FAQs – LME warehousing consultation

Q. What are you announcing today?
A. The LME is announcing the introduction of a package of warehouse reforms in response to a three-month consultation with market participants. Included in the reforms are changes to the LME warehousing policy, which are designed to cut queues at warehouses.

Full details of the reforms can be found in the documents listed for download on the LME website. http://www.lme.com/warehouseconsultation

Q. Why are you doing this?
A. The price of "free metal" is set efficiently and economically by the market. The price of an LME warrant will trade at a defined discount to the "all-in" metals price, because a buyer of metal taking an LME warrant may receive metal of a brand different to that desired, in a location different to that desired, and will have to pay a free-on-truck ("FoT") charge to remove the metal from a warehouse. This is a natural feature of the market.

However, the discount is increased by the presence of queues, because the recipient of an LME warrant must pay rent while in the queue, and there is an opportunity cost to waiting for metal.

The market observes these discounts as the "all-in" metal price trading at a premium to the discounted LME price. As such, an element of the premiums currently seen in the market is caused by queues.

While the LME does not believe that the effect of queues is indicative of economic or market failure, the Consultation has clearly indicated that the existence of queue-related premiums creates significant difficulties for the metals community in respect of both discovery of the "all-in" price, and effective hedging of that price. Accordingly, it is appropriate to take action to address the issue of excessive queues.

Q. What changes have been made to the original Proposal, and why?

A. Changes have been made in respect of the following:

- ***The 100-day threshold.*** As a result of the views expressed in the consultation, the 100-day threshold for queues has been reduced to 50 days, ie when queue length at a particular warehouse location reaches 50 days the linked load-in load-out mechanism of the Rule is triggered.

The reason for the reduction in the threshold is that, while metal users are unlikely to make significant use of LME warehouses to source metal directly, it is nonetheless considered that the LME's role as a supplier of last resort entails warrants being accessible to the user within a time frame comparable with that of sourcing from a merchant. However, the threshold cannot be too low or else the Rule may be triggered whenever warrant holders decide to cancel warrants for operational reasons. A 50-day threshold is considered low enough to meet the comparability criteria and yet high enough to avoid excessive triggering of the Rule.

- ***The calculation of the load-out requirement***. A number of warehouse owners asked whether the calculation of the load-out requirement could be on an averaged basis, as the proposed basis might have arbitrarily increased the load-out obligations on warehouses where warrant creation tends to 'bunch' on particular days as compared with warehouses where warrant creation is more evenly spread. The LME accepts this point, and has decided to allow calculation of the requirement on an averaged basis over the calculation period, albeit that the Rule will apply for the whole of a calculation period if the warehouse is caught by the Rule for any portion of that period.

- ***General power to investigate queue formation***. Given the varied ways in which queues may arise, including in response to incentives from the warehouse operators, the LME is empowered to investigate particular cases of queue formation and implement special measures to address any abusive behaviour found.

- ***Provision of per-warehouse information***. The LME already provides transparency through stock information reports on a per-location basis. Some respondents requested more detailed information at the warehouse level. The LME sees the merit of the request, but would not wish to encourage activity reacting to such information in real time. Accordingly, the LME intends to provide per-warehouse information on stocks and queues on a regular but delayed basis, and will work with participants to develop the format of the report.

- ***Commitment of traders report***. The consultation highlighted market demand for broader transparency, particularly in the form of a commitment of traders report showing the split of market open interest by the nature of the ultimate holder of such interest. Although the LME does not see such report as affecting queues and premiums, it believes that the request has merit in its own right, and has begun discussions with practitioners on the format of such report.

