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Interview: Spimex CEO Maps Out Challenges for Urals Futures Contract

In the latest effort to turn Russia's Urals crude oil export blend into a new international price benchmark, the St. Petersburg International Mercantile Exchange (Spimex) launched trading in its deliverable Urals futures contract at the end of 2016. In an interview with Nefte Compass, the exchange's CEO, Alexey Rybnikov, explains why the Spimex Urals Crude Futures contract has yet to get real sellers and buyers and what it needs to attract the necessary liquidity. He also notes that Spimex is developing a similar instrument for Russia's Espo blend crude oil ([NC Jan.25'18](#)).

Q: Trading of the Urals futures contract started in November 2016. Where do we stand now?

A: We are currently doing several parallel things and each is important for our future work. The first one is work with Russian oil companies. Primary liquidity can only appear if there are physical players that work with physical Russian crude flows. Physical players are Russian companies, which produce and export the crude, as well as foreign players, mainly global traders, which buy the crude through tenders, long- or short-term contracts. These two groups should necessarily be on the market, because only they can provide primary liquidity and physical crude for the futures market.

Q: What about financial players?

A: Financial players are necessarily needed as a future element of the system, and they will appear later, when there is already some liquidity. Financial players never enter an empty market.

Q: How is your work going with Russian companies?

A: Not that easily. They all look at each other. Each Russian company says: "Bring a global trader," and each trader says: "Bring a Russian company first." This is a vicious circle that we need to break somehow. What do we do? We sign market-maker agreements not only with financial players that we already have and that currently set prices. We are currently adding Russian oil companies to the list of market makers, because for foreigners, the key positive indicator is that Russian producers are on the exchange and set prices. We have recently inked such an agreement with Gazprom Neft. We have similar agreements with Lukoil and Zarubezhneft.

Q: What do oil firms do as market makers?

A: This is a very interesting question. In fact, Russian oil firms lag behind the international majors in terms of trading capability. Rosneft has RN-Trading, Lukoil has Litasco, Gazprom Neft has Gazprom Neft Trading, but still, those are not big names like Glencore or Vitol or others. So, Russian oil firms say that trading a financial instrument -- and the Urals contract is a financial instrument -- is something they don't understand well and are even afraid of. But we tell them that now it is important that they enter the market. Because if they do, we would have to disclose this. And this will be a strong signal for foreigners. We do not ask companies to do something impossible. Market making when you quote both sides with a narrow spread and trade large volumes is not really necessary at the first stage. There is no reason to trade large volumes now, because there is no buyer. So, companies need to signal that they enter the

market and are ready to set prices at a level they feel is right for them. Most likely, initial prices would be far from the market ones. Our companies will likely prefer higher prices, while foreigners, when they come to the market, would seek lower prices. And then, when they finally stand face to face with a wide spread, gradually something should start happening and the spread will be less and the liquidity will grow.

Q: Basically, you are only asking Russian firms to act as market makers?

A: We are currently focusing on market-making agreements. We tell oil firms they should be on the market and get experience in trading, pricing, accounting, taxation, risk management, etc.

Q: And what about foreigners?

A: The same thing. But the process is much longer. All Russian companies are already trading on the exchange. They trade petroleum products, crude oil and natural gas. Foreigners are not on the market. They need to read and understand trading and clearing rules, get tax support, understand how currency legislation and customs work. This work doesn't require major investments, but it requires internal resources. We already see that some of the big traders are in the process. That is, they are reading the documentation, doing the due diligence and asking questions. This is what happens on the buy side. And the list of our market makers is open for foreign participants.

Q: What other things are you doing?

