



Russian Oil Pricing

CJSC SPIMEX

# 1

Importance of the Correct Oil Pricing for Russia  
can be hardly overestimated. What does the current pricing procedure look like?

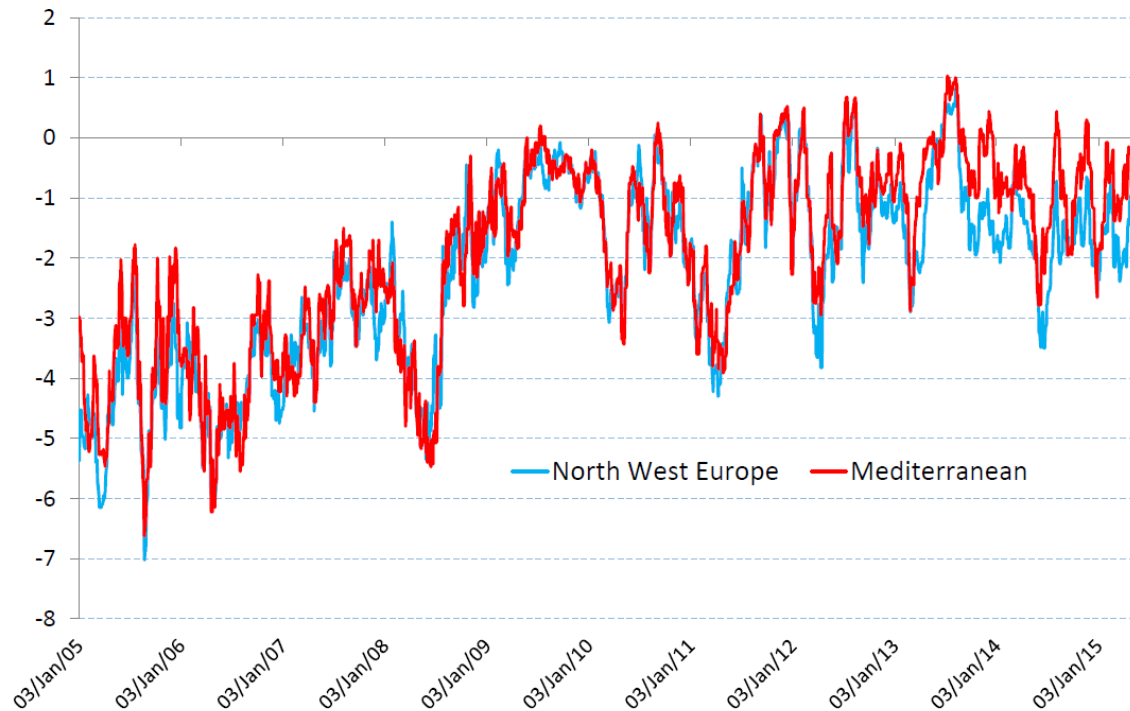
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## Current Russian Oil Pricing

Reference to the Brent Price

The Russian oil is sold for export using the formula pricing with reference to the price of Brent oil grade valued by foreign pricing agencies.

Differential between Urals  
and Dated Brent (dollars/barrel)



# 1

## Pricing Factors

Given Reference to the Brent Valuation

In theory, the differential between the price to the Russian oil (e.g. Urals) and Brent shall be effected only by two factors:

1. difference in quality
2. logistics

In reality this is not the case

The valuation of Brent (and correspondingly of Urals) depends on the data collected, processed and published by **Foreign Pricing Agencies (FPA)**.

**FPA**s strive to carry out their valuations on the basis of data on deals with physical oil. BUT:

- The number of such deals is **insignificant** compared with the volume of the Brent futures market
- Correspondingly they often have to use data on parties' intentions, rather than on actually closed deals
- The valuation methodology is **complex, controversial and lacks transparency**
- The good faith of the companies reporting deals with physical oil is often challenged

# 1

## Methods of Manipulations

with Brent Quotation

The possible methods of manipulations with the oil price by companies sending deal reports to the Pricing Agency include the following:

- A report on the price of one oil tanker may be used for valuation of several other tankers with undisclosed conditions
- A report on the contract may fail to contain important additional data effecting the final price
- In reality the reported contract is connected with other, undisclosed contracts, which changes the actual price of the goods delivery
- A contract may be made by formally independent companies that have entered into conspiracy

Use by Pricing Agencies of non-transparent and easy-to-manipulate methodology hinders determination of the real oil price



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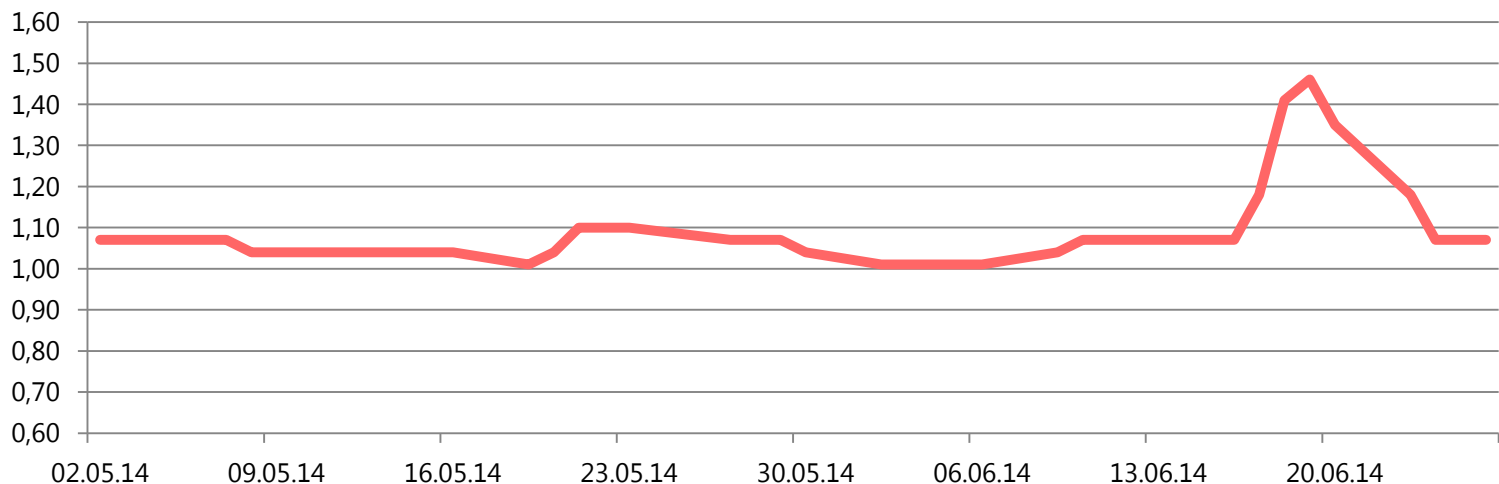
## Additional Distortions

