

# Commencement of Black Gold Futures in Russia

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Here is a great reason to consider the day of June 8, 2006 as the commencement of a new era in the Russian oil market. According to an announcement made by the Stock Exchange RTS (Russian Trade System), its division of futures and options FORTS\* will begin trading futures and options contracts on Russian oil Urals and Urals oil products such as diesel fuel, jet fuel and crude oil for the first time in Russia trade history.<sup>1</sup>

The main stipulations set up by RTS are that all transactions must take place in rubles; the maturation of futures and options contracts is fixed at one month; contractual payments with settlement in July of 2006 up until June of 2007 will begin trading at the same time; the commitment guarantee is fixed at 5% of the contract value while the margin requirement is set at 10% of that value; the Exchange fee will be set up as one ruble per contract; and under a recently signed contract with RTS, Platts, a division of the U.S. based McGraw Hill Co., will be the provider of the licensed oil pricing data for the underlying asset.

The latest news is that the underlying asset will be the Urals blend of crude oil, one of Russia's top blends whose name alone brings to mind its Russian roots. Urals is oil that is not just extracted from territory of the Russian Federation, but it is also the country's most widely distributed.

The legal developments that mitigated the revisions on the Russian Exchange and the improvements of the legal regulation of the Russian oil market is another question worthy of note. Without a doubt, where there is oil, there is politics, and the analysts of the Alfa-bank group have drawn the conclusion that the increased attention that is being given to the oil and gas markets is politically charged.<sup>2</sup>

President Vladimir Putin has more than once stressed the importance of Russian oil and its fair pricing for the stability of the national economy. In the late spring of 2006 Russian senators dis-

cussed the different alternatives for regulating oil pricing and initially suggested two bills. The first draft set up a state-controlled mechanism of price regulation, including retail price. The second proposed an extraction tax, and an export duty on oil. In the third draft, senators suggested that the key to stabilizing the oil price is to increase the liability for a breach of Russian antitrust law in the oil markets.<sup>3</sup>

Another point of view is that the reason for the inflation of oil prices was legal in nature. The Deputy Minister of Economics, Kirill Androsov, stressed that international pricing and the currency supply volume are the main causes of the inflation.<sup>4</sup> Obviously it seems as though the time has come for Russia to build a flexible and competitive domestic oil market.

Thus far, trading of Urals crude oil in Russia, instead of the most widespread Brent oil, hasn't had the chance to influence either the domestic or global price of oil. Some financial analysts believe that the news regarding the trading of oil futures in Russia will not reduce the price gap between Urals and Brent.<sup>5</sup> At the same time, the question of whether Brent or Urals should have priority is a topic of concern not only for Russia. Experts' projections that the availability of Brent oil will not be quite enough to meet the bullish demand is a worrisome topic for many, and one that is full of potential consequences for global industry. However, many believe that despite Brent's command over the market, it is not capable of controlling pricing across the domestic and world markets.

There has been unavoidable debates over

\* FORTS, Futures and Options on RTS was founded by the Stock Exchange RTS and the Stock Exchange "Sankt-Petersburg" in September, 2001.

<sup>1</sup> There is not only Russian organized market is interested in trading of Urals extracted in Russian Federation. Regarding foreign and international markets the plans to begin trading in Russian oil futures in fall, 2006. See "Your Own Way" by Dmitry Butrin// "Kommersant", April, 14, 2006, www.kommersant.com.

<sup>2</sup> Monthly survey of the markets № 65. www.alfabank.ru.

<sup>3</sup> Igor Efimov, The Federal Council of RF worries of the increase of the oil prices, March, 03, 2006. The publication on the web-page Страна.Ru (Strana.Ru).

<sup>4</sup> Igor Efimov, The Federal Council of RF worries of the increase of the oil prices, March, 03, 2006. The publication on the web-page Страна.Ru (Strana.Ru).

whose oil should be chosen as the standard by which other oils are priced. Leading blends of crude oil such as Urals, WIT, Brent and other premium blends are among the top choices, Urals has every opportunity to become a benchmark in the world oil market, according to Platts, because of its increasing production, widespread popularity, and high quality in comparison to other oil blends.<sup>6</sup>

The Russian government has plans to form a trading platform spot trading in about a year and a half.<sup>7</sup> Thus, it would be beneficial to examine the onset of trading of futures and options contracts on oil and oil products concurrently with the upcoming opening of a spot market.<sup>8</sup>

It is widely known that all over the world spot markets take precedence over futures markets. The legal regulations of organized markets, including exchanges, develop in the same way. Currently, "around the world futures markets have an influential role on all other organized trade markets, including exchange markets," says the Director of the National Commodity Exchange Co. Sergey Naumov.<sup>9</sup> It is well known that the world futures markets are enormous. To put things in perspective, there are times that the US futures markets surpass its gross domestic product.