A: There are issues we faced only when we started doing some practical things. One is the issue of a clearing bank. Oil traders work at different exchanges worldwide under the same scheme: There is always a clearing bank that stands between the trader and the central counterparty, a clearing organization that every exchange has. The task of a clearing bank is to free a trader from some routine work, including performance bonds, collateral management, money transfers, payments, foreign exchange deals, etc. The trader should be focused on placing trade orders. Few traders do what is called self-clearing because it is more expensive. Today there are five or six big players that provide such clearing bank services. So, when we started the contract, traders told us: "Go and sign agreements with a clearing bank, at least one. Because we want to work with you like elsewhere in the world." And we had to meet those giants, which had little idea of who we were and what the Urals contract was. We had to explain. Some of the banks immediately said they were not interested, others said we might be interested in a year or two. But there are a couple of players that showed real interest. We are now waiting for them to make final decisions. We would not need many clearing banks initially, so the first that comes might take a significant market share. And apart from Western majors, Asian banks and Russian banks that have an international presence are also trying to enter this market of clearing services. So, the key question is: When will we finalize agreements with a clearing bank? We hope to do that within a month, which means that the first traders might come soon afterwards.

In fact, a London-based subsidiary of a Russian bank has already agreed to provide clearing bank services to a top-tier global trading house, and we know that they are working to bring more traders to the exchange through them.

Q: What other issues are there?

A: The next issue we are working on is taxes. I think we were right when launching the contract in November 2016. Because, even though there is still no real life in the contract, and transactions are few and liquidity is low, we detected nuances that we would not have figured out if we hadn't launched the contract. The tax issue is a good example.

Today, there is uncertainty about the withholding tax applicable to non-residents of Russia who trade in physically settled futures for Russian exported crude oil. Russian law is ambiguous on the matter. Thus, we turned to the Ministry of Finance for clarifications and found that it also has issues with how to treat the Russian tax code in this case. The ministry asked us to study world practice on the issue. We did, having looked at the US, Germany and the UK. And we wrote a brief note essentially saying that withholding tax relating to variation margin is not charged on non-residents in order to attract them to the market. So, we immediately asked the ministry to consider amendments

to the tax code and to formalize this approach. The key issue is that currently there is revenue from this source for Russia's budget, so it will lose nothing. Indeed, the budget will earn indirectly if there is greater liquidity in the future. We are currently in a dialog with the ministry and I think we should come to an agreement here.

Q: What else?

A: Many issues, including currency regulation and currency control. Under Bank of Russia regulations, you needed to open a transaction passport, which certainly means additional paperwork and delays the transfer of funds to the accounts of trading participants and clearing participants. Most of the currency control-related issues are already resolved in the new version of the regulations, which came into effect as of Jan. 1, 2018.

Customs procedures were another issue. If you move to physical delivery under the futures contracts, you need to ink a supply contract. What is this? In accordance with the current Russian legislation on organized trading, a supply contract made on the exchange is confirmed by an electronic extract from the exchange's register of contracts. That's all. We sent letters to the customs authorities saying that when people come to you with such a supply contract, please keep in mind that they will not come with a piece of paper with signatures and seals, but they will bring an extract from the exchange's register of contracts. The official answer states that the set of documents envisaged by the Spimex trading rules is sufficient for the purpose. The go-ahead received from authorities definitively makes the test physical delivery nearer.

Q: When can we expect the maiden cargo to be delivered under the Urals futures contract?

A: This tops our priorities list. Once we have several Russian and foreign players on the market, we need to make such a delivery to demonstrate that it all works smoothly. But we have no intention to accelerate the process: oil majors, traders and commodity market infrastructure companies need more time to get acquainted with the new model of the marketplace. We have passed the route section, which has been mapped in great detail; now we have entered uncharted waters.

Q: You haven't yet made up the first cargo, which needs 720 contracts each worth 1,000 barrels to be sold, right?

A: But who today could make it?

Q: Is there a deficit of sellers or buyers?

A: Spimex discloses the list of trading participants. You can go online and see them. If you look now, you will see non-residents of Russia -- Rosneft Trading Geneva, VTB Capital Zug, Omega and Otkritie Capital International. On top of that, several global traders are already registered as clients of Russian brokers. We have also received an application from a Japanese house for a direct exchange participation. More are to follow. All key Russian oil companies are already set up and registered as members, as well as several Russian market makers from the financial sector.

Q: Who will be the first?

A: There are seven big names. I can't tell you who will be first as I don't know myself.

Q: Some of the traders, including Glencore, Vitol and Trafigura, have supply contracts with Russian majors. Why would they buy Urals using the futures contract?

