet their contractual obligations in this respect, overseen by the LME. Those against FTA felt that the LME has the power to deal with warehouse operators which do not promote proper standards and that as a result, there is no need to add uncertainty to the market by introducing a short term licensing regime.

Analysis (updated where necessary or appropriate)

Does the FTA Discussion Item seek to achieve a regulatory, prudential or organisational objective?

145. An FTA system, incorporating a review process, might in theory promote good practice amongst warehouses companies. Review criteria could well include provisions relating to charge levels which could reduce the incidence of high Headline Warehousing Charges – as outlined above, an outcome which, in the view of the LME, represents a key regulatory deliverable in the context of the LME market.
146. However, given that the key effect would likely only be in respect of Headline Warehousing Charges (on the basis that other items are broadly addressed by the LME's existing rules and powers), the LME agrees with a significant proportion of respondents that this would represent an indirect method of addressing the issues and that, therefore, high charges could be more efficiently addressed through other means.



147. The LME is cognisant of a certain amount of dissatisfaction from certain areas of the market that it has not felt able to pursue those warehouse operators perceived as failing to meet the standards required by an LME warehouse operator and understands the market desire to see such players held to account – one method of which would be to implement an FTA regime. However, the LME does believe, especially following the reforms of the past three years, that its set of policy documents, including the Warehouse Agreement and the Policy for the Approval and Operation of Warehouses, represent such a code of conduct, and it fully intends to continue to work with all its stakeholders to investigate any potential infractions, and enforce discipline as and where necessary and appropriate.
148. As such, the LME does not feel that an FTA system would be the most appropriate route through which to achieve the regulatory aim of addressing high charges, or the organisational aim of running an orderly process for rate-setting on an annual basis.

Is FTA likely to have an effect on competition (noting that, for this proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

149. To the extent that FTA results in warehouse operators observing a set of maximum Headline Warehousing Charges, it is possible that Headline Warehousing Charges will broadly “float up” to, or near to, the maximum rates, and that the maximum Headline Warehousing Charges could act as a “signalling mechanism” by which warehouse simply set their Headline Warehousing Charges at, or near, the maximum levels.
150. However, as addressed in Discussion Point 8 (paragraph 116), respondents to the 2016 Discussion Paper and the LME are in agreement that capping Headline Warehousing Charges through an FTA review process would not represent a diminution of competition as competition takes place at a different level of the economic system. Accordingly, the LME does not expect that FTA would have an effect on competition.

Does FTA comply with the principle of proportionality? In particular:

(a) Is FTA capable of meeting the relevant objectives?

151. To the extent that warehouse operators heed the LME’s powers not to re-authorise particular warehouses, then FTA is capable of achieving the relevant objective. However, the danger exists that warehouses choose to maintain high levels of Headline Warehousing Charges, and simply challenge the LME’s powers not to re-



authorise – as highlighted by respondents. Particularly if the warehouse in question holds significant quantities of metal, the disruptive impact on the LME market may outweigh the benefit of non-re-authorisation, and FTA may not achieve its goals.

(b) What are the most pertinent arguments for FTA?

152. FTA may achieve the LME's stated aim of addressing high Headline Warehousing Charges, hence reversing (or limiting) the negative market effects. In particular, the LME believes that most warehouse operators wish to play their part in promoting an orderly and efficient market, and would be expected to respect the Target Future Maximum Headline Warehousing Charges promulgated under FTA, and indeed, welcome the guidance and clarity thus delivered to the market.
153. Introducing FTA to the LME's current warehouse system could positively impact the orderly functioning of the LME's market in other ways by encouraging restraint and best practice. It would also place the onus of responsibility on warehouse operators, allowing autonomy for logistical operations which reflects their expertise in this field.

(c) What are the most pertinent arguments against FTA?

154. The most pertinent arguments against FTA are:
- (i) Many LME-listed warehouses store thousands of tonnes of warranted material. Should a warehouse operator fail to pass the licence renewal process, this material would have to be shipped to another warehouse location at the cost of the warehouse operator, which could cause significant disruption to the orderly functioning of the market. A lost licence could also cause severe disruption to a short seller of metal, who found themselves unable to warrant metal due for immediate delivery into the system, potentially causing them to default on their position.
 - (ii) Warehouse operators or other market participants may take the view that the maximum Headline Warehousing Charges reallocate economics too severely from warehouses to metal owners, particularly if incentives have historically been paid in respect of the underlying metal. Accordingly, warehouse operators may ignore the FTA system and challenge any attempt to refuse re-authorisation, or challenge the FTA rule itself, which could exert a disruptive impact on the LME market. The extent to which this is likely to happen would depend on the severity of the changes to Headline Warehousing Charges, as



discussed in relation to Discussion Point 3 (section 3, starting at paragraph 70). While the LME believes that it would win any challenge to FTA, the disruptive interim effects may be deemed sufficiently undesirable that it would be deemed preferable not to proceed with implementation.

