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Russia Steps Up Drive for Urals as International Benchmark

Russia's plans to turn the country's Urals crude oil export blend, one of the biggest crude streams in the world, into a new international benchmark are gaining momentum. In an interview with Nefte Compass, Mikhail Temnichenko, first vice president of the St. Petersburg International Mercantile Exchange (Spimex), explains what should be done to achieve the goal and what obstacles stand in the way.

Q: Spimex has announced plans to launch a deliverable futures contract for Russian export crude, which should later form the basis for a new benchmark. Why is there a need to look for a new benchmark?

A: The answer is rather simple. First, there is a market request for a price indicator, to which Brent doesn't fully match today. Second, Urals as a physical crude flow, as a trademark, has those characteristics that are necessary for a benchmark candidate. These two factors have coincided today.

Q: What do we mean speaking about market's request?

A: The oil market consists of several focus groups. The first one — crude oil producers and consumers — has the highest demand for a new benchmark. The second group includes oil trading majors, banking institutions such as JPMorgan and Goldman Sachs, and traders like Vitol, Gunvor, etc. This group also needs a new benchmark, although to a lesser extent. For this group, any new trading tool is useful and interesting, because they are professional users of such tools. Finally, there are antitrust and other regulating authorities, which call for clear and transparent pricing mechanisms.

Q: Why has Brent changed its status as a key price indicator?

A: In recent years, talks have intensified that the physical flow of Brent is running out, while the addition of new grades further blurs the benchmark. The benchmark grade is becoming a broader notion, its quality characteristics are expanding. The Brent basket already includes Buzzard crude, which is close to medium, sweet crudes like Urals in terms of its characteristics. Moreover, benchmark price assessment mechanisms of pricing agencies, including Platts, raise a lot of criticism. Initially, there were calls to improve existing mechanisms, but we can now hear more frequently the question: Is there a replacement for the Brent basket? These factors give birth to projects like ours.

Q: There have long been plans to turn Urals into a benchmark. However, over the last year this project has become a truly national issue with interest now coming from the level of both the Russian president and the government. Why?

A: There is no single reason for that. The state has always been interested in having Russia's own benchmark. However, five years ago the exchange was not seen by Russian oil majors as a platform that would be able to establish something alternative to Brent. Moreover, a benchmark quotation is a good status, but it is lifeless if no one uses it. And Russian companies simply had no demand for such a tool in recent years. When the crude price was above \$100 per barrel, oil firms took their revenues and had no thoughts of hedging or risk management. "We are not trading futures. We produce crude," that's what they said. But we see what happened to prices and what opportunities were lost.

Q: What is the project about?

A: We are establishing a direct market quotation of Russian crude based on a Urals export deliverable futures contract on an f.o.b. [free on board] basis.

Q: How did Spimex come across the idea?

A: In recent years the exchange strengthened its positions. We gradually got an idea of how to turn Urals into a benchmark. Initially, we were looking at Platts mechanisms and there were notions of setting up a mechanism for trading physical crude volumes. Based on deals with physical crude, a quotation was supposed to be established to be further used for other trading tools — futures, swaps, etc. Then we understood that it was this way that led Brent to a dead end. And we gradually invented a tool close to that used by WTI [West Texas Intermediate]. This tool is a deliverable futures contract, where the quotation is a daily price of that daily traded contract, but where the implementation of the contract is strictly set. If you have open positions before the contract expires, you have to supply the crude physically. This is a different mechanism.

Q: What was done to develop the project?

A: There are three stages for the project implementation. The first is the preparation of the technology platform and communication with Russian market players. Over the last two years, Spimex specialists gradually prepared specifications, rules, models, calculation methods and advertising materials for the project of establishing a

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direct market quotation of Russian crude based on a deliverable futures contract. Those efforts helped to establish the technology platform to launch the contract, whose quotation should become a benchmark. Last year, we launched test trading with deliverable futures contracts. So we have two stages left — developing initial liquidity to start up the futures market and sustain the already launched contract; and attracting all other market participants.

Q: Is there interest among oil companies?