### Effecting Russian Urals Pricing

Pricing Agencies make **additional distortions** when pricing Russia Urals:

- A Pricing Agency regularly presents in its reports **an incorrectly calculated refining margin for Urals from NWE.**
- The existing valuation system makes it possible to understate the Urals price by several dollars.
- A Pricing Agency **distorts the valuation of the freight cost**, decreasing the price for the Russian oil. Freight rates are often increased on delivery dates under a contract with Russian oil companies.

**Urals Freight NWE** as per a Foreign Pricing Agency, dollars/barrel



# 1

## Key Conclusions

### on the Current Russian Oil Pricing System

- The existing Russian oil pricing is **subsidiary, lacks transparency and is subject to distortions. There is no fair pricing** of the Russian export oil!
- The current oil valuation system based on Dated Brent **has lost its significance** as a measure of the real cost for the global oil market. But it is still applied since:
  - a) those few parties supporting this outdated pricing structure in prejudice of manufacturers' interests are interested therein;
  - b) Pricing Agencies have not been able to suggest any other reasonable alternative.

Changes in the oil pricing are unavoidable, and Russian players of oil markets shall turn such changes to their account and to the account of physical oil markets in general

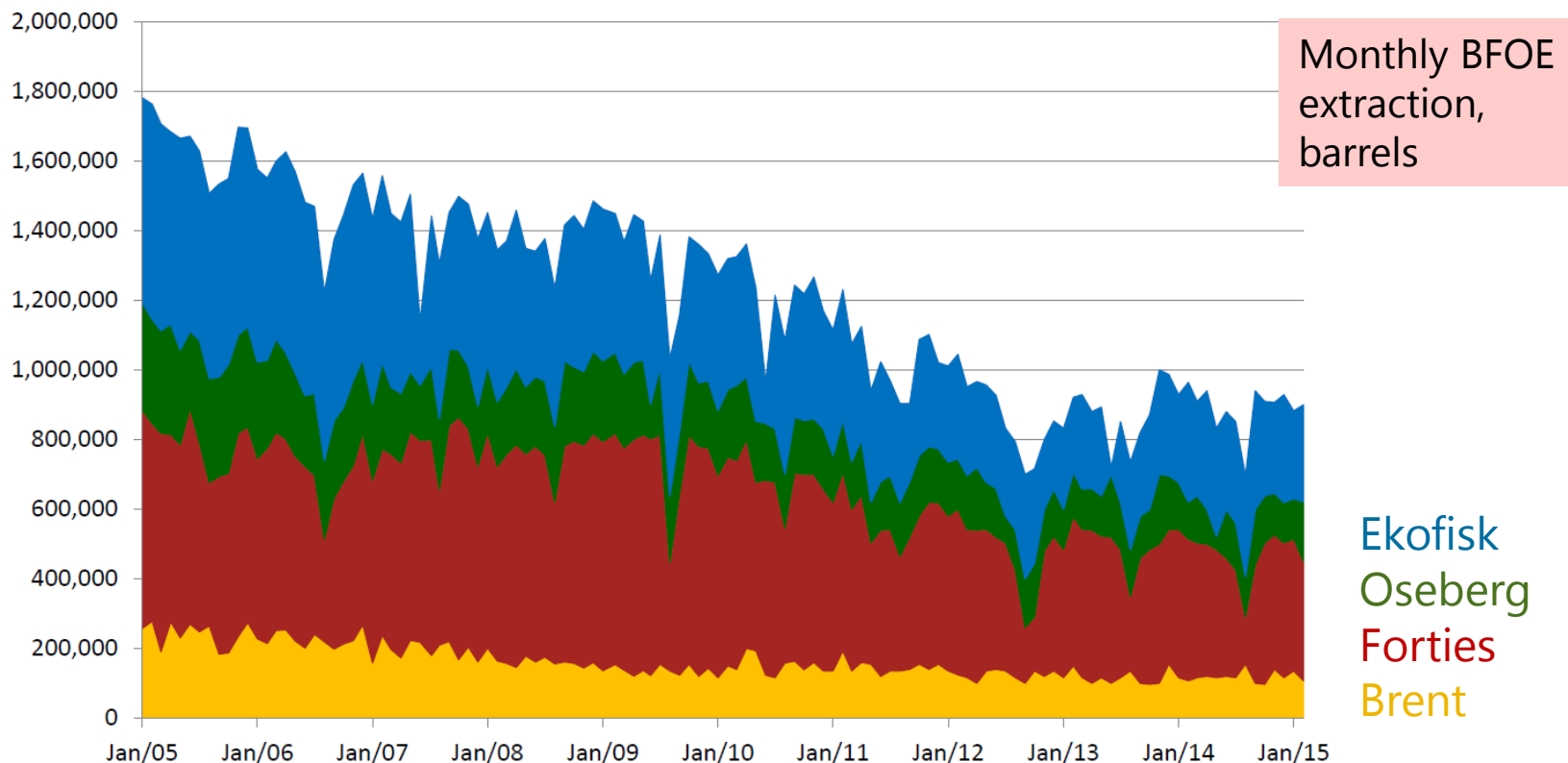
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## Why it is the right time

to Create a New Market Grade

**Oil flows** included into the **BFOE basket** (Brent, Forties, Oseberg, Ekofisk – Brent complex) **keep on decreasing and have achieved the critical level.**

Despite the decreasing BFOE flow, prices for about 70% of the oil traded in international markets are calculated with reference to the ICE future for Brent or to Brent prices published in the trade press.