- (iii) If warehouses do adhere to the proposed maximum Headline Warehousing Charges, there is a possibility of all operators converging on the maximum Headline Warehousing Charges, with an apparent reduction in the level of competition in the marketplace. As set out in paragraph 123, the LME does not believe this would represent a valid interpretation of the fact-pattern – however, there would still exist a danger of competition law or regulatory action, which could exert a disruptive impact on the LME market.
- (iv) It could be argued that FTA represents CC “by the back door” without the certainty of CC. Presumably, if the LME were to exercise its power not to renew its agreement with a warehouse under FTA because the warehouse’s charges were viewed as too high, it would need to issue guidance as to its view on acceptable charges. This guidance would effectively amount to CC. It may be deemed preferable by the market, if the aim of the LME is to limit Headline Warehousing Charges, simply to do so by the more direct CC route.
- (v) Should the market as a whole accept and abide by the proposed maximum Headline Warehousing Charges, FTA could render the business of LME warehousing less attractive than at present for any warehouse operator currently levying charges above the FTA thresholds. Although the LME does not agree with this assessment (since, in the view of the LME, much of the Headline Warehousing Charges generally are paid out as incentives), warehouse operators may (on that hypothesis) exit the market, hence reducing the provision of LME-listed warehousing services, and making it more difficult for metal owners to place their metal on LME warrant. This could cause problems for short position holders on the LME, who may not be able to deliver in metal and hence create an artificial backwardation.

(d) *Are there any other, less restrictive means of achieving the same objective(s)?*

155. None of the respondents to the 2016 Discussion Paper addressed this question directly, however it is possible to infer from some of the criticisms of this Discussion Item that, while it would, indirectly, address the issue of high charges, an FTA system could also have the unintended side effect of restricting a number of other



areas of warehousing operations – perhaps most importantly, the ability of warehouse operators to build business models extending out further than the review period. Given that measures which more directly address high charges would not run this risk, arguably they would be less restrictive than FTA in achieving the same objective.

(e) *Would the negative effects of FTA be too great to justify implementation?*

156. The LME does not believe that the negative effects of FTA would outweigh the benefits of addressing high Headline Warehousing Charges; however, as outlined above, it does believe that there are more direct, and more effective, methods of addressing these charges.

Discussion Point 11: Do you have any comments or feedback on the CC Discussion Item?

157. Less feedback was received in respect of this Discussion Item specifically, as many respondents commented that they had articulated their detailed comments in response to the questions pertaining to key parameters (outlined in section 3 above).
158. However, in summary, many respondents felt that this idea had merit and were in favour of its implementation, stating that it would add transparency and leave little room for charges to continue to rise inappropriately. Some respondents expressed the view that this would be the only measure which could be implemented realistically and would appropriately address the issues outlined in the 2016 Discussion Paper.
159. Some respondents did outline the risks involved. These include the risk of legal challenge (especially considering that the LME has previously suggested that it might not be lawful to implement such a rule), and consequent market disruption. This risk was perceived to be increased by the fact that many warehouses have secured metal and paid incentives based on current FOT levels, and that any attempt to cut these levels would cause losses to these warehouses. Other risks include that warehouse operators leave the market, leading to increased price volatility and artificial backwardations, and that lower FOT-based incentives to attract metal on-warrant would mean metal no longer comes into the LME system at all.
160. Those against charge-capping felt that it was variously dangerous, arbitrary, anti-competitive or a disproportionate way to tackle the issue of high charges. One respondent stressed that they did not agree with the concept of imposing artificial revenue caps on any business where competitive market forces are free to act. Instead, they believed that, provided a warehouse company meets all its contractual



obligations, they should be free to set their own rates. One respondent said that if the LME felt that these rates were too high, they could pursue the relevant company using the enhanced powers under the revised Warehouse Agreement which came into effect on 1 June 2015.

161. Others felt that the LME has already significantly discounted rates through other reform measures and that warehouses already compete fairly on price and service, and that, following existing reforms, any metal owner unhappy with the price offered by its current warehouse can simply move their metal elsewhere. Others felt that any further adjustments would make little sense without repealing other reforms (for example, LILO, LORI and / or QBRC). One respondent did not feel that charge-capping would provide an advantage to the LME system and was concerned about the uncertainty engendered by the implementation process, though they did agree that a control on rate increases was needed. Another respondent felt that charge-capping would unfairly discriminate against those warehouse companies which had distinguished themselves by offering a premium level service.
162. On this theme, another respondent commented on the difficulties in setting up a new LME-listed warehouse, including high real estate costs resulting from warehouse expansion and greater competition. Even once operational, this respondent was concerned that the LME does not discriminate between operators, commenting that listed warehouses vary significantly in terms of size but that, as long as all of them meet the LME requirements, the LME must ensure that they are all allowed to participate fairly in the market. This respondent commented that it might seem that the LME favours the large warehouses, feeling that they are more beneficial to the market, but that the Exchange must not weight any regulation in their favour. This respondent was especially concerned that smaller warehouses, who have a higher cost per unit of space, should not be prevented from charging appropriately to cover these costs, especially in an environment where they might not be able to compete on incentives. They asked the LME to ensure that charge-capping is both commercially acceptable and required by regulatory obligations and specified that warehouses charging rates which are deemed too high should either be left so that they have to compete on a commercial basis (and suffer the economic consequences of too high charges), or that the LME should clearly define the commercially economic calculation that the warehouses should use.



Analysis (updated where necessary or appropriate)

Does the CC Discussion Item seek to achieve a regulatory, prudential or organisational objective?

163. The effect of CC could be to reduce the incidence of high levels of Headline Warehousing Charges, hence reversing the negative market effects set out above, which in the view of the LME represents a key regulatory deliverable in the context of the LME market.