A: Over the last three years, we have been actively explaining the specifics of the new mechanism and why it is the most reasonable one. As a result, we have quite a wide circle of people in oil companies, the Federal Antitrust Authority (FAS) and the government who no longer see the benchmark as a word in the dictionary, but see a concrete project behind it. What we see today is that the psychology of Russian market players has changed. We managed to explain that the deliverable futures contract is not a crude sales tool that should replace current practices. This is not the idea. The idea is that we are setting up a market of deliverable futures contracts, where a fair price is being established. Each company might later use this mechanism for its internal purposes, simultaneously using the existing crude sales mechanisms. A company might ship its barrels using the futures contract, might simply fix the delivery price or might not use it at all, but include in its long-term contracts a clause that the delivery price is that for Urals set during deliverable futures trading. This should help deviate from differentials between Urals and Brent. What do we have now? The Brent quotation is formed using Platts methodology, which is also used to define differentials with Urals. And there is also a recalculation of the futures quotation for dated Brent figures. So we have three points of uncertainty. Our idea is to replace those mechanisms with a direct quotation of Russian crude f.o.b. Primorsk or Ust-Luga, which would be familiar to Russian oil firms. Moreover, Russian companies will become direct participants of the price-forming process on the market.

Q: It is clear that the establishment of a benchmark requires the participation of foreign players, including oil firms, traders and financial groups. What are the plans for promoting the project internationally?

A: Here is where we get to the project's second stage. Starting from 2016, we will actively work with external markets, counterparts and potential international participants.

Q: Who are they?

A: Primarily pricing agencies. We can always announce that the quotation is now determined not using their methodology, but using exchange trading. But how would this information spread further? Through those agencies. Our task is not to simply establish a quotation, but to make it an accepted standard for all market players. And we are going to communicate with agencies, provide information that they would pass onward to their clients. The proj-

ect's second stage envisages communication with international players. We will get them acquainted with the new tool, persuade them to participate in test trading. The plan is to attract not only trading giants like Trafigura, Vitol or Gunvor, but all potential Urals consumers, including refineries. As a result, we should establish a market on the exchange that includes all possible consumers of the grade. We believe that this might also help raise Urals quotations and possibly redistribute margins in favor of producers and consumers.

The plan is to carry out those activities through the whole of 2016. The next step — scheduled for the second half of the year — is the actual trading start-up, building and sustaining daily liquidity of the quotation, its positioning as a benchmark, linking other contracts to the quotation, establishing pricing standards linked to this quotation. Only when the liquid market is established and only when contracts are being linked to the new quotation, can we say that we have succeeded. Success is when we can say that the quotation of the nearest series of deliverable futures contracts on Spimex is a benchmark, which means it is a key figure considered by the participants of the global oil market. Finally, when people talk about oil prices, we should hear the following: Brent price is..., WTI price is..., Urals price is....

Q: When can this happen?

A: As I said, actual trading start-up is scheduled for 2016. Then the pricing history should be formed. I think we can start positioning Urals as a benchmark in a year after trading starts.

Q: Who should confirm Urals status as a benchmark?

A: No one, since a benchmark is not an awarded status. This is a market recognition of a quotation as a benchmark. Two simple things would confirm this status. First, when Urals long-term contracts are linked to a Urals quotation of the deliverable futures contract. And second, when contracts for other crude grades are linked to this quotation as well.

Q: What is the key difference of Urals from other benchmarks?

A: The Brent market is a huge liquid market of paper crude, which has a latent link to the physical crude market through Platts methodology. Our contract would be fully supported by direct physical deliveries. So you can cancel a futures by either closing the position on the market or by physically supplying the crude. Otherwise, you will be fined.

Q: Are the futures contract parameters ready?

A: The contract is fully developed, the specifications are written. It includes quite clear standard parameters: The contract is for 1,000 barrels, the delivery lot is 720 contracts f.o.b. Primorsk or Ust-Luga. There is a bit on the quality parameters of the crude supplied. We have a table agreed with oil firms on the quality

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characteristics of the crude coming out of the pipe in key export ports, which we sent to Transneft. However, the problem is that there is no obligatory document on Urals quality standards. There is the scheme of normal crude flows, which regulates crude quality today. But the document is not obligatory for exports. Moreover, the quality of crude shipped to the west is deteriorating, while a futures contract should have the product quality characteristics and its guarantees ideally for three to five years. Transneft cannot provide guarantees now. While the issue is unsolved, the contract's development is becoming more difficult, but is still possible. A futures contract is quite a flexible tool, which can include the upper quality limits. If there is a serious deterioration of the quality, we can amend the contract parameters.

