

To: All members, warehouse companies and their London agents

Ref: 14/039 : A037 : W024

Date: 5 February 2014

Subject: **ANNOUNCEMENT OF WAREHOUSE AND PHYSICAL NETWORK REFORMS**

Summary

- 1 The LME is pleased to announce to the market the implementation of several measures introduced in Notice 13/326 : A312 : W125 (the “Consultation Results Notice”).
- 2 The Consultation Results Notice set out the results of a three-month market consultation (the “Consultation”) in respect of the Linked Load-In / Load-Out Rule (the “Rule”) and introduced a package of recommended measures. Further detail was provided in the accompanying report (the “Consultation Report”).
- 3 Today, the LME is setting out an assessment of market developments, and announcing updates in respect of:
 - A. Enactment of the Rule (with a 50-day queue threshold)
 - B. Enhanced LME investigation and action powers against artificial queues
 - C. Warehouse logistical review
 - D. Legal review of the Warehousing Agreement
 - E. Introduction of a separate load-out rate for steel
 - F. Creation of a Physical Market Committee
- 4 Capitalised terms not otherwise defined herein shall have the meaning ascribed to them in the Consultation Results Notice.

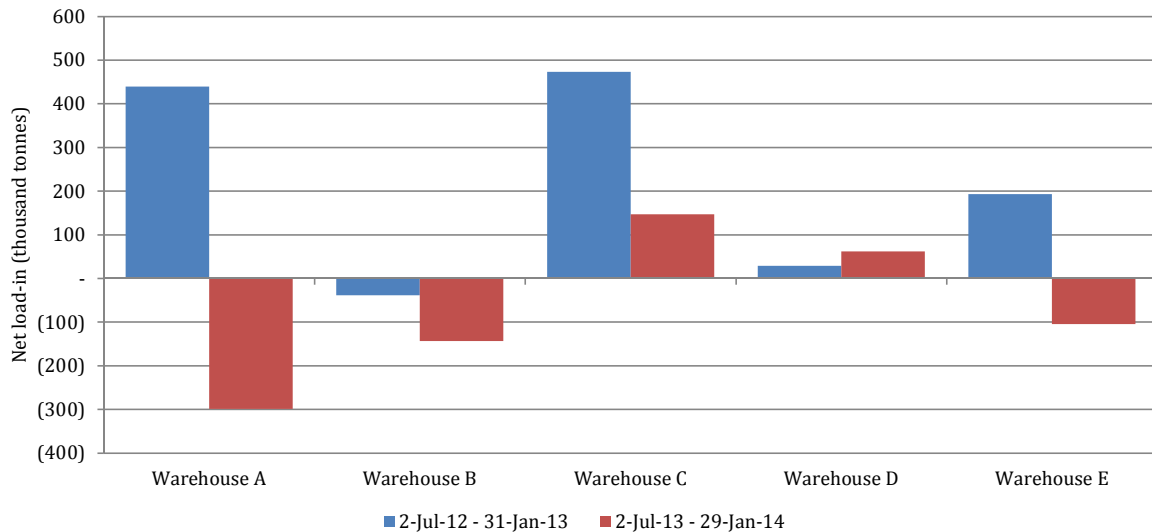
I. ASSESSMENT OF MARKET DEVELOPMENTS

Warehouse behaviour

- 5 The primary aim of the Rule is to reduce the growth of stocks, and hence queues, at Affected Warehouses. Although the Rule will not come into effect until 1 April 2014, it is already beginning to have an effect as a result of the Preliminary Calculation Period, which commenced on 1 July 2013.
- 6 This is demonstrated by the graph below. During the period between 2 July 2013 (the day following announcement of the Consultation) and 29 January 2014, three of the five Affected Warehouses have loaded out more stock than they have loaded in, thereby directly contributing to a reduction in stocks at Affected



