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OPINION on position limits on EEX NCG Natural Gas contracts

I. Introduction and legal basis

1. On 31 May 2021, the European Securities and Markets Authority (ESMA) considered that sufficient information was received to assess a notification received from the Federal Financial Supervisory Authority ("BaFin") under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II"). The notification is regarding the exact position limits the BaFin intends to set for the EEX NetConnect Germany (NCG) Natural Gas Future commodity contracts in accordance with the methodology for calculation established in Commission Delegated Regulation (EU) 2017/591 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits in commodity derivatives[2] ("RTS 21") and taking into account the factors referred to in Article 57(3) of MiFID II.

2. ESMA's competence to deliver an opinion is based on Article 57(5) of MiFID II. In accordance with Article 44(1) of Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)[3] ("ESMA Regulation"), the Board of Supervisors has adopted this opinion.

3. On 31 July 2020, ESMA issued an Opinion regarding the position limits BaFin intended to set for the EEX NCG contracts. The position limits considered by BaFin in March 2020 were 29,511,000 MWh for the spot month limit and 14,182,031 MWh for the other months' limit. In this opinion, ESMA concluded that the position limits considered by BaFin complied with the methodology established in RTS 21 and were consistent with the objectives of Article 57 of MiFID II.

4. According to Article 57(4) of MiFID II, a competent authority shall review position limits where there is a significant change on the market, based on its determination of deliverable supply and open interest and reset the position limit. BaFin has calculated the open interest in the EEX NCG contracts again throughout the period from April 2020 to February 2021 based on position reporting data. BaFin considered that there had been a significant reduction in the open interest compared to its initial submission and that the position limits for both the spot month and the other months had therefore to be reconsidered. ESMA understands that the

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).
[2] Commission Delegated Regulation (EU) 2017/591 of 1.12.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits commodity derivatives (OJ L 87, 31.3.2017, p. 479).
[3] Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15. 12.2010, p84).

new position limits will apply upon publication of this opinion and replace the previous position limits as determined by BaFin.

5. In this opinion, ESMA is assessing whether the new position limits BaFin intends to set for the EEX NCG contracts comply with the methodology established in RTS 21 and are consistent with the objectives of Article 57 of MiFID II.

II. Contract classification

Commodity base product: energy (NRGY)

Commodity sub product: natural gas (NGAS)

Commodity further sub product: other (OTHR)

Name of trading venue: EUROPEAN ENERGY EXCHANGE

MIC: XEEE

Venue product code: G0B

III.Market description by the competent authority

6. The EEX NCG Natural Gas contract is a derivative contract referring to the future physical delivery of gas into the NCG transmission system. The contract used to be traded at Powernext. However, trading of derivatives contracts on gas was moved to EEX end of 2019 and since 1 January 2020 all prior Powernext gas contracts are traded at EEX.

7. Natural gas is a hydrocarbon gas mixture consisting largely of methane and other hydrocarbons, occurring naturally underground (often in association with petroleum). It is used as a source of energy for heating, cooking, electricity generation, fuel for vehicles and chemical feedstock in the manufacture of plastics and other organic chemicals.

8. The German wholesale market for natural gas is split into two different but overlapping transmission systems - GPL and NCG. NCG is the transmission system and virtual marketplace operated by NetConnect Germany GmbH & Co.KG (NCG). Due to regulatory requirements GPL and NCG are going to be merged in October 2021 to form a single transmission system called Trading Hub Europe (THE). The two current German gas contracts - NCG and GPL - are going to be replaced by one THE contract. Whereas GPL is phasing out, NCG will from October be rebranded as THE. Consequently, market participants are already shifting liquidity from GPL to NCG, closing positions in GPL and opening positions in NCG. The new THE contract is therefore likely to have at least a combined open interest of NCG and GPL.

9. The German gas market is one of the biggest in Europe and relies mainly on pipeline imports. Different privately-owned market participants are active in the German gas market, ranging from transmission system operators (TSO), traders to storage operators.

10. Market participants negotiating on NCG contracts can be classified as:

- Utilities, which have a gas portfolio (entry/exit capacities, storages capacities, consumption clients) and use the market for optimizing or sourcing;

- Industrial consumers, which are essentially buyers in the wholesale market;

- Municipalities, which aggregate final consumers and bring their needs to the wholesale market;

- Operators (Transport system operators, storage system operators, LNG system operators) which enter the system for their own needs or for balancing purposes; or

- Trading companies which do not have a shipper or supply agreement in the market (banks, commodities traders, investment firms).

