Energy Intelligence

NEFTE COMPASS®

A weekly publication on oil and gas in Russia, the Caspian, Central Asia and Eastern Europe

THU, NOV 3, 2016

Urals Futures Contract Ready for Lift-Off -- Spimex President

The St. Petersburg International Mercantile Exchange (Spimex), Russia's largest commodities exchange, is gearing up to launch a Urals futures contract at the end of November, which is seen as another step towards the government's long-standing goal of establishing the Russian crude oil export grade as an international benchmark. In a comprehensive interview with Nefte Compass*, Spimex President Alexei Rybnikov explains how the exchange put together the details of the contract and talks about the painstaking process of preparing the market for its introduction.*

Q: Spimex is preparing to launch the Urals futures contract trading at the end of November. Are there any steps that you still need to complete before the launch?

A: Yes and no. Technically we are ready. Rules of trading and rules of access are in place. They contain a very important new element which didn't exist before, namely direct non-resident access to trading commodity contracts on a Russian exchange. This is in reality the first ever direct access of non-residents to the Russian market. In the Russian financial market you cannot do that. The law was passed by the State Duma [lower house of the Russian parliament] in the summer and was signed by the President and came into effect in July. But technically in order to implement that we had to register all their access with Central Bank, which we did, so it's already there. To come back to your question on whether there is anything else we need to do before the launch, I'd say it is lots of talking with market participants because they have a number of questions about access, trading, clearing, settlement, risk management, tax, currency control, delivery and transportation. We have to answer such questions over and over again because companies have to do their own due diligence on us. It takes time.

Q: Have you already got some feedback from market participants?

A: Yes, this is a very important aspect, because if there is no one willing to trade the product, what is the point of doing it? It's not only about Russian companies who want to trade it, traders must be willing to do it, or otherwise it will simply not fly. We started talking to the global trading community about a year ago, and the original response back at that time was: "If you do it right, we will look at it." First of all, traders say they need a paper Urals product because they trade physical volumes of Urals crude. Secondly, this is a deliverable contract. Traders say that any spot f.o.b. cargoes are very welcome by traders from time to time. And third, for traders a new properly structured contract is always a good thing because they can arbitrage, they can trade different contracts versus each other. As European refineries buy Urals, it's always good to have access to a paper instrument and be able to do things for their customers.

Q: Do you have commitments from anybody who is ready to trade?

A: What do you call a commitment? A commitment is when somebody is registered with the exchange, has technical access to the exchange and electronic passwords, and is ready to trade. We have three foreign companies willing to trade at the moment. I cannot name them at this stage as we can only disclose names when we have signed agreements with companies.

Q: What about residents?

A: With residents it's much simpler because companies such as Gazprom Neft, Rosneft and Surgutneftegas are members of the exchange. Lukoil has been set up for the derivatives section for over a year now, so with Russian companies it's not an issue at all.

Q: You have launched test trading. What do Russian companies and other participants think of it?

A: The test trading basically gives you a tool to play with the system. No more than that. You check the interface, you see how it works, you learn to put in orders and see how the system reacts. A more important thing is what they think about the contract and whether they want to trade it. That is key. The biggest problem that we had with Russian oil companies up until recently was a lack of internal infrastructure to support trading on the derivatives market because trading derivatives is different from supplying crude oil to oil traders. It requires a different set of skills. Companies need to have risk management procedures, trading infrastructure, people who understand how to trade derivatives and what risks this entails. You need accounting, tax and legal personnel within Russian oil companies to be able to work with this product and it's fair to say that almost all Russian oil majors have not had this infrastructure ready for operations in the derivatives market until recently.

Q: How are you planning to go about it?