As organized markets continue to grow in Russia, it would be beneficial to take into consideration the experiences of other organized markets in different parts of the world. Recent bills from the State Duma demonstrate this. On March 23, 2006 the State Duma passed Act № 2940-IV ГД. It establishes the bill "Concerning Amendments to the Laws of the Commodities and Exchange Trade".<sup>10</sup> The bill provides that the government control of the organized markets in Russia will be carried out by the Federal Service on Financial Markets of the Russian Federation. In addition to

the overall supervision of commodity exchange activity, state regulation also applies to the licensing of exchanges, exchange brokers, and agents making commodity futures and options contracts. This bill and the concerns of the RF about oil pricing on the national markets and those abroad are promising signs. According to the figures of FORTS, the futures and options markets demonstrated impressive growth; the volume of FORTS' markets was 22.5% higher in June than it was in the previous month.<sup>11</sup> The reason for this is the arrival of the Urals futures on the RTS markets, marking the first time Urals has been traded on the world market. Another reason is the strong attention being given to this sector by key players in the Russian financial market. Yet, the volume of the Russian derivatives markets and the number of financial instruments are much less in comparison with other global markets. The FORTS futures and options contracts on oil and oil products such as diesel fuel, jet fuel, and crude oil are now among the 15 that are being traded on the most developed futures markets in Russia. "It took several years just to work out the new types of futures on the domestic market", according to Roman Gorunov, the vice-president of the Stock Exchange "Russian Trade Systems". He stressed "the absence of legal regulation of futures and options contracts in Russia law".<sup>12</sup> The legal aspects, including the mindset of the state authorities, leaves much to be desired. In terms of organized markets of this vast country, current legislation needs to be reviewed and modernized. In terms of the futures and options markets, the legislation that is most important to Russia at this time concerns the regulation of the national markets of derivatives.

The government of the RF acknowledged this in its program for social and economic development from 2002-2004, and pointed out the shortcomings in financial law and in the regulation of the futures markets.<sup>13</sup> The "watchdog", the Federal Service on Financial Markets, agrees that there are improvements that should be made in the regulation of the futures markets. They affirm that passing the derivatives regulations will allow Russian markets to compete with other futures markets around the world.<sup>14</sup> We can see that the opinion has changed from what it was previously. In 1999 the capital markets were lacking in legal defense for derivatives market cases. that depriving the participants' of capital markets right of the legal defense on cases for.<sup>15</sup> In 2002, the constitutional court formally recognized a one type of derivatives contract, the forward contract, [which] is a type of contract in which payment can be de-

<sup>6</sup> www.platts.com.

<sup>7</sup> Spot – the cash commodity, the actual physical commodity, sometimes called actual. From "The Glossary of Terms" of the New York Mercantile Exchange "Glossary of terms", www.nymex.com.

<sup>8</sup> About some issues concerning a criticism of present pricing system is based exchange trading in American WTI and North Sea Brent types of oil and the pricing gap between them and Urals see "Your Own Way by Dmitry Butrin" // "Kommersant", April, 14, 2006, www.kommersant.ru.

<sup>9</sup> Interview with Director of the National Commodity Exchange Co. Sergey Naumov.// "MICEX Bulletin" № 8(22) 2005.

<sup>10</sup> Russian Law Database "GARANT". File for the bill the bill N 219131-4 "About to bring in the Law of RF "About Commodities and Exchange trade" and "Code of the violation of the Administrative Law" (regarding to hand over Commodity Exchange Commission to Federal Service on Financial Markets).

<sup>11</sup> *Alexandr Patrikeev*. I ask to exercise. Business-Week Russia. 26.06.2006.

<sup>12</sup> Conference "The prerequisites of the forming the international commodities markets in Russia", Moscow, June, 11, 2006. The official web-page: www.finmir.ru.

<sup>13</sup> Decree of the Government of RF on July, 10, 2001, "About program of the social and economic development of RF...in 2002-2004".

<sup>14</sup> Passing the derivatives regulations will allow Russian markets approach to worldwide average. Official web-page of the Federal Service on Financial Markets of Russian Federation www.fcsm.ru.