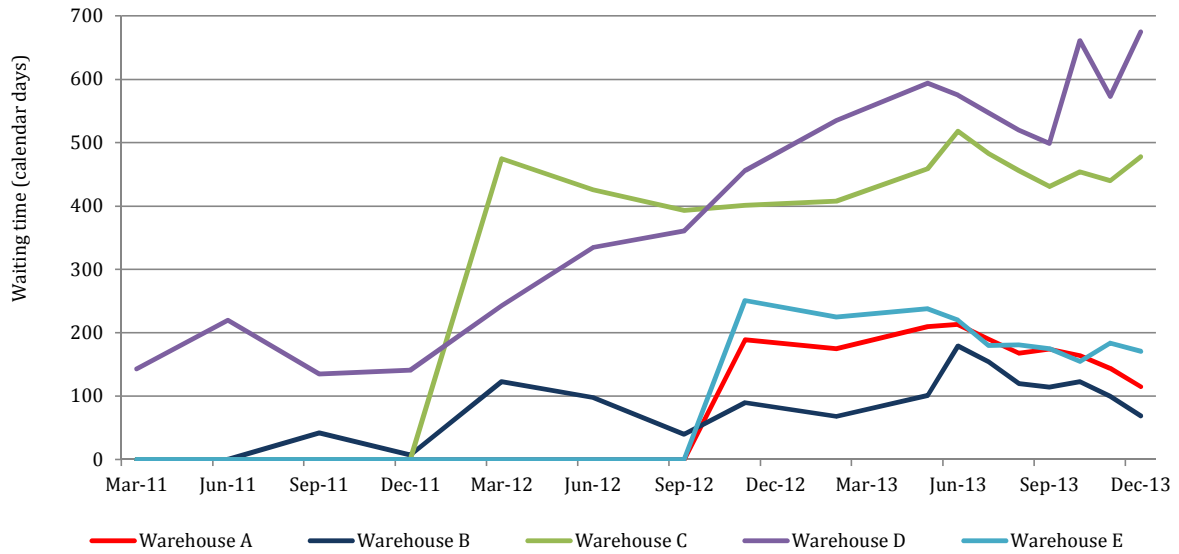
Warehouses as envisaged by the Rule. Two warehouses have demonstrated a net load-in during the same period – however, at Warehouse C, the amount of net load-in is significantly reduced compared with the comparative prior year period, and at Warehouse D, the figures for both periods were low on a relative basis.



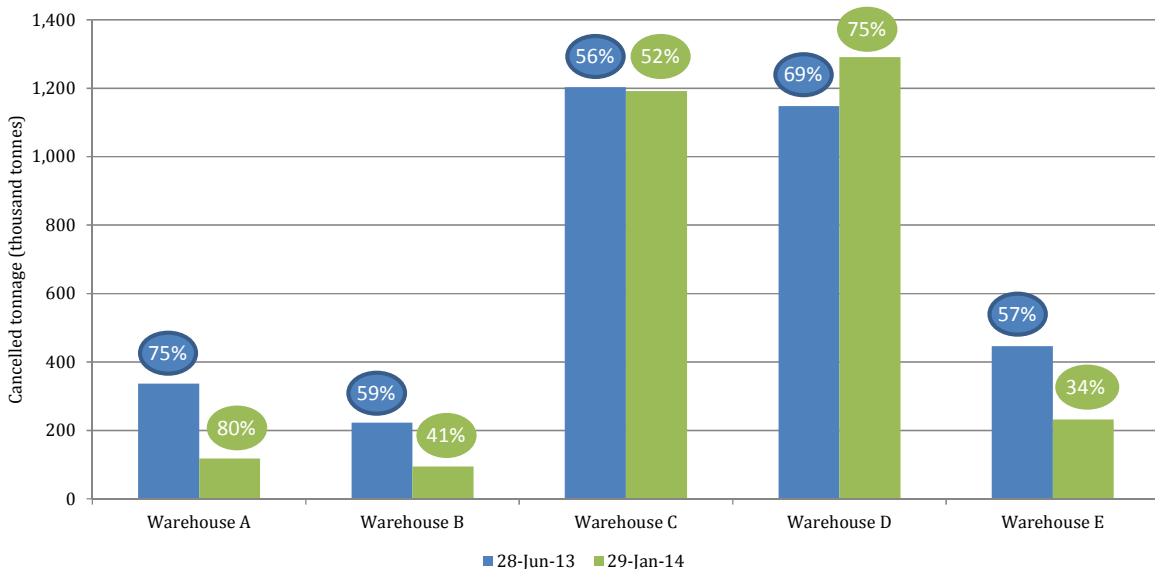
- Affected Warehouses that have demonstrated a net load-in during the Preliminary Calculation Period will incur greater load-out obligations as of the Preliminary Discharge Period on 1 May 2014. All Affected Warehouses will incur greater load-out obligations as of the First Discharge Period on 1 August 2014, unless they entirely cease load-in during the First Calculation Period, or cease to become Affected Warehouses before that time.
- In the absence of action on the part of the LME, it is likely that stocks at Affected Warehouses would have continued to rise. The response the Rule has received is indicating that the reduction of stocks, which is itself a key precursor to the Rule's stated aim of reducing queues, is being achieved.

