

Electronic Gas Trading in Russia – Next Steps Towards Deregulation?



Adam Smith
Associate

Adam Smith

White & Case LLC, Moscow

On 7 June 2008 the CEO of Gazprom Aleksey Miller announced at the St. Petersburg International Economic Forum that Gazprom is planning to launch a new exchange for international trading in natural gas futures. The St Petersburg International Commodity Exchange is expected to open in 2009, and is intended to work in parallel with Russia's electronic gas exchange for the domestic market, the Mezhrefiongaz exchange.

The development of electronic gas trading in Russia heralds possible future market deregulation and harmonisation of domestic and international pricing; Gazprom was first allowed to sell gas on the exchange at market prices on an experimental basis in 2006, and it was announced in February 2008 that this experiment could be put on a permanent footing.

Background

In contrast to the electricity sector, where the process of unbundling and deregulation is well-advanced, the Russian internal gas market remains dominated by a single vertically-integrated supplier (Gazprom) and heavily regulated.

Most of the natural gas which changes hands on the wholesale market within Russia does so at regulated tariffs.

The regulatory regime for the Russian gas market focuses on the industry giant, Gazprom, which occupies a unique position in the legal framework. On the one hand, Gazprom enjoys a legal monopoly on most gas exports from Russia, guaranteeing it a major revenue stream from sales of gas to Europe¹. On the other, at least until recently, the entirety of Gazprom's gas sales on the domestic market have been subject to regulated tariffs set by the Federal Tariff Service (FTS). In contrast, independent gas producers have been able since 1998 to sell their gas at market prices freely negotiated with customers.

Major independent producers of natural gas in Russia include the major oil companies, such as LUKoil and Rosneft, as well as gas specialists, such as NOVATEK and Itera. Independents account for about 14% of Russian production, with the remainder being produced by members of the Gazprom group.

Electronic Gas Trading in Russia – Next Steps Towards Deregulation?

Under the regulated tariff system, differential wholesale tariffs are set for gas destined for industrial use and domestic consumers, further broken down by reference to sixty-seven tariff zones, most representing a constituent Subject of the Russian Federation. However, gas supplied by Gazprom onto the market at regulated tariffs is insufficient to meet domestic demand, so there remains a need among users for additional quantities of gas at market prices.

Gas Pricing Policy and the Move Towards Deregulation

Historically, in order to protect domestic industry and consumers, gas tariffs have been set at levels which have not allowed Gazprom to make a profit on domestic sales; as a result Gazprom has in effect subsidised the Russian domestic sector on the back of its export business.

This is now changing. The Russian government's aim is that, by 2011, domestic wholesale tariffs will be set at a level where their profitability for Gazprom is equal to that of its foreign exports (taking into account transportation and customs costs). As a result, Gazprom is expected to make a profit on domestic gas sales for the first time in 2008.

This gradual increase in wholesale tariffs is intended only as the first step towards possible future deregulation. In particular, by the end of 2008 the Russian Government is due to make a proposal for the transition from regulation of wholesale gas prices to regulation of transmission tariffs alone, to come into force with effect from 1 January 2011. (The year 2011 will therefore be doubly significant for downstream energy deregulation in Russia, in that it also marks the expected full marketisation of electrical power prices.)

The Mezregiongaz Exchange and the "5+5" Experiment

The Mezregiongaz Exchange was opened in 2002, and is run by the Gazprom subsidiary of the same name. The exchange's stated objectives include:

- to reveal an equilibrium price for gas, so as to form the basis for long-term investment strategies;

- to form a mechanism for creditworthy buyers to obtain additional volumes of gas, with guaranteed access to the Gazprom transmission network for their delivery; and
- to establish an effective trading system for the disposal of significant quantities of gas.

Within the Gazprom group, Mezregiongaz is the holding company of a large number of local supply companies, and so is in effect the main supplier of gas to end users in Russia. In this capacity Mezregiongaz itself has an active interest in the market, in that its subsidiary supply companies count among the buyers on the system. However, because of Gazprom's regulatory status, until 2006 only independent producers were able to sell gas on the exchange.

By a government regulation of September 2006², Gazprom was for the first time allowed to sell a limited amount of gas on the domestic market at unregulated prices, through the Mezregiongaz exchange. The basis for this is the so-called "5+5" formula, whereby Gazprom is allowed to sell up to 5 Bcm of gas through the exchange, provided that the amount sold by Gazprom cannot exceed the amounts sold by independent producers. As such, the exchange now represents a significant, but tentative, step towards broader price liberalisation. The first trading session under the 5+5 experiment took place in November 2006. Alexei Miller commented in St Petersburg that Gazprom views electronic trading on the exchange as one of the instruments for assisting Russia's transition to market pricing principles.

How the Mezregiongaz Exchange Works

Currently gas may be traded through the Mezregiongaz system under one-month and ten-day contracts, with the gas to be supplied evenly over the delivery period. In order to trade, buyers and sellers must have submitted an application to Mezregiongaz by the 1st of the month preceding the month of delivery and, once accepted, sign an agency agreement with Mezregiongaz. In respect of the monthly contract, trading taking place between the 15th and the 20th of the month.

The unit of trade is 100 thousand cubic metres of gas. Participants submit their respective bids

Electronic Gas Trading in Russia – Next Steps Towards Deregulation?

for the supply and purchase of gas electronically, and the resulting bids are made available to other participants in an anonymous form. The system automatically matches buyers and sellers whose offers coincide, and removes them from the list of bids open for acceptance by other users. It is only when bids are matched that the system notifies the buyer and seller of the identity of the counterparty.

