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Gas Trading Takes Off as Spimex Fine-Tunes Market Mechanisms

Gas trading was launched on the St. Petersburg International Mercantile Exchange (Spimex) two years ago. In an interview with Nefte Compass, Spimex Vice President Anton Karpov, who is in charge of the exchange's gas trade, looks at how the business has developed and outlines the key tasks and challenges that lie ahead.

Q: How do you evaluate the progress of gas trading on the exchange? Have key goals been reached since the beginning of trading two years ago?

A: In terms of sales volumes, we see growth. In 2016, sales were 16.8 billion cubic meters -- twice as much as in 2015. The required liquidity level is determined quite clearly by the Federal Antimonopoly Service -- 35 Bcm/yr, or 10% of the domestic market, should be sold on the exchange. We also need as many producers as possible to take part in the trade. When we have all these factors, we will be able to say that we have a liquid market and a price indicator. At the moment, only Gazprom, Rosneft, Novatek and two small companies sell natural gas on the exchange.

Q: Who are the small players?

A: European Trading Co. [a Belarusian trading company selling associated gas produced by Yangpur, a West Siberian subsidiary of Belarusneft] and Gaz-Oil Trading [a joint venture between Gazprom and Lukoil]. Chemical company EuroChem, which has a gas-producing unit, has also taken part in trading. The company is interested in trading and has resources to sell on the exchange on a regular basis. On the other hand, the likes of Lukoil and Surgutneftegas do not take part in trade, although they have gas resources. We would also like companies that produce associated gas and sell it to gas processing plants to also come to the exchange.

Q: When do you expect the 35 Bcm/yr target to be reached?

A: We'll see in 2017 what an actual timeline could be. The fact is that according to a Russian government ruling there is a principle of parity between Gazprom and independent companies, which means that Gazprom is allowed to sell no more than 17.5 Bcm/yr. Last year we came close to that limit, and Gazprom was the biggest buyer, which means that if the volumes increase a little more, Gazprom will not be able to

sell more. That is why we support the idea that the cancellation of the parity principle should be discussed. The 17.5 Bcm/yr limit means [that Gazprom can only sell] 1.4 Bcm/month. The company could sell more, and we think we need to help, as the exchange market is generally being formed. Resources are available at the exchange, and consumers have also come, confident that they can buy gas on the exchange in addition to their direct supply contracts. This makes market participants change their perception of the trade and it can also affect their behavior.

Q: On the other hand, if the parity rule is cancelled and Gazprom is allowed to sell the biggest portion of the gas traded on the exchange, will we see proper liquidity?

A: Gazprom is now not allowed to sell gas at flexible prices under direct contracts, it must sell at a regulated price. It has thus a commercial interest toward the exchange trade. Independent producers have the right to sell gas at any price under their contracts, and they don't always have resources to sell on the exchange. Some of the independents don't even want to support the exchange trade. That is why cancellation of the parity rule will, on the contrary, spur competition on the market. The gas market is relatively predictable. Consumption is not getting bigger than it is. If there is a more attractive offer in the market, including from Gazprom, why shouldn't a customer buy this gas?

Q: If liquidity is reached mainly thanks to just one seller, will it contribute to the development of a market price?

A: Of course it will. Consumption on the market will not change. If someone buys gas from one producer, that means that another seller doesn't sell this gas. This logic works, and we have seen it from the experience of [steel-maker] NLMK, which used to cover 70% of its gas demand by buying gas on the exchange and then signed a very attractive contract with Novatek. A bigger supply, not 17.5 Bcm/yr but more, can spur other producers to sell their gas on the exchange, because direct contracts do not provide the possibility to sell gas fast. In order to close a deal outside the exchange, you need to sign a contract, submit an application for access to infrastructure -- this takes two months -- and only then begin supplies.

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Q: What plans do you have for 2017?

A: First of all, we need to settle the issue of contracted but unused natural gas. This may involve some sort of a resale, one of the elements of commercial balancing. For example, if the buyer realizes that it cannot consume all the gas bought on the exchange or under direct contracts, it should have the right to resell this gas. First we need to test this mechanism with unused gas bought on the exchange and then we need to think how to expand this practice into the OTC (over-the-counter) market. But here we face the problem of the regulated prices of Gazprom. It would not be correct to resell gas on the exchange which was bought at a regulated price. Also, we consider the possibility of shifting from the T+2 settlement regime to T+1, which means to settle transactions one day after the trade date, instead of two days after the trade day. If we simultaneously introduce a same-day record-keeping system and the possibility of reselling gas, we shouldn't have any difficulties in shifting to such a settlement regime. Besides, we need to think of longer-term instruments, such as forward contracts for delivery in any month of the year. Market participants say they are interested in such instruments. These changes, we believe, will help considerably increase the liquidity of the exchange trade.

Q: When can forward contracts be launched?

A: Forward contracts are a very interesting program. I believe that this year we will propose its implementation. The question is how to ensure the supply for this program. With the current trade volumes, to introduce forward contracts would be to kill all the liquidity of day-ahead and month-ahead trade. We need an economic balance between the instruments. If we introduce this program, we need to know whom this is done for, what gas resources will be used for it and whether this doesn't damage the main process of trading. So, the program should be introduced together with other things. We need to let Gazprom increase its supply level, expand the list of sellers, etc.

Q: What amendments to legislation are needed to increase the liquidity of trading?

