

## **The Development of Pricing on the International Oil Market: New Benchmarks, Currencies and Settlement Technologies**

### **KEY CONCLUSIONS**

#### **Conditions are being created to establish a Russian oil benchmark**

"The creation of a benchmark for exported oil cannot be a success unless it takes place in a transparent pricing system not only on the foreign, but also on the domestic market [...] We have already come a long way in this regard. Exchange and off-exchange indicators are generated and published on a regular basis in Russia. Roughly 20% of petroleum products are traded on the stock exchange and delivered to the domestic market. We have launched derivative trading for oil and petroleum products. The St. Petersburg International Mercantile Exchange has launched a futures contract for the URALS blend. Liquidity is now being formed on this market, and a dialogue is being held with all concerned participants. At the same time, the Moscow Exchange has launched contracts for WTI mini Brent and indices on the futures market. And now our two exchanges are working to launch similar trading for URALS, and the issue is also being discussed for the East Siberian-Pacific Ocean pipeline", Deputy Head of the Russian Federal Antimonopoly Service Anatoly Golomolzin said.

"A benchmark is a product of trust. It must be liquid, and people must understand that they are trading in a fair market [...] URALS can take off, but it will take time [...] We see that there is little supply on the market today. It is declining [...] We are including new benchmarks for crude oil brands [...] URALS has the potential to become a major benchmark", Editorial Director for European and African Oil at S&P Global Platts Joel Hanley said.

"A framework exists for calculating a reliable index. Cooperation among all the parties concerned on this issue indicates that we can expect to start trading these contracts on a regular basis throughout 2018 and early 2019 within the framework of the road maps approved by the Russian government and within the framework of the exchange committee. And there is every

reason to expect that this will be a benchmark in global trading”, Golomolzin said.

### **The Russian government’s decisions are stabilizing the oil industry**

“In the past year and a half, a lot of work has been carried out: the budget rule and the fact that foreign currency is withdrawn from the market to the reserve fund have allowed us to stabilize the exchange rate and inflation. These are two factors that give investors confidence [...] When we market the URALS product, it should not be an effort just by individual government agencies or companies. It should be a collective effort. The Ministry of Energy is ready to provide a platform to unite regulators, the exchange, and consumers for joint efforts in futures marketing”, Russian Deputy Minister of Energy Pavel Sorokin said.

“Stability is one of the main factors in the hands of the government, the state, and business that can be influenced. We complain about external factors, and they are, indeed, quite often fundamental, but sometimes we forget about what we can change. This concerns taxation and regulatory conditions, which are important for launching new products and new projects”, Sorokin said.

### **Russian companies are optimizing business processes**

“Over the past two years since the launch of the contract, many important events have occurred [...] Russian companies have begun restructuring their business processes, training personnel, and adopting various internal documents. We see that Russian companies have advanced far down this path [...] Over two years, we have figured out elements [...] that interfere with practical work. The procedure for interaction with customs makes it possible to use electronic contracts for registration. In terms of currency regulation, the Central Bank has done a number of important things, significantly simplifying work with clearing organizations. There has been significant progress with respect to taxes”, St. Petersburg International Mercantile Exchange President Alexey Rybnikov said.

### **The promotion of a benchmark needs to be incentivized**

“URALS is already a benchmark, so we need [...] an incentivized approach. We need to look at all futures contracts that work on the tax policy as a whole in order to launch the whole process [...] The reduction in production in the Northern Amur has led to an increase in demand. And URALS could easily fall

into this basket”, Chief Strategy and Business Development Officer at Argus Media Group Matthew Thompson said.

“We sell a total of more than 220 million tonnes of URALS almost exclusively through the pipeline system. There is also railway transport [...] Our supply and the volume of daily and annual production that exists in the Russian Federation is a significant factor that influences the market. The benchmark is nevertheless an indicative figure that should be formed as a certain standard [...] The very concept of a Russian oil benchmark can be defined in smaller volumes and have certain specific qualities”, Aide to the Chief of Staff in the Presidential Executive Office Kirill Molodtsov said.

## PROBLEMS

### **Insufficient liquidity**

“The exchange can make a contract. The contract we made is a supply contract for URALS export oil [...] The simplicity of the contract also lies in the complexities associated with initiating liquidity on this contract because a substantial portion of liquidity is created by financial players [...] But not a single financial player will ever show up if there is no primary liquidity on the contract, which can be created only by the main market participants – in this case, Russian producers and large global, mainly foreign, oil traders. So far, no initial liquidity initiation has taken place”, Rybnikov said.