A: Traders want the ability to get a free cargo out of Primorsk. Secondly, people who trade physical Urals are the natural client base for risk-management instruments built around paper Urals. And thirdly, a well-structured contract at an exchange is something every trader will look at for the purpose of being ready, just in case. Besides, Urals is too important a grade. Urals accounts for 30% of European crude imports and some people say Urals is already a price-setting grade there.

Q: Are you talking about recent offers to include Urals in the Brent basket?

A: The issue was raised a number of times in recent years. In a nutshell, there is an ongoing discussion that something should be done about the Brent basket. Adding Urals somehow is always looked at in this regard, because many experts believe that Urals should be recognized in the oil pricing environment, should find its place and formal status. This is yet another answer to your question why global traders need this contract.

Q: How will oil deliveries be effected under the futures contract?

A: Spimex has an agreement with the Russian pipeline company Transneft, under which one might be able to request specific dates and confirm the deliveries through the exchange. The logic is as follows. Each company plans its deliveries under the quarterly export program issued by the energy ministry. If you are an oil company and you know your three-month allocation, you can approach Transneft through Spimex and ask for a certain date of delivery.

Q: Earlier you asked Transneft to issue loading schedules for Primorsk for two months in advance. Is Transneft doing that now on a regular basis?

A: When we started this project, we inevitably became involved in many issues that had to be tackled even without the Urals futures contract. The matter of loading schedules is one of them. Loading schedules with firm dates come at the end of the month before deliveries, while the Brent shipping schedule appears a month before the month of delivery. So, people plan Brent earlier and Urals is something that remains. This undermines Urals' competitiveness. So, it would be ideal to issue loading schedules a month before the actual month of delivery. But there are some hurdles. Primorsk is traditionally seen as a balancing direction where oil producers go after allocating their barrels through high-margin destinations. Nevertheless, we started moving forward with the issue and today we see that the Primorsk schedule appears in advance. Another issue we faced is crude quality and I assume we will return to this issue.

Q: How long do you think it will take for the contract to gain liquidity?

A: Liquidity has a long way to go. Real players should come to the market first. Liquidity is a long-term target and it turned out it might take longer than expected to reach. But although you can't see all the little steps we do, we are constantly resolving various minor issues as we go.

Q: What is liquidity, in your opinion?

A: There are no figures to describe whether the contract is liquid or not. An analogy is the world financial center. How can you define which city is exactly this center? You ask people. The same with liquidity. If you want to know whether something is liquid or not, you ask a trader. You can invent artificial figures, but they mean nothing. For example, some 240 million barrels were delivered last year through the execution of the contracts made at the Dubai Mercantile Exchange. This is about one-third of Omani crude exports. But if you ask a trader, he will tell you that the contract is not liquid. Why? With Brent, you have a million contracts a day. Is it liquid? It is. Will we ever have millions of contracts a day? I doubt it, at least in the next five years. But is 10,000 a day liquid? It is unclear. But you should start doing something to get it rolled out.

Q: Some market players worry about political factors that might impact the Urals futures contract project. Do you think these fears are justified?

A: I heard people raising this issue. But I also heard contrary arguments, that there are political factors everywhere. This is just an issue of credibility. People either believe you or not. I don't believe that the state will ever use Primorsk as leverage.

Q: Are you still considering similar futures contracts for other Russian crude grades?

A: All the focus now is on Primorsk. We might then turn to crude flows from Novorossiysk, via the Druzhba pipeline. We are also developing a futures contract for the Espo blend.

Q: Russia's relations with Opec are currently getting more intense. Might Spimex also be interested in promoting the contract among Opec members?

A: We have presented the Urals futures contract to the Opec Secretariat last June.

Q: Why are they interested?

A: Just because all Opec members sell crude. Some of the grades have similar characteristics and are supplied to the same regions. And pricing for those grades is also far from being perfect. There is this general feeling in the industry that you should do something. So, people are looking at what is happening in different markets. People try to experiment with different stories on the market. No one knows exactly what will happen, but something will happen. Therefore, what we are currently doing is, on the one hand, creating our own pricing mechanism and, on the other hand, preparing for future changes.

Q: Why would Spimex be interested in cooperation with Opec?

A: We just want to show what we are doing. We will then find out what might happen.