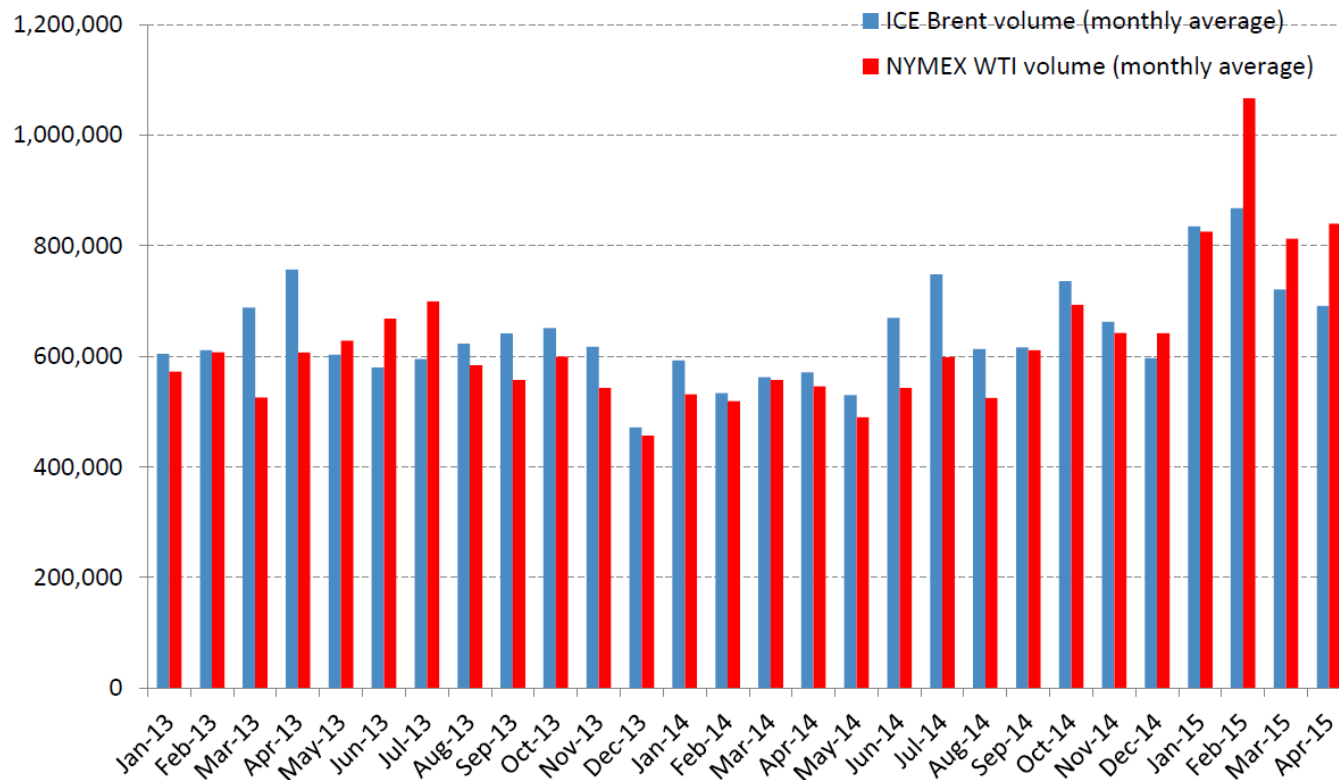


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## Why it is the right time

to Create a New Marker Grade

Volumes of trade in Brent futures evidence the increasing demand for the reference futures contract despite the actual reduction of the physical oil extraction volumes. Use as a benchmark of the cost of the futures for the reference oil grade that is extracted in small volumes and keep on reducing, results **in the distortion of the global oil pricing and price manipulation.**



Average daily trade volume, in contracts

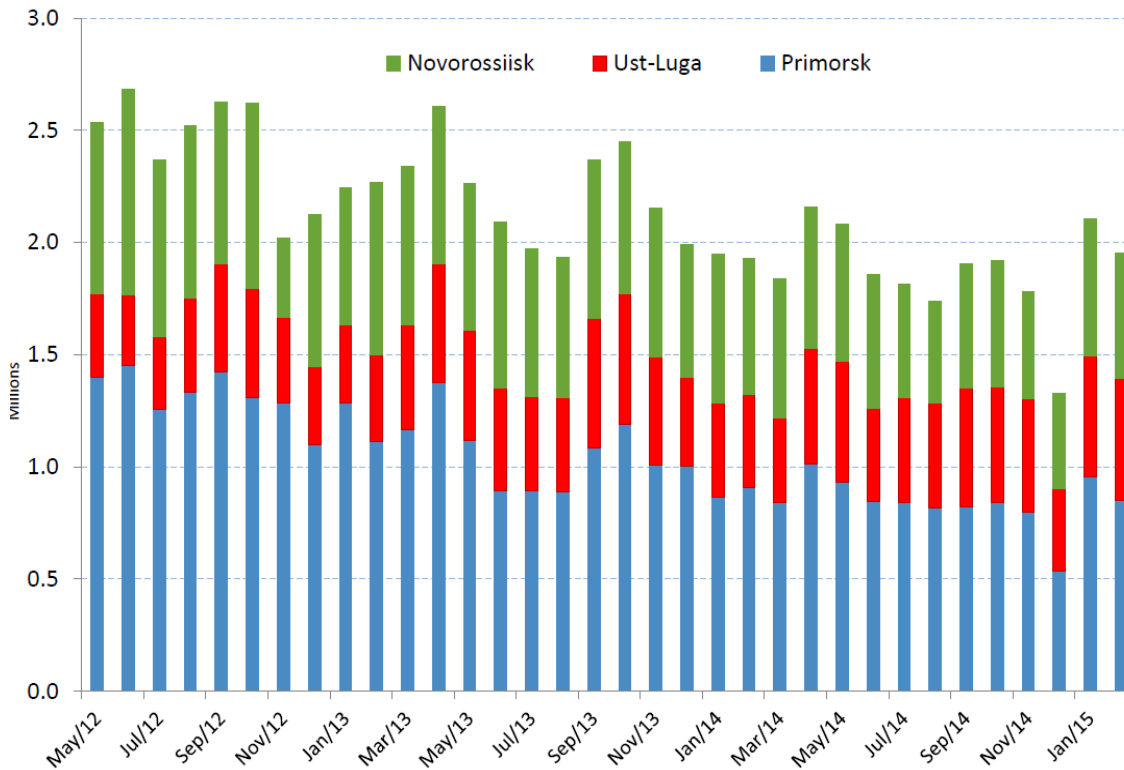
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## Why is the Russian Oil

the Ideal Option of the New Marker Grade

High and stable export volumes

The volumes of supplies of Urals/ESPO to international markets **twice exceeds** the combined volume of BFOE, Oman and Dubai