Is CC likely to have an effect on competition (noting that, for this proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

164. The LME observes that maximum pricing rules are not typically restrictive of competition because their direct effect is only to put a cap, and not a floor, on prices. The LME is aware, however, that one consequence of CC may be that Headline Warehousing Charges will broadly “float up” to or near to the maximum rates, and that the maximum Headline Warehousing Charges could act as a “signalling mechanism” by which warehouses simply set their Headline Warehousing Charges at, or near, the maximum levels. In other contexts, effects of that kind could be characterised as restrictive of competition.
165. As set out in paragraph 123, however, the LME’s provisional view is that in the specific context of Headline Warehousing Charges, such an effect would not be a restriction of competition. As explained above, the LME’s analysis is that warehouses do not currently compete to set low Headline Warehousing Charges to attract business. Rather, competition takes place at a different level of the economic system – on the basis of discounted rates. Furthermore, as also explained above, the position with a charge cap in place is in principle less restrictive of competition than the position of ever-increasing headline charges in the absence of charge-capping. Accordingly, the LME’s provisional view is that CC would not restrict competition and this is echoed by many of the respondents to the 2016 Discussion Paper.

Does CC comply with the principle of proportionality? In particular:

(a) Is CC capable of meeting the relevant objectives?

166. On its face, CC achieves the relevant objectives by embedding them in an LME rule which would be binding on warehouse operators. However, as further set out below,



if CC were to be challenged (even if unsuccessfully), that may impact its short-term ability to achieve its objectives.

(b) *What are the most pertinent arguments for CC?*

167. CC is expected to achieve the LME's stated aim of addressing high Headline Warehousing Charges, hence reversing the negative market effects set out in the 2016 Discussion Paper and above. CC represents the most direct and straightforward means of achieving this aim.

(c) *What are the most pertinent arguments against CC?*

168. The most pertinent arguments against CC are:

- (i) Warehouse operators or other market participants may take the view that the maximum Headline Warehousing Charges reallocate economics too severely from warehouses to metal owners, particularly if incentives have historically been paid in respect of the underlying metal. Accordingly, warehouse operators may challenge the CC rule itself, which could exert a disruptive impact on the LME market. The extent to which this is likely to happen will depend on the severity of the changes to Headline Warehousing Charges, as set out further in section 2 of the 2016 Discussion Paper. While the LME believes that it would win any challenge to CC, the disruptive interim effects may be deemed sufficiently undesirable that it would be viewed as preferable not to proceed with implementation. To an extent, the likelihood of a challenge being brought will depend on the impact of the proposed rule on the economics for warehouse operators. In that regard, the LME's view is that a challenge may be more likely with options (c) or (d) than (a) or (b) (see paragraph 68 of the 2016 Discussion Paper).
- (ii) Given that warehouses will be required to adhere to the maximum Headline Warehousing Charges, there is a possibility of all operators converging on the maximum Headline Warehousing Charges, with an apparent reduction in the level of competition in the marketplace. As set out above, the LME does not believe this would represent a valid interpretation of the fact-pattern – however, there would still exist a risk that others would take a different view, and any competition law or regulatory action could itself exert a disruptive impact on the LME market.
- (iii) CC could render the business of LME warehousing less attractive than at present for any warehouse operator currently levying charges above the CC thresholds. Although the LME does not agree with this assessment



(since, in the view of the LME, much of the high Headline Warehousing Charges generally are paid out as incentives), on this hypothesis warehouse operators may exit the market, hence reducing the provision of LME-listed warehousing services, and making it more difficult for metal owners to place their metal on LME warrant. This could cause problems for short position holders on the LME, who may not be able to deliver in metal and hence create an artificial backwardation

(d) Are there any other, less restrictive means of achieving the same objective(s)?

169. Market feedback on the relative restrictiveness of CC appears largely to depend on what position the LME would take on the appropriate maximum levels of headline charges (Discussion Point 3, paragraph 70). As outlined in paragraph 89 above, the LME agrees with the majority of market feedback that options (a) and (b) (inflationary increases and charge freeze respectively) seem to offer the best compromise as compared to options (c) and (d) to both address the issues (to differing degrees), and prevent any perpetuation of charge increases, without materially impacting the economics of any market participant. The LME understands that, were it to proceed on this basis, the view of the market would be that CC would be less restrictive than other reform methods.

170. On a similar note, the other advantage of CC is that it deals directly and conclusively with the issue of high Headline Warehousing Charges, as opposed to other methods which either have a wider sphere of influence (FTA, FOTC) or a less categorical structure (CBIG), both of which have the potential to incorporate other areas of the warehousing system with their scope.

(e) Would the negative effects of CC be too great to justify implementation?

171. The LME does not believe that the negative effects of CC would outweigh the benefits of addressing high Headline Warehousing Charges.

Discussion Point 12: *Do you have any comments or feedback on the CTG Discussion Item?*

172. As with the CC Discussion Item, many respondents gave detailed feedback pertaining to the parameters of any form of charge cap within section 3.

173. However, broadly speaking, the predominant opinion on the CTG Discussion Item was that it did not offer any significant improvement on the current process whereby



the LME can request economic justification for charge increases but has no power to compel any actual change in submitted charges. As one respondent pointed out, the 2015 charge-setting cycle should be taken as evidence that this system does not work and that any incidence of non-compliance or mistakes under CTG would have a negative impact on the LME's reputation. One respondent felt that operators would find legal ways to justify rate increases, and that the guidance would therefore offer unnecessary additional complication for limited benefit, unless it led ultimately to the implementation of charge-capping. Thus, of the respondents who replied in favour of charge-capping, all bar one preferred charge-capping as a rule rather than as guidance as being more straightforward, providing greater certainty and being more simple to police.

174. One respondent commented that they would prefer guidance to a rule and another thought that would likely be seen as the most acceptable of all the options contained in the 2016 Discussion Paper, one that warehouse companies could support provided their views are given reasonable consideration and that all warehouse companies are subject to relentless scrutiny and, if necessary, tough sanctions.

