

## **London Metal Exchange FOT STUDY**

Note by Phillip Crowson – 13 March 2007

I was asked in late February 2006 to chair an LME Working Group for commissioning and overseeing an impartial and objective study of the implications of changing all LME metals contracts from delivery 'in warehouse' to a 'free on truck' (FOT) basis. Other members of the Working Group are Jim Coupland, Chairman of the LME Warehouse Committee, Miles Linington, Vice-Chairman of the Warehouse Committee, and LME staff, Liz Milan and Robert Hall.

Several consulting companies were invited to tender for the study, on the basis of Terms of Reference drawn up by the Working Group. Three companies submitted bids and Europe Economics' proposal was accepted. It began work in July 2006 with the objective of completing the study by the end of 2006. Its work programme was well under way and on schedule until October, when actions and statements by the International Wrought Copper Council caused delays and an additional workload. The study was not carried out in response to the IWCC's interventions, but arose from continuing discussions and differences of view within the Warehousing Committee. There have long been well entrenched and firmly held opinions on the issue, often based on subjective beliefs and partial analysis.

Europe Economics was asked to study the implications of a change in LME contracts, without any presumption about the desirability of a change. Nor was the company requested to advise the LME on whether or not a change should be made. That is a policy matter for the LME itself to decide on the basis of the evidence presented.

The main conclusions of the Study are that the practical problems of changing could be overcome and the change implemented (Executive Summary para. 48 to 50). It did not examine the problems in detail and the LME staff believe that implementation would be far from straightforward. A change in the contract:

- Would increase the price of warrants, with a rise in the short run of about the same order of magnitude as the FOT liability. (Executive Summary para. 18 to 21).
- Might in the long run reduce producer premia, but the effects are uncertain and there could be a significant period during which they were maintained. (Executive Summary para. 22 to 27).
- Would reduce warehouse incomes by about 20% or more, over the cycle and averaged between metals. In consequence the capacity of LME warehouses could be reduced. (Executive Summary para. 28 to 36).
- Would lead to less metal being placed on LME warrant, and increase the likelihood of metal being withdrawn. (Executive Summary para. 37 to 38).
- Would be equivalent to the imposition of a zero price for exit services, which might raise questions about Competition Law similar to those raised about the LME imposing maximum FOT charges. (Executive Summary par. 38).
- Have no impact on the geographical location of LME stocks, which depend on other issues essentially separate from a change in the contract. (Executive Summary para. 39).
- Would, at the margin, reduce LME stocks and thereby reduce market transparency and affect liquidity. (Executive Summary para. 40 to 42).
- Would not, overall, reduce metal prices. (Executive Summary para. 43 to 47).

These conclusions strongly indicate that any benefits of a change in the contract basis for the market as a whole would be relatively limited, when set against the likely costs and disadvantages. **The Working Group therefore recommends against a change in the basis of the contract (from 'in warehouse' to 'FOT') for any metal.**

Warehouses form the interface between the LME, a terminal market of last resort, and physical metals markets. Very often the LME system is a convenient scapegoat for problems and issues, such as the nature and determination of producer premia, which may arise in the physical markets. Such issues should be tackled directly by those concerned, rather than indirectly through changing LME systems. The consequences, which are often unpredictable, of such changes may be far more damaging than the original concern, and may not adequately solve it.

That does not mean that the status quo is always desirable or that the LME should be complacent. The Study has highlighted several issues:

- Warehouse companies are an integral component of the LME system, but there appears to be far too much of an adversarial relationship rather than constructive cooperation. This has to change.
- The LME should continue careful monitoring and analysis in order to optimise warehouse numbers and locations as market circumstances change. The criteria for determining warehouse locations and registering warehouse companies should also be periodically reviewed.
- Unless there is some form of control it is possible for warehouses to seek to retain metal by raising FOT charges. This could lead to an upward spiral in FOT charges to the detriment of those withdrawing metal, given the 'seller's option' basis of LME settlement. The present system of bilateral discussion of warehouse charges between the LME and individual warehouse companies is not wholly satisfactory.
- The LME needs to maintain strong vigilance over all warehouse rents and charges, within the constraints of competition law. Those constraints should be aggressively challenged. The LME should seek informal guidance from the EU Commission and other relevant authorities on setting maximum FOT charges.

PCFC

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