

Metal Exchanges, a Playground for Speculators or a Market for Industry?

Thierry Centner

Chairman, International Wrought Copper Council
Vice President, Copper Products, Cumerio SA



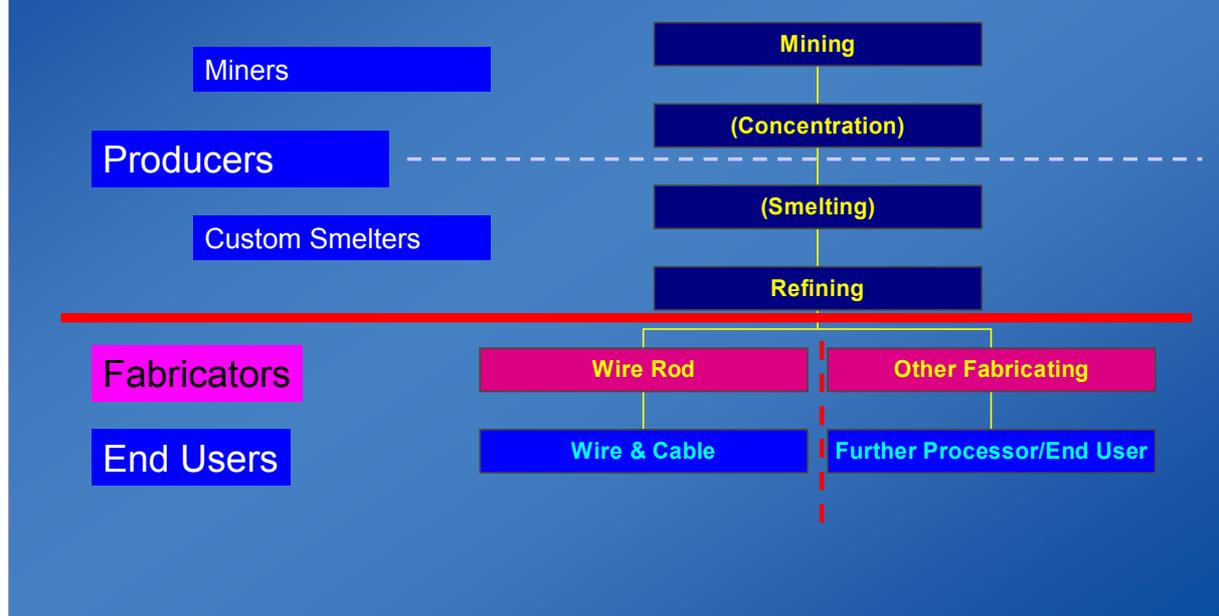
Mr. Gregory Lampert, Session chairman

Our third speaker of this session is Mr. Thierry Centner representing the International Wrought Copper Council. After 2 years as a consultant in North Africa, he spent 30 years with different companies owned by the Belgian group, Union Minière, now called Umicore. He has been commercial director for the division of Cobalt and Special Products before joining Umicore Copper 19 years ago. He is Vice President of Copper Products and the Chairman of IWCC. We look forward to hearing his interesting perspectives on the copper market. Thierry please take the floor.

Mr. Thierry Centner

Mr. Chairman, Ladies and Gentlemen,
this is the first time that the Chairman of the International Wrought Copper Council, which is a 53 years old organization, has addressed you in that capacity. Let me therefore quickly explain to you that, just as the ICF is the representative international trade association for the cable industry, the IWCC is the representative international trade association for the copper fabricating industry. However, the definition of that industry is less focused than your own, so let me also explain what the copper fabricating industry is.

The Great Divide in the Copper Industry

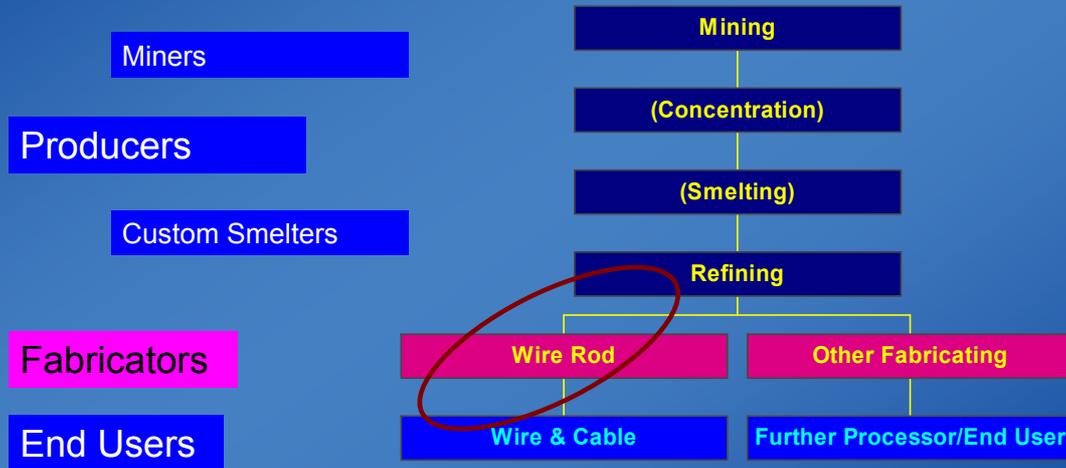


Compared with, say, the aluminium or the oil industries, the copper industry has been characterized for many years by structural divides which very much limit the degree of vertical integration.

On the one side of the main horizontal divide, we have the copper producing industry, those who mine copper and extract the metal. That takes us to the refined metal stage – notably the cathode which is the basis of the LME copper contract. Then we have the copper fabricating sector, that segment represented by the IWCC, which comprises those who take the metal and turn it into a semi-finished, and in a few cases, a finished product. Downstream of that there are further processing industries, such as your own, who take the semi-finished product and turn it into the final product.