Analysis (updated where necessary or appropriate)

Does the CTG Discussion Item seek to achieve a regulatory, prudential or organisational objective?

175. The effect of CTG could be to reduce the incidence of high levels of Headline Warehousing Charges, hence reversing the negative market effects set out in the 2016 Discussion Paper, which in the view of the LME represents a key regulatory deliverable in the context of the LME market. However, the LME is inclined to agree with the preponderance of respondents who felt that CTG would provide less clarity and simplicity and would thus be less effective than introducing CC as a rule.

Is CTG likely to have an effect on competition (noting that, for this proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

176. To the extent that CTG achieves its objective, the competitive effects of CTG are likely to be very similar to those of CC. The only material difference is that warehouse operators will have less certainty that charging Headline Warehousing Charges above the maximum level would constitute a breach of the Warehouse Agreement and would result in enforcement action. But the objective and intended effects of the measures are essentially the same: that all Headline Warehousing Charges would be below the maximum levels. Consequently, the analysis set out in paragraphs 164-165 above applies to the effects of CTG on competition as well.



Does CTG comply with the principle of proportionality? In particular:

(a) Is CTG capable of meeting the relevant objectives?

177. To the extent that warehouse operators heed the guidance of CTG, then CTG is capable of achieving the relevant objectives. However, as outlined by some respondents, the danger exists that warehouses choose to maintain high levels of Headline Warehousing Charges, and simply challenge the LME to take action, given that CTG represents guidance, not a rule. One of the main levers compelling warehouses to adhere to the relevant guidance would be the threat of the LME introducing the guidance as a rule. Given that this is the case, one might legitimately conclude that it would be preferable to introduce a rule, rather than guidance, in the first place.

(b) What are the most pertinent arguments for CTG?

178. CTG may achieve the LME's stated aim of addressing high Headline Warehousing Charges, hence reversing the negative market effects of high charges. In particular, the LME believes that most warehouse operators wish to play their part in promoting an orderly and efficient market, and would be expected to respect the maximum Headline Warehousing Charges promulgated under CTG, and indeed welcome the guidance and clarity thus delivered to the market.

(c) What are the most pertinent arguments against CTG?

179. The most pertinent arguments against CTG are similar to those in respect of CC. The only additional consideration that the LME has identified at this stage is that a guidance regime creates risk of disorder in the event that warehouse operators chose not to follow the guidance. There is less certainty under CTG as to what consequences would follow the imposition of charges above the maximum levels.

(d) Are there any other, less restrictive means of achieving the same objective(s)?

180. As guidance rather than a rule, it might be argued that CTG represents a less restrictive method of introducing a charge cap than the implementation of a charge-capping rule. However, it could only be less restrictive in practice if warehouse companies did not respect the guidance, in which case it would also be commensurately less effective than CC.



181. As with CC, the main consideration in respect of CTG's restrictiveness, therefore, would be the LME's position towards the appropriate level of maximum charges, the LME's thinking on which is fully outlined in paragraph 169.

(e) *Would the negative effects of CTG be too great to justify implementation?*

182. The LME does not believe that the negative effects of CTG would outweigh the benefits of addressing high Headline Warehousing Charges. However, taking market feedback into consideration, the LME's opinion is that CC would represent a more direct and effective method of addressing such charges, and that the greater effectiveness of CC outweighs any greater restrictiveness of CC.

Discussion Point 13: *Do you have any comments or feedback on the CBIG Discussion Item?*

183. In general, respondents reported that they felt CBIG was too weak, a waste of time and resource, and that it would not bring any additional certainty to the market given that companies will make commercial decisions without guidance from LME.
184. Although some respondents acknowledged that rate charges do provide the economic basis for incentives, therefore that any incentives paid above these rates would be difficult to justify and that therefore, CBIG does have the potential to lead to lower charge levels, it was seen as more likely to increase confusion, as being open to interpretation and carrying the potential for legal challenge.
185. Two respondents asked how the LME would investigate and police CBIG, suggesting that this would take significant time and effort and would require discretion which could result in the LME getting caught up in an extended process. Questions were also asked about who would pay for this process. Other concerns around monitoring included that the link between incentives and other benefits would be impossible to establish making it easy to abuse, with trading companies owning warehouses having an even greater advantage, that operators would be able to find ways to hide incentives paid to customers (for example, those warehouse operators owned by trading companies could hide incentives through dividend payments), and that these methods would be outside of the regulatory reach of the LME. One respondent felt that monitoring difficulties could be overcome through a semi-voluntary system but was concerned that incentives may not be consistent from location to another.
186. One respondent commented that incentives are only possible due to high FOT levels and that it would be more straightforward, therefore, to address the cause rather



than the effect. In the same vein, others felt that it is not the LME's role to intervene on incentives, even if they are higher than those which would initially appear to be based on rent and FOT charges.

187. One respondent felt that CBIG would have the opposite of the desired effect, in that the warehouse would still be able to charge high rates but would just not being able to use these to offer incentives – thus in reality competition would be reduced rather than increased. Their conclusion was that it would make no sense to implement reform which exacerbates rather than corrects the underlying structural problem.

Analysis (updated where necessary or appropriate)

Does the CBIG Discussion Item seek to achieve a regulatory, prudential or organisational objective?

188. The effect of CBIG could be to reduce the incidence of high levels of Headline Warehousing Charges, hence reversing the negative market effects of such charges, which in the view of the LME represents a key regulatory deliverable in the context of the LME market. However, the LME respects market feedback which suggests that this would be an overly complicated and indirect method to address the stated issues, and that other methods, specifically CC, would provide a more straightforward solution which would be easier to implement, run and monitor, and hence be more acceptable to the market.

