

Look in the warehouse

LME warehouses do not store huge volumes of steel but they make a vital contribution to the success and integrity of the Exchange. By **Graham Hawkins**

The LME's base metals contracts are among the most successful in the world and the metals industry uses LME official prices as the definitive pricing reference in more than 98 per cent of all purchase and sale contracts struck globally. Some people might wonder why this is so and many would be surprised by the answer. One of the principal reasons behind the LME's success is its warehouse system.

Only a fraction of the huge volumes of steel billet traded each year will ever pass through LME warehouses. Most contracts are executed directly between producers and consumers, moving along highly evolved supply chains en route to end consumption. The LME warehousing system does not replace those existing logistics chains, nor is it intended to. So what is the point of it? Quite simply, the LME warehouses provide a delivery option of last resort. The ever present opportunity (or threat) of being able to buy or sell metal at the current LME price and fulfil that commitment through the physical delivery of metal into or out of the Exchange warehouse stocks keeps the LME price in line (converged) with the physical market price. This underpins industry respect for the prevailing LME price and breeds price integrity.

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Regional contracts for regional markets

To maximise the realisation of this constant opportunity to deliver physical metal through the Exchange, LME warehouses are located in key port locations nearest the areas of net consumption of the metal. Initial proposed delivery locations for the Mediterranean steel contract are Dubai, United Arab Emirates, and Marmara Region in Turkey, both key points in the established supply chain of steel billet exported from the Black Sea region. For the Far East steel contract, Incheon, South Korea, and Johor, Malaysia, are listed as the first two delivery locations, supporting the flow of billet exported predominantly from Chinese mills through to consumption in Asia.

Having two LME steel contracts acknowledges and serves the existence of regional pricing in the industry. And these two major markets are better able to discover their true local market price by having two regional steel contracts, one for the Far East and one for the Mediterranean.

Physical delivery using the LME warehouse system

If an organisation is short of steel billet, it can buy LME warrants through an LME broker at the prevailing LME cash steel price and take immediate delivery from an approved LME warehouse facility. Conversely, an organisation can deliver surplus billet into an LME warehouse to create LME warrants, which it may sell through an LME broker and receive the current LME cash steel price with prompt settlement.

LME warrants are widely recognised by the international banking community as financeable documents, so they may be used by producers, consumers and merchants to raise finance for stock held at LME warehouse facilities.

Creating an LME warrant

The warehouse is notified in advance by a shipper of the total quantity, brand, shape and expected shipping schedule. The billets are received and stored in a secure LME-approved warehouse compound, arranged in standard lot sizes of 65 tonnes of one shape and one brand. The billets are physically inspected and the accompanying paperwork is checked to make sure it complies with LME rules. Each lot is now ready to be issued with a receipt, or warrant, representing a specific parcel of steel billets.

The warehouse issues a unique pile number for every lot and records all the necessary details in its stock control system. When instructed by the owner, the warehouse issues the warranting instruction, and its London agent issues the warrants electronically in the LME's SWORD system. This proprietary system provides a real-time database of stock ownership and movement. It is used to calculate and collect warehouse rent owing on individual warrants and every warrant is issued and cancelled electronically in SWORD.

Once warrants have been issued electronically, they are printed onto the warehouse's branded security paper as the hard copy of the warrant. The paper warrants are couriered to the client's nominated broker and held to their account. These warrants can then be sold, delivered against a maturing LME futures short position or held to the owner's order pending further instruction.

Taking delivery from the LME warehouse

Once the paper warrants are in free circulation they are kept in the London depository until they are required for cancellation and delivery. At this point they are returned to the London agent who stamps them as 'cancelled' and cancels them electronically in SWORD. The owner's release instruction is then passed by the agent to the warehouse, which holds the physical material until they receive further instructions from the owner to deliver the material from the warehouse.

Ensuring the smooth running of the system

The warehouse is regarded as the gatekeeper to the LME physical delivery system, only issuing warrants for billet that conform to the LME rules.


Delivery locations are only approved by the LME in areas of net consumption, served by minimum levels of logistics infrastructure, such as container terminals, berths of a minimum draft, highways and rail connections. The port area has to have 'freezone' or 'bonded' status too, which means goods can be stored indefinitely in the warehouse, free from local inventory taxes or duties, while the steel billet is traded multiple times in warrant form.

Only LME-approved warehouse companies can operate approved warehouses. Each facility must pass regular audits by LME staff whose checklist includes building structure, security and minimum levels of operating efficiency. These well-established monitoring procedures ensure high standards are maintained throughout the delivery system.

The warehouse plays a crucial role, therefore, in the proven success of the LME model. The system provides the industry with an ever present delivery option of last resort, encouraging convergence between the physical market price and the LME cash steel price. The daily publication of warehouse stock movements acts as a barometer of underlying supply and demand fundamentals and creates an efficient tool for price discovery and managing price risk.

So, although the volume of steel passing through LME warehouses represents a fraction of global trade, it provides huge benefits to the wider industry at large. ■

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