A: The good thing about this whole exercise was the decision by the presidential commission on energy in October last year that this is an important product and the government had to approve the plan of preparation for the launch of the project and that actually set the wheels rolling within Russian oil companies. Every single major Russian oil company now has internal documents, working groups, plans, all approved by the top management of the companies, to prepare for trading the product. Many companies hired people, set up internal infrastructure, trading departments, started to discuss internal procedures. It's a huge amount of work within Russian companies aimed at creating the trading capability on top of the production and supply capability that they currently have. Russian oil companies are making investments in these areas at the moment, which is a sign of their interest. They are making investments in people, systems, consulting, efforts. Many of these companies are talking to the big four consulting firms to help them design internal risk management procedures because time is limited and the amount of work that is required is huge.

Q: Will the futures contract represent a risk for Russian companies' term contracts?

A: We think that our contract is a very good complement to the portfolios of long-term contracts that the Russian companies have for the simple reason that long-term and also medium- and even short-term contracts that Russian companies currently have are all based on a formula linked to the assessments of the Brent price by major price reporting agencies. And because you have the formula and a certain differential that is defined in the contract, if you have access to the Urals futures contract, if you have access to the Brent futures contract and at the same time, you have your own portfolio of physical contracts linked to the Brent price, then within that triangle you can design very interesting trading strategies locking at a certain level of differential between Brent and Urals at any moment of time. We actually recommend informally to Russian oil companies to not only look at trading Urals with us but also to prepare themselves to be able to trade Brent futures contract simply because they have long-term contracts linked to Brent. If you simply go to the Urals market and only open a position there but don't do anything else, you immediately create price risk against market fluctuations of your own long-term contracts linked to Brent. Therefore it's not sufficient just to come to us and try to trade Urals futures with us. Building trading capability within Russian oil companies is absolutely necessary for the contract to succeed. Companies need to have access to international exchanges, not just to us.

Q: Must the contract be settled with physical deliveries and is there a specific window for this?

A: The trading of the contract stops 21 days before the beginning of the delivery month. It can only be settled with physical delivery, so at the moment we don't have a cash settlement option. We will look into that when we have enough liquidity in the future but right now the plan is to go with physical delivery settlement only. If you don't want to take it as settlement through physical delivery there is a tool that allows you to transfer the position to the next month. There is also an option of going through an EFP (the Exchange of Futures for Physical) procedure, which is already built into the rules. It is also possible to settle on a bilateral basis. If two parties are nominated to the exchange, we can make a direct settlement of the contract between them.

Q: Isn't a full cargo position of 100,000 metric tons too big?

A: Yes, it is sizeable and big and we are already told that traders would be quite weary of building positions because there is a risk that you don't build up the position to a full delivery lot. By the time the contract expires, if you don't have a full cargo position you can be either squeezed out of the market or you will be required to pay a delivery margin which is quite high. Based on this, market participants asked us to consider trading partials and arranging partial settlement. However, that requires a lot of changes on the part of oil companies and [Russian national oil pipeline monopoly] Transneft, so we decided that we would launch the futures contract with one full cargo settlement option only and afterwards we would sit down again with oil majors and Transneft and figure out how to create partials and how to settle partial cargoes. This can be done. If you look at Dubai, there is a very active partials market on the Dubai Mercantile Exchange which we are very familiar with.

Q: Have you settled all the quality issues with Transneft?

A: Yes. Everything has been resolved. Frankly, it's a fairly straightforward question because in terms of quality Urals is what it is. Whatever flows out of the pipeline at Primorsk is exactly what you are getting under the terms of the contract. The only intrigue was how to define this in the contract. There was a lot of discussion about whether we have to settle on a specific figure in terms of the API number, sulfur content, etc. and at the end of the day we together with Transneft, the energy ministry, the Federal Antimonopoly Service (FAS) and oil companies decided not to do that and instead define the quality in the following fashion: the quality has to correspond to the Russian government standard and Transneft's document defining different streams of Russian crude, which stipulates density and sulfur content at all the major exit points out of the Transneft pipeline system. And in terms of Primorsk, the sulfur content is defined at 1.55%, while in reality it's even lower than that today. Because of that we decided not to fix the exact number in the contract as you are getting what you are getting. It's physical flow anyway, so we just refer to the government-approved document and believe everyone will be satisfied this way.