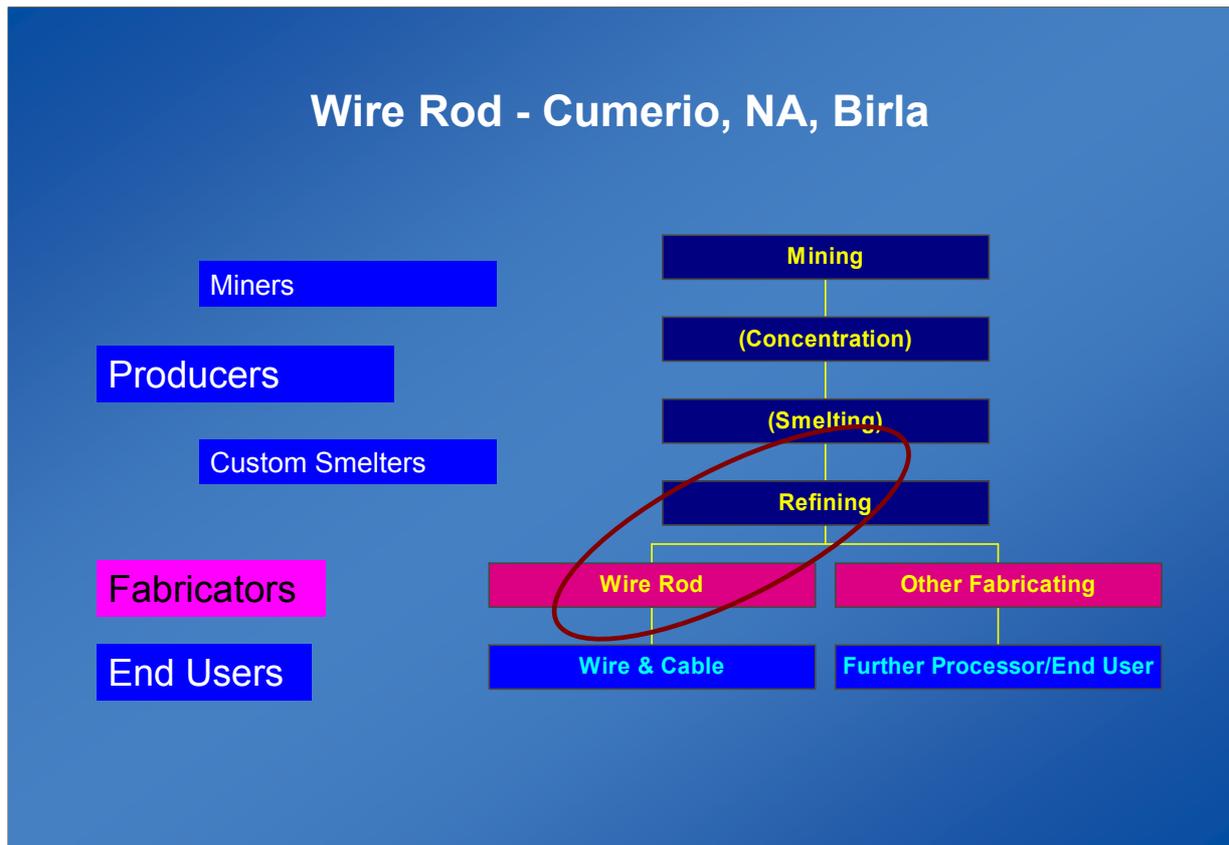
Having set out the basic structures of the industry let me add that there are a number of exceptions and additional complexities. For example, there exists a major sector, the so-called custom smelting industry, which for a fee known as the treatment and refining charge (TCRCs), undertakes the process of winning the metal. That is particularly the case in Europe, Japan, China and India.

Wire Rod



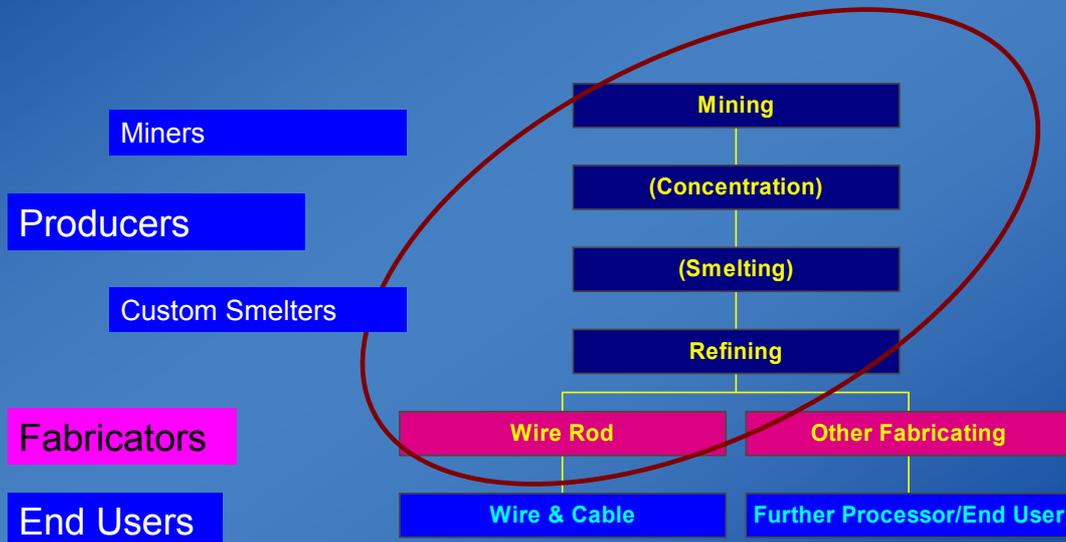
Another exception, and from your point of view an important one is the positioning of copper wire rod production in the industry structure and value chain. In some cases this is seen as an extension of the copper refining operation, where value can be added conveniently to the copper cathode.

Wire Rod - Cumerio, NA, Birla



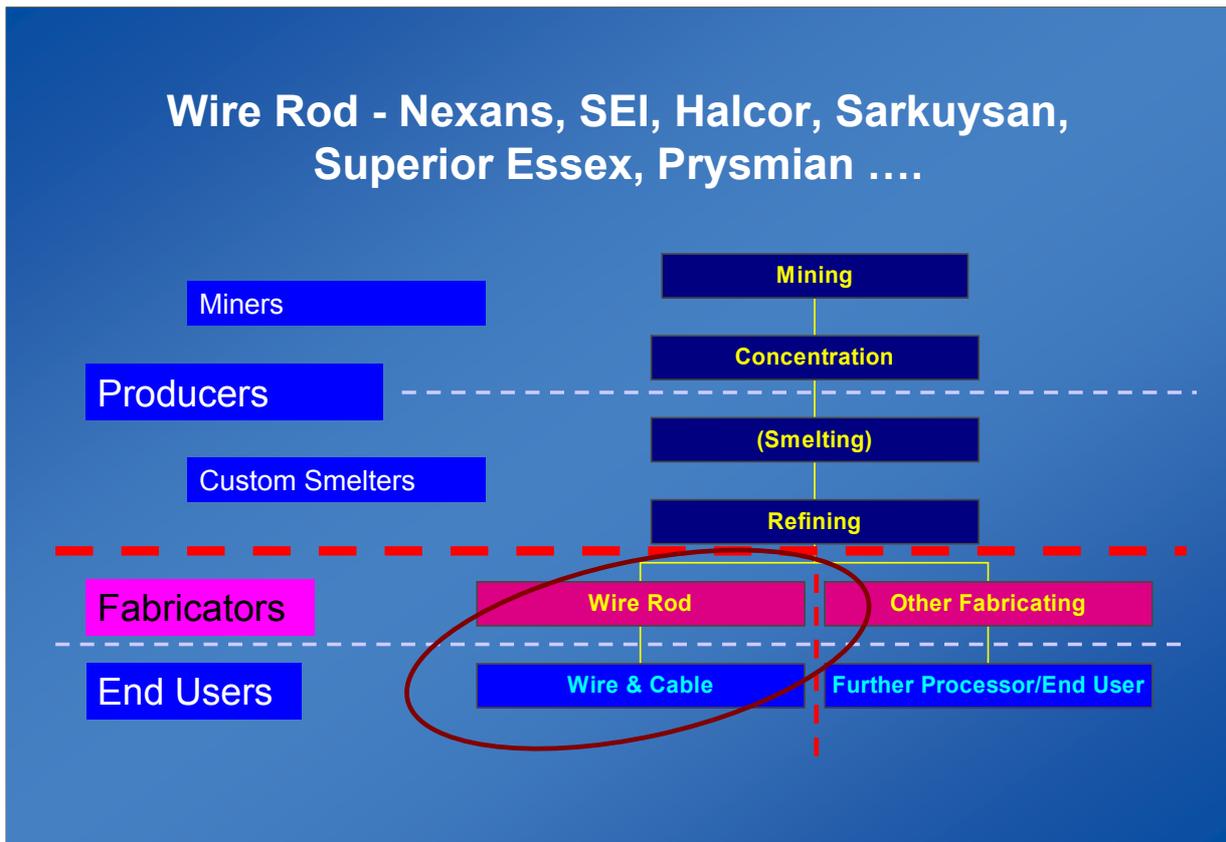
Examples include Norddeutsche Affinerie (NA) and my own company, Cumerio, in Belgium and Hindalco/Birla in India.