Urals export, mio barrels

Current situation:  
According to Platts, Brent shipments over the last week of July 2015 amounted to 85 thou bar/day, i.e. **reduced by 50%** of usual volumes

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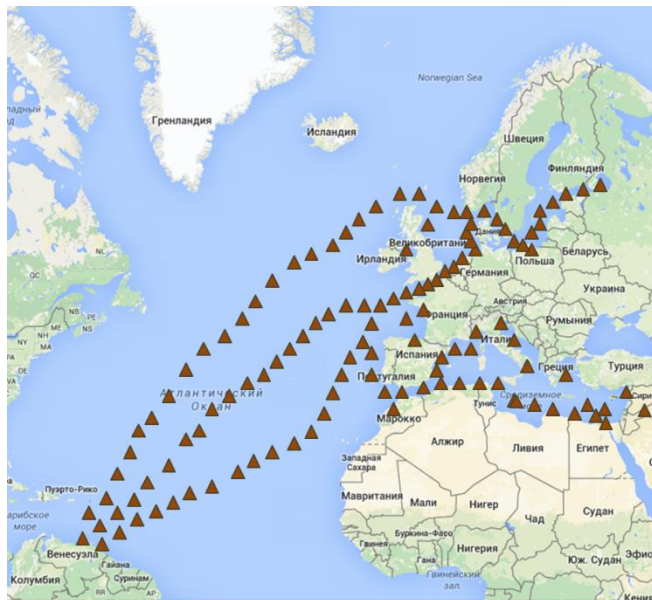
## Why is the Russian Oil

the Ideal Option of the New Market Grade

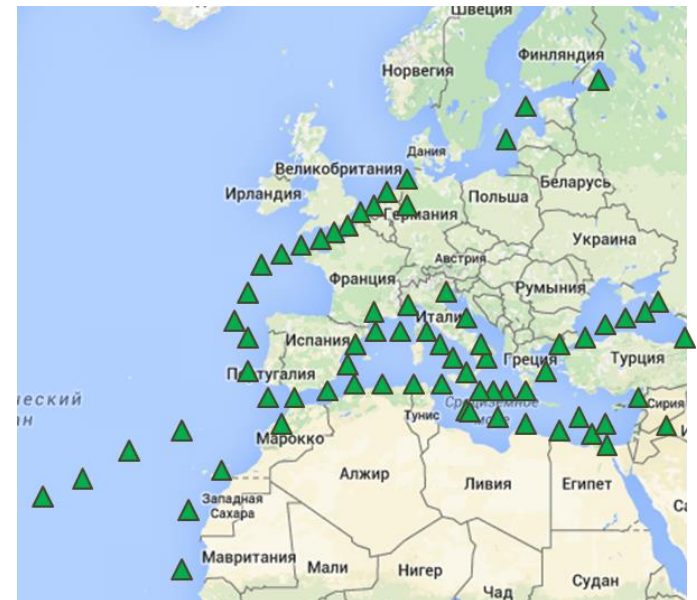
### Extensive Export Geography

No other oil grade has such an **extensive geographical coverage** as the Russian oil. Export flows of URALS/ESPO go through ports in the Baltic and Mediterranean seas (Urals) and from Far East (ESPO).

#### Export from Primorsk



#### Export from Novorossiysk



# 1

## Why is the Russian Oil

the Ideal Option of the New Market Grade

### Favourable market structure

There is a sufficient number of manufacturers and end consumers in the market to ensure compliance with the pricing transparency requirements. The Russian oil is extremely important for end consumers and no factors are forecasted evidencing the Russian oil market oversaturation and uncontrolled pricing process.

### Market Size

Volumes of the Russian oil extraction are stable and exceed the volumes of the Brent extraction by almost 13 times.



# 1 Conclusion

Creation of a **new marker grade on the basis of the Russian export oil** ensuring the **fair and transparent pricing** has good prospects and will satisfy both interests of the Russian manufacturers and of the whole market, and of the Russian Federation in general



2



# Benchmark

for the Russian Export Oil

# 2

## What shall the Price Reference

for the Russian Export Oil – a New Global Benchmark - Look Like?

The conditions required for the benchmark creation are obvious:

1. The price for the Russian oil shall be determined **without reference to other export grades.**
2. The oil pricing shall be absolutely **transparent and competitive.**
3. The market shall be legally regulated and have **clear rules.**
4. Contracts made in the oil market shall be **standardized.**

All the above requirements may be complied with only if the price for the Russian oil is fixed in the result of trading in the Russian stock exchange.



# 2

## Can Contracts with Physical Oil

- Spot Contracts, Short Forwards – Determine the Price for the Marker Grade?

### Mistakes

Dependence of the reference grade price to the prices of deals in physical markets allows buyers and sellers to be sure that the price is fair, since it is fixed based on the real physical deliveries.

### Reality

The number of contracts made in physical markets is too low to ensure fair and transparent pricing and such contracts are poorly standardized (some of the conditions may be ignored), therefore they are subject to manipulations and wrong interpretations.

Conclusion: it is undesirable to use contracts with physical oil to create the benchmark.



# 2

## Can Oil Futures

Determine the Marker Grade Price?

### Mistakes

The futures market is 'paper' and has no reference to the real oil, it is the shelter for stock jobbers and the object to manipulations.

### Reality

The stock futures market is a strictly regulated, absolutely transparent mechanism with a reliable system of guarantees. Futures is a standard contract. Manipulations in financial markets are prosecuted under law. The large number of participants having various interests additionally hinders manipulations. If a futures contract is a deliverable one, a reliable connection between the futures and physical markets is established.

Conclusion: a deliverable futures contract is the best tool to create the Russian oil benchmark.

# 2

## Participants of the Futures Market – Who are They?

The oil futures market belongs not only to **oil companies, trader buyers and oil refining companies**.

Over recent years the global oil futures markets have attracted a large number of **financial participants**, including **swap dealers, pension funds, hedge funds, index investors, technical traders and retail investors**.

