

# NEFTE COMPASS®

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## Interview: Spimex Focuses on Russian Gas Market Reforms

*After almost four years of exchange-based natural gas trading in Russia, the St. Petersburg International Mercantile Exchange (Spimex) is technically ready to offer its platform for gas export deals. But as expansion beyond Russia is still hindered by legislation and to a large extent depends on how state Gazprom will adjust its own export policy, Spimex remains focused on developing the domestic market, where much remains to be done to create equitable conditions for participants. In an interview with Nefte Compass, Spimex Vice President Anton Karpov describes the measures needed to improve the liquidity of gas trade and outlines Spimex's proposals on how to reform the broader gas market in Russia by liberalizing domestic prices and shifting to a European model of gas transportation tariffs.*

**Q: Spimex has been developing the gas exchange trade in Russia for almost four years. Are you ready for export trade? Are you considering such a possibility?**

A: The gas export issue is still very complicated. We have the law on gas export [giving Gazprom the monopoly right to export pipeline gas]. Independent producers have a desire to supply gas to export markets, but we don't take part in this discussion. The idea to add exchange trade to the export channel sounds interesting though, and it is, in our view, technically possible.

**Q: But it remains impossible with the current legislation, doesn't it?**

A: In theory, export trade could be possible even with the current legislation. For example, if Gazprom Export acts as an agent. But we are now focused on the development of the domestic gas market.

**Q: Gazprom is reorganizing its export and trading operations in Europe ([NC Feb.15'18](#)). Does it discuss with you any cooperation within its new export strategy?**

A: Gazprom in 2017 agreed with the European Commission on commitments to improve its sales practices on the EU market and is now considering how to implement the changes. We can hardly say what it will decide. Spimex has created a solid technology platform for gas trade that reflects gas transmission tariffs and provides capacity limitations for almost any trading point [hub] location. This platform can be effectively implemented for export trade. It's not without reason that Spimex has 'international' in its name, after all. We can offer a modern system of clearing as well. We are always open to discussion.

**Q: With the rise of LNG, including in Russia, do you consider trading LNG on the exchange?**

A: We have had no immediate plans. But in theory, why not? The share of Russian companies on the global LNG market should increase significantly. New LNG projects of Novatek, Gazprom and Rosneft will triple Russia's LNG sales by 2030-35. So it would be logical to expect that an exchange price indicator will be needed for Russian LNG. Obviously, LNG can well be a product for exchange trade.

**Q: You have had several meetings over the past year with representatives of European gas hubs, including the Baumgarten hub in Austria. What do you discuss with them?**

A: We share our experience. This discussion is interesting to us, mainly in terms of how EU markets have been developing and changing. The main topics for us regarding the European market, and Austria's in particular, are the gas trade participants and the functions of the Central European Gas Hub as the operator of the Baumgarten hub, and Pegas, the pan-European gas exchange, the principles and mechanisms of the commercial balancing of gas in the pipeline system, Austrian gas market legislation, gas transportation pricing, the work of the E-Control regulator, pipeline capacity trade and over-the-counter [OTC] gas trade.

**Q: How far is the Russian market lagging behind Europe?**

A: Significantly. The EU has managed to successfully revise the US' and UK's experience in gas market liberalization and introduce a universal model for the wholesale gas market, synchronized with the power market. They have launched a specific clearing mechanism providing for a zonal system of gas balancing. The market there is based on a gas transportation capacity trade. But introduction of such mechanisms in Russia requires a serious adjustment based on the peculiarities of the Russian gas market.

**Q: Do you discuss any cooperation with your European peers? For instance, equity participation in European hubs or their investments into the Russian exchange trade?**

A: No, we don't. Why should we?

**Q: To increase profits and get access to information.**

A: They already tell us everything frankly. The EU and Russian gas markets are developing very fast but, in fact, independently of each other due to completely different starting positions. That is why joint investments are not high on [our] agenda now.

**Q: Turning to the domestic market, Spimex recently reported that the gas exchange trade showed a 17.5% decline in the first half of this year ([NC Jul.19'18](#)). What caused the decline? What is your forecast for full-year 2018?**

A: The independent gas producers were less active. In the first quarter of 2018 they had no uncommitted volumes for Spimex trade because they supplied all their available amounts under direct term contracts. Gazprom, on the contrary, keeps Spimex sales at stable volumes. We understand that Gazprom will reach its maximum allowable volume of sales of 17.5 billion cubic meters per year by the end of this year. If the government ruling of April 2012 on natural gas exchange trading in Russia is not amended by canceling the parity principle [for Gazprom and independent producers' maximum allowed sales volumes] and increasing the Gazprom quota, we expect the total trade volume to be flat on the year at 20 Bcm in 2018.