Wire Rod - KGHM, Grupo Mexico, Kazakhmys, PD,



Wire rod may also be produced by integrated mining and refining companies, such as KGHM in Poland, Grupo Mexico, Kazakhmys in Kazakhstan and Germany, and Phelps Dodge in the USA, where the integration extends into cable.

Wire Rod - Nexans, SEI, Halcor, Sarkuysan, Superior Essex, Prysmian

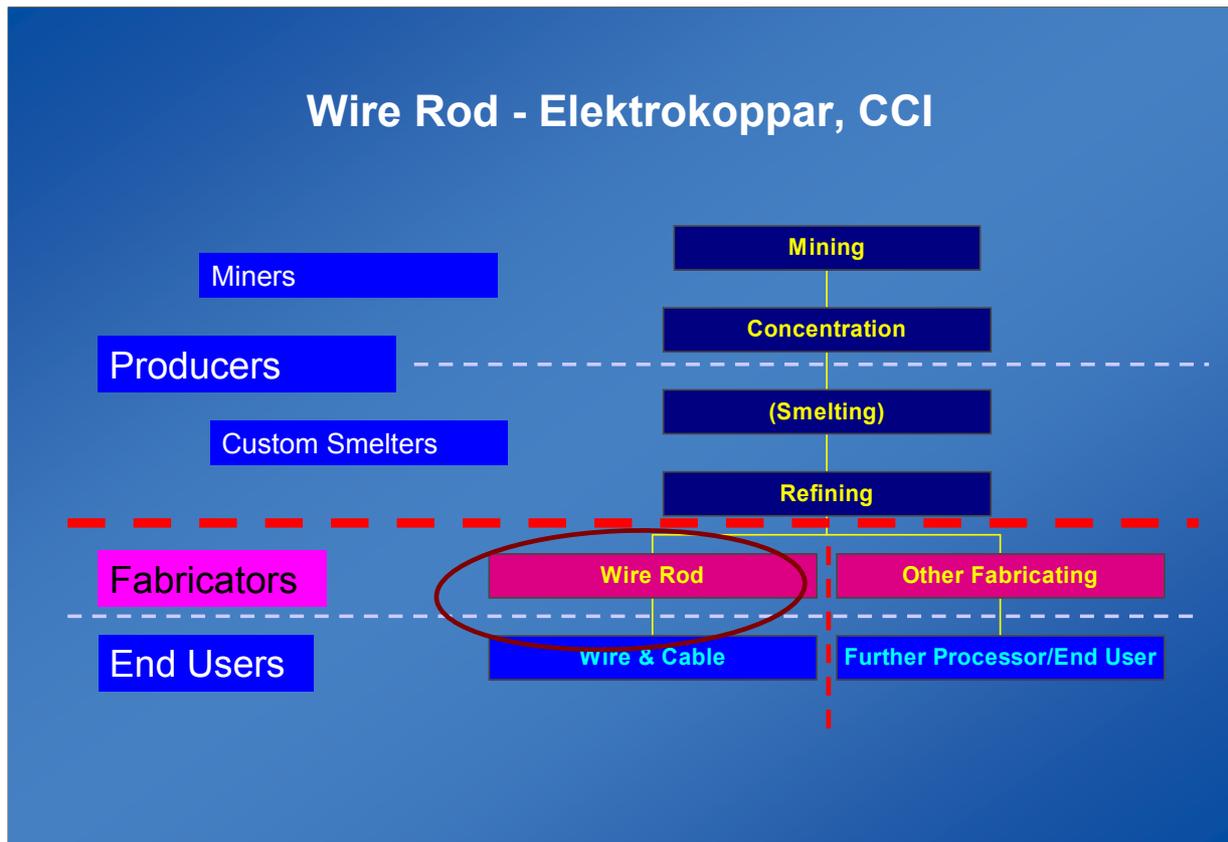


On the other hand, wire rod manufacture may be integrated with drawn and enamelled wire and/or cable making, perhaps as a security of supply. Examples include Nexans, Sumitomo Electric, Halcor, Sarkuysan, Southwire, Superior Essex and, only for a couple of months, Prysmian.

It is not surprising that this is an area coming under scrutiny at the moment by their owners: It is one thing to focus on cable making as an area of expertise. The process of turning a commodity metal into another commodity form takes a cable maker into an area of other pressures and skills, which may be seen as a distraction from the core business.

Thus Prysmian has announced the closure of its one European rod mill, that in the UK. If you look back at Prysmian's genealogy, the Pirelli and Siemens genes were never orientated to wire rod manufacture, whereas its grandparent, BICC, (remember that name?) not only produced their wire rod, but also operated a copper refinery as well, and at one stage had an indirect minority stake in a mine. Those days are long gone: Nexans has announced several times its desire to change its involvement in copper rod manufacture.

Wire Rod - Elektrokoppar, CCI



There are some stand-alone manufacturers of wire rod, who turn cathode into rod and sell it on to the wire and cable industry, but this is rare, not surprisingly considering the slender margins involved. I could point to Elektrokoppar in Sweden or CCI in Italy as examples, but even in those cases the companies have moved increasingly into added value areas.

Why am I telling you all this? I think it is important to set this scene for the next part of my paper, which will focus on the copper market and the issues it is raising for the copper industry.

The Copper Industry - Health Warning!