Is CBIG likely to have an effect on competition (noting that, for this proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

189. The objective and intended effects of CBIG are similar to those of CTG, discussed above. While warehouse operators would retain freedom to set higher Headline Warehousing Charges, in practice there would be a substantial penalty for doing so, in that the warehouse operator would be unable to offer competitive incentives based on those higher charges and would therefore be placed at a competitive disadvantage. For that reason, the LME expects that the impact on competition would be the same.
190. In the event that a warehouse operator chose to impose such higher charges, however, the direct consequence of CBIG would be that during that year, the warehouse operator's ability to grant discounts would be materially restricted, which might in itself be characterised as a restriction of competition.



Does CBIG comply with the principle of proportionality? In particular:

(a) Is CBIG capable of meeting the relevant objectives?

191. To the extent that warehouse operators react to CBIG by keeping Headline Warehousing Charges within the proposed maximum levels, then CBIG is capable of achieving the relevant objective. However, because of the “indirect” nature of CBIG, this cannot be guaranteed. In particular, warehouses may choose to keep levying high Headline Warehousing Charges, and simply take these as profit, rather than paying incentives on the basis of such charges.

(b) What are the most pertinent arguments for CBIG?

192. CBIG may achieve the LME’s stated aim of addressing high Headline Warehousing Charges, hence reversing the negative market effects of such charges. In particular, the LME believes that most warehouse operators wish to play their part in promoting an orderly and efficient market, and would be expected to respect the maximum Headline Warehousing Charges promulgated under CBIG, and indeed welcome the guidance and clarity thus delivered to the market.

193. Furthermore, by utilising an existing mechanism (the LME’s powers against excessive levels of incentive), CBIG does not require the construction of an entirely new market enforcement mechanism.

(c) What are the most pertinent arguments against CBIG?

194. The most pertinent arguments against CBIG are essentially the same as those for CTG, save for the additional argument, referred to above, that CBIG may restrict competition by preventing discounts from being granted by warehouses who (contrary to the LME’s expectation and intention) continue to set higher Headline Warehousing Charges without returning such revenues in the form of incentives.

(d) Are there any other, less restrictive means of achieving the same objective(s)?

195. Market feedback to the 2016 Discussion Paper did not deal with this question directly; however, the LME’s analysis of the relative restrictiveness of CBIG is broadly similar to that in respect of CTG, namely that it would be less restrictive than other Discussion Items given that it would act as guidance rather than a rule. However, as with CTG, to the extent that it is less restrictive, CBIG would also be less effective.



196. As with CC, the main consideration in respect of CBIG's restrictiveness, therefore, would be the LME's position towards the appropriate level of maximum charges, the LME's thinking on which is fully outlined in paragraph 169.

(e) *Would the negative effects of CBIG be too great to justify implementation?*

197. The LME does not believe that the negative effects of CBIG would outweigh the benefits of addressing high Headline Warehousing Charges. However, as with CTG, the LME considers that, as an indirect method of addressing the issue of high warehousing charges, the implementation of CBIG would not be as effective, or as straightforward as CC, and that the increased effectiveness of CC outweighs any increase in restrictiveness.

Discussion Point 14: *Do you have any comments or feedback on the FOTC Discussion Item?*

198. Six respondents felt that FOTC was an idea worthy of further exploration with the potential to lead to a desirable market situation, with one respondent believing that it would be the best solution to get the market where it needs to be. Another of these respondents added that shifting the burden from warehouse operators onto metal depositors (those who receive the benefits of the current system) could be an elegant solution, and more so, because the metal depositor would not be able to try to charge the warehouse operator for this cost as the operator would not have the cash flow until the metal is taken off warrant.

199. However, only one respondent offered any opinion on the practicalities of the LME progressing with this reform idea – commenting that the contracts could be closed before a “big bang” date and subsequently re-opened.

200. More broadly, the implementation difficulties were widely acknowledged, although one participant felt that the market has survived significant change in the past and could therefore do so again.

201. Five respondents felt that this would be extremely complicated – even impossible – infeasible, disruptive and unlikely to lead to the desired outcome or definitively make customers better off. Instead, it was viewed as likely to exacerbate perceived current problems with liquidity and spread tightness since it would likely lead to less metal on-warrant – metal owners would wait for a backwardation before delivering in metal in order to cover the FOT cost.



202. One respondent pointed out that many warehouses have secured metal and paid incentives based on current FOT levels. Any attempt to move to an FOT contract would therefore cause losses to those warehouses and risk that they would subsequently attempt legal action against the LME which would be disruptive to the market.
203. Some respondents viewed this rule as benefitting asset-heavy warehouses (those with their own labour and equipment) at the expense of asset-light warehouses. More generally this was seen as leaving all warehouse operators unprotected from potential abuse by financial institutions undertaking significant destocking; warehouses would never receive the FOT charge. Additionally, it was seen not only to affect incentives offered to attract metal (already viewed as having been capped by previous LME reforms), but would also remove the incentive for LME warehouse operators to participate in the market at all, meaning that it could well lead to a reduction in storage capacity on the LME network.
204. One respondent noted that a significant proportion of LME business is financial rather than hedging-based, meaning that many market participants would be affected by the delta between FOT paid and unpaid, resulting in financial losses which could create significant anger. Further to this, one respondent agreed with the LME's analysis that the majority of LME contracts are settled via offset rather than delivery, so therefore any FOT conversion would have to take into account the fact that delivery-out would be the contentious area, not settlement.
205. One respondent felt that the LME is the dominant base metals exchange for several reasons, one of which is that the warehousing system works. Making incessant changes was viewed as undermining this, and encouraging market participants to consider other credible alternatives at competing exchanges.
206. Other risks included that FOTC would likely involve a period of time during which FOT was paid and metal was put on and taken off warrant creating high levels of stock movement, increasing the costs for warehouses without a concomitant increase in revenue. As a result, as well as being difficult to implement, it was also seen to add considerably to the administrative and logistical burden for the entire metals community.
207. One respondent felt that, while premiums would likely soften, the LME base price would rise to reflect the new FOT element and thus, end consumers would be no better off. In fact, another respondent felt that the all-in price of metal would be so negatively impacted by an FOT conversion that producers in particular would be likely to challenge the implementation on a legal basis.



