MetalMiner™

No Pain, No Gain for Industrial Aluminum Buyers

The runway for a competitor to launch an alternative aluminum contract to the LME's just got longer.

Last week, a judge from the UK High Court http://in.reuters.com/article/2014/04/16/lme-warehouse-appeal-idINL6N0N82R620140416 rejected the London Metal Exchange's appeal of an earlier decision in favor of UC Rusal that would have prevented any warehouse reforms designed to shrink load-out times, reduce queues and make its physically delivered contract more efficient.

That means aluminum buyers should not expect to see any type of LME warehouse reform in coming months, most likely not until 2015, at least.

Producers like UC Rusal instead prefer the status quo – one that creates a distorted global aluminum market.

We know the market has become distorted because the LME aluminum futures contract no longer moves in tandem with the US Midwest (MW) delivered price, a long-trusted feature of global aluminum markets.

If the gap between the MW premium and the LME price has widened (which it has) and if the premium has moved in opposite directions of the LME price (which it also has), it means the LME no longer serves as an accurate price discovery vehicle for global aluminum markets, something it has effectively done since contract inception in 1978 through much of last year. *We will further highlight this point in an upcoming piece.*

Without an efficient price discovery vehicle, industrial metal buyers find themselves in a situation where they must kluge various mechanisms and strategies, not only for price discovery, but more importantly, for risk mitigation.

By risk mitigation, we refer specifically to margin protection.

Consider the historical model (pre-2007):

LME (hedgeable) + **MW Premium** (stable, no hedge needed) + **Conversion cost** (can be negotiated fixed with suppliers) + **Freight/delivery** (also fixed) = ***Total landed cost per pound***

The buyer could take out a hedge for the LME portion of the metal, tack on a historical MW premium ($0.05/lb), negotiate a fixed price conversion cost and freight/delivery charge with its suppliers and manage its volumes on an on-going basis.

In other words, a company could confidently manage nearly all of its semi-finished or finished aluminum price risk on an on-going, longer-term basis.

So how does the current model turn all of this on its head?

Join us for a one-hour informative session featuring an aluminum market outlook (LME price + MW premium) and the potential for the CME Group's new physically backed ALI contract scheduled to debut May 6, 2014. (https://www1.gotomeeting.com/register/258531400)

How Aluminum MW Premium Throws a Wrench Into Risk Mitigation

In the not-too-recent past, a manufacturing company could confidently manage nearly all of its semi-finished or finished aluminum price risk on an on-going, longer-term basis.

Not so much anymore.

We broke down the pre-2007 model in the earlier part of this article.

Now consider the current model:

LME (hedge not working) + **Midwest (MW) Premium** (volatile and rising with AUP as only available hedge) + **Conversion cost** (same as in historical model)+ **Freight/delivery** (same as in historical model) = ***Total landed cost per pound***

The buyer takes out a hedge for the LME portion, but this no longer tracks well with the MW delivered price. Therefore, a separate hedge is required to protect against changes in the MW premium in addition to negotiating a fixed price conversion cost and freight/delivery charge with its suppliers.

The additional complexity has made it difficult for buyers to manage their volumes and protect their margins on an on-going basis.

Components of Price

Futures and forward contracts, after all, are standardized instruments that provide for a defined amount of a particular grade of material to be delivered at a specific location at a predetermined time in the future.

The issue at hand is that the current LME contract no longer relates to a Midwest-delivered location, nor does it accurately reflect the actual time when a buyer can access his or her material.

You Can't Get It (Only) Half Right

Let's consider a different example. If one lived in Detroit, Mich., and wanted to buy an Aston Martin with which to leave on a vacation next Monday, and two dealerships offered the exact same car for the exact same price, what additional information would one need to decide who offered the better deal?

Two important factors to determine prior to entering into a contract: *location* and *availability* of each of the vehicles. If, in the example above, one dealership could guarantee delivery in Detroit at an acceptable time and date prior to departure, and the other regularly delivers vehicles of this kind to Detroit, but could not provide specifics on vehicle delivery, the decision becomes easy.

Current Solutions

The only risk mitigation tool available for the MW premium is the CME Group's MW AUP contract – better than nothing, for sure, but by no means elegant because it works in conjunction with the LME contract.

More about that in our upcoming webinar.

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