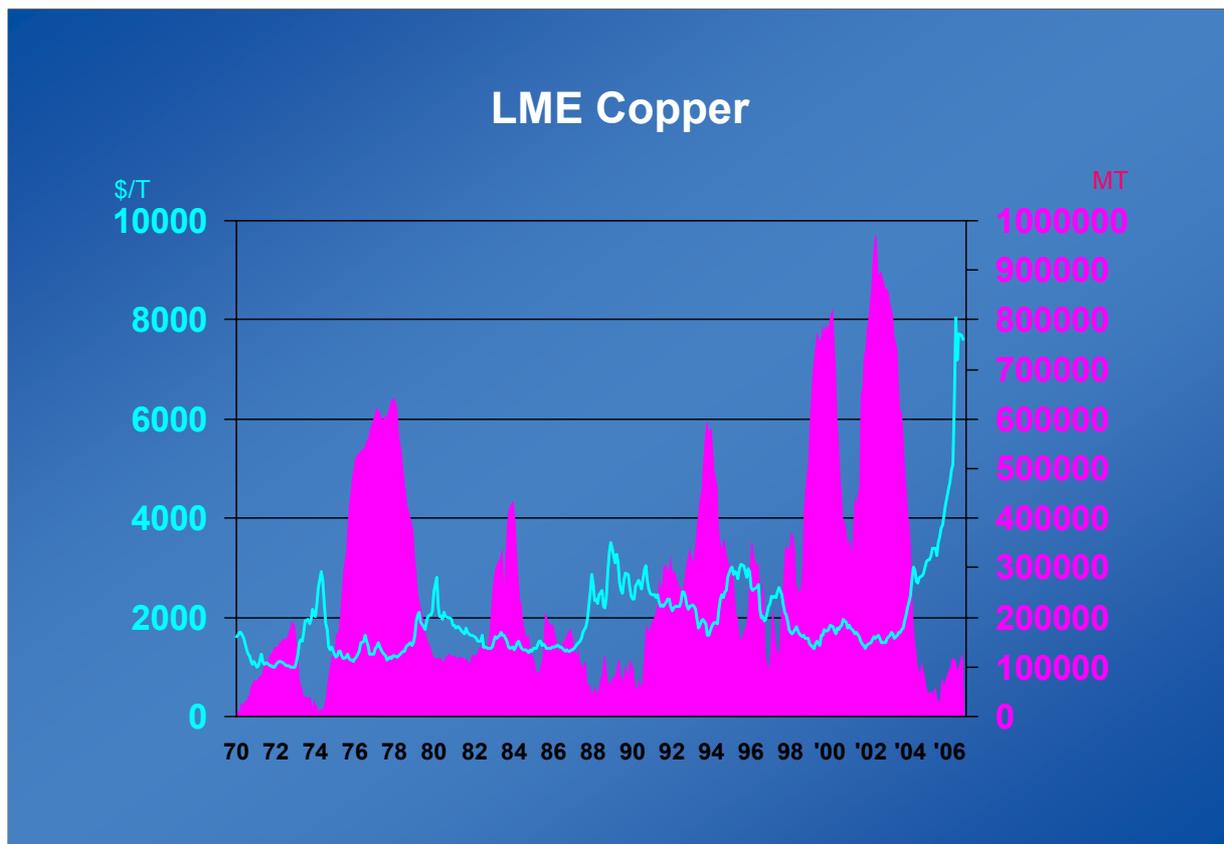
The Copper Industry consists of several industries linked by a common material, and does NOT necessarily have common interests, drivers, challenges and solutions....

But that is an oversimplistic way of putting it, because a range of reasons, including industry structure, dictates how different companies are impacted by the behaviour of the copper market, and where their interests lie in its future development. It would be easy for me to say, "We are all in this together". But be careful, it is in situations such as these that you find out who your friends are!

The copper industry comprises several different industries linked by a common material, but that is not the same as having common interests, drivers, challenges and solutions.

Let me say now that if you are expecting a detailed short-term analysis of the copper market, culminating in a price forecast, you should have invited an analyst! I am going to take a much broader view, because I think that there are issues we need to look at together.

So what is the situation in which we find ourselves? It hardly needs me to tell you that the last twelve months have seen the copper market behave in an unprecedented manner. In the next part of this paper, I shall remind you of what has happened, speculate (if that is an appropriate word in the circumstances) on why it has happened, consider its effects on the industries producing, processing and using copper, and finally offer some thoughts on whether this evolutionary process is something we all have to live with, or is capable of improvement or even change.

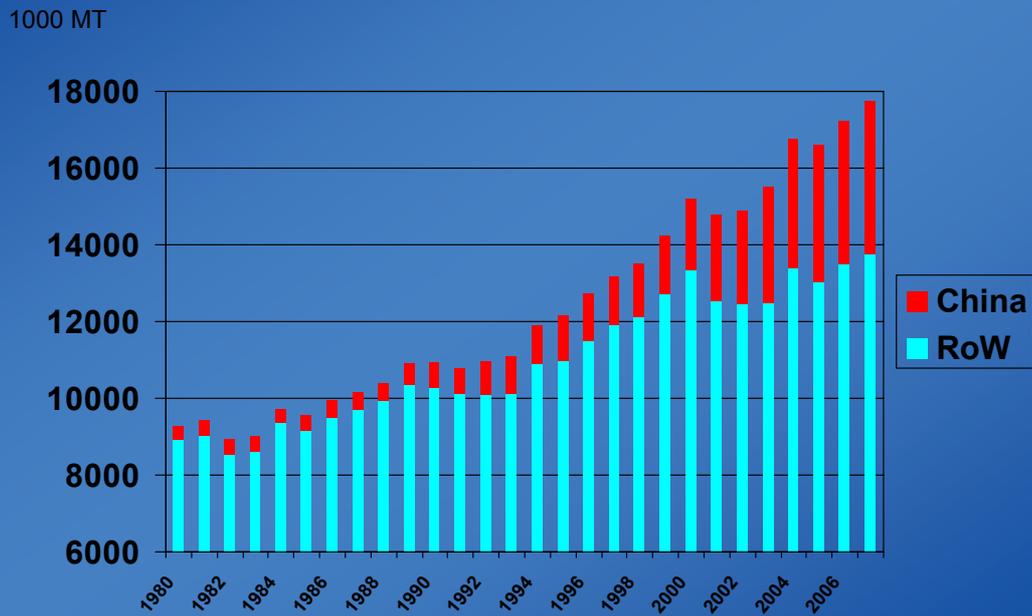


Let me firstly put the recent behaviour of the copper market in an historical context.

If we look back to 1970, a number of things are obvious. Price peaks coincide with low points in the stocks, notably in 1974, 1984, the end of 1988 and 1995, and most of all in the current cycle. Note that LME stocks do not get to zero. In 1974 they were down to 10,000 tonnes, but as they approximate to zero, the backwardation tends to attract metal from somewhere. But in terms of money of the day, there is no doubt that the recent behaviour of the copper market has taken us into new territory.

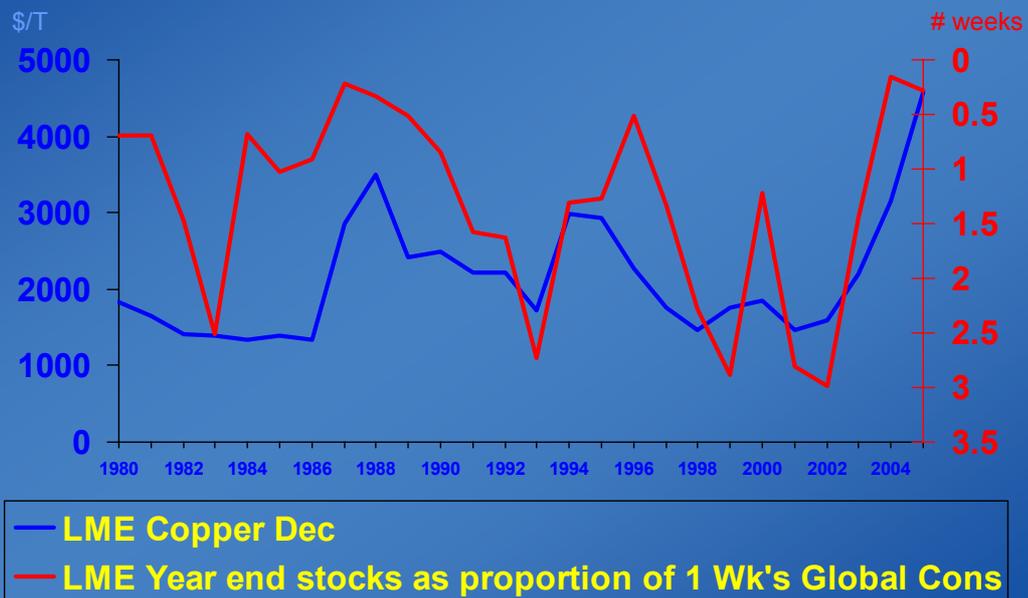
We have all asked if the price behaviour is justified by the fundamentals.