208. The LME was urged to examine the relative success of other FOT contracts in commodity markets before pursuing such a reform.
209. Finally, one respondent felt that the opinions of brokers and merchants would be most pertinent to this discussion.

Analysis (updated where necessary or appropriate)

Does the FOTC Discussion Item seek to achieve a regulatory, prudential or organisational objective?

210. The effect of FOTC could be to reduce the incidence of high levels of Headline Warehousing Charges, hence reversing the negative market effects of high charges, which in the view of the LME represents a key regulatory deliverable in the context of the LME market. However, the practical impact would depend on the model chosen and would in any event be expected to have a direct effect on FOT rates only, and thus the issues outlined in the 2016 Discussion Paper in respect of rents could be expected to persist.

Is FOTC likely to have an effect on competition (noting that, for this proposal, even if it is likely to have an effect on competition, it may still be justifiable and proportionate)?

211. As set out above, the LME expects that FOTC would have a positive effect on competition, in that warehouses looking to attract metal from metal owners planning to subsequently sell that metal on the LME would compete on the basis of low FOT charges, rather than high incentives, given that the FOT charges would need to be funded by the metal owner when selling the metal on the LME.

Does FOTC comply with the principle of proportionality? In particular:

(a) *Is FOTC capable of meeting the relevant objectives?*

212. Converting the LME contract to an FOT-paid contract would address the issues of lack of downward pressure on FOT rates and, as such, would be expected to reduce the incidence of high headline FOT rates. However, as noted above, it cannot be expected to have any direct effect on rent rates.



(b) *What are the most pertinent arguments for FOTC?*

213. The most pertinent arguments for FOTC are:

- (i) An FOT-paid contract would directly reverse the current structural issue of lack of downward pressure on FOT charges, incentivising metal owners to negotiate discounted rates when depositing metal and promoting competition amongst warehouse operators.
- (ii) This would be achieved without resorting to a specific price control regime.

(c) *What are the most pertinent arguments against FOTC?*

214. The most pertinent arguments against FOTC are:

- (i) The implementation difficulties, outlined in detail in the 2016 Discussion Paper, which could lead to instability in the LME market; and
- (ii) FOTC only addresses the issue of FOT rates. The issues outlined in respect of high rents might be expected to persist, unless FOTC was implemented in conjunction with a parallel measure intended to address high rents.

(d) *Are there any other, less restrictive means of achieving the same objective(s)?*

215. The LME is cognisant that some market participants could view FOTC as less restrictive than a form of charge-capping, as it would not impose any restriction on headline rent and FOTs. However, feedback to the 2016 Discussion Paper suggests that many respondents shared the LME's concerns with the difficulties of implementing such a significant change into the established LME ecosystem, a change which would fundamentally alter the economics of trading and storing metal on the LME network. The LME therefore agrees with respondents that the practical difficulties would outweigh the benefits of such a change. Further, given the LME's analysis of the issues, the LME believes that it would be more appropriate, and ultimately less restrictive, to focus its attention on Headline Warehousing Charges specifically – and thus address the stated issues via the most direct and straightforward route available – rather than implementing a significant and wide-reaching market reform which could have significant consequences across the LME community.



(e) *Would the negative effects of FOTC be too great to justify implementation?*

216. In the 2016 Discussion Paper, the LME noted that the success of FOTC would depend on whether the procedural issues of contract conversion could be resolved. Although the LME recognises that markets are capable of withstanding such change, the absence of any significant feedback detailing proposed resolution of these implementation difficulties suggests to the LME that there is little real appetite to implement an FOTC reform.

SECTION 5: ASSESSMENT OF DISCUSSION POINTS 15 AND 16

Discussion Point 15: Do you have any comments or feedback on the IB Discussion Item?

217. There was a degree of discrepancy in market feedback on the IB Discussion Item.
218. Many respondents, including one already subject to LME Information Barriers, felt that this point is unnecessary, and that the current rules suffice. They pointed out that the Warehouse Agreement requires data confidentiality and thus expanding the information barriers would add nothing to the orderly operation of the market, but instead would just alienate the smaller, independent warehouses who should instead be encouraged to create competition.
219. These respondents pointed out that information barriers, and associated audits, are necessary to prevent trading companies which own warehouse companies (or vice versa) from benefitting from confidential information – and that recent developments such as queues and high charges could be seen as an indication that trading companies will influence the market via their warehouse company if the opportunity were available. They believed that audits should otherwise only be necessary if a warehouse company is suspected of not respecting the confidentiality requirements in which case it was felt that the LME should investigate and require an audit.
220. Those who agreed with this idea, or felt that it was worthy of further consideration, did not oppose the idea of adding more robust language to the Warehouse Agreement, but felt that, given the importance of LME Information Barriers, their preference was for expanded audits as the best mechanism to ensure compliance (potentially on a random, rotated basis).
221. Other respondents were more positive about IB, arguing that those currently required to undertake third party audits are at a competitive disadvantage and do not believe that those currently exempt maintain the same standards of confidentiality given the lack of market attention they receive on this issue, and the unlikelihood



that they will be caught as a result of the lack of audit requirements. They stressed the necessity for all warehouse companies to be subject to the same standards and obligations regardless of their ownership status, and asked that the LME's Information Barriers policy be made more rigorous.