The large number of the participants with significant capitals and various interests stabilizes the market, hinders manipulation and in the long run creates a fair pricing mechanism.

Conclusion: it is possible to say that without stock futures contracts one cannot “identify” or determine the oil price within the current pricing system.

# 2

## Advantages

### of Oil Deliverable Futures Contracts

**Advantages of oil deliverable futures contracts** traded in the SPIMEX underlie the Russian export oil pricing:

- Oil pricing based on the futures price – **global standard**.
- Futures is **performed through oil delivery**, which establishes connection with the physical market and hinders price manipulation.
- The futures market **is regulated by the Bank of Russia**.
- The price is determined according to the Russian stock site rules.
- The futures is **standardized**, all conditions of the contract are known.
- Standard mechanisms of the financial market: **clearing, risk management system, central counterparty**.
- The stock pricing based on the balance of the demand and offer of a large number of participants **united** in a single site determines the **most fair price for goods**.

The physical oil market (the short forwards market) is a convenient method of allocation of particular physical deliveries among buyers and sellers. A stock market like this shall also exist, but the pricing role is performed by another market – the futures market deemed the most suitable site for such purposes due to its characteristics.

**The connection between the physical and futures market is secured by delivery and EFP mechanisms** (as shown below).

# 2

## Parameters

of Oil Futures in the SPIMEX

Type	Futures contract
Performance of the futures contract	Physical oil delivery
Underlying asset of the futures contract	Russian export oil
Terms of delivery	FOB Primorsk/Ust-Luga
Scope of one contract	1,000 barrels
Deliverable lot	720,000 barrels (100 thou tons)
Currency of the contract	The initial stage of the project – USD (further – Russian rouble and other currencies)

Launch in the Russian stock site CJSC SPIMEX of the deliverable market contract is the most efficient method to fix the market price for the Russian oil without reference to other oil flows.

# 2

## The Issue of the Quotation Currency

of Oil Futures Contracts in the SPIMEX

Why it is suggested that the quotation at the first stage of the project be denominated in US dollars :

- To ensure successful start of the project, **attraction of the maximum liquidity** in the stock exchange is required;
- It will be **impossible** to attract a large number of foreign participants if their entrance a new market is associated with **additional risks and expenses**;
- If the oil futures quotation is denominated in roubles, foreign participants will face such problems **as currency risks, rate volatility, the need to obtain rouble liquidity**;

The proposes solution:

- **At the first stage of the project** – the futures quotation shall be denominated in **US dollars** as the **global standard** for marker grades;
- Then **attraction of foreign participants and liquidity inflow to exchange auctions** shall be secured. Russian oil futures are deemed a global **benchmark**.
- **At the second stage**: having the reputation of the recognized global benchmark and using the created liquidity, it possible to launch futures with **alternative quotation currencies: Russian rouble, Euro, RMB**.

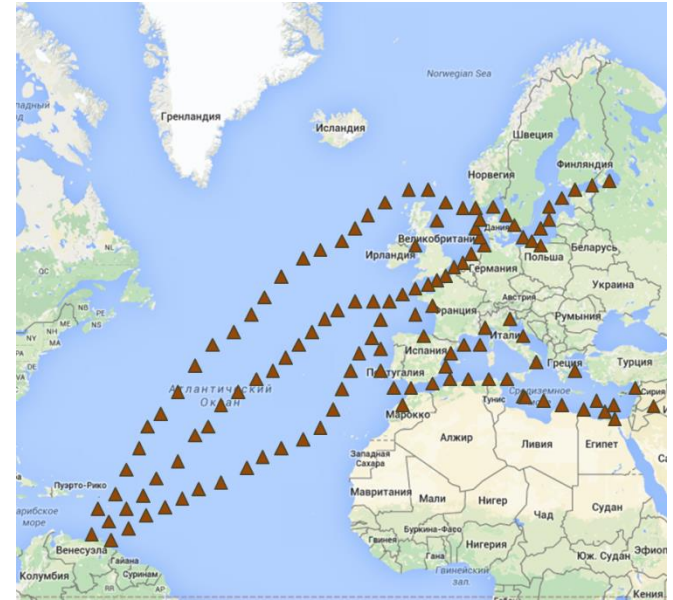


# 2

## Why shall Urals

Exported via the Baltic Ports be Used to Fix the Russian Oil Price?

- The oil delivered from the Baltic parts is the bets option for use as a basis for valuation of deliveries via two other main routes – via the Kozmino port and via the Black sea.
- The oil delivered via the Baltic ports can compete with deliveries of Brent to Far East where ESPO is delivered from the Kozmino port, and to Mediterranean where Urals is delivered from the Black sea ports.
- Pricing in such markets (Far East and Mediterranean Sea) can be based on the spread trading between them and the Baltic ports – this is the most popular and efficient pricing method in the global oil trading market.



