Hands-on Management



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London Metals Exchange (LME)

The London Metals Exchange (LME) is the predominant pricing tool for the producers and consumers of metals worldwide. The Exchange sets a price for the following metals: Primary aluminum, aluminum alloys, copper, lead, nickel, tin and zinc. Two key LME prices are "cash" (the price two business days forward from the current business day) and "three months" (three months ahead of the cash date). Let's examine some of the practical workings of the LME and how these aspects affect the metal finishing marektplace.

The principal function of the LME is hedging, a financial tool to minimize the risks involved in buying and selling commodities. It is unlikely that any but the largest of metal finishers can get directly involved in hedging, because the smallest lot size for nickel is 13,200 lb, and for copper it is

Phys	sical Transaction	LME Transaction
First day Cash Agre nicke	price per ton is \$8,000 e to supply 6 tons of el in 3 weeks @ \$8,021	Buy 1 lot of LME nickel for delivery in 1 wk @ \$8,007/ton
One week later		
Rece	vive the 6 tons of nickel	Sell the 1 lot of LME nickel
but p	price is now \$8,040	@ \$8,040
Three weeks later		
Supp	bly your customer with	
6 ton	s of nickel @ \$8,021	

55,000 lb. Let's examine a case where a company will sell six tons (long tons equal 2,200 lb) of nickel to its customer in three weeks (see table).

On the physical transaction side, we lose \$19 per ton, but on the LME transaction we made \$33 per ton. The result is a profit of \$14 per ton. If the price over the three weeks goes down, then the physical transaction side would show the profit and the LME



side would lose, but the net result is the same—a profit of \$14 per ton. The cost differential between the cost to buy and sell yields the net profit and is the mechanism of the hedge. Hedging works to stabilize market prices by making it less likely that any one trade will lose money. This is a major benefit to metal finishers.

If you think about it, higher prices in the future should be the natural state of the metals market. Future prices, with normal supply-anddemand forces, should reflect the cost of money and warehousing. The market, however, can experience higher nearby prices and lower forward prices. This can happen if a shortage of nearby metal has caused "panic buying," which then drives up the price compared to the forward months. Actual shortages of metal will cause the nearby prices to rise to a level where, hopefully, sellers can be found. I said "actual" because of the way investments made by fund managers and brokers can sometimes control the price of metals (especially nickel) with only loose correlation to actual market forces. Another reason for lower forward prices can be that, when the price of the metal is relatively high, producers can lock up

profit margins by selling more than the usual metal into the forward months.

The LME as an organization uses specifications to control the quality of the metal sold on the Exchange. A London Metal Exchange nickel contract pamphlet1 states the following: "The nickel delivered under this contract must be Primary Nickel of minimum 99.80% purity with chemical analysis conforming to the current ASTM specification.' Specifications control the shape of the cathodes (electrolytical production methods mean your anodes are first cathodes), pellets or briquettes. Warrants are issued for each lot (6 tons) of nickel packaged in steel drums of uniform size and weight. Only the production of LME-approved metal producers can be sent to the delivery points, which are certified warehouses. A trading member of the LME can place the metal product on a warrant under certain conditions. All of the metal in

any one delivery must be from only one supplier known to the associate (a member of the LME). The warehouse must inspect one drum (picked at random) in 10 from each lot to be certified. The warehouse is required to retain the record of certification for a minimum of six months after the nickel leaves the warehouse.

The LME sets the prices on nickel for up to 15 months in the future, and copper up to 27 months. The finisher can take advantage of this by locking in a price for future delivery. He is therefore able to know and control a critical portion of the fixed costs. For example, I have placed orders for part of my metal needs with a distributor as far forward as March 2000. Market aberrations during the past 12 months have created some real opportunities for the finisher to purchase metal at very low prices. This is especially true for copper, nickel and zinc.

If you use long-term contracts over an extended period of time, the results (good and bad) tend to average out. Our customers, for example, are asking for longer and longer contracts—in some cases, up to five years with fixed prices. Using a distributor with the ability to go out 27 months on copper can make the job easier to quote. "Even if a metal finisher isn't in a position to book future prices, it's useful for finishers to be familiar with the workings of the LME. Spot purchase prices are directly related to the LME as well. It's simply a matter of being a smart consumer."² P&SF

Columnist's Note: Additional reference material obtained from "Solutions to Market Aberrations," a press release by Alan Whiting, LME executive director, Regulation and Compliance.

¹*LME Basic Market Functions*, Martin Abbott, associate director, Marketing Sogemin Metals, Ltd.

²Greg Landry, marketing director, Allied-Hunter