**Q: At what stage is the discussion on raising the Gazprom quota?**

A: The Federal Antimonopoly Service of Russia [FAS] and the energy ministry are actively discussing this issue. There have been a number of options on the table. The latest one is to increase the quota to 25 Bcm/yr, but with the recent government reshuffle the issue might need to be discussed again.

**Q: Another figure, 35 Bcm/yr, had been previously mentioned ([NC Jan.25'18](#)). Why has it been reduced?**

A: This is a matter of compromise. Several parties take part in the discussion -- FAS, the energy ministry, Gazprom, independent producers. The positions are often the opposite. Gazprom would like to sell as much as possible, while independent producers would like to keep the current restrictions intact. The regulators are trying to find a balance between these two extreme positions.

**Q: What is Spimex's position?**

A: Our position, which we submitted to the government, is to raise the quota to 35 Bcm/yr. This volume of natural gas traded on the exchange is stipulated in the government ruling as the level that ensures market liquidity. If Gazprom is ready to increase its sales and independent producers do not have enough gas, why should we deprive Gazprom of the possibility to sell more? Let's not forget about consumers, who do not really care whose gas they buy at Spimex - - Gazprom's or independent producers'. It is only important to them that the gas is available on the exchange at any time. Now it is Gazprom who provides the liquidity.

**Q: What is the next step of the discussion? When can we expect a decision?**

A: Making amendments to the legislation is not a Spimex task, it is the task of the regulators. As experts, we can only give recommendations on how to organize the trade both on the exchange and outside the exchange to build a unified system of gas trade in Russia. We are doing our job. We have the task to introduce fresh exchange-traded instruments needed for further development of the gas market.

**Q: Do you discuss any measures to stimulate gas trade by the independent producers?**

A: Amendments to regulation are discussed, particularly to set the requirement to sell at least 10% of production volumes on the exchange. For Rosneft that would be 5.1 Bcm/yr, for Novatek -- 7.3 Bcm/yr. The idea enjoys broad support. Now the conditions on which to set this requirement are under discussion. But regulators might take producers' motivation into account. If two large producers [Rosneft and Novatek] operating in the unregulated price environment do not sell their natural gas at Spimex for whatever reasons, and another producer [Gazprom], operating in the regulated price environment, is ready to increase its sales volumes, shouldn't we give it such an opportunity? The inflow of gas on the exchange will improve competition anyway because consumers will choose where and how it is more convenient to buy the gas.

**Q: But if the liquidity is increased by only one producer, will you get a proper price indicator?**

A: Why shouldn't it be proper? Besides Gazprom, the buyers are also there. There is also the OTC market, which has an indirect influence on exchange prices. The buyer always looks for the most favorable price terms. That is why we don't see any serious problem here. Moreover, a price can be regarded as market-based when market participants begin using it in the price formulas under term contracts. And we know that there are already such contracts.

**Q: Are there many contracts linked to the exchange price? Do Rosneft and Novatek have such contracts? Why would they need them? They have usually set their prices based on the regulated tariff of Gazprom.**

A: I would not go into detail, but such contracts are present on the market. They can be needed to reduce the risk of losing the buyer if the exchange price happens to be lower than the independent producer's price under a term contract.

**Q: What are the prospects for gas price liberalization in Russia? What are the difficulties?**

A: According to the national plan for the development of competition for 2018-20 approved by the Russian president, the shift to market pricing should be made by developing exchange and OTC price indicators. There are difficulties everywhere, but two years, in our view, is enough. We have already passed part of the distance.

**Q: If the regulated tariff is abolished, won't Gazprom just quit the exchange?**

A: I think, when preparing to abolish the regulated tariff, FAS will introduce the requirement [of a minimal trade volume] so that the regulator could assess the market price level, as it does on the oil product market. Then producers that have a dominant position on the market will be obliged to sell a certain amount of gas on the exchange -- say, 10% of production volumes -- to avoid antimonopoly claims from FAS. Market liberalization is supposed to be reached by creating exchange and OTC price indicators, and the exchange price indicator could be created by

reaching a certain trade volume.

**Q: Then the question of how to attract independent producers to the exchange trade will be solved, too, won't it?**

A: They will simply find themselves in a situation where it will be better for them to sell gas on the exchange to minimize the risk of claims arising under Russian antimonopoly legislation. They are all dominant players in some regions. FAS now has no such claims because they offer prices lower than the regulated tariff of Gazprom. But what if there is no regulated tariff anymore?

**Q: What else should be done to liberalize the gas market?**

A: To have adequate market price indicators, volumes traded on the exchange shall at least be equal to 20% of total domestic sales, i.e. 70 Bcm/yr to 80 Bcm/yr. That is why the first steps should be the cancellation of the parity principle and an increase in the sales quota for Gazprom. Besides, we need to amend government regulations on gas supply, nondiscriminatory access to the gas transportation system and natural gas metering. Now it is only clear whether a buyer has actually offtaken their gas purchased on the exchange at the end of a calendar month. So we need daily metering of gas. Also, we need to give buyers a possibility to resell gas they failed to offtake, for which we offer to provide the right to conclude OTC deals with the transfer of gas from the seller to the buyer at the balancing points rather than at the exit points of the gas transportation system as is customary now. These measures will help create a system of commercial balancing of gas in the gas transportation network both for the exchange and OTC segments of the market.