Q: Has Transneft started issuing the loading schedules two months ahead?

A: I tend to look at the entire project as work in progress. There is a certain mechanism as to how the ministry issues export quotas. They have to be approved 15 days before the start of a quarter. The first thing is to change this mechanism of issuing export quotas because everyone knows that the loading schedules for Urals are the last loading schedules for any oil stream. The Brent loading schedule goes out on the fifth date of the month preceding the delivery month, so you have the whole month before the month of delivery and you already know the loading schedule. With Urals, sometimes you don't know the loading schedule for the next month until the very end of the previous month. Coming back to the quarterly schedules, if you want to know the loading schedules at least 25 days in advance of the month, you first have to change the quarterly schedules. There is an agreement with Transneft which is already implemented: Transneft will issue so-called preliminary schedules for the next month. This does not provide much information because preliminary schedules do not include exact dates, so in that sense they are not precise vessel loading schedules. However, this is the first step in that direction and we will at least know how many vessels each company will have in the next month of delivery. The next step is to amend the governmental decree defining how and when quarterly export quotas are issued. For the futures markets, it is vital to know the exact dates because different dates cost different money. Currently, we have a target of 25 days before the delivery month.

Q: Is this going to be an obstacle for the trading launch?

A: In terms of launching, this is not an obstacle and as I said we don't expect all of a sudden to have liquidity on the first day of trading the contract. That's not our goal. Our goal is to launch, start moving, take the next steps, and gradually bring the contract to sufficient liquidity by ensuring all the little nuances have been considered. This will take time.

Q: How do you see the first day of trading?

A: I would be surprised if any financial players come on the first day, because they typically need a certain level of liquidity before they start trading. In the first few months of trading, we expect producers and oil traders to be the key participants. Initially, we will be looking at 10-15 participants coming to the exchange. But the number will increase as each company completes its own internal approval procedure, it just takes time. It could be a lengthy process, but this does not stop us. Low trading volumes and liquidity in the early months do not define our success. One can only assess whether the contract has been a success after 12 to 18 months.

Q: When will Urals reach benchmark status?

A: We launched Russia's domestic refined products exchange in 2008. The market started talking about our prices as benchmarks in 2013-14. A benchmark becomes such when the market decides. There is no rule. It becomes a benchmark when the traders say so. Even if the contract has sufficient liquidity after 18 months, it would still be premature to call Urals a benchmark. Take our natural gas exchange contract for example. It was launched two years ago, we are building volumes and we expect to have roughly 10% of domestic supply by the year end, but it's still too early to call this a benchmark. The term does not only depend on the volume and liquidity, it's based on the market's habits. Traders and media should be accustomed to using the instrument for it to be referred to as a benchmark. It took six years for Russian media to adopt our refined products prices as benchmark references. Until then, nobody viewed them as benchmarks.

Q: Is the Russian government supporting the Urals contract and why should it support it?

A: We are regularly talking to government stakeholders, namely the Central Bank as the primary regulator of the exchange, the Ministry of Energy, the Ministry of Economy, which ultimately sets export duties, and the FAS. In the past year, I have not seen any weakening in the government's enthusiasm for the project. What I do see is more and more people from different agencies becoming increasingly familiar with the product and supporting it. We are conducting seminars to educate agencies on the products and the market. We are in fact building an army of supporters within Russia for this entire exercise. What's in it for the government? It's simple. If there is something in it for Russian oil companies, with increased revenue and tax payments, then there is something in it for the government, too. Russian companies look at the Urals futures trading as a means to hedge risk and to make money from trading. If Russian companies are successful in building their trading arms, this will create additional revenue for them. You can look at it as the ultimate increase in the price of Urals but I look at as an increased revenue stream from increased Russian oil sales, which does not necessarily translate into a higher oil price.

Q: Is the Urals futures contract a final piece in the puzzle to help Urals displace dated Brent as a primary benchmark off which other crude grades can be priced?