Queue development

- The following graph sets out the development of queues at Affected Warehouses (data through 31 December 2013):



- 10 Since the start of the Consultation on 1 July 2013, queues have fallen at four of the five Affected Warehouses.
- 11 As the LME clearly messaged to the market in its Consultation Report, the initial effect of the Rule may be that queues lengthen, if metal owners respond to it by cancelling their warrants in the expectation of achieving quicker access to their metal. As shown in the following graph, the development of queues is broadly correlated with cancellation behaviour – and, in particular, the growth in queues at Warehouse D (which has demonstrated the greatest such increase) has clearly been caused by a pick-up in cancelled warrants.



(percentages show cancelled warrants as proportion of total stock)



- 12 However, the mathematical effect of the Rule is that, even if all warrants were cancelled and queues initially increased as a result, those queues will reduce over time.

Observations on premiums

- 13 The LME notes the recent increase in levels of reported premiums, in particular in the North American aluminium market. Accordingly, the Exchange feels it appropriate to restate its position in respect of premiums.
- 14 As set out in the Consultation Report, the LME believes that an element of premiums is related to queues. However, there exists an additional element of premiums that is not related to queues. These two elements will be considered in turn.
- 15 The LME has taken action on queue-related premiums via the Consultation. As such, as queues fall, this element of premiums should fall. However, warrant holder cancellation behaviour has resulted in queues at certain warehouses continuing to rise – accordingly, the fall in this element of premiums may not be fully observed until all queues begin to fall.
- 16 Non-queue related premiums are outside the scope of LME prices, and are driven instead by specific market supply and demand factors. Nevertheless, the LME has committed to explore the potential introduction of premium hedging tools to help the market address risk management concerns in respect of non-queue related premiums.
- 17 The LME notes also the significant market commentary in respect of metal in non-LME licensed storage. As clearly set out in the Consultation Report, an expected consequence of increased load-out of metal from LME warehouses is a quicker net flow of metal to off-LME storage, with potential difficulties for the market in respect of stock visibility, premium price discovery and hedging. Off-LME storage is, by definition, not a topic on which the LME can comment – however, the LME is investigating whether the launch of a premium hedging contract will allow more effective hedging of regional premiums (noting that such premiums may be affected by developments in the off-LME metal market).

II. UPDATE ON IMPLEMENTATION STATUS

A. Enactment of the Rule

- 18 The enactment of the Linked Load-in / Load-Out Rule will proceed as planned on 1 April 2014 with a 50-day queue threshold.
- 19 Certain elements of the package of measures introduced with the Rule require changes to the LME Warehouse Agreement (the “Warehousing Agreement”) and the LME Policy Regarding Approval of Warehouses (the “Policy”). As a result, Notice 13/327 : W126 initiated a further consultation, specifically with warehouse companies (the “Warehouse Contractual Consultation”) in accordance with the Warehousing Agreement.
- 20 The results of the Warehouse Contractual Consultation were announced in Notice 13/375 : A359 : W152 on 30 December 2013. A point-by-point



assessment of the issues raised in the Warehouse Contractual Consultation is available in the relevant Notice.

- 21 Accordingly, the LME will proceed with implementation of the changes to the Warehousing Agreement and the Policy as set out in the Consultation Results Notice as scheduled on 1 April 2014.

B. Enhanced LME investigation and action powers to tackle artificial queues

- 22 The revisions to the LME Warehousing Agreement include the addition of a new Clause 9.3.4, which gives the LME enhanced powers to investigate the formation of queues, and to impose additional load-out obligations on warehouses that have paid incentives in order to artificially create or maintain queues.
- 23 The Exchange is pleased to announce that the LME Special Committee will be ultimately responsible for sanctioning any enforcement action under Clause 9.3.4. The Special Committee is already responsible for the exercise of certain discretionary powers in respect of the LME market in accordance with Regulation 15 of Part 3 of the LME Rules. The Special Committee is composed of persons who have no material interest in the contracts traded on the Exchange. The involvement of the Special Committee will ensure an independent and impartial approach to any action under Clause 9.3.4.

