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This issue of the Oxford Energy Forum is devoted to analysing the role of oil benchmarks, their evolution over time, the challenges facing the most established benchmarks, and the extent to which the current transformations in oil market fundamentals and crude trade flows as well as changes in the regulatory environment are likely to result in the emergence of new benchmarks and new crude oil pricing systems...

... Another potential contender is the physically settled Urals crude futures contract on the Saint Petersburg International Mercantile Exchange (SPIMEX). Alexei Rybnikov predicts that the sufficiently large, freely tradable volumes of Urals alongside an open, transparent, and well-regulated futures market will eventually result in the market's acceptance of Urals as a superior benchmark to existing ones. According to the author, Baltic oil remains the most appropriate choice for a reference pricing point to the two other main export routes of Russian crude oil, Kozmino and the Black Sea, given the destination flexibility that Baltic oil enjoys relative to other Russian crude exports. The key advantage of the Baltic oil acting as a benchmark is that it allows producers to manage their risks and identify arbitrage opportunities when open. The author notes that the volume of Baltic deliveries of Urals is twice that of the Brent complex and the scale and scope of the supply and consumption of Urals is larger than those of any other single crude oil stream in northwest Europe. SPIMEX is still working to solve complex issues, but Rybnikov believes that eventually, the futures contract will emerge as the appropriate and rational choice for much-needed improvement in the current oil pricing systems...

URALS CRUDE OIL AS A FUTURES CONTRACT BENCHMARK

Alexei Rybnikov

On 29 November 2016, the Saint Petersburg International Mercantile Exchange (SPIMEX) started trading physically settled SPIMEX Urals crude futures (FOB Primorsk). Sufficiently large and freely tradeable volumes of Urals oil from the ports of the Baltic Sea would ensure that market forces prevail and that Urals oil is appropriately priced. We predict that with an open, transparent, and well-regulated futures market, the acceptance of Urals FOB Primorsk as a superior benchmark for many of the world's main export crude oil streams will follow.

The superiority of FOB Primorsk

Baltic oil is the most appropriate price and value basis for the two other main export streams for Russian crude oil, Kozmino and the Black Sea, because oil is regularly shipped from the Baltic into the Far East and the Mediterranean, the natural destinations for East Siberia–Pacific Ocean (ESPO) ex-Kozmino and Urals ex-Black Sea, respectively.

The flexibility of the physical flows of Russian oil ex-Baltic to other regions will enable Russian producers to best manage their oil flows by destination and thereby optimize the performance and profitability of their operations. Urals ex-Mediterranean and ESPO ex-Kozmino do not enjoy the same flexibility of destination, on a regular basis, as ex-Baltic oil. Rather, they are priced relative to Urals ex-Baltic and thus form a single, robust benchmark for Russian crude oil export operations.

To achieve the transparency and price discovery that mark the operation of a successful futures contract, it is preferable that any Baltic Urals contract be deliverable. Baltic deliveries operate with few logistics or quality problems. Key elements for an FOB Primorsk Urals futures contract Urals ex-Baltic's fungibility in terms of logistics and quality makes it well suited to form the basis of a deliverable futures contract. It is, however, vitally important that Russian oil producers' contracts for physical delivery be standardized in line with futures-related pricing and delivery mechanisms. To the advantage of the futures contract, Russia imposes no restrictions on the secondary trading of Russian oil.

The volume of ex-Baltic deliveries of Urals crude oil is twice that of the Brent-Forties-Oseberg-Ekofisk (BFOE) complex, which reputedly is the price basis for more than 60 per cent of the world's crude oil exports by volume. In addition, Brent futures and the Dated Brent quotation form the price basis for a huge volume of related exchange-traded and over-the-counter contracts.

The scale and scope of the supply and consumption of Urals oil is perhaps greater than that of any other single crude oil stream in the North Western Europe (NWE) region. Multiple suppliers and consumers will be able to participate in the transparent price discovery that exchange-traded futures will bring as well as in exchange trading in order to efficiently and effectively manage their operations.