A: To cancel the parity rule. To amend the gas supply rules. To put in place sanctions both for contracted but unused gas and for off-taking in excess of the contracted volumes. Such sanctions may be linked to the exchange settlement price for the current day. In other words, to cancel the current practice when buyers can take without sanctions 10% more and 20% less gas than stipulated in the contract. All these instruments were introduced in 2007, but technology was different at that time. There is no point now in keeping the practice of such tolerance limits, because we have the exchange trade, which allows for gas to be bought for delivery on almost any day of the year, including weekends and holidays. Tolerance limits

result from the problem of planning accuracy. For instance, in 2016 buyers ordered 42 Bcm more than they actually bought. Why? This consumption is not real, it's only on paper.

Q: You now have three balancing points used as hubs in the exchange trade. Is that enough?

A: These three balancing points pump 98% of Russian gas. Moreover, we want to make one point out of two -- Vyngapur and South Balyk.

Q: Could you elaborate?

A: This will be a new balancing point, with a new name. It will be located where gas can be flowed from of all producers, which separately can reach either South Balyk or Vyngapur. This is only preliminary information.

Q: So, instead of three balancing points you will have two -- a new one and Nadym, won't you?

A: Yes, we will. But we are sticking to our plans to develop the trade at Parabel as well.

Q: What is hindering the launch of trade at Parabel?

A: There are no gas resources. There are companies that have resources [apparently, Independent Petroleum Co.], but they are not active. We still hope to convince the potential sellers.

Q: The idea also circulated of creating a virtual balancing point. Are you considering this option?

A: The existing balancing points are physical places along the pipeline. In order to use a virtual point instead of them, we need to solve the problem of tariffs. Now we have a gas transportation tariff that has two components – one is fixed and the other is calculated in the process of delivery and is calculated based on the length of the actual route used to flow the gas. This results in different tariffs [for delivery to the same location]. This is not how it should be. In our view, it is the job of the gas transportation system operator, Gazprom, to optimize the routes of supply. Why should its clients care what route its gas is using? The transportation system is unified, it has the same pressure everywhere and always the same amount of gas, approximately 8 Bcm, in it. We can apply a different approach and use the entry/exit pricing. Gazprom Mezhhregiongas Postavka [a transportation agent] already implements a similar model for the exchange trade. The company sets the price for piping gas to the balancing point and for piping it from the balancing point to a certain gas distribution plant. This price doesn't change during the whole process of trade on the exchange. In other words, the gas producer knows that in order to get its gas to the balancing point it needs to pay, say, 100 rubles for

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transportation, while the buyer knows that in order to receive the gas at its local gas distribution plant it needs to pay 1,000 rubles. This looks like a payment for the route, but in fact it works like the entry/exit pricing. If we implement such a scheme and introduce a fixed transportation tariff that would not depend on the route, we will indeed be able to switch to one virtual balancing point from a group of physical points.

Q: Which option is now regarded as the priority?

A: All options are regarded as being of equal priority. But we live in the reality that is around us. Now the work on the enhancement of the pricing for transportation services is under way, but there is no firm decision yet how to do it. During the discussions this year, we will present our view of the possible solution. Then it will be clearer how to move forward. As long as we calculate the length of the routes, we will offer to use Nadym and the projected balancing point number two.

Q: But if the pricing principles are changed, then a virtual balancing point will appear, won't it?

A: If the pricing principles are changed in such a way that entry/exit tariffs could be calculated, I believe, we will quickly advance to the idea of creating a single virtual balancing point.

Q: Turning back to the participation of gas producers at the exchange, how would you explain the fact that Gazprom is now clearly dominating the trade?

A: Indeed, not every company takes part in the trade, and the resources of those independent producers that do take part are limited. When it is cold, they send gas to buyers under direct contracts and don't have gas to sell on the exchange. But we have seen that when Novatek and Rosneft had available resources, they always offered them on the exchange.

Q: So, this is a temporary problem, a seasonal one?

A: This is not a temporary problem, this is a problem of the market. You cannot solve it with exchange trade. If the market is like it is, the exchange will not change it. The exchange will only reveal that a problem exists. This is a multifaceted issue, linked particularly to the need to expand the list of buyers.

Q: How can you stimulate sellers?

A: This is -- among other things -- a regulatory issue, a question of models of behavior of certain market participants. At the moment we have tasks that are on the surface -- cancellation of the parity rule and an increase in Gazprom's allowed supply volume. These will already be steps forward, steps toward the forming of a stable supply volume.

Q: In late 2016, the price was higher on the exchange than Gazprom's regulated price. Why?

A: In some regions it was higher, in some it was lower.

Q: Does it reflect the market situation?

A: This is a question of trust in the trade, of the price indicator's credibility. Does it reflect the actual state of things? If some people sell and others buy, it does reflect it to some extent and people are ready to pay this price.

Q: At the same time, the situation is that Gazprom sells more than others on the exchange and buys more than others as well. That raises doubts among some observers about the adequacy of the price indicator.

A: Apart from Gazprom, there are other buyers who also pay this price.

Q: Who buys gas on the exchange?

A: Big lots are mainly bought by large industrial consumers -- power generating, metallurgy, mining companies, etc. But there are some other companies. For example, there are small heating plants consuming about 300,000 cubic meters per month. They can cover 100% of their demand with exchange-traded gas.

Q: What groups of consumers also see the exchange trade as the main source of gas?

A: Exchange-traded gas used as the main source of supply is the exception rather than the rule. The supply on the exchange is not as big as at the OTC market, and from the consumers' point of view, it might be not right to assume that all gas should be bought on the exchange, because the main source of supply for large consumers is contracts stipulating guaranteed supply volumes. Consumers need to find a balance. Meanwhile, spot trade, in my opinion, should account for no more than 30% of the buyer's purchases.