Export from Primorsk



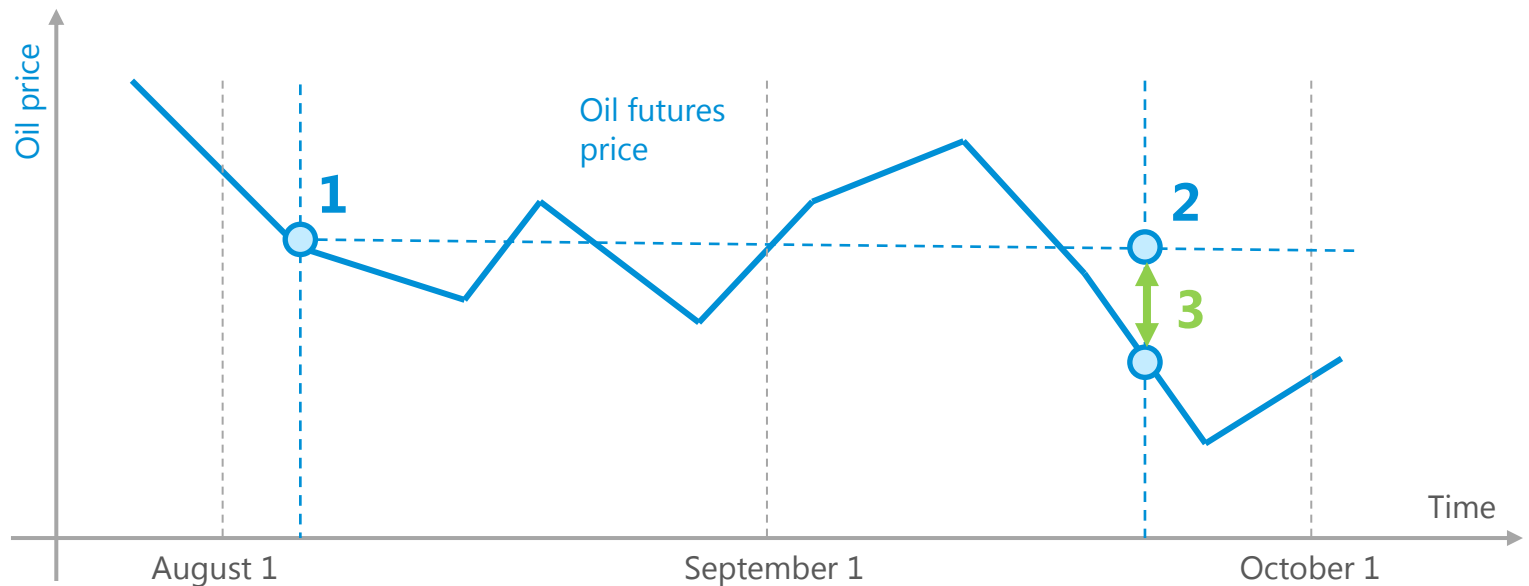
# How Can Russian Export Oil Futures Be Used

# 3

## How can Russian Export Oil Futures

Be Used

A futures contract is a method of the **price fixing in the future**. Manufacturers use sale of the deliverable futures is to **manage the price risk**.



1. The Russian oil company (ROC) sold in August a fixed futures deliverable in September.
2. The ROC shipped goods in September and received the payment at the price fixed in August.
3. After sale of the futures the financial result of the ROC does not depend on the oil price at the moment of delivery.



# 3

## Why is it Profitable to Use Futures?

For Russian Oil Companies (ROC)

- A ROC selling futures **takes part in the Russia oil pricing** instead of accepting the market price.
- The futures price **has no reference to any oil flows** other than the Russian one.
- Unlike the complicated structure of the risk arising from pricing based on the Dated Brent formula, **risks in the futures market are clear and easy-to-manage**.
- Futures is a convenient method to **manage a company's budget**.

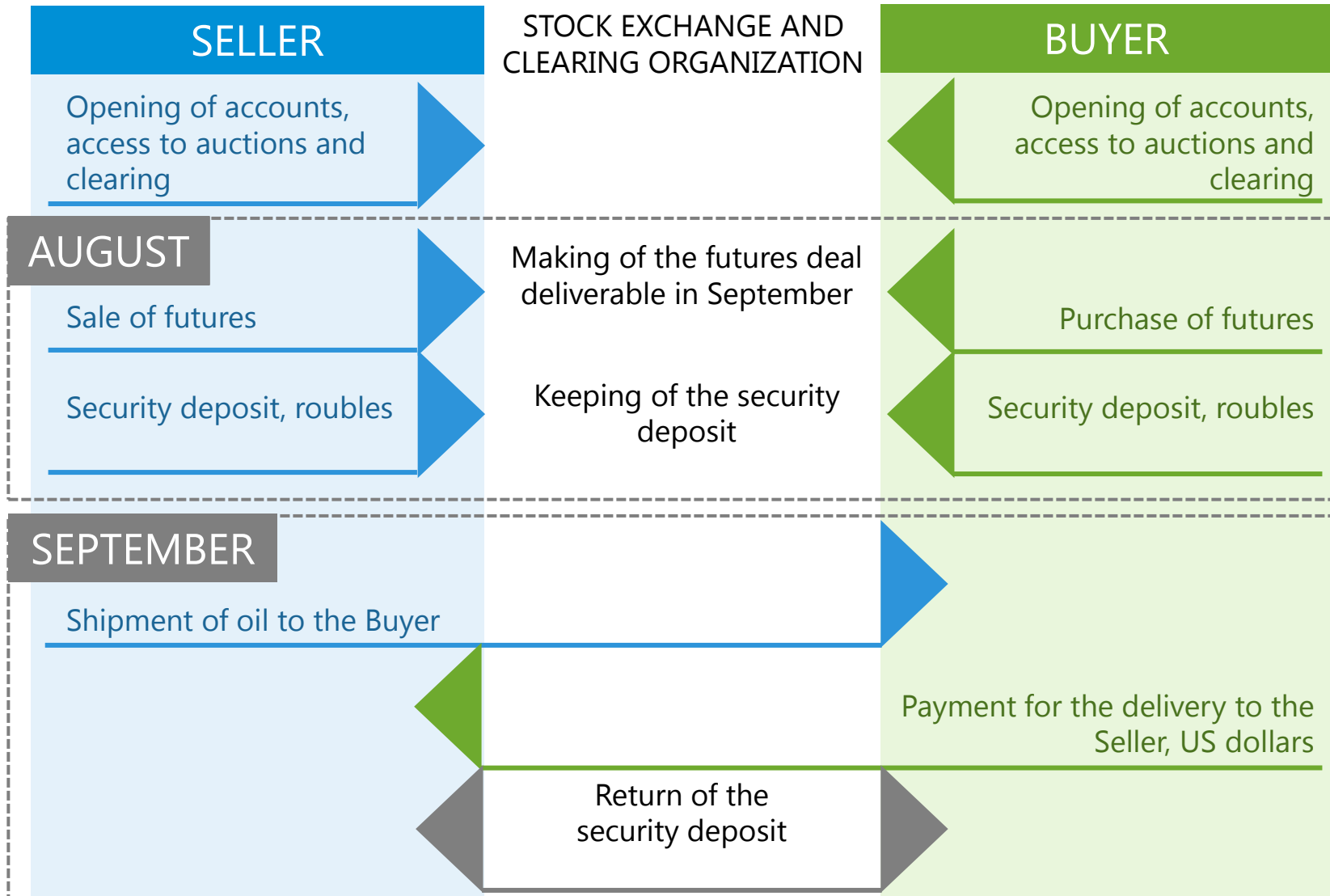
A deliverable futures is a method of fixing a fair price for the Russian oil with participation of manufacturers. Without any distortions or manipulations.