A: It is interesting that you said that dated Brent is the price benchmark. I frankly do not look at it this way. I think that most of the price discovery process is taking place through the trading of the ICE Brent futures contract, rather than through dated Brent, because you see so few deals happening in any physical market -- be it Russian Urals or dated Brent -- that these volumes are probably not sufficient for effective price formation. Exchanges play a much more active role in this process. Secondly, I am somewhat surprised at how fast the market is endorsing the idea that Urals can become a benchmark. A few years ago, this concept was dismissed by the market. But if you talk to traders and oil companies today, most would agree that Urals can become a benchmark. So the perception of the market and the degree to which it will accept a shift away from Brent to Urals, in my opinion, is very high. It does not automatically mean that we will succeed and Urals will become the benchmark, but the situation is different now and we have quite a good chance. The declining volumes of Brent production help us in that respect.

Q: Structurally speaking, are all the mechanisms now in place for that to happen?

A: The benchmark becomes a benchmark when it is liquid enough, and it will not achieve that unless financial players come into the market, because the price formation process does not take place in the physical market. It will take place in the financial market. So the goal is to start with a relatively modest volume and only a handful of deals initially. But as we get the mechanism rolling and bring more players to the market, we will build more nuances into the product to make it more flexible for everyone.

Q: Is establishing a Urals benchmark an effort from Moscow to disconnect oil price discovery from the West?

A: The market will not overpay for crude oil, no matter where it is priced and where it is traded. The core issue is that there is no direct pricing of Urals. It can only be traded at a differential to another benchmark which is priced differently and exists separately. If a foreign exchange could do everything we have done so far, then Urals could be traded on a foreign exchange.

Q: Why didn't the Urals futures contract take off in New York in 2006?

A: It did not work in New York because there was no support from Russian companies who would be the first ones to trade the contract. There was no internal infrastructure within Russian oil companies to trade paper contracts, there was no agreement with Transneft, which is absolutely vital for delivery procedures and loading schedules. If a foreign exchange can replicate all of that, then yes, a Urals contract could be very successful on a foreign exchange. We have learned from that failure and are working with many of those involved at the time. It failed then because it did not have enough political support and there was not enough support from Russian companies.

Q: What volumes can we expect to be delivered into the contract in the first year?

A: It's impossible to speculate how much oil will be delivered into the contract at this point. There were some Russian agencies that suggested guaranteeing the number of vessels that should be sold through the exchange, thereby setting the price based on a fixed number of obligatory crude deliveries. We firmly objected to the concept, even if it did bring liquidity to the exchange, simply because it would have put Russian producers delivering into the exchange at a disadvantage. Because if the market knows you have to sell fixed volumes, then buyers will bring the price down. So we objected, and every company will be free to decide if it wants to sell the contract and settle on delivery, or transfer positions, or settle through a bilateral deal. We cannot dictate their trading strategy, and that is the beauty of an exchange where you have different trading animals. Multiple players with different strategies will ultimately help to create liquidity. So I don't even want to know how many cargoes will be delivered into the Urals futures contract.

Q: Urals futures price formation is based on oil transactions delivered to Primorsk. Does this prevent or deter other players taking deliveries at Novorossiysk?

A: The plan is to launch the f.o.b. Primorsk deliverable contract first of all. Then we will look at launching other Russian contracts. Especially Espo, which might be traded as a differential to the Urals contract or as a separate contract in its own right. There are pros and cons to both sides and we have time to decide. The same goes for the Black Sea and the Druzhba pipeline. Will it be separate contracts or differentials? It may be differentials, but we will definitely do something because this simply increases the volume and the number of free cargoes available into these different delivery points. For example, if you price Espo as a separate contract, you are targeting the Asian contract, which needs a benchmark contract eventually, but there are so few free Espo cargoes available that it would be difficult to launch a contract on a standalone basis. If you go with a differential, that gives you more liquidity but creates obstacles to direct pricing by buyers and sellers. We are not rushing into a decision, we still have time. This could happen in spring/summer 2017, but not earlier than that.