11. All the NCG contracts are physically delivered via a nomination to the relevant TSO.

12. According to official data on market concentration from 2017, the market concentration for wholesale gas supply in Germany is lower than for the EU average[4].

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

13. Deliverable supply amounts to 204,683,760 MWh.

14. The calculation of the deliverable supply is based on actual daily entry capacities of each of the source type described below to the NCG market area. While the capacities of the system are relatively stable during the year, the flows of gas depend on the consumption, which depends on the weather conditions. This calculation takes into account the following sources:

1) Entry pipeline capacity = 4,160 GWh/d in 2020[5]

2) LNG import capacity = 0 GWh/d[6]

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[4] https://ec.europa.eu/info/sites/default/files/energy-union-factsheet-germany_en.pdf p. 6
[5] https://entsog.eu/sites/default/files/2021-01/ENTSOG_GIE_SYSDEV_2019-2020_1600x1200_FULL_047.pdf

3) Storage withdrawal capacity = 2,663 GWh/d in 2020[7]

4) Average indigenous production = 0 GWh/d[8]

15. The total deliverable supply sums up to 6,823 GWh/d. This equates to 204,683,760 MWh/ month.

Spot month limit

16. Spot month limit amounts to 10,234,188 MWh which corresponds to 5% of deliverable supply.

Spot month position limit rationale

17. Since the EEX NCG Natural Gas contract is not a food contract, the baseline figure for the spot month, which is based on deliverable supply, was calculated as 25% of the estimated deliverable supply, i.e. 25%* 204.683.760 MWh = 51.170.940 MWh. There is only one market maker. Thus, the limit is to be set within a range of 5% - 50%.

18. BaFin considered the following factors relevant for adjusting the limit downwards:

- Article 18(3) of RTS 21: the deliverable supply is significantly larger than the open interest. BaFin has applied a reverse interpretation of Article 18(3) of RTS 21 and therefore adjusted the spot month limit downwards, in order to ensure that no position holder is able to hold excessive shares of overall open interest due to large deliverable supply / low open interest.

- Article 17 of RTS 21: Gas delivered in Germany is also used as the deliverable supply for other commodity derivatives in the EU, for instance at ICE Endex.

19. In considering the volatility in the contracts, as required by Article 21 of RTS 21, there has been some variation in the price of the commodity derivative, but BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

20. All other factors have been considered and were not regarded as material or relevant to require additional adjustments, either up or down, from the baseline.

21. Based on the above, BaFin has decided to make a total downward adjustment of 20 percentage points to the baseline. This provides a spot month limit of 10,234,188 MWh representing 5% of the deliverable supply.

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[6] https://entsog.eu/sites/default/files/2021-01/ENTSOG_GIE_SYSDEV_2019-2020_1600x1200_FULL_047.pdf
[7] https://agsi.gie.eu/#/historical/DE
[8] http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nrg_103m&lang=en – The data on the indigenous production of gas in Germany corresponds to gas available only to the GPL hub, therefore it is not counted in the deliverable calculation for the NCG hub.

Other months' position limit

Open interest calculation methodology

22. Open interest amounts to 23,930,984 MWh.

23. Open interest calculation methodology: the open interest for the position limit at hand has been calculated on basis of the reports of daily net positions submitted to BaFin pursuant to Art. 58 MiFID II. The daily net positions have been added up and divided by the factor 2 ("net approach"). The number provided is the average size of daily open interest throughout the period from April 2020 - February 2021.

Other months' limit

24. Other months limit amounts to 10,768,942 MWh which corresponds to 45% of open interest.

Other months' position limit rationale

25. The open interest amounts to 23,930,984 MWh. The baseline figure for the other months limit amounts to 25% of open interest, i.e. 5,982,746 MWh.

26. The following factors were considered relevant for adjusting the baseline upwards:

- Article 16(2) of RTS 21: For a given trading day, there is a large number of separate expiries (EEX lists future contracts for the next 6 months, the next 7 quarters, the next 6 seasons and the next 6 calendar years). In total, EEX lists 25 future contracts each day.

- Article 18(3) of RTS 21: the overall open interest is significantly lower than the deliverable supply, the other months limit is therefore to be adjusted upwards.