**Q: What is being done in that direction now?**

A: Gazprom Mezhhregiongas Postavka [Gazprom MRGP is now actively working on the rules of gas metering as part of its tasks as the Spimex gas trade's operator of supplies. Together with Gazprom MRGP we are also actively working on the option to resell the gas on the exchange. We believe that if a buyer fails to offtake the purchased amounts it should have the right to resell the gas on the exchange. And if it fails to resell the gas, measures should be taken to balance the gas in the transportation system. There could be different models for such balancing. In the EU, for instance, this is the task of gas transmission system operators, which buy the excessive gas at a discount to the market price. We are now working to apply a similar model in Russia -- first on the exchange and then expand it to the OTC segment, too, because all market participants should be part of a single system.

**Q: When could this system start working?**

A: The Bank of Russia, which is the regulator of the clearing operations, has already drafted the necessary regulations that might be approved by the end of the third quarter of 2018. After that, Gazprom MRGP will be able to apply this system for the exchange trade. In the fourth quarter, buyers will be able to try to resell the first lots of gas. The buyers will become the sellers. This is a significant step forward for our market.

**Q: How will this model be expanded to the off-exchange segment, where there are more participants and gas volumes are bigger?**

A: This is the next issue that we will have to thoroughly think over. Now we need to create a working mechanism and see how it suits with real life. We will do everything step by step.

**Q: How should the gas transportation tariff system be reformed?**

A: We need to get away from the situation when we count the route lengths from the entry point to the exit point, and switch to the entry/exit tariff approach. The producer will pay for the gas' entry to the pipeline system, and the buyer will pay for the exit. The buyer won't need to think about a gas transportation contract or count the transportation cost based on the route length. The only thing that matters for the buyer will be the gas price at the balancing point

and fixed price for his particular exit point from the gas transportation system. The methodology for calculating the entry/exit tariff could be different, but all market participants realize that such a tariff is necessary. Certain steps in this direction have already been taken on the exchange, as Gazprom MRGP sets entry tariffs for the seller's entry points and, separately, exit tariffs for the buyer's exit points, both valid for a certain period of time.

**Q: Do you plan to introduce new balancing points?**

A: The switch to the entry/exit tariff can lead to a reality where we don't need two balancing points. We will be able to switch to trade on so-called virtual balancing points. France is a good example, as it has switched from three balancing zones to two zones in five years. So is Germany, where the NetConnect Germany and GasPool zones are expected to be unified by 2022.

**Q: Are you working on new exchange instruments?**

A: We are working on the resale of gas, first of all. Also, we are working on the possibility to launch contracts for delivery in any month of the year, which will give buyers an opportunity to buy gas, for example, in November, and receive it in any of the 12 months of the following year.

**Q: You've been working on this instrument for more than a year, haven't you?**

A: Yes, but this is not a quick process ([NC Jan.26'17](#)). New instruments should be launched at certain stages of market development. A new instrument should be a mechanism contributing to an increase in liquidity and reduction in risks. To launch such a long instrument now, without the possibility of reselling the gas, is pointless. When gas cannot be resold ahead of the planned month of delivery, for example, when the buyer has made a mistake in planning, this instrument looks very risky.

Liquidity is also important. Now trade volumes are limited because of the quota set for Gazprom. If we introduce a new long instrument, Gazprom's sales of monthly and daily trade will be diluted. The launch of a new instrument is not the primary goal. The instrument must be backed by liquidity on the market. That is why we need to first increase trade volumes, create the system of commercial balancing in both exchange and OTC segments and make the resale of gas possible. If we do all these things, we will launch this instrument, as well as futures and option contracts on exchange indexes. We have hopes for further development of the electric power exchange trade and are ready to offer derivatives for gas and electric power trade that would help market participants hedge their risks.

**Q: Some experts have doubts about the exchange trade's ability to become a proper price indicator because the exchange prices are basically hovering around the regulated tariff of Gazprom.**

A: When all the mentioned measures are taken, we believe we will have sufficient liquidity. The point is to abolish the regulated tariff, which will put all the market participants on an equal footing. Also, there is a set of objective criteria that allows for making a comprehensive assessment of the degree of maturity of the national gas commodity exchange market. An example could be the criteria developed by [the EU's Agency for the Cooperation of Energy Regulators] Acer. If you calculate similar ratios common for the Russian market, you will see that the gas exchange trade is generally developing positively in Russia.