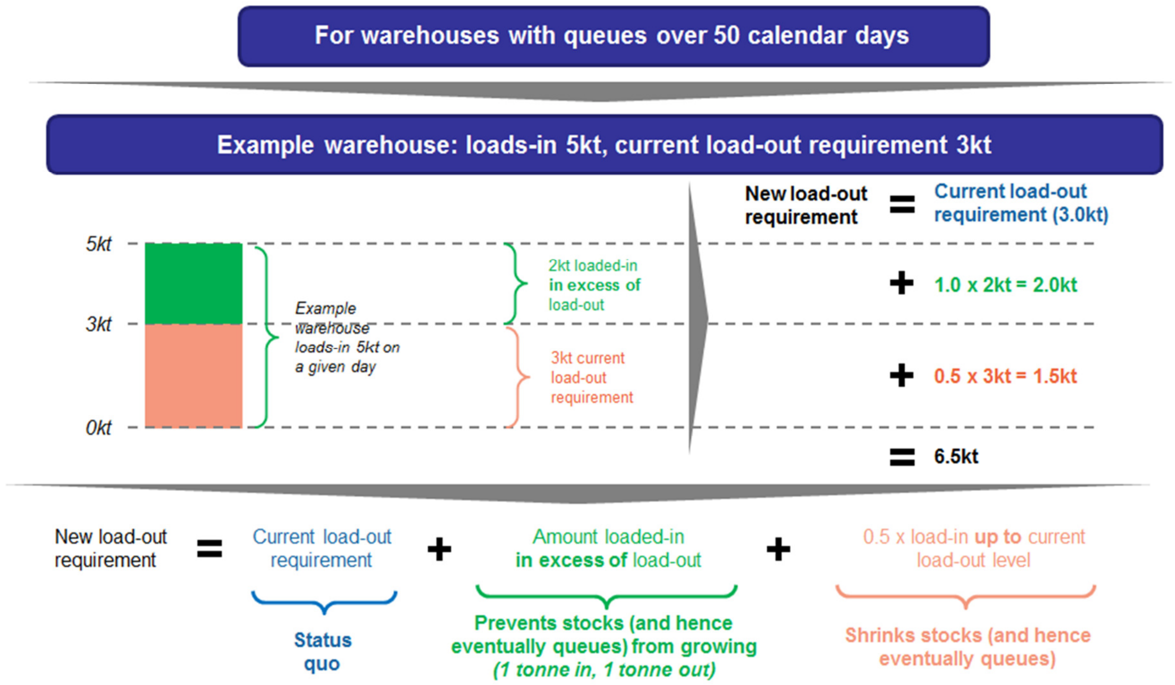
- ***Representation of physical market***. The consultation revealed a perception that the physical metal market (both producers and users of LME metal) is not well represented on LME governance structures. The perception is not valid in respect of the various metals committees, and 4 of the 14 User Committee members are from the physical industry. Nonetheless, to ensure full and sufficient representation of the physical industry, the LME will create a Physical Market Committee with invited representatives from across the industry. Among other things, the Physical Market Committee will be expected to play a significant role in the continuing six-monthly reviews of the new Rule and its impact on queues.

- ***Steel billet***. The steel billet contract has been converted from a global to a European basis, with the result that warranted steel in non-European warehouses has to be withdrawn by 30 April 2014 or shipped to a European location. However, much of the steel billet is still sitting in queues. Accordingly, a separate load-out rate is provided for steel.

The new Rule and the other action steps set out above will come into effect on 1 April 2014. The implementation of certain elements of the package will be discussed further with warehouse companies in accordance with the terms of the warehouse agreement, but it is expected that this will not delay the implementation of these measures on 1 April 2014.

Q. Why did you reduce the threshold from 100 days to 50 days?
A. Feedback from the physical industry suggested that the LME's role as a market of last resort should require warrants to be accessible within the sourcing horizon of members of the physical industry. In accordance with this view the LME reduced the threshold to 50 days. The Board will keep this figure under active review.

Q. How will the 50 day rule work?
A. The following is provided as an illustrative example of how the load-in load-out proposal will operate:



Q. How many warehouses have a queue of more than 50 days?

A. As of 31 October 2013, five warehouse locations have queues greater than 50 days and of these two have queues greater than one year.

Q. How long will it take for queues to shrink under the new rules?

A. The rate of queue shrinkage will depend on precise behaviour of (i) warehouses in terms of load-in, and (ii) warrantholders in terms of cancelling warrants. However, we would expect to see the impact on metal premiums in the nearer term.

Q. Since the queues have been a long standing problem, why did the LME take so long to address the issue?

A. The LME first responded to concerns about the queues in October 2010, when it commissioned Europe Economics to prepare an independent assessment on whether the then-existing load-out rates were satisfactory. A summary of the review findings were published on 27 May 2011. The following actions were taken:

- On 17 November 2011, the LME announced an increase in the minimum load-out rates that took effect on 1 April 2012.
- On 1 August 2012, the LME confirmed the additional delivery out rates for nickel and tin that took effect on 1 April 2013.

- On 20 December 2012, the LME introduced additional requirements on warehouse companies to address the effect that long queues for one metal may have on the availability of other metals. This also took effect on 1 April 2013.

Q. What are the calculation and discharge periods?
A. The Preliminary Calculation Period shall be the nine months between 1 July 2013 and 31 March 2014. The associated Preliminary Discharge Period will be the three months between 1 May 2014 and 31 July 2014, inclusive.