### **A lack of understanding of pricing risks**

“Today, the view of Russian companies on risk is that they have no risk at all because they all trade according to the price formula, as a rule. And a simple and deceptive external impression has been created that there is no risk because at each moment in time oil is being sold at the market price at the moment it is loaded”, Rybnikov said.

“First comes the physical risk, then there is a need for hedging, and then we have the stock exchange. You have all the conditions for success. There are fantastic physical volumes in Primorsk. There is a wonderful contract on the St. Petersburg Stock Exchange. There is not enough physical risk [...] If you can transfer this risk to the stock exchange, then you will have fantastic potential”, Managing Director for Energy Research and Product Development at the CME Group Owain Johnson said.

### **The trading business is underdeveloped**

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"Apart from a few, Russian companies do not have their own trading business. Russian companies simply sell oil virtually without any commerce, and the trading business is tens of cents or dollars that can be earned on each additional barrel of Russian oil [...] We believe that benchmark status gives an additional premium to the price because it is a premium for liquidity [...] but it will come sometime later. And the first component that will come is additional revenue from trading", Rybnikov said.

"We support the initiatives that the exchange is implementing [...] Trading at Russian oil companies was poorly developed two years ago, and today we can't say that it's the best practice or a developed segment of our business [...] We are gradually moving towards this. We have launched the management of commodity risks at our company [...] We need liquidity and risk, but, on the other hand, we understand that in order for liquidity to come – and it will come through international players first and foremost – we need to make sure that clear and precise rules apply here and that it works over a certain period of time [...] It is essential that both the exchange and the regulator are interested in developing this tool and listen to the needs of the participants", Zarubezhneft Deputy General Director for Economics and Finance Denis Maximov.

## SOLUTIONS

### **Transparent pricing and risk management**

"One of the important components for the emergence of a Russian benchmark on the global market is above all the stability of supplies both in terms of volume and in terms of quality [...] We predict a flow of 37–38 million [tonnes] at the port of Primorsk, plus, if we are talking about the Baltic Sea basin, we mustn't forget about the Ust-Luga port, where the capacity amounts to roughly 36 million tonnes [...] The port of Novorossiysk is also an important export direction for URALS [...] In terms of the physical supply of URALS, we do not see any risks [...] As for the quality [...] there has been a decrease in the quality of raw materials [...] We are keeping a close eye on this in cooperation with the Ministry of Energy and oil companies, and a permanent working group has been set up", Transneft Vice President Sergey Andronov said.

“This whole process should be transparent. We have to trust URALS. And there must be a liquidity aspect [...] We need people who take risks, and also, as it turns out, people who will deal with these risks”, Vice President for Crude Trading and Supply at Shell International Trading and Shipping Company Limited Mark Quartermain said.

“We have a gigantic physical market, a resource base, and potential. So it’s totally logical to ask – if the resources are ours, the suppliers are ours, the transportation are ours, and the customers ours, why is this all being traded on other exchanges? Why are other indicators being used and what should we do about it? If we want to attract consumers, we need to provide them with clear conditions and outline the benefits that they will receive. In today’s world, the benefit is a reduction in the degree of manipulation and the creation of an alternative to well-established indicators”, Sorokin said.

### **Introduction of new pricing mechanisms**

“Along with our core contracts, we are experimenting with various new ideas and mechanisms. Today, after this session, a memorandum will be signed with the leading price agency Platts. The memorandum is aimed at searching for and the fragmentation of ideas that could be used in world oil pricing. We are working on launching a settlement contract for the Urals index. The main thing here is that we lack the very basic asset that does not allow for launching settlement contracts. I think that we will come to this”, Rybnikov said.

### **Digitalization of the oil industry**

“The system of theoretical standards is outdated, so we must concentrate on pricing indicators of the real prices for real oil grades that appear on the market [...] We can create a single database that will include, first on a regional basis and then on a global basis, data about the quality, volume, and variety of oil that is produced and exported as well as information about refineries and petroleum product markets [...] We came up with the idea of introducing a system of markers for oil [...] so that we could then trace the fate of this oil to the end refinery [...] Thus, there will be transparency and confidence in the quality of the refineries [...] The implementation of this system will also optimize the revenue of oil producing companies”, Integral Petroleum SA General Director Murat Seitnepesov said.