# 3

## How shall a Futures

with a Fixed Delivery Price be Used?



# 3

## Why is it convenient to Use Futures?

For Russian Oil Companies (ROC)

- After sale of the futures in the volume of the tanker lot, **physical delivery of oil will be effected.**
- All major ROC (OJSC OC Rosneft, OJSC Gazprom Neft, OJSC OC LUKOIL, OJSC Surgutneftegaz, etc.) **already participate in exchange auctions in petrochemicals** in the SPIMEX and this experience is deemed successful
- Oil delivery under a futures contract will be effected **using 'General Terms of Delivery'** of the customary conditions of the oil export deliveries agreed by the Stock Exchange and Russian oil companies

For the oil companies to participate in the export oil futures trading, no principal reconstruction of the business process will be required.



# 3

## Methods of Deliveries Management

under a Futures Contract

A Russian oil company (ROC) making a futures contract in the stock exchange may:

1. Upon expiry of the contract, delivery oil under standard conditions to the **buyer nominated by the stock exchange**.
2. Upon expiry of the contract effect an addressed oil delivery under standard conditions **to the buyer at the option of the ROC** (addressed delivery).
3. At any moment effect an addressed oil delivery **to the buyer at the option of the ROC**, including under non-standard conditions through the **Exchange of Futures for Physicals procedure** or EFP Procedure).

The futures market combines physical deliveries and transparent pricing with flexible abilities of sellers to nominate counterparties for deliveries



# 3

## Retention of the Pricing Scheme

for Russian Oil Companies (ROC)

A Russian oil company (ROC) may participate in the futures market retaining the delivery price reference to the floating oil price (i.e. retain the customary pricing scheme):

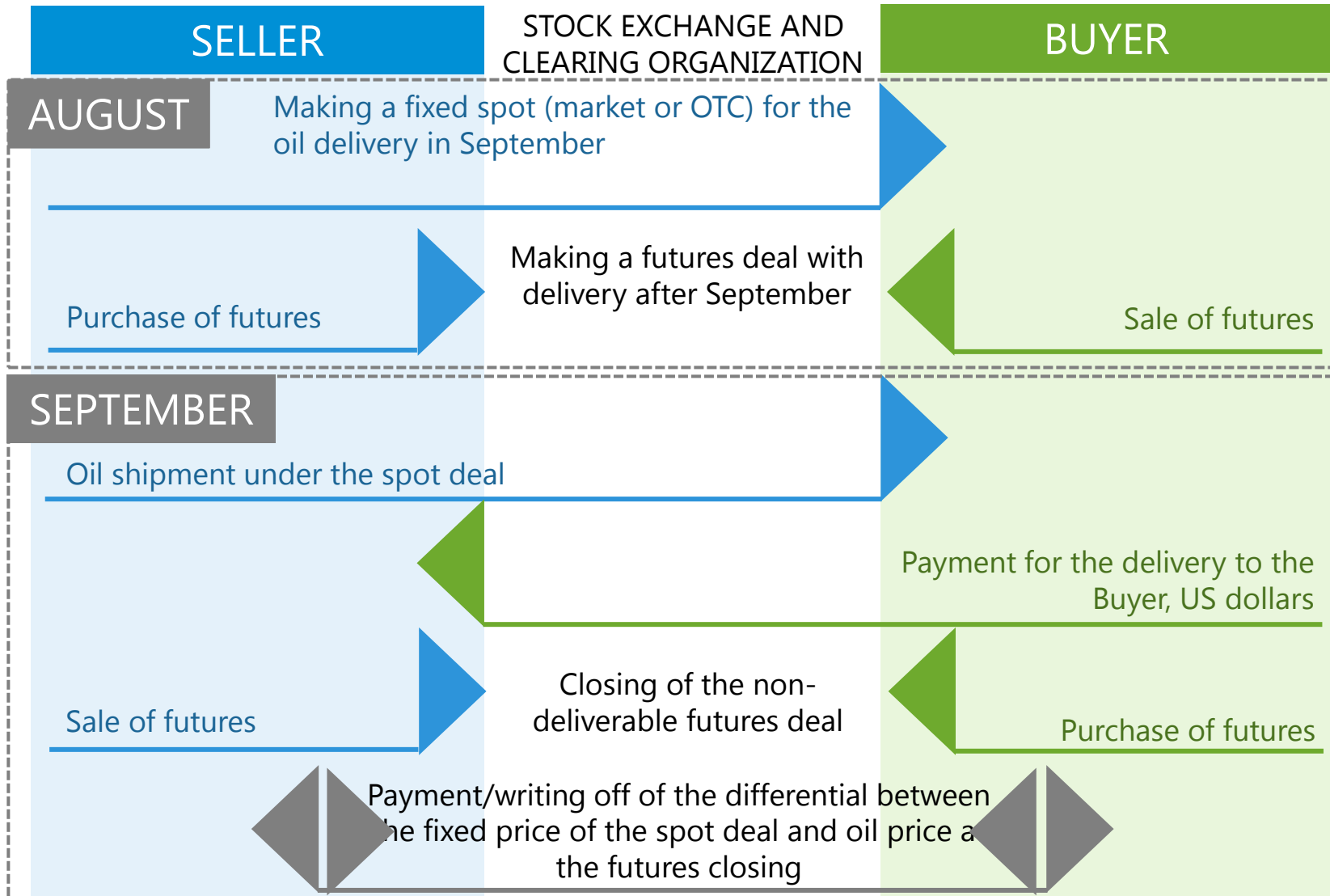
1. ROC makes a **spot oil delivery contract** (market or OTC).
2. Then ROC **makes a reverse futures deal** for the same volume of goods (**purchases a futures contract** from an oil buyer under a spot contract).
3. Financial flows from futures (credits in case of the price increase and debits in case of the price decrease) **ensure dependence of the physical delivery price on the current oil price**
4. Upon completion of the physical delivery, futures positions are closed by a reverse deal.

Due to such combinations of the deals, ROC will effect deliveries at the prices depending on the oil price effective at the moment of the delivery (like in the current practice used by ROC).