The primary producers and end consumers of Urals oil, under the current pricing regime, suffer multiple layers of risk, on top of the natural volatility of oil markets. The real function of a futures exchange is to provide a forum where buyers and sellers of risk may transact; but in order for such risk to be palatable in contract form, it must be clear and distinct and not confused in the stratification of risks that Dated Brent-related pricing entails. Reducing the risk of Urals oil to market price risk benefits the producers and consumers of Urals crude oil. Reduction of this single risk element will allow efficient hedging via the ex-Baltic futures contract.

Arbitrage

Certain producers of Russian crude oil are sellers of complementary crude oils in NWE, the Mediterranean, and ex-Kozmino. These special circumstances would greatly enhance these producers' opportunities to manage their operations and their risks with a single benchmark as the price basis for all three export regions. To relate the prices to a single benchmark makes it immediately apparent when arbitrage opportunities open and naturally closes them without the intervention of intermediaries.

To complete the price integration of all main Russian crude oil export routes, an FOB Primorsk futures contract can form the basis for Druzhba and associated pipeline deliveries. Since Kozmino seaborne already constitutes the price basis for ESPO pipeline deliveries, this would result in FOB Primorsk serving as the price benchmark for Russian oil in NWE, the Mediterranean, the Druzhba pipeline, Kozmino, and the ESPO pipeline. This integrated approach to the pricing of Russian export oil would establish a system of valuation that would be difficult to resist and would promote its use as a benchmark for other non-Russian crude oil streams.

SPIMEX Urals crude deliverable futures contract

On 29 November 2016, SPIMEX started trading in physically settled SPIMEX Urals crude futures (FOB Primorsk). Access to the SPIMEX futures contract trades is granted to Russian and foreign legal entities. The SPIMEX Urals crude futures contract is settled by physical delivery upon expiration. Such a futures contract has a direct link with the crude oil spot market and prevents price manipulation.

Terms and conditions of the physical delivery are set out by SPIMEX along with key Russian oil producers in line with current market practice. Crude oil under the futures contract is delivered FOB Primorsk by standard deliveries, each equal to 720,000 barrels (about 100,000 tonnes, a full cargo – see the table below). In 2017 over 4,000 Urals crude futures contracts (FOB Primorsk) were traded.

Contract Terms	
Settlement method	Deliverable
Underlying asset	Russian export Urals-grade crude oil
Hub name	Primorsk
Currency	US dollars
Contract size	1,000 barrel
Standard delivery	720,000 barrel
Minimum price flux per barrel	US\$ 0.01
Last trading day	21 days prior to the first calendar day of the delivery month
Delivery period	Delivery month
Delivery price	Final settlement price of the futures contract set on the last trading day
Performance procedure	The parties enter into physical contracts at the SPIMEX derivatives market on the terms and conditions and under the procedures set forth in the relevant contract specifications, the Trading Rules, and the in-house regulations of the clearinghouse.

In 2017 SPIMEX successfully attracted new participants to trading in the Urals futures. Market makers, setting buy and sell quotations, will provide initial liquidity along with Russian oil companies.

Physical deliveries of crude oil should be the next step in the promotion of the project. SPIMEX is now actively working on this issue and has solved several issues related to the customs clearance of the export contracts required to carry out the futures contract. Russian Federation currency control regulations have been amended to allow, and provide the appropriate conditions for, the use of foreign currency as collateral by non-Russian residents. The remaining regulatory item on the agenda is the clarification of the withholding tax regime for foreign companies' income from operations in the Russian derivatives market.

Step by step, SPIMEX is working to solve many complex issues, developing the contract in close interaction with authorities and Russian and foreign participants in the crude oil market. We believe that a Urals crude oil FOB Primorsk exchange-traded futures contract is an appropriate and rational choice for a much-needed improvement in the system of global energy pricing.

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