Copper Consumption



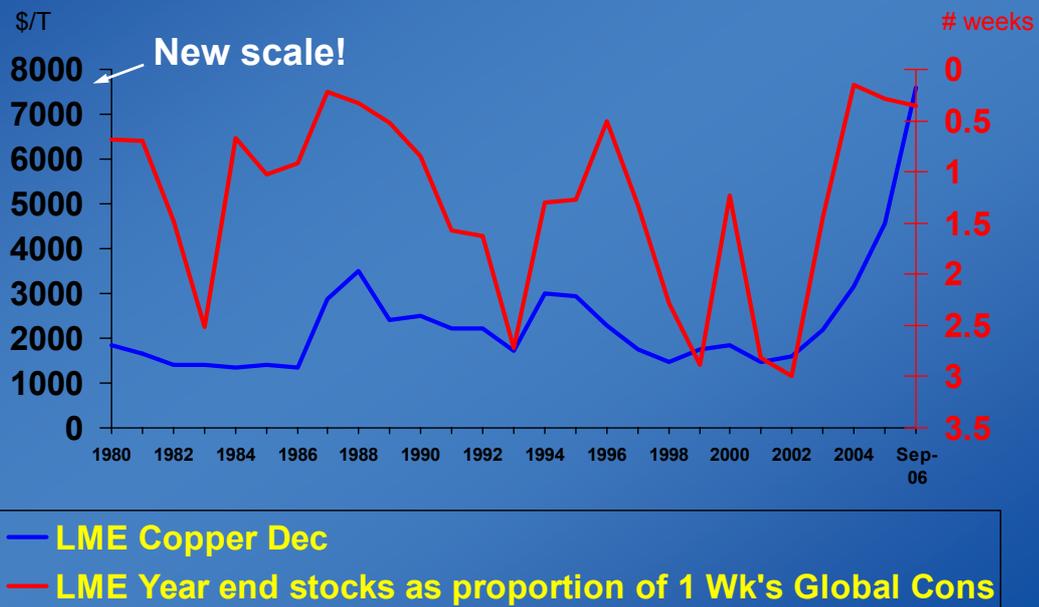
Copper stocks should always be considered in the context of global consumption, and that has been growing a very healthy rate in recent years, driven by strong Chinese demand.

Copper Stocks and Consumption



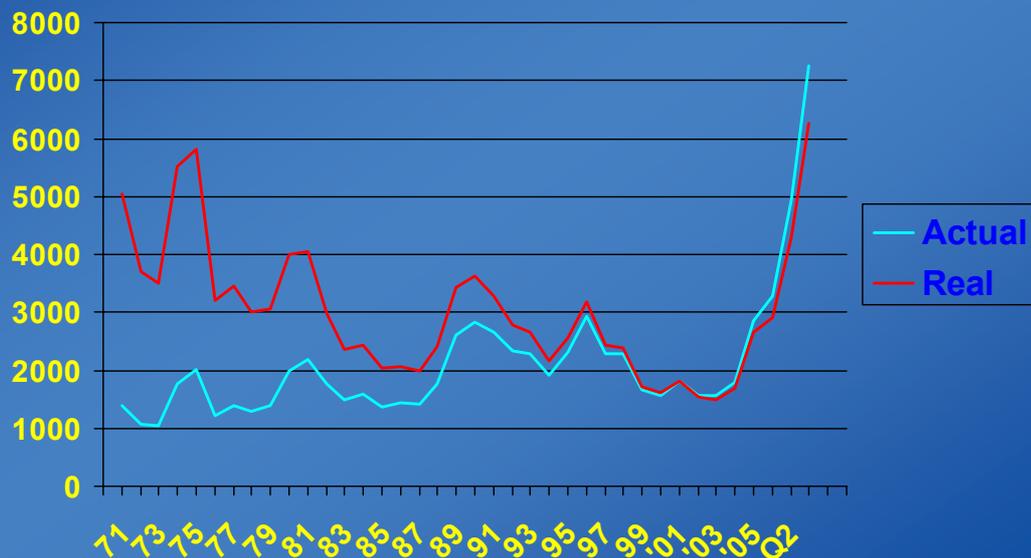
This chart shows the level of LME stocks at the end of each year, expressed as a proportion of one week's global consumption of copper, and compares this with the LME price at that time. To identify a correlation more, the proportion is shown inversely. I think you will agree that it produces an interesting comparison. It's a fairly crude measure but there seems to be some visual correlation,

Copper Stocks and Consumption



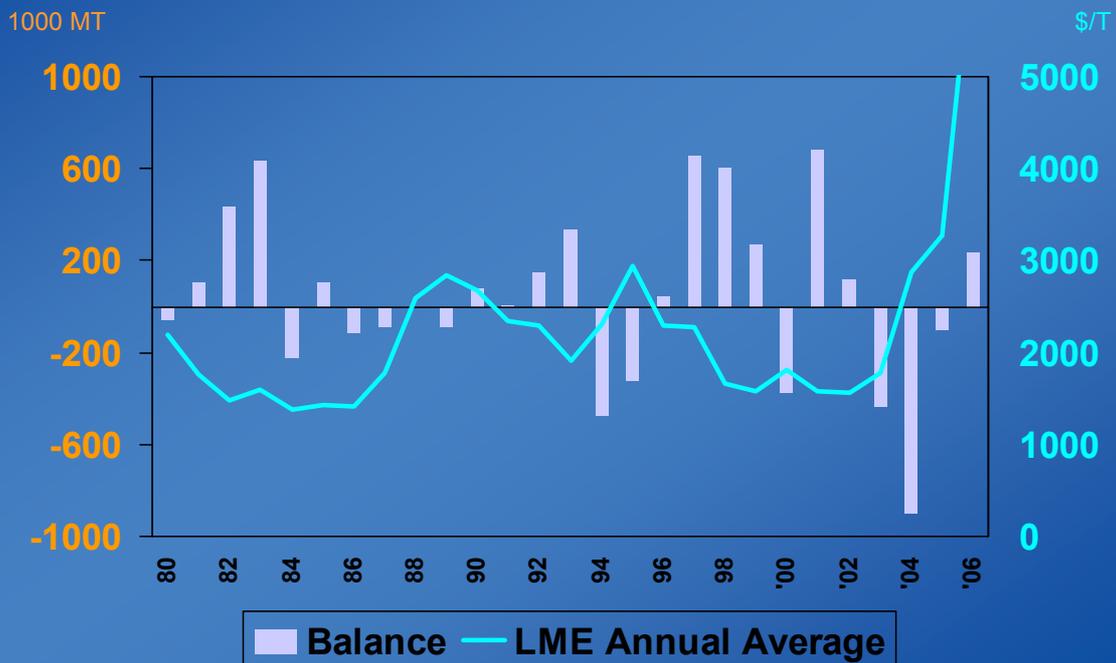
But if we take the latest data for 2006, at the end of April, we have to adjust the scale and the correlation is not so strong. This perhaps helps to confirm that the recent price behaviour takes us into new territory.

LME Copper in Real Terms (US GDP Deflator 2000 = 100)



But is that really the case? When we look at the copper price in real terms, in constant 2000 dollars, we can see that even including the first two quarters of this year, it is only a little above the 1974 level. If you remember back that far, in early April LME copper stocks touched an all-time low of 10,000 tons, and a huge backwardation developed, but it was followed by a very rapid fall. It was a genuine physical shortage. There were speculators and investors playing the market at that time, but not on the scale we see today.