222. One respondent asked that the LME implement a process by which to ensure that all warehouse companies and any related trading operations are fully cognisant of the requirements and their implementation, and felt that all warehouse companies should be able to provide evidence of policy compliance across all related entities.
223. One respondent pointed out that the costs of third party audits are included when warehouse companies consider appropriate levels of storage fees for the LME metal.
224. The LME understands that a proportion of its warehouse companies which are already subject to IB requirements feel that it is unfair that these are not applicable to all LME-listed warehouses companies. However, it notes that all warehouse companies are subject to the terms of the LME Warehouse Agreement, which state in Clause 1.5.2 (under Clause 1.5 "Restrictions"):

*A Warehouse may not deal directly or indirectly in Contracts, and shall observe such other requirements contained in Relevant Law and Regulation, and any Exchange notice relating to the separation of Warehouses from Members **and the maintenance of confidentiality in respect of price sensitive and customer confidential information** [emphasis added].*

225. In the LME's view, this clause, which is legally binding upon all LME-listed warehouse companies, adequately provides appropriate protection against any dissemination of confidential or market sensitive information by any warehouse company. Added to which, the LME is highly aware, as discussed below in relation to Discussion Point 16 (starting at paragraph 226) of a current market preference for, at the least, a pause in any further reform. Furthermore, it is the view of the LME that the risk of transmission of confidential information must, to some extent, be greater where trading companies and warehouses are in the same group, and therefore it is appropriate that additional protections are put in place in relation to such arrangements. In light of this, and given the divergence in opinion on the IB topic, the LME is not minded to introduce additional market change in relation to IB.



Discussion Point 16: *Are there any other matters you wish the LME to consider in the context of any aspect of this Discussion Paper?*

226. A number of respondents had more general points to make regarding the Discussion Paper, or LME warehouse reform more generally.
227. Most consistently, respondents voiced concerns that the LME has already implemented a significant number of reforms which have had a market-wide impact (but particularly on the warehousing community) and have resulted in a complex set of existing rules which are allegedly difficult (or “impossible”) to follow, a loss of metal and consequent loss of transparency from the LME system, market volatility which has enabled some market participants to “squeeze” nearby spreads and is the root cause of recent market backwardations. Further, they argue that the LME reform programme has broken the link between the LME and the physical industry. In general, such respondents argue that the more reform is introduced, the less attractive the network becomes and that the LME system will use its relevance as other exchanges and off-warrant alternatives become more appealing options.
228. One respondent viewed it as inevitable – given these reforms – that there will be unintentional breaches and issues despite the best efforts of warehouse companies to comply.
229. One respondent, while recognising that rates are high, pointed out that the motivation for warehouse operators to set high charges has been the case for many years, and that, while previously warehouses have acted responsibly and commercially to set rates, 2015 saw an unprecedented level of reform, particularly QBRC, which forced an unwelcome but unsurprising rise in charges.
230. One respondent also commented that through the staged reform process, taking place over several years, the LME has lost sight of the bigger picture and failed to articulate its ultimate aim in pursuing its reform agenda. Another respondent felt that, despite the LME’s efforts to communicate its reform programme to the market, the Exchange has taken a haphazard and uncoordinated approach, attacking warehousing issues from all angles rather than making a genuine effort to identify, diagnose, articulate or address the root cause of issues. They believe that, out of the LME’s broader warehouse reform programme, the LILO Rule was the only element representing a meaningful attempt to address the true underlying problems. They argue that the warehouse network has, in fact, continued to fulfil its role as a market of last resort.



231. As a result, some respondents feel that the LME should desist from further change to allow the market a sustained period of consistency and stability to allow new policies to take effect and the market time to digest and adjust business plans accordingly. This would also allow warehouse operators to take heed of the warning that a charge-capping system would follow were charges not set more reasonably in future. Those respondents that are in favour of the LME taking some action to address the issue of high charges agreed that, following this, the LME should allow a significant period of time (potentially for up to 36 months) to elapse before pursuing any further reform. This would also alleviate the legal risk, according to one respondent, as the history of exchanges and regulators capping charges is not encouraging.
232. One respondent commented that they felt that the LME has misdiagnosed some of the issues in the market. While they agree that efficient price discovery – and an efficient physical delivery network to support it – should be the primary aim of the LME, they disagree with the LME’s methods of achieving this. They argue instead, that the LME should engage its entire ecosystem to ensure that the physical delivery network supports trading and price discovery, with a focus on attracting more metal into the LME physical network – an outcome which they perceive as being unlikely to result from the items contained in the 2016 Discussion Paper given that any rebalancing of the market from seller to the buyer would likely result in a decrease in the flow of metal onto the Exchange, hampering liquidity and price discovery and potentially leading to further backwardations. They also felt that the financial arrangements for storage do not have a significant impact on price discovery, instead arguing that this is influenced more by supply and demand. This respondent suggested that the LME would be better served by focusing on its forwards contracts – including the monitoring of dominant long positions – rather than supervising bilateral premiums given that it has no regulatory remit in this regard. Ongoing risks were seen as the physical market wanting to find other price references than those currently provided by the LME.
233. One respondent expressed their disappointment that the LME has not grandfathered reforms implemented, feeling that this would be appropriate and uncontroversial given that decision made by organisations in the past has been made in the context of rules in existence at that time. They argued that failing to grandfather is a simple redistribution of economics and means that the LME has not taken into account historical investments made by warehouse companies.
234. On the attractiveness of the LME market in particular, one respondent commented that the addition of new warehouses to the LME network is not indicative of the attractiveness of the LME network. They pointed out that many warehouses have