# 3

## Retention of the Pricing Scheme

for Russian Oil Companies (ROC)



# 3

## Conclusion

For the Russian oil companies creation of the oil benchmark is a unique opportunity to independently fix the price of the export oil along with retention of the customary procedures of the physical delivery and flexible selection of counterparties, as well as to effect the global oil pricing and to gain a dignified position in the market.



# 4

## Implications of the Oil Benchmark Creation

for the Market in General and for the Russian State

1. **Elimination of price manipulations** and **undervaluation of the Russian oil** through a transparent and easy-to-understand pricing mechanism.
2. **Reduction of discounts** through publicity and general availability of the price information about real deals.
3. **Simple and efficient management of risks** of oil companies ensuring more efficient funds management.
4. A more precise **calculation of the customs duty**.

The financial result of the benchmark creation means additional income for oil companies and budget of the Russian Federation.





# 4

## Steps to the Creation

of the Russian Oil Benchmark

Stages of the Russian Oil Benchmark project implemented by **SPIMEX**:

1. A **concept and plan of the benchmark implementation** developed.
2. **General Terms of Delivery under Deliverable Futures** agreed with oil companies.
3. **Trading Rules and Specifications** developed.
4. Training of the auction participants, technical implementation and game auctions – Q III-IV 2015



# 4

## Steps to the Creation

### of the Russian Oil Benchmark

The success of this program depends on the implementation of a complex of measures **to strengthen the stock exchange infrastructure** and **to ensure its international positioning**. In particular:

- improvement **of the software and hardware complex** of the stock exchange and clearing organization. Provision for the compliance with international standards.
- **Promotion and marketing of new stock exchange instruments** at the international level;
- Insurance of the **risk management system** compliance with the best international standards;
- **Increase of the level of capitalization** of the stock exchange holding and its recognition by international traders and regulators.



# 4

## Interaction with Federal Executive Authorities and Infrastructure Entities

For the project to succeed, a **coordinated interaction** of the federal executive authorities, Bank of Russia, oil manufacturers, settlement banks and a wide number of foreign and Russian traders, as well as solution of a number of issues going beyond the competence of the Stock Exchange will be required:

- taking decisions by the Government of the Russian Federation on the issue of **the oil quality stabilization** within the oil-trunk pipeline system;
- synchronization of the procedure for the formation and publication of **export and position schedules** with the procedures for the exchange commodity delivery following results of exchange auctions;
- transfer to use by the federal executive authorities of the **price information** (stock exchange quotations) of the Russian commodity and raw materials stock exchange for calculation of duties, taxes and other obligatory payments;
- making relative **changes to the current normative legal base** in the area of the oil stock exchange trading, to the tax and customs laws;
- introduction into the commercial practice of the Russian oil companies of **general terms of delivery**, preparation for operations in the futures and options market of the stock exchange, implementation of risk management systems;
- implementation of the **market participants incentives program** to ensure liquidity in the exchange oil market to set up a new price benchmark.

# 4

## Steps to the Creation

of the Russian Oil Benchmark

Steps to be effected by **SPIMEX** under the project:

1. Provision for the **project support** on the part of the Government and concerned ministries.
2. Marketing **promotion of the Russian oil benchmark** among national and foreign market participants. Organization of the road show, training events, game auctions.
3. **Modernization of the stock exchange and clearing infrastructure** and of the normative base in line with the project requirements.
4. Implementation of the project road map. **Achievement of the initial liquidity and launch of the trading.**



## Detailed Schedule of the Export Oil Pricing Project Implementation

<b>Task</b>	<b>Commence ment</b>	<b>Completion</b>	<b>Notice</b>
<b>Preparatory measures</b>			
Set up of the working team with the Ministry of Energy	June 2014	June 2014	Performed
Identification of the project concept, plan of operations	June 2014	September 2014	Performed
<b>Creation of the basic conditions of the export oil stock exchange market</b>			
Development of the General Terms of Delivery of the Russian oil	September 2014	November 2014	Performed
Provision of the project support on the part of the Government and ministries	November 2014	October 2015	
<b>Modernization of the stock exchange and clearing infrastructure of SPIMEX</b>	September 2014	April 2016	
<b>International positioning of the stock exchange holding</b>	April 2016	December 2016	
<b>Provision of the technical readiness of the Stock Exchange and clearing</b>			
<b>Preparation of regulatory documents:</b>			
Rules of formal market and clearing	December 2014	August 2015	Performed
Futures specifications	December 2014	August 2015	Performed
Other internal regulations	August 2015	November 2015	
<b>Provision of the basic technical readiness</b>			
Improvement of the software and hardware complex	March 2015	August 2015	Performed
Testing of the software and hardware complex	August 2015	October 2015	
Launch of test auctions	October 2015	December 2015	
<b>Creation of the primary pool of traders</b>	October 2015	December 2015	
<b>Promotion and marketing</b>			
<b>Holding of theoretical and practical training seminars</b>	October 2015	May 2016	
<b>Translation of rules and other documents</b>	August 2015	December 2015	
<b>Road show as per the list of exporters and Russian banks and brokers</b>	December 2015	April 2016	
<b>Acceptance and access of traders</b>	August 2015	April 2016	
<b>Readiness to the auction launch using the basic benchmark model</b>	Q III 2016		
<b>Analysis of the results of the 1<sup>st</sup> project stage, making adjustments</b>	April 2016	October 2016	
<b>Development of the tools of the benchmark basic model through spot contracts</b>	April 2016	October 2016	

## 4

## Parameters of Deliverable Futures for the Russian Export Oil in the SPIMEX

Type	Futures Contract
Futures performance	Physical oil delivery
Underlying asset of the futures	Russian Export Blend Crude Oil
Terms of delivery	FOB Primorsk/ Ust-Luga/ Kozmino
Volume of one contract	1,000 barrels
Deliverable lot	1. 720,000 barrels (100 thou tons) for FOB Primorsk/ Ust-Luga 2. 750,000 barrels (100 thou tons) for FOB Kozmino
Contract currency	US dollar (further – rouble and other currencies)
Futures quotation	USD/bar
Variation margin	In roubles at the CB rate
Initial margin	In roubles (or partially in a currency or bank guarantees)
Last trading day	First business day preceding the fifteenth calendar day of the month preceding the first day of the month of delivery
Day of the futures performance	Last trading day of the futures
Period of delivery under the futures	Month following the month of the futures execution