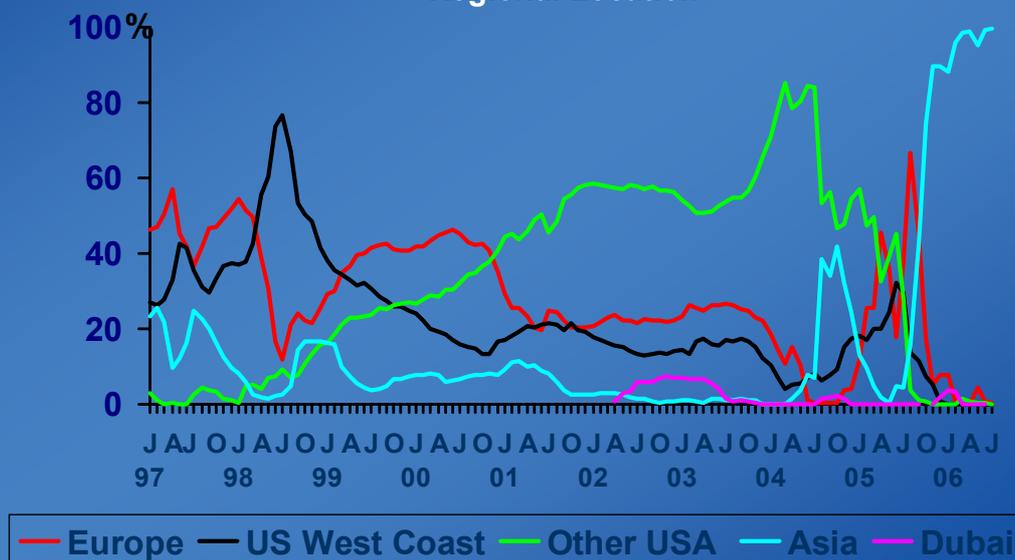
World Refined Copper Balance



What does this tell us about the LME? In a perfect market, a price is made when marginal supply and marginal demand are cleared, that is to say all parties are satisfied. In the case of copper, total global supply and total global demand are usually very similar figures, but the margin between them, although small in relation to the totals, is sufficiently mobile to lead to volatile price movements.

Where's the Surplus Copper?

Distribution of Copper in LME Warehouses by Regional Location



Moreover, at the global level, there may be a surplus of copper but the distribution of the metal around the globe, and the length of the supply pipelines, can lead to the skewing of that global balance at the regional or local level. This chart shows the variation in the principal location of LME stocks. Almost all the copper is in Asia, whereas a year ago it was mostly in Europe and two or three years ago it was almost all in the USA.

It only needs a vessel carrying copper from South America to say Europe to be held up in the Panama Canal, for a sudden shortage to appear in Europe, as users scramble to cover their needs. One of the consequences of high prices is that no one wants to hold much stock, but a hand to mouth existence does not allow much room for error. The LME, therefore, gives us an overall representation of the value of copper, but not necessarily a value for a specific situation.

So in that sense, is the LME a perfect market and what does it represent? The brief answer is that it is probably as near perfect as it could be, which is not to say that it could not be better.

The commodity which it trades, in this case Grade A copper, is defined by reference to a European standard; it is homogeneous and fungible, that is to say one lot of copper is interchangeable with another. We may note that the standard was developed over twenty years ago, largely I may say, through the work of the IWCC and a group of copper producers and consumers which we organised.

The number of players in the market is sufficient. Accessibility is open, in that anyone meeting the conditions of financial security can trade through a qualified LME member.

A Perfect Market?

- A defined commodity of a global standard
- An accessible market
- No domination
- Transparent
- Physical delivery

Perfection, but other factors at play

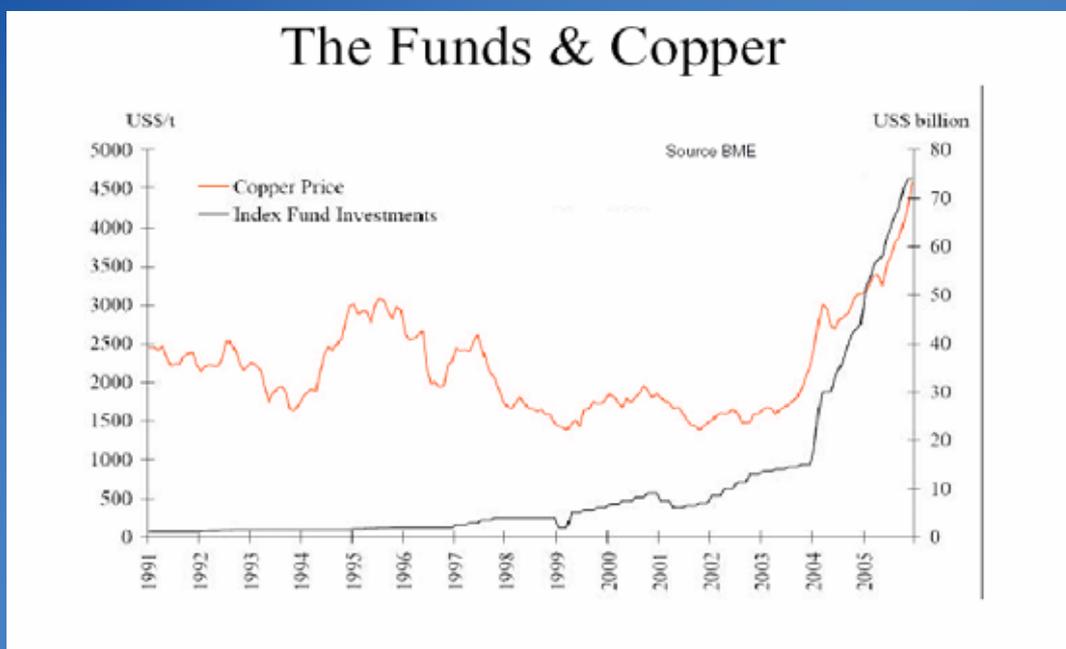
No one player on the producer or consumer side can dominate the market, although consolidation on the producer side may create a greater tendency or ability to make, rather than take, the price, a situation which consumers need to watch carefully. I would note here that while the number of LME Ring Dealers has changed, their background has changed even more. Most of them, and the broker clearing members, are owned by banks, and therefore it is not surprising that they see the LME as another financial market. The days when the LME ring and brokerage was largely occupied by metal traders are long gone. There is no doubt that this does have an effect on attitudes to the metals industries' interests in the LME and this may have a bearing on what I shall say later.

The LME is a transparent market, and access to real time information is certainly possible through the vendor feed system. The growth of electronic trading platforms also offers global access to live market data.

We must recall that the LME is a physical market, so that delivery and take-up of metal to and from the market respectively is possible. However this can only be done through the LME approved warehouses in LME approved delivery points. There are a number of key areas of the copper world which are underrepresented in this respect, notably of course China.

We must also recognise that although the delivery basis in LME contracts are "in-warehouse", that is the cost of getting metal in and out of a warehouse is not part of the contract itself, there are circumstances which make it easier to deliver to the exchange to offload marginal excess than it is to take up metal to meet marginal additional requirements. I shall return to this and to the concerns of the IWCC later. Let us assume that the LME is a perfect market. Let us assume that Exchange stocks are an excellent barometer of the overall physical supply demand situation. Everyone is pretty busy, so there is no surplus metal to be offloaded into LME warehouses. We may assume therefore that the balance of physical supply and demand is tight. But does this account for the vertiginous ride in the copper market this spring and summer. Is physical demand what is driving this market or not?