Q: Transneft has proposed singling out a separate high-sulfur crude flow for exports from Ust-Luga.

A: This could have helped to solve the quality issue. For us, it means that the number of standard loading ports would be diminished in the futures contract specification, but loadings from Ust-Luga should still be possible using the EFP (exchange of futures for physicals) option.

Q: What else are you discussing with Transneft?

A: In 2016 we should discuss a number of issues. Apart from quality issues, the market should be ready for actual deliveries. If someone supplies crude under a futures contract, it means the position should be met next month. And there are lots of questions on the supply schedules, tanker delivery dates, etc. Transneft said it might issue port loading schedules for longer periods so that oil firms know their opportunities for two or three months ahead. They will then understand their physical crude flows and what position they might take in case there is a need for physical crude supplies.

Q: So is there a need for vacant positions in the loading schedules?

A: Not necessarily. Let's imagine company X has an export schedule approved by the energy ministry. Transneft confirms those volumes for next month. And then the company might either hedge those volumes on futures and supply them, thus closing the futures position. Or it can supply through the futures contract by simply selling the volumes, or just do nothing. However, a company should understand the volumes in advance to be able to manage this position even if it is linked to a long-term contract. If a company wants to have a physical delivery, it should know its loading opportunities.

Q: Do you believe oil firms will switch their long-term contracts to a new quotation?

A: It would be good if they switch their contracts to direct

Urals quotation. However, it is clear that it will take time to untie them from Brent.

Q: Are oil firms ready to amend their contracts?

A: The trouble among our domestic market players is that they still consider the deliverable futures contract a replacement for the existing oil market. This is incorrect. It stands somewhere close to it. These are two parallel markets. Physical tenders and long-term contracts won't disappear. But a new tool is appearing and its advantages can be used. You can sell 5% or 20% of crude using the tool or nothing. It is important to simply be on the market.

Q: How might rising competition with Middle East producers, Iran or the US for European markets impact the project?

A: There are certainly risks. But refining specifics in Europe won't allow competitors to easily oust Urals. It should take time for Urals' share to change. Then all the market participants using crude oil similar to Urals in terms of quality would be able to enter the market of deliverable futures on Spimex. If they link contract pricing to Urals quotation, they will get a chance to use our futures to manage their own sales. On the other hand, they will need a tool to hedge pricing risks. As a result, parts of the physical crude market would be naturally combined with the general futures market.

Q: Does Urals have any competitors for benchmark status?

A: Urals export blend takes the leading position in terms of its characteristics if we are talking about a physical crude oil flow localized in one particular place with clear quality characteristics, volumes and a significant number of players. Moreover, the advantage of our contract should be a clause we plan to include on the possibility of linking deliveries not only to Primorsk and Ust-Luga. Using the EFP mechanisms, the contract might be implemented in Novorossiysk, via the Druzhba oil pipeline. There are simply no other crude grades with similar parameters.

Q: How did the current price slump impact your plans?

A: Ironically, it had a positive impact because oil firms' interest in the project increased. When prices start rising, the instrument should be ready and liquid so that oil firms could hedge sales at high prices.

Q: Are we talking only about Urals when we say benchmark? There were plans to turn the Espo crude grade into a benchmark as well.

A: We say Urals to make the current dialogue easier. In fact, we are talking about the technology of a deliverable futures contract on an export basis that might be used for Urals, Espo, oil products in the future.

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Q: There have long been talks on exports priced in Russian rubles, but the futures contract is a foreign currency instrument, right?

A: We are establishing a quotation in dollars per barrel. This was a deliberate decision because a quotation should be convenient for the global oil market participants. It would be difficult to persuade a person to trade a new contract with a new quotation, which is not integrated into his trading system. And for us 50% of success depends on foreign participants. We should give them a quotation that should enter their trading systems without changing anything. However, the tool is being established on a Russian platform, guarantees are in rubles, and variation margins are also recalculated in rubles.

Q: What do you need from the state?

A: We have already sent proposals for the Bank of Russia to introduce amendments to Russia's legislation that should allow foreign players to directly enter the mercantile market. Today, a foreign resident can't trade at the Russian exchange as a participant. We would also want the state to use our quotation in the future to calculate taxes, export duties.

Q: How can Western sanctions impact the project?

A: As practice shows, exchange trading in the whole world stands outside sanctions. And when we launch our project, we would be able to raise confidence in our financial markets.

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