- NCG futures contracts are all physically settled and thereby result in an actual physical flow of gas. Market participants active in the physical gas market who operate facilities with substantial generation/storage capacity or large demand assets, can have a natural relatively large position in the gas derivatives market. On the other hand, only a few utility firms act as liquidity provider. This needs to be taken into account under Article 20 of RTS 21, including 2(c) in relation to the structure, organisation and the operation of the market, and 2(d) in relation to the composition and role of market participants on the underlying commodities.

27. The following factor was considered relevant for adjusting the limit downwards:

- Article 17 of RTS 21: Gas delivered in the German market area via the virtual trading point of NCG as underlying is also used as the deliverable supply for other commodity derivatives in the EU, for instance at ICE Endex;

28. In considering the volatility in the contracts, as required by Article 21 of RTS 21, there has been some variation in the price of the commodity derivative, but BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

29. All other factors have been considered and were not regarded as material or relevant to require additional adjustments, either up or down, from the baseline.

30. Based on the above, BaFin has decided to make a total upward adjustment of 20 percentage points to the baseline. This results in an other month's position limit of 10,768,942 MWh accounting for 45% of the open interest. BaFin also took into account the fact that the open interest in the NCG contracts is expected to grow as market participants migrate their positions from GPL to NCG before GPL futures are delisted and NCG is rebranded as Trading Hub Europe (THE). An upward adjustment to 50% seems not feasible though given the fact that the underlying is also traded at other trading venues.

V. ESMA's Assessment

31. This Opinion concerns positions held in EEX NCG Natural Gas Futures.

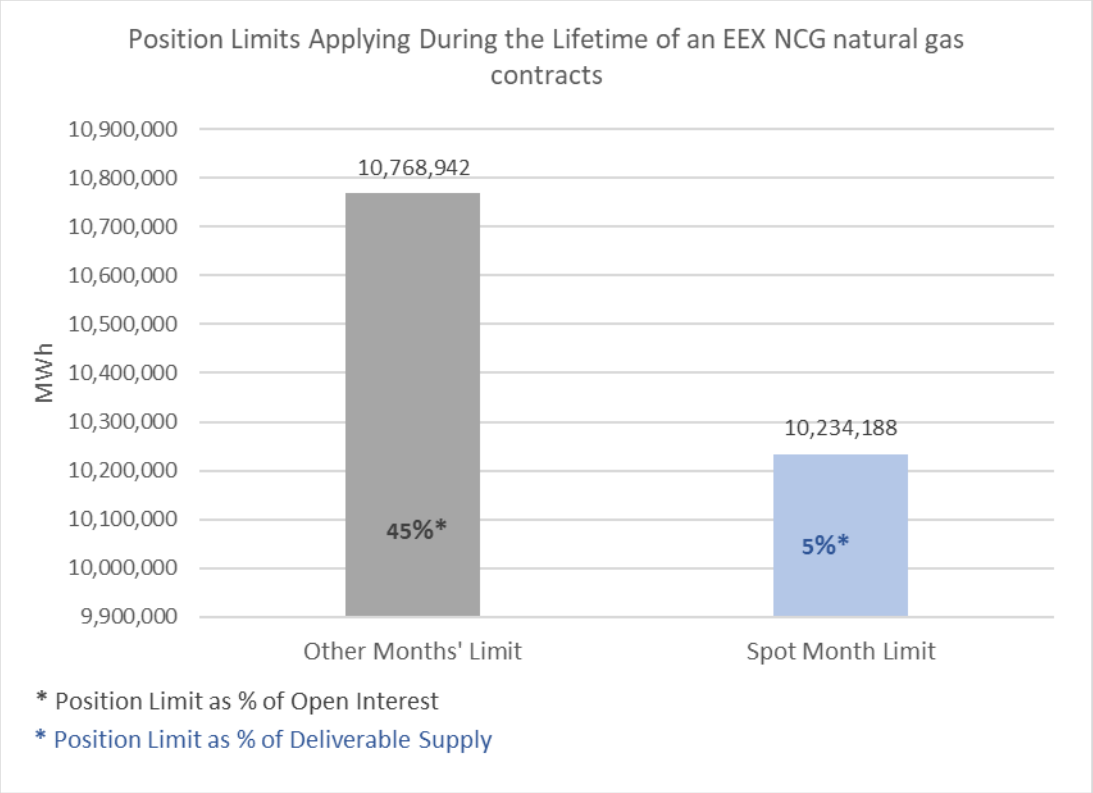
32. ESMA has performed the assessment based on the information provided by BaFin.