The Role of Funds



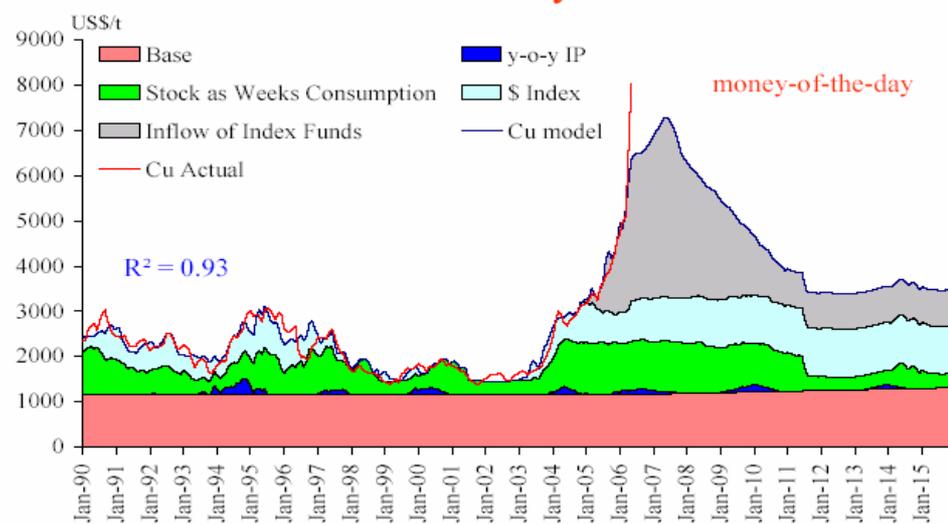
The LME has always attracted speculative or investment money from those seeking a store of value, or simply making a bet on the market. This input has provided liquidity to the market, counterparties willing to take a position opposite to that of industry players. Indeed if there was not that input of liquidity, it is very doubtful that the LME would attract sufficient turnover to justify an exchange, its members and infrastructure, or to produce a reference price meriting global recognition by the copper industry. So we have never denied the value of the speculator to the market.

What has changed is the scale of the money searching for this store of value. The funds have huge sums at their disposal. Where those funds are derived from, the extent to which they are built on firm foundations, and whether this money supply is leading to a new wave of global inflation, are issues for another time and place, but the fact is that the money is there, the funds are there, and are willing to invest what is in fact only a small proportion of their assets in commodities.

I am sure that you will agree that the physical price/supply-demand relationship will never be automatic, that a given statistical balance will result in a given price. However, attempts have been made to analyse the components contributing to a price.

The Role of Funds

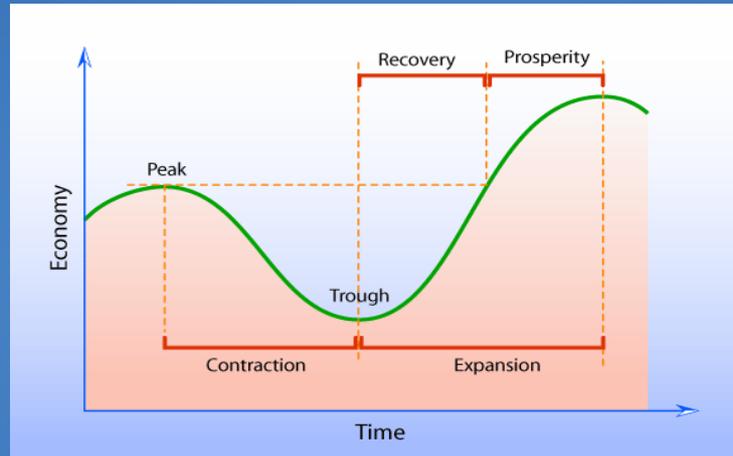
BME hybrid model, combining industrial raw materials market drivers and commodity index funds invested



A recent one is the Bloomsbury model, which factors in year on year industrial production changes, the currency value of the dollar, inflows from investment funds and actual versus required working stocks, thus combining the industry and speculative interest in the market. Whether that works predictively remains to be seen. It nevertheless tends to suggest that these price levels will be here to stay for a time.

The Cycle

Ignore at your peril !



When prices are unusually high or indeed unusually low, there is a tendency to say “paradigm shift” or “the cycle is over” or some similar phrase suggesting that the rules of the game have changed and that all previous assumptions are invalid. But we ignore the cycle at our peril. High prices lead to high production, which lead to surpluses, which lead to lower prices, which lead to insufficient supply, which leads to shortages, which lead to high prices, and thus we begin again. Indeed as these prices will lead producers to mine the more risky prospects, our vulnerability to the cycle in the future might be greater.

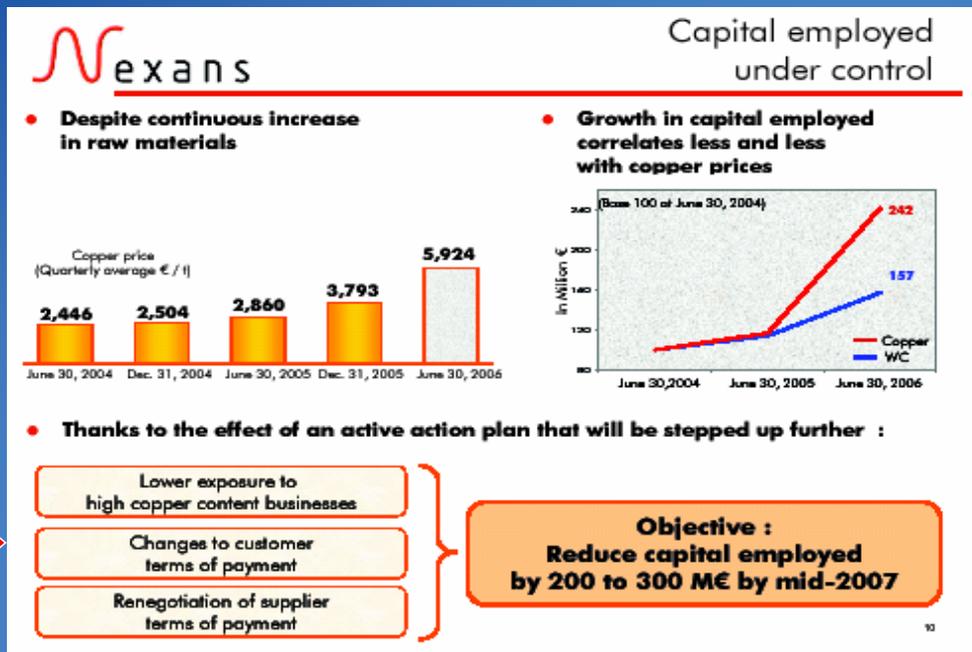
What this leads to is greater volatility, and if there is one thing our customers do not like, it is volatility. So let me look at the effect of this present market situation. How does it impact our industry?