Following completion of the trading session, the buyers and sellers whose bids have been matched are required to sign a standard form paper gas supply contract reflecting the agreed quantities and price. Mezhrefiongaz takes a commission of 1 percent of the value of the gas at the delivery point from each of the buyer and seller.

Payment for the gas is in advance, so the seller is not exposed to credit risk. The standard form contract is on a take-or-pay basis, in that the full price of the gas must be paid whether or not it is in fact taken.

Transmission Issues

Russia has already taken some significant steps towards liberalising the gas market, in that Gazprom is required to provide third party access to spare capacity in its transmission network to independent gas producers, under a system of regulated transmission tariffs set by the FTS. (Roughly 115 Bcm of independent producers' gas was transported through Gazprom's network in 2006.) One of the objectives of the electronic trading system is to streamline the process for accessing Gazprom's network.

Users of the exchange have a choice of three delivery points (or balancing points) for the gas bought and sold, being three compression stations located near to the main gas producing areas in the Tyumen Oblast' (Yuzhno-Balykskaya, Vyngaporovskaya and Nadym). Title to and risk in the gas passes from seller to buyer at the balancing point chosen.

Under the exchange's procedures, Gazprom's Central Production and Dispatch Department gives advance notification of the available transmission capacity in the network along the main routes from the balancing points to the outlets into local gas distribution networks, and Mezhrefiongaz passes this information on to the

participants. Once the available transmission capacity is reached for a particular routing, the trading session is terminated for that routing. In this way, when a sale and purchase transaction is concluded through the system and the gas sale agreement is signed, the parties know that (barring *force majeure* circumstances) the necessary transmission capacity will be available for delivery to take place.

Transmission from the seller's entry point into the Gazprom system to the buyer's point of offtake is organised by Mezhrefiongaz on the parties' behalf under the terms of the agency agreement, at the parties' expense. The seller to pay for transmission of the gas from the seller's entry point into the Gazprom system to the relevant balancing point, and the buyer for transmission thereafter. Payment is on the basis of the transmission tariffs published by the FTS, based on the cost of an *average* routing between the relevant start and end points, so preventing any discrimination by choice of routing.

Prices

During 2007, the price for gas on the exchange (as delivered to the relevant exit point from the transmission system into local distribution networks) varied in a range of approximately 23 – 45% above the average regulated wholesale tariff for industrial consumers in the corresponding region, with the overall mean figure for the year being 37%.

However, as a result of high demand caused by cold weather, prices hit record levels in the early months of 2008 (during February as high as double the level of the regulated tariffs). This experience exposed a weakness of the regulatory system which has had a distorting effect on the market. Under the system of regulated gas tariffs, if a customer of Gazprom exceeds its agreed offtake level it must to pay a penalty of 50% over the regulated tariff. The difficulty experienced by Gazprom in early 2008 was that the market price of gas on the exchange exceeded even the penalty tariff, with the result that users chose to offtake unauthorised quantities, rather than to buy gas on the market. As a result, Gazprom had to introduce more gas into the system to compensate for the unauthorised offtake, and withdrew from trading on the gas exchange, citing the resulting unavailability of spare gas to trade. Gazprom is

Electronic Gas Trading in Russia – Next Steps Towards Deregulation?

understood to be lobbying the government for an increase in the penalty tariff in the light of this experience.

Buyers and Sellers on the Exchange

Recent participating sellers on the exchange have included LUKoil, ROSNEFT, NOVATEK and Itera, as well as Gazprom. The number of buyers is much larger, including local gas supply companies (Peterburgregiongaz, Volgogradregiongaz, and a number of others), industrial users (including cement and metals concerns), and the electricity generation sector, with the recently formed independent generation companies (OGKs and TGKs) being well represented.

Future Developments

Mezhregiongaz is understood to be consulting with its users on the introduction of day-ahead trading, (in addition to the existing month and ten-day contracts). It had been hoped to launch day-ahead trading in the Spring of 2008, although the response from users has delayed its roll-out; the independent generators, in particular, are believed to prefer a two-day ahead system, in order to allow them to have concluded their gas purchases before trading on the day-ahead power market.

The volumes of gas sold on the exchange are still small, at less than 2% of the gas produced in Russia. However, Mezhregiongaz is understood to be planning to increase sales on the exchange to 15 Bcm in 2008, compared with 10 Bcm in 2007 (with Gazprom and independent producers accounting equally for 7.5 Bcm). Meanwhile, in February 2008, the Russian Government announced that a proposal is being prepared for Gazprom to be allowed to sell gas on the Mezhregiongaz exchange at market prices on a permanent basis. A working group has been set up, which is due to report in September 2008.

Adam Smith

Adam has broad experience with corporate and commercial transactions in the energy and technology sectors. Adam has advised on M&A transactions, joint ventures, and a range of commercial arrangements, including process technology licenses and fuel supply agreements. Prior to joining White & Case in 2008, Adam worked as an associate at an international law firm in London for over ten years. Adam graduated from Oxford University (B.A. History, 1993) and York College of Law (CPE and LPC, 1995), and has obtained a LLM in petroleum law at the University of Dundee. He is qualified to practice law in England and Wales.

- 1 Article 3 of the Law on the Export of Gas of 18 July 2006, No. 117-FZ
- 2 Regulation No. 534 of 2 September 2006 on the Conduct of an Experiment for the Sale of Gas on an Electronic Trading Platform.