C. Logistical review

- 24 The LME is delighted to announce that, following a rigorous tendering process, Oliver Wyman has been appointed to conduct a logistical review (the “Logistical Review”) of the LME warehousing network.
- 25 The Logistical Review has already commenced, and will provide the LME with an independent view on reasonable operational expectations and requirements for the loading in, holding and loading out of metals.
- 26 Within this scope, the LME has asked Oliver Wyman to report on logistical rate considerations, suitability of good delivery locations, warehouse companies and warehouse sheds. Oliver Wyman’s scope of work will include all logistical concerns raised during, and following, the Consultation.
- 27 Additionally, the Review will assess the optimal process for the approval of applications, including the proper advisory role of the LME’s Committees.
- 28 The LME would like to invite any interested market participants to contribute to the Logistical Review. Sessions will be scheduled for market participants to interact with Oliver Wyman in due course, and a Notice will be published to that effect.
- 29 A public report of the logistical review is due for delivery by the end of August 2014. Depending on the recommendations made by Oliver Wyman, it may be necessary to further consult the market before the recommended changes are implemented.

D. Warehousing Agreement legal review

- 30 In parallel with the Logistical Review, the LME has commissioned a legal review of the Warehousing Agreement. This will be carried out in conjunction with



Addleshaw Goddard LLP and will focus on: (i) ensuring that the Warehousing Agreement remains fit for purpose; and (ii) implementing any proposed changes arising from the Logistical Review which require modifications to the Warehousing Agreement. The findings will be incorporated into the report of the Logistical Review, due by the end of August 2014.

E. Steel

- 31 An important element of the package of measures was the introduction of a separate load-out rate for steel. Although this will not come into effect until 1 April 2014, the LME steel contract is already reacting in a positive manner.
- 32 Between July 2013 and January 2014 the average monthly price differential between the LME steel billet contract and the SteelOrbis FOB Black Sea price has converged from \$378 to \$156.
- 33 The price convergence of the LME steel billet contract has been driven by two pro-active revisions by the LME to the contract – firstly, the upcoming implementation of separate steel load-out rates, and secondly, the regionalisation of the steel contract back to Europe.
- 34 The Exchange is pleased to note this price convergence. However, the LME recognises that usage of the steel contract continues to be low. Accordingly, the LME is working with the steel community to further enhance the price discovery and hedging use of the contract, including potential changes to the contract specifications.

F. Physical Market Committee

- 35 The LME has already announced the formation of the Physical Market Committee, which will provide a forum for all sectors of the physical industry to represent their views to the Exchange. This Committee will meet quarterly as part of the regular cycle of metal committee meetings. The Physical Market Committee's inaugural meeting will be in March 2014.
- 36 The LME is delighted to announce that Professor Phillip Crowson has been appointed as Chair of the Physical Market Committee. Phillip was made an Honorary Member of the London Metal Exchange in October 2009 and has served both as an Invited Director (for 12 years) and the current Chairman of the LME's Special Committee.
- 37 A Cambridge graduate, Phillip worked in the UK chemicals industry for 10 years before joining the economics department of The RTZ Corporation (now Rio Tinto) in 1971. He became the company's Chief Economist in 1981. Since leaving in 1997, Phillip has taken an active role in many industry organisations, including serving as the Chairman of the European Copper Institute and President of the Mining Association of the United Kingdom.
- 38 Phillip is an Honorary Professor and part-time Professorial Research Fellow at the Centre for Energy, Petroleum, and Mineral Law & Policy at the University of Dundee, Scotland. He has written several books and published papers and articles on aspects of the mineral industries. His most recent books are *Mining Unearthed* and *The Official LME Guide to Managing Metals Price Risk*.



- 39 As the Chair of the Physical Market Committee, Phillip will also have a seat on the User Committee and the Warehousing Committee, where he will represent the interests of the physical market.
- 40 Other prospective Physical Market Committee members have been contacted, and their appointments are currently being formalised. Appointees include individuals who nominated themselves for the Committee, and also those serving at the request of the Exchange, in order to achieve balance across metals and roles in the production chain.
- 41 Additionally, the Warehousing Committee will be restructured, and will be composed of one invited representative per LME warehouse operator, the Chairman of the Physical Market Committee, and an independent Warehousing Committee Chairman, thus ensuring that the voices of all warehouse operators are properly represented to the LME Executive and Board.
- 42 The LME is delighted that Fabian Somerville-Cotton, the current independent Chairman of the Warehousing Committee, has agreed to continue to serve in this role.
- 43 The Warehousing Committee currently includes a number of members not associated with warehouse operators, who have played an extremely important role in representing the views of LME market users to the warehousing community. Going forward, this function will be performed by the Physical Market Committee, and consequently these members will leave the Warehousing Committee. The LME is extremely grateful to these members for their valuable service.

A handwritten signature in black ink, appearing to read 'Matthew Chamberlain', with a horizontal line extending to the right.

Matthew Chamberlain
Head of Business Development

cc: Board directors
User Committee
Warehousing Committee
All metals committees