



NOTE FOR LME: ADVICE ON NEXT STEPS

Introduction

Phillip Crowson has requested that, as project director for Europe Economics of the recent study “A review of possible consequences of a change in contract terms from “in warehouse” to “FOT basis”, with respect to all metals traded on the London Metal Exchange” (20 February, 2007) I provide a short note of our recommendations on next steps. These recommendations are outside the terms of reference but arise directly from the work we have done.

Most of the concern that was been expressed to us in the course of our research about FOT charges referred to the copper market, rather than other metals, but our recommendations apply to all LME metals.

Recommendations

1. LME warehouse contract

Do not implement the change to an FOT contract. This would achieve nothing for consumers and would not improve the overall efficiency of the LME system. It would increase the face value of LME warrants but stickiness in the market means that this would not necessarily be offset by a reduction in producer premiums. Prices to end users would not be reduced and could increase, particularly in the short term. In addition warehouse incomes are likely to be reduced and warehouse capacity could fall. The combination of reduced incentive payments and reduced out-charges is likely to result in less metal being on warrant. Overall there would be a reduction in transparency which could affect the liquidity of the LME markets, and might even lead to increased prices.

2. FOT charges

Staying with the current ‘in warehouse’ contract means that, unless some form of control is in place, it remains possible for individual warehouses to seek to retain metal by raising the FOT charge. This could lead to an upward spiral in FOT charges and it could become prohibitively costly to withdraw metal. That would discredit the LME warrant system as a supplier of last resort for physical delivery of metal and undermine the LME market in its role of providing a global reference price for metals.

At present discussion of the level of warehouse charges takes place bilaterally between the LME and individual warehouses. This practice has been accepted by the parties involved but the scope of such discussions is not well defined. In order to minimise the risk of future disputes, it would be desirable to establish more clearly the limits of LME’s authority in this matter.

Therefore, LME should be prepared to seek informal guidance from the European Commission and other relevant authorities on setting maximum FOT charges for warehouses individually, recognising that this is likely to lead to convergence on a single FOT charge. A statement of case should be prepared drawing on the Europe Economics study with the aim of demonstrating that the proposed approach would contribute to the EU objective of ‘improving the production or



distribution of goods ... while allowing consumers a fair share of the resulting benefit.' (Article 81.3.)

The situation with regard to plastics should be distinguished, since plastics have a relatively short shelf life and it is feasible to prohibit their being re-deposited. Also the plastics contracts are in their infancy and experience with their operation is limited.

3. Location and capacity of warehouses

The question of the optimal number and location of LME warehouses should be the subject of a new, separate economic study.

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