limited or no LME inventory and that what is there continues to decline. They reported that, anecdotally, LME warrants are less in demand by banks and finance houses than in previous years and that fierce competition is taking place in the off-warrant market with deals being completed below cost. This respondent disagreed that warehouse companies would leave as a result of charge-capping, but did flag that, should the LME rules become over-burdensome, independent companies would be likely to change their focus leaving LME stocks in increasingly fewer – mainly merchant-owned – warehouses, likely to be those who support an investment agenda rather than the need for the LME network to provide a market of last resort. Combined with decreasing volumes on the Exchange, their view was that this presents a serious threat for the LME.

235. One respondent pointed out that they are supportive of any proposals which promote free market competition and economics which, in turn, would regulate warehouse behaviour. Proposals which rely on exchange intervention, artificial restrictions and charge-capping (except where targeted specifically to address existing queues) are not necessary and have the potential to create significant unintended consequences.
236. One respondent commented that the LME's change from a member owned and driven market to a profit driven organisation has created a conflict of interest for the Exchange – forcing it to balance its regulatory duties with the need to generate revenue. They asked that the LME be explicit about not using one as a cover for the other. They were particularly concerned that the LME does not view capping charges as a way of encouraging more metal into warehouses which would generate profit for the LME through the stock levy. They felt that this would be misguided, especially as on-warrant stock is driven by supply and demand, and that over-intervention by the LME would have the opposite effect.
237. One respondent commented that the issue with the discussion and consultation process was that it allowed ample opportunity for market participants to raise objections and to find alternative ways of operating within the guidelines of new rules before they are even implemented. This corroborated the views of another respondent, who believed that the LME should consider all the ways in which market participants will try to “game” whatever new measures are introduced.
238. The LME recognises that its market engagement process does provide for a significant amount of time for market participants to both consider the issues with any proposal, and also to how to work within its rules, should implementation go ahead. However, the LME cannot see such a practice of open communication as a bad thing – indeed, as the responses to the 2016 Discussion Paper show, some



market participants have felt disenfranchised by the reform process, and even that the LME has not gone far enough in communicating its intentions.

239. Regardless, the LME feels very strongly that engaging and consulting with its market on any change is an essential part of the process and it has no wish, despite some market perception to the contrary, to make unilateral change without having made every effort to communicate, solicit feedback and engage with as many market participants as possible.
240. The LME notes concerns that it would introduce reform in order to attract more metal into the LME system to generate revenue. However, the LME feels that this is unjustified, given both the extent to which the LME has been transparent about its analysis as to the issues affecting its physical network, and the fact that its reform measures to date have clearly prioritised market orderliness over any such alleged attempt to attract more metal. The LME also notes that other respondents were critical of the LME for not focusing more on attracting metal into the system, and who pointed to the loss of metal created by existing warehouse reform as having had a negative impact on liquidity and spreads.
241. Regardless of this divergence of opinion as to the LME's aims, the LME feels it has been consistent and transparent in its goals. Although the LME will always weigh up the market consequences of any reform action, its primary commitment is to its regulatory obligations in respect of its physical network, the absence of which would have a materially detrimental impact on its core franchise of price discovery.
242. That said, the LME is also highly aware of the fact that many market participants feel that the LME has taken sufficient action and, too, recognises the need for stability and adjustment. Indeed, the LME has been clear about this in previous notices, including most recently, the LORI and QBRC Implementation Notice, while concurrently highlighting that all such change has been part of a widely advertised package of reform first announced in July 2013. As outlined above in paragraph 33, the LME had previously taken a "wait and see" approach to CC and would have been happy to maintain this had the rate submission process at the end of 2015 not highlighted the issues with the current system and the very real need to address both these issues, and those relating to high charges more generally. The LME remains fully committed to maintaining a transparent and orderly market, pursuant to its statutory duties, and firmly believes that an orderly process for rate submission should be a crucial component of an efficient physical network.
243. However, the LME is also aware, not least as this has been highlighted in other discussion and consultation processes, that some market participants disagree with



its analysis of the underlying causes of issues in the LME warehouse network. The LME recognises that many alternative explanations and assessments exist and has always made itself available for discussion of these at every opportunity. However, ultimately the LME has to draw conclusions and enact reform on the basis of those conclusions as deemed necessary or appropriate. The LME does not take this responsibility lightly, and as ever, is highly aware of the need to ensure the ongoing viability of warehousing as a business model.

Conclusion

244. In short, following this discussion process, the LME has concluded that the CC Discussion Item represents the most straightforward, focused, fair and proportionate route to addressing the stated issues with both high Headline Warehousing Charges and the annual charge-setting process – a factor which the LME believes contributes significantly to the perpetuation of the problem. The Charge-Capping Consultation Notice released today outlines the LME's proposal for the implementation of charge-capping, informed by all the considerations explored above, and opens this proposal to feedback from the market.

Matthew Chamberlain
Head of Business Development

Cc: Board Directors
Warehousing Committee
Special Committee
Physical Market Committee
User Committee
All metals committees