<sup>15</sup> See: Decisions of the Highest Arbitrazh Court of the Russian Federation N 5347/98 on June, 8, 1999

ferred over a certain period after which the contract can be settled... Risks on such contracts cannot be considered a regular business risk".<sup>16</sup>

At the same time, the court recognized that regulation by Russian Civil Law was lacking, and that there was no clear criteria for distinguishing a derivatives contract from mere gambling, for example. Can we blame the judicial system for their inability to carry out the responsibilities of the legislative branch of the state power? Who is responsible for creating the legal infrastructure for futures contracts markets? The Constitutional Court judge Gadzhiev reveals in his dissenting opinion that although economic courts cannot fulfill legislative responsibilities, they can at least offer understanding and support of new economic trends.<sup>17</sup>

Lawmakers' silence is not helpful in terms of encouraging courts to change its policies for handling the legal investigation of futures contracts. The decision of the Moscow Federal Arbitrazh Court (FAC) in August of 2005 didn't help the situation. Futures contracts were once again compared to gambling, which is regulated by article 1062 of the civil code of the RF and is not protected under the law. As Olga Pleshakova notes, this decision aggravates the problem, and makes it more difficult to hold parties liable for the breach of a futures contract and pursue much needed legislation to reform the legal policy for the handling of such contracts.

The Moscow FAC summarized that in the absence of a legal defense for futures contracts, all cases would result in a mistrial. Seven years earlier, the case would at least have been heard, but could not, however, have been won because of the what the court explained as a lack of evidence that in the case of futures contracts, obligations are set up with an economic purpose and it is not analogous to gambling.

Since January of 2001, Russian tax law has provided regulation for taxation derivatives under article 301 of the tax code.<sup>18</sup> The fact that the Tax Law served as the incentive to provide legislative regulation of derivatives markets was a topic of controversy because under a strict interpretation of legal theory this would be a systematic error. Before dealing with the semantics of tax law, technically there should be laws that deal directly with the regulation of the derivatives. However, the good that came from article 301 was that it led to the first legal definition of derivatives: derivatives transactions are interpreted as agreements binding two parties to a contract relating to the exchange of an underlying asset. The underlying asset is

the instrument on which an options or futures contract is based. And according to the Russian tax code it includes in its definition, property and property rights, as well as interest rates, credits, price indexes or interest rate indexes. Thus, article 301 sets up two types of futures contracts: those that can be used for physical delivery and those that can be used as a hedge against unfavorable price changes or by speculators who hope to profit from such changes.

However, in analyzing the Tax Code regulations, some specialists believe that Article 301 is limiting for futures exchanges because it is confined to a short list of commodities.<sup>19</sup> Under the current law, futures and forwards contracts of commodity exchanges must deal with the underlying assets that are defined as commodities. Under articles six, seven, and eight of Russian law concerning commodity exchanges and exchange trade, oil as well as gold can be considered underlying assets. Therefore, it would be fitting to give oil and gold the status of exchange commodities so that they can be legally traded on the exchange like other commodities.<sup>20</sup>

In conclusion, the trading of oil futures on the Russian market is an exciting affirmation of Russia's development and economic progress. However, there is still much progress that can be made. Oil is still not being traded on the commodities market in Russia, but, according to the Minister of Trade and Economic Development, it will start being traded in 2007.<sup>21</sup> Long term growth will not be possible without adequate legislation to regulate the growing markets. When establishing new legislation, it will be beneficial to take into consideration the experiences of other developed nations and established markets, while still creating laws that fit into the context of Russia's historical traditions and present legislation. At the present time, the lack of adequate legislation in place for the regulation of the derivatives market can lead to serious complications when pursuing legal action for breached obligations on these markets. With improved legal regulation we can not only ameliorate some of these complications and begin to protect the rights of those invested in these markets, but we can also create an environment conducive to growth and economic progress. □

<sup>16</sup> Decisions of the Constitutional Court of the Russian Federation № 282-O on December, 16, 2002.

<sup>17</sup> *Id.*

<sup>18</sup> The word-for-word translation of Russian term from the Tax Code might sound as "financial instruments of futures" but we choose the polysynaptic, extended and more proper term "derivative".

<sup>19</sup> G. Plstov, The determination of the tax base on the transactions with derivatives. "The Financial newspaper", April, 2002, Issuers 13, 14, 15. [www.com2com.ru/fingaz](http://www.com2com.ru/fingaz).

<sup>20</sup> The Federal Law of RF N 2383-I "About commodity exchanges and exchange trade", February, 20, 1992.

<sup>21</sup> Events. Facts. Forecast. The magazine "Accounting at the budgetary and non-commercial organizations", № 3, 2006.