

#UkrFinForum17

Day 1. Panel 2-2

Commodity trading exchanges: where we are, where we need to be

Ukraine is highly dependent on international commodity trade, and is a price-taker on major imported energy resources (natural gas, oil, oil products, and coal) and exported commodity products (steel, grain). According to **Timur Khromaev, Chairman of the National Securities and Stock Market Commission of Ukraine**, total annual trading volume of natural gas, coal, electricity, grain, and sunflower seed in Ukraine is about US\$25bn, and accounted for 27% of Ukraine's GDP in 2016. This significant volume is subject to substantial price volatility, so market participants urgently need effective hedging tools.

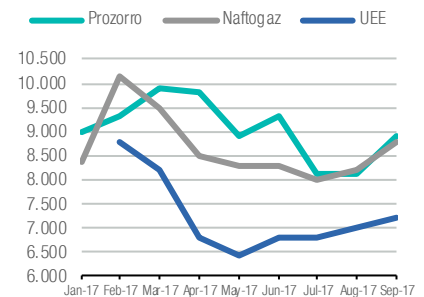
Owain Johnson, Managing Director of Energy Research and Product Development, CME Group, is of the opinion that further development of commodity exchanges and establishing dependable price benchmarks should solve the issue of hedging price risks and improve the effectiveness of the Ukrainian commodity market overall. Ukraine has great potential as a location for exchange-based, commodity trading, and has already taken important first steps in this regard. Creation of new price benchmarks is not an easy task, and it requires considerable effort in three key areas: selecting commodity products, organising operational activity, and creating regulations. Still, Ukraine is in a favourable position to learn from the mistakes of others, and can build on the best world experience.

Oleksii Dubovskiy, Chairman of Exchange Committee, Ukrainian Energy Exchange (UEE), sees an opportunity for Ukraine to liquidate monopolies and oligopolies in the energy markets by way of reforms similar to what the European Union accomplished under the Third Energy Package framework several years ago. Against this backdrop, the Ukrainian Energy Exchange has made quite significant progress. In slightly more than a year, UEE's trading turnover amounted to UAH22bn, with more than 13,000 contracts concluded by 600 participants. UEE's sales comprised more than 21% of the market for gasoline and diesel fuel, 15% of the LPG market, and 6% of the coal market in Ukraine. Since 2017, UEE has begun and is ramping up the forward trading of natural gas. According to Oleksii Dubovskii, the exchange trading of natural gas has proved to be more efficient than gas purchases through Prozorro, a hybrid, electronic, open-source government e-procurement system, as state companies using Prozorro paid prices 6–38% higher than what they would have paid using UEE during 1H17. This is more evidence that exchange trading is currently the most efficient trade tool. It allows participants to manage risk and establish representative benchmarks for prices. Effective pricing, in turn, helps Ukraine increase competitiveness, especially in Central and Eastern Europe.

However, as **Oleg Tkachenko, CEO of the Ukrainian Exchange**, noted, Ukraine still does not have its own benchmarks. He thinks that Ukraine could become an exchange trading and price-making center of the Black Sea region, if it succeeds in creating a highly liquid market for derivatives. While the large Ukrainian agricultural

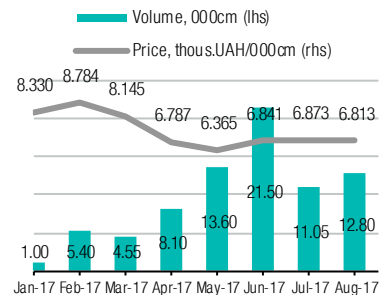
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Natural gas prices in Ukraine (UAH/000cm)



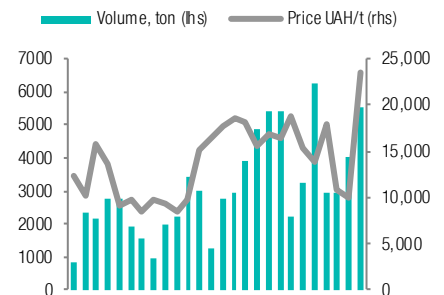
Source: UEE.

Trading of natural gas in UEE



Source: UEE.

Trading of automobile LPG in UEE*



Source: UEE.

* - automobile delivery

Commodity exchanges help producers hedge price-volatility risks and create lower financing costs

producers can trade using international benchmarks including those of Chicago Commodity Exchange, small and mid-size producers do not have this flexibility. Currently, the Ukrainian Exchange is preparing to establish a futures market. An important next step is launching a new financial instrument, which will use a price benchmark on CPT Odessa terms with delivery to one of the authorised grain elevators. With the help of this instrument, small and mid-size agricultural producers will be able to hedge price-volatility risks, which should help them lower financing costs.

Better risk management and higher liquidity attracts banks

This point was also reiterated by **Leah Soroka, Program Manager at ECA Agricultural Financial Services, IFC**. She said that development of efficient financial instruments via commodity exchanges creates opportunities for agricultural producers because better risk management and higher liquidity attracts banks. However, to further develop these instruments, Ukraine needs to create clear and transparent rules of the game. Transparent regulations are necessary to create effective commodity exchange markets, which boost trading volumes, open access to cheap financing, and support the national economy overall. Ukraine has not yet done much in this area, because so far, the commodity exchange market remains underdeveloped: trading volumes are small, exchanges use mostly spot prices, while inadequate regulations cause non-transparent pricing, and the lack of effective interaction and licensing.

Having effective and transparent regulation creates confidence in the market, and attracts investors

Kevin Piccoli, Deputy Director at the Office of International Affairs of the Commodity Futures Trading Commission explained why the Ukrainian commodity exchange trade remains weak. Piccoli noted that the establishment of favourable regulations requires detailed discussion between regulators, exchanges, producers, and other market participants. In addition to this teamwork, it is important that detailed market information be available to all the participants. Piccoli also highlighted other important factors, such as developed mechanisms of delivery, quality control, and commercial arbitrage. As for regulation, he cautions that it should not become overregulation. The regulator should not be in the business of approving each contract, just disapproving those not in compliance with regulations. Further, the industry, mainly through associations, should do most of the work regulating itself, which will go a long way to building confidence in the market and attracting investors.



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