The Impact of the Copper Price Rise

- Exposing the financial weakness of some companies
- A more pragmatic to traditional Credit Risk disciplines

Firstly, it exposes some of the financial weaknesses in our industry. Financing work in progress with copper at \$2000 a tonne is one thing, financing it at \$8000 is another. Getting customers to pay promptly is another issue. Credit limits set at one level may become unrealistic in volume terms at the present level. Many are forced to take risks that in the past they would not have done, because they need the business volume and margin, but they also need to be paid. There may be a healthy outcome to this if it forces industry at every stage of the value chain to review payment terms, which have become vastly over-generous. Indeed suppliers have competed to be as generous as possible to customers. If there is one thing the copper producers have been right about, it is in their attitude to payment terms. If you want metal you pay cash. It is a discipline that is as admirable as it may be frustrating for their customers, forced to pay cash for inputs and give credit for outputs, a simple map of the road to ruin.

The Nexans Approach



I note the remarks of Mr. Hauser in his presentation of Nexans' second quarter results. His "active action plan" will ring bells in many companies in our industry! Needless to say, at every stage of the transformation chain, the concern is becoming similar.

The Impact of the Copper Price Rise

- Risk of Substitution but Copper's unique set of qualities are difficult to reproduce



Secondly, it may impact the demand for the product. Copper has a unique combination of properties, while substitutes may offer only some of these characteristics at the expense of others. But where like for like can be obtained with comprising too much on performance or service, and initial costs are more important than lifetime costs, substitution is inevitable. It is up to the copper industry to demonstrate that short-term savings may jeopardise longer-term economies, but it is not always an easy case to make.

You cable makers already have a flexible approach. You make the cables from the material that will sell best. Your allegiance is not to the copper industry but to your market. That is a challenge for us upstream.

In fact the substitution experience so far is in a limited range of applications, which says much for copper's qualities. It may also depend on the proportion of the copper cost in the finished product. While it cannot be said that anyone likes to pay for copper four times what they did four years ago, end use demand has shown a surprising resilience to commodity price increases over the last few years, and manufacturers have shown a surprising ability to absorb the increased burden, perhaps by sharing the pain across the whole value chain.

Metal Exchanges

Is the “investment” influence dominating the market to the extent that its industrial relevance is declining?

Whether the current situation is only a transitory phase in the copper price cycle or these are price levels to which we will have to get used to in the future, we should ask ourselves if it is right that the market on which we rely for our price reference should be so susceptible to such influences. Is the “investment” influence dominating the market to the extent that its industrial relevance is declining?

Different Interests

- Producers - High Prices
- Traders & Investors – Volatility
- Fabricators & End Users - Stability

This is not a simple question, but it is one that the IWCC is asking because it believes that it should be debated. It is not easy to engage the market actors in this debate.

Producers are benefiting hugely from the current situation. Cash is rolling in so fast that they cannot dispose of it fast enough: there are only a limited number of acquisition targets, which may be fiercely fought over as a result. Funds are returned to shareholders. The copper fabricating industry can only look upon this with envy.

For the other market actor, the traders, high volatility and high turnover are the key to their success, but some of the biggest price movements have been on the basis of relatively low turnover.

It is then left mainly to the copper fabricators, and perhaps you as cable makers, to make a case that the balance of market interests is wrong and that some actions might be taken to redress that balance in the interests of stability. We have given it some careful thought and have put some proposals to the LME. Some of you here have been involved in that debate. You will know that it has not been easy to identify actions that would have a beneficial effect, that would not invoke the law of unintended consequences and would not hit ourselves more than our intended targets.

Let me share some ideas with you.

IWCC Objectives

- **Aim: an improved balance between industry and financial interest**
- **A free market with a regulator and safety valve**

Firstly, we support free markets, but.... . You may say that this is how any protectionist states their case. But the LME is a very free market, which also claims to serve an industrial interest. So it must look to its structures and rules to see that those interests are served. We believe that the domination of financial players has reached the extent where some balancing-up is required. We believe that financial investors should always be able to contribute liquidity to the market and to serve their own interests. However we are concerned that there is no regulator to adjust the head of steam that builds up from time to time, which, without a regulator valve, can result in explosive behaviour. Governments use interest rates to adjust the money and credit supply to control inflation. No one suggests that this interferes with the free market. It simply leads to orderly economies. Can the LME not do the same?

The ideas which we have put forward are intended to create a broader debate on the compatibility of competing interests in the metal prices derived, or discovered, on the metal exchange. The IWCC believes that this is a valid issue for further discussion.

IWCC Proposals

- **Cash Clearing for financial interests; credit for industrial interests or**
- **Apply margins differentially between the interests**
- **Overhaul the warehousing system to give fairer access to fabricators to use the market as a resource of last resort**

Firstly, we believe that investors should be cash cleared daily, while industry players should be able to trade on credit. This would redress the balance of power in the market.

Alternatively, we believe that the LME needs to use margins in the same way, but in a manner which differentiates between the type of operator. At present margins are used to protect the risk of the clearing house which guarantees the performance of all metal exchange contracts. If the clearing house sees a risk to its integrity, it increases margins to lower that risk. The primary aim is not to reduce activity in the casino, but to ensure that sufficient capital is staked up front on the table before the game is played, to protect the house, and to remove the more risky elements from the room.

We believe that margins could and should also be used in order to regulate the activity on the exchange. Overheated markets could be cooled in this way. However, margins should not fall equally on market participants, but according to their status and interest. Industrial players should be margined at a lower rate than speculative players. It may be argued that it is sometimes difficult to distinguish between the two.

It is possible if the political will is there: the US Commodities and Futures Trading Commission does it. It may not always be fully accurate, and some industrial players may be classed as investors and vice versa. As long as the system is fair (with an appeal procedure) and fails safe, it should be possible.

Before I describe our third area of concern, I would say that our initial discussions last week with the LME itself on these two ideas and our desire to focus on the balance of competing interests has not met with a positive response. Their position, as an institution, is that they are the provider of the market facility, and as long as that is free from manipulation and is orderly in that sense, they are concerned neither with the origin of the forces of supply and demand which find expression in the Exchange, nor with the price behaviour which derives from that.

Thanks for your attention

(and thanks to all those companies whose websites were a source for the slides)

It may be that in making such proposals to the LME, we are not addressing the right people. We understand that the Exchange itself has very little interest in the debate which we are trying to initiate. They think that our concerns about market structure and balance of interest are just another way of saying that we are unhappy with the absolute price level. This is of course over-simplistic, but we must recognise that LME itself will not address our fundamental concerns. Maybe we should have to find a different audience.

Our third proposal relates to the LME arrangements for delivery against its contracts. Under the present arrangements, the role of the LME as a market of last resort is in practice open only to a producer with metal to deliver, who is willing to do so because the warehouses will offer incentives. For the consumer, the LME is not a realistic option as a market of last resort because of the seller's option, coupled with the cost of getting metal out of warehouse, which is heavily burdened in order to recover the cost of the incentives given on the other side. We believe that for the metal users, the market in LME warehousing services has failed to the extent that it is not a functioning two-sided market. We also believe that for many years the LME has recognised but failed to address the issue.

As a result of these concerns the IWCC has now made a formal complaint to the Competition authorities of the EU. This is directed towards the LME warehouses themselves, whose system of inducements to get metal in, and recovery of those inducements through inflated out-charges has directly contributed to that market failure, and towards the LME's contract structure which creates the system within which the LME approved warehouses operate.

Last week, LME informed us that they have instituted a review to consider whether the metal contracts should be changed from an in-warehouse basis to a Free on Truck (FOT) basis. We have been very concerned to ensure that the remit, scope and timetable for that review are clearly defined and transparent. We have made some progress in this area in the last few days.