Statement of Jacques Gabillon Before
the U.S. Senate Permanent Subcommittee on Investigations
Hearing on "Wall Street Bank Involvement with Physical Commodities"
November 20, 2014

Chairman Levin, Ranking Member McCain, and Members of the Subcommittee:

My name is Jacques Gabillon. I lead Goldman Sachs' Global Commodities Principal Investment Group, or GCPI, and I also serve as chairman of the board of directors of MITSI Holding LLC, the company that owns Metro International Trade Services LLC.

I have spent my entire career in commodities-related areas, first in commodities sales, and most recently in GCPI. I have been at Goldman Sachs for more than 13 years.

GCPI is the part of our commodities business that has been primarily responsible for making investments in commodity infrastructure assets, including the investment in Metro in early 2010. We believed that a metals warehouse was a sound investment because the global recession had reduced worldwide demand for aluminum, and aluminum producers have historically delayed cutting production for as long as possible. At the same time, we knew from our market experience that when a commodity such as aluminum is in surplus, near term prices fall relative to future prices. This dynamic encourages market participants to acquire aluminum as part of trades that present limited financial risks but require storage that are commonly referred to as "cash and carry" transactions.

At the time we were considering the investment, customers had already deposited over 800,000 tonnes of aluminum at Metro's facilities. In making the investment we believed that the surplus conditions would persist. Metro was well positioned to continue to realize the demand for storage because of its location near centers of North American production and its access to transportation and less expensive industrial real estate in Detroit.

Metro's board of directors is the body that sets the general strategy of the company and conducts oversight of the company and its management's performance in keeping with standards of good corporate governance and the requirements of the Bank Holding Company Act's merchant banking rules. In addition to myself, the board of Metro includes representatives not only of GCPI, but also of several of the Firm's control functions, including the Compliance Department.

As you know, Metro is subject to the rules of the London Metal Exchange ("LME"). Such rules, including the minimum amount of metal required to be loaded out of LME warehouses each day, are set by the LME — not by the warehouse companies.

The operations and dynamics around the LME system are often mistaken for the broader aluminum market. Recognizing this distinction, particularly as it relates to the availability of metal and the prices consumers pay, is essential to understanding many of the issues this Subcommittee has raised.

The price negotiated between many sellers and buyers of aluminum in the United States (as determined by a daily survey of the different prices negotiated by individual sellers and buyers) is commonly referred to as the "Midwest Transaction Price." This price is prominently quoted as an "all-in" price for aluminum. The difference between the Midwest Transaction Price and the price for an LME warrant is referred to as the "Midwest Physical Premium." The Midwest Transaction Price fell substantially since 2008.

Any suggestion that end users are paying more for aluminum because of a higher premium is simply not supported by the facts. A reduction in the LME spot price may result in a greater differential between the "all-in" price paid by consumers and the LME spot price but does not change the "all-in-price" itself. The fact that the differential between these prices for two different products is referred to as a "premium" has contributed to confusion about this in the media.

Like every other market, the price of aluminum is established through supply and demand fundamentals. And, those trends have been unmistakable. There has been a consistent surplus of aluminum since 2008, resulting in a large volume that has been placed in storage. Each year, approximately 49-50 million tons of aluminum are produced. Since 2008, production has exceeded consumption by one to two million tons a year, resulting in an increasing surplus that has gone into storage. That's why there has never been a shortage of aluminum.

Let me address a related issue to the Midwest Premium – queues. There are currently approximately 4.4 million tons of LME warranted aluminum and there is estimated to be almost 8 million tons being stored off-warrant. Of the LME warranted aluminum, more than half is held at "non-queue" locations.

As a result, of the aluminum currently held in storage, approximately 9.6 million tons — or close to 80% — is not subject to any queue. Again, any suggestion that there is a shortage of aluminum is not rooted in the facts. This 9.6 million tons is theoretically available to be sold by its owners on immediate delivery terms, but the owners find it more profitable to continue to store their metal and choose not to sell it until the market dynamics change.

The length of the queue to remove metal from Metro's Detroit warehouse is not the result of action by either Goldman Sachs or Metro. Queues really started to build up in 2012 — two years after Goldman Sachs' purchase of Metro. During that time, the near term prices for aluminum remained lower than the future price. At the same time, general economic confidence and availability of credit improved, making the lower cost but less liquid off-warrant storage a more attractive alternative for the hedge funds and trading houses that were implementing cash and carry trades. This occurred not only in Detroit, but also in another major city for metals warehousing, Vlissingen, The Netherlands.

Interestingly, coinciding with more customers removing their metal out of LME warehouses into off-warrant storage were new rules from the LME that doubled the minimum load-out requirement from 1,500 tons per day to 3,000 tons per day. With lower off-warrant storage costs, it became more valuable to cancel warrants. In other words, when the LME doubled the minimum load-out requirement, the result was longer, not shorter, queues. In fact, based on the reports we have provided to the Subcommittee, these queues do not drive the overall price of aluminum that consumers pay.

On a related issue, we have provided a significant amount of information to the Subcommittee on incentives. I will discuss this issue in the context of the oversight we provide Metro as the Board. In order to compete, warehouse operators typically offer one of two types of incentives to potential customers. Operators may offer an up-front payment on future rent collections to customers who place metal on warrant in its warehouses. In other instances, operators offer discounted rent to customers who agreed to store their metal for specific durations. These incentives are similar to those offered by landlords, such as offering one-month's free rent to attract a tenant, or reducing rent for a tenant who signs a long-term lease.

Metro has offered both of these types of incentives, consistent with both LME rules and industry practice. In all such instances, the inducements that Metro has offered have been the product of arm's-length negotiations with the customer.

Finally, I'll briefly conclude with a description of the information barriers that exist between Goldman Sachs and Metro. The LME rules require that an information barrier be established between a warehouse company and affiliated trading entities. Goldman Sachs has such a barrier in place which not only meets, but exceeds, the LME's requirements. We take this issue very seriously.

For example, much of the material that Metro generates and distributes to the Metro board and me is not actionable for a trader and, in any event, is dated and sanitized to remove the names of counterparties. Regular reviews by Goldman Sachs personnel have not found a single instance where confidential Metro information went to the metals trading personnel of Goldman Sachs. And an outside auditor has reviewed Metro's information barrier policy finding no issues.

The investment in Metro was never part of Goldman Sachs' core franchise and has not been integrated into our commodities market making activities. In fact, because the investment was made under the merchant banking authority, we are required to sell it within ten years. And now more than four years into this period, we are actively involved in a sales process for Metro.

In the many hours we have spent with the Subcommittee's staff, we have reinforced the importance of understanding the market fundamentals that dictate price and availability as well as the transactions and dynamics surrounding them. I look forward to continuing that discussion today, Mr. Chairman.