The First Calculation Period shall be the three months between 1 April 2014 and 30 June 2014 inclusive. The associated First Discharge Period shall be the three months between 1 August 2014 and 31 October 2014 inclusive.

Q. How will you ensure, in the meantime, that warehouse companies don't incentivise queues or form several queues just under the threshold?
A. The LME will reserve a general power to take specific action against warehouses which it considers to have been intentionally creating or maintaining queues, even if such queues remain below the threshold.

Q. When does this come into effect?
A. The new rules will take effect on 1 April 2014. Certain elements of this package of measures will require further discussion with warehouse companies, but it is not expected that this will delay the implementation of these measures on 1 April 2014.

Q. How many people responded to the consultation?
A. We undertook a detailed consultation process. We received 33 written responses and in addition to a number of participants gave oral feedback to the LME – we held more than 70 meetings as part of the process.

Q. What were the main views submitted and by whom?
A. The identity of parties making submissions or expressing views on the Proposal is kept confidential.

The views expressed by respondents to the consultation were very diverse, reflecting the respondents' differing interests as metal producers, users, traders or warehouse owners. Nonetheless, all parties expressed the view that some form of action should be taken; the differences were on what action would be best to take.

Respondents' comments were wide-ranging, and covered many aspects of warehousing, queues, premiums and other areas of LME business. The main focus of the comments was on:

- The 100-day threshold triggering the linked load-out requirement
- The 0.5 decay factor
- The calculation of the load-out requirement
- Other suggestions for dealing with queues

The consultation process has been rigorous and in-depth, flushing out views from all sectors of the market and on all relevant areas of LME operation. All views have been gathered for a balanced decision on policy changes to be made.

Q. Is this the end of the consultation? Will the LME be taking any more market views into consideration?
A. The LME has an on-going commitment to keep the warehousing policy under six-monthly review, in which the new Physical Market Committee will play a substantial role.

Q. When can we expect to see the additional proposals mentioned in the release implemented?
A. The additional measures will be fully assessed and further communications will be made in due course. We do not have a fixed timeline on this, and it is important that all options are considered and that all users are properly consulted before implementing any new measures.

Q. You state that the LME will have enhanced powers to address queue formation. Can you explain the nature of these enhanced powers?
A. The LME would be empowered to form a view as to whether an attempt has been made by warehouse companies to artificially create a queue by the use of incentives, and impose greater requirements on that warehouse. This would potentially include imposing the rule on warehouses with queues below the threshold if it is deemed necessary.

Q. How will the LME enforce these new rules?
A. The LME has the power to audit warehouse companies to ensure that, amongst other things, metal is placed on warrant in accordance with the contract rules relating to each metal, listed warehouses continue to meet the conditions of listing, and warehouse operators are reporting warrant movements properly.

The LME has disciplinary powers over warehouse operators which are incorporated in the warehouse agreement and are exercised by the Warehouse Disciplinary Committee. The sanctions include a warning or reprimand, a fine, a requirement to comply with stipulated terms and conditions, withdrawal of warehouse status, and such other penalty as the committee sees fit.

Q. When will the Physical Market Committee be put together and who decides who sits on it?
A. The terms of reference for the Physical Market Committee are being drawn-up, but are expected to give power of appointment to the Board. The Executive will compile a list of key stakeholders, based partly on participation in the Consultation process. Anyone wishing to nominate themselves for the Physical Market Committee is welcome to make such interest known to the LME.

Q. What is the timeline for the logistical review of the Warehousing Agreement?
A. This will be initiated as soon as possible, but the timing will ultimately depend on the schedule proposed by the chosen third-party review provider.

Q. What material changes are being made to the information barrier policy?
A. The LME believes that its existing policy on information barriers represents market best practice. However, the LME will commit to inform the market, on an annual basis, once it has received the required third-party audits in respect of information barriers at the warehouse operators, and identify any general issues arising therefrom. Additionally, with the assistance of external counsel, the LME will continue to monitor the sufficiency of the information barrier requirements.

Q. Does the LME profit from the warehouse system?
A. The LME charges a stock levy on warehouse operators amounting to 1.1% of the daily rent collectable on LME warrants. Additionally, the LME charges an annual warehouse listing fee of US$5,000 per warehouse company per good delivery point, and a one-off listing fee of US$4,000 for additional sheds. However, the stock levy is a mechanism by which warehouses recognise and pay for value gained through being part of the LME network, including the use of our brand and customer confidence in our rules and procedures. It is true that more metal in LME licenced warehouses results in a higher stock levy but this is not a financial management target for the LME.