33. For the purposes of this Opinion, ESMA has assessed the compatibility of the intended position limits with the objectives of Article 57(1) of MiFID II and with the methodology for calculation of position limits established in RTS 21, in accordance with Article 57(3) of MiFID II.

34. The overall open interest in the EEX NCG contracts 23,930,984 MWh, which translates into 33,237 lots.

Compatibility with the methodology for calculation of position limits established in RTS 21 in accordance with Article 57(3) of MiFID II

35. BaFin has set one position limit for the spot month and another position limit for the other months.



<u>Spot month position limit</u>

36. The calculation of the deliverable supply is based on the average entry pipeline capacity for Germany and the storage withdrawal capacity for the year 2020. The source of data used to calculate deliverable supply (ENTSO-G, GIE and Eurostat) ensures publicly available figures that are consistent at the European level.

37. ESMA considers that this methodology to calculate deliverable supply is consistent with Article 10(1) of RTS 21 that sets out that deliverable supply shall be calculated “by identifying the quantity of the underlying commodity that can be used to fulfil the delivery requirements of the commodity derivative.”

38. The monthly deliverable supply figure has been calculated by converting the capacity to MWh per month.

39. This approach is consistent with Article 10(2) of RTS 21, which sets out that “Competent authorities shall determine the deliverable supply […] by reference to the average monthly amount of the underlying commodity available for delivery over the one-year period immediately preceding the determination”.

40. ESMA agrees that a downward adjustment of the spot month position limit is justified in accordance with Article 18(3) of RTS 21 given that the deliverable supply is significantly larger than the open interest. ESMA also agrees that a further downward adjustment is justified under Article 17 of RTS 21 due to the fact that the deliverable supply is also used as deliverable supply for other commodity derivatives.

Other months' position limit

41. The open interest has been calculated on the basis of the reports of daily net positions submitted to BaFin pursuant to Art. 58 MiFID II. The daily net positions have been added up and divided by the factor 2 ("net approach"). The number provided is the average size of daily open interest throughout the period from April 2020 - February 2021. ESMA considers that such calculation of open interest by the competent authority provides the most accurate and reliable figure and promotes convergence in the setting of position limits by competent authorities. ESMA also considers such approach consistent with Article 12 of RTS 21.

42. ESMA agrees that an upward adjustment of the other months' position limit is justified in accordance with Article 18(3) of RTS 21 given that the deliverable supply is significantly higher than the open interest. ESMA also agrees that an upward adjustment is justified by the fact that there are a large number of separate expiries in the contract, as per Article 16(2) of RTS 21.

43. Finally, ESMA agrees with the application of a downward adjustment in accordance with Article 17 of RTS 21 as the deliverable supply in NCG natural gas is also used as the deliverable supply for other commodity derivatives.

44. Consequently, these position limits have been set following the methodology established by RTS 21.

Compatibility with the objectives of Article 57(1) of MiFID II

45. Under Article 57(1) of MiFID II, the objectives of the position limits are to prevent market abuse and support orderly pricing and settlement conditions including preventing market distorting positions.

46. Based on the information provided by the competent authority, ESMA understands that the spot month limit for the EEX NCG contract is substantially higher than the open interest for the spot month.

47. ESMA understands the need to avoid the risk of unduly constraining trading in this increasingly liquid commodity derivative market where underlying market participants have a key presence. However, there is a risk that the objectives set out in Article 57(1) of MiFID II may not be achieved where the limit set for the spot month is well above the positions held by market participants.

48. In light of the assessment above, ESMA considers that the position limits set for the spot month and the other months overall appear to achieve a reasonable balance between the need to prevent market abuse and to ensure an orderly market and orderly settlement while ensuring that the development of commercial activities in the underlying commodity market and the liquidity of the EEX NCG Natural Gas Futures contracts are not hampered. Furthermore, the position limit for the other months is set at a level that it should not hamper the migration towards THE.

49. However, to help ensure that the risk of not achieving the objectives set out in Article 57(1) of MiFID II does not materialise, ESMA considers that trading patterns in the EEX NCG Natural Gas Futures contracts should be carefully monitored by the competent authority, in particular during the spot month.

VI. Conclusion

50. Based on all the considerations and analysis presented above, it is ESMA's opinion that this spot month position limit does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II. This other months' position limit also complies with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris, 24 June 2021

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Interim Chair

For the Board of Supervisors