European Securities and Markets Authority

Date: 24 September 2018
ESMA70-155-2931

OPINION on position limits on Phelix DE/AT Base Power contract

I. Introduction and legal basis

1. On 20 October 2017, the European Securities and Markets Authority ("ESMA") received a notification from the Federal Financial Supervisory Authority ("BaFin") under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits the BaFin intends to set for the Phelix DE/AT Base Power Futures and Options commodity contract 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.

II. Contract classification

Commodity base product: energy (NRGY)

Commodity sub product: electricity (ELEC)

Commodity further sub product: base load (BSLD)

Name of trading venue: EUROPEAN ENERGY EXCHANGE

MIC: XEEE

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[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.December.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, p. 84).

Venue product codes: F1B, O1B

III. Market description

3. Electricity is a grid-bound commodity, where delivery takes place through meshed transmission system grids. This means that market participants have no control over the actual destination of the generated power. Electricity can only be stored to a very minimal extent, i.e. by means of battery storage. In fact, electricity is still widely considered as a non-storable commodity. Furthermore, prices of derivatives markets are closely related to spot markets. There are also some seasonal effects in the electricity market. Due to heating demand in winter or air-conditioning demand in summer, electricity generation tends to be higher in times of climatic extremes. However, such seasonal effects are small.

4. Since the electricity system constitutes critical infrastructure, power markets in Germany and Austria are subject to close surveillance of national and European regulators, including supervision for the purpose of the prevention of abusive practices of dominant positions. Similar to financial markets, REMIT prohibits market manipulation of the spot market.

5. There is a high number of producers and their role in the market is very diverse. In Germany about 700 companies are holding a license to supply electricity to retail clients. Germany is currently in a process of fundamental market design changes (‘Energiewende’). At the same time, more and more renewable energy generation facilities and new generation companies are entering the market. The market is thus becoming increasingly diverse, a trend that is further demonstrated by the recent decision of former German market leaders RWE and E.ON to split their businesses to focus on conventional energy business on the one hand and the renewable business on the other hand.

6. Recently, the Monopolies Commission has submitted its Special Report on the development of competition in the market of grid-bound electricity. Based on the assessment of the so called Residual Supply Index and the Return on Withholding Capacity Index by means of which market power has been examined, it has concluded that since 2012 Germany's four biggest energy producers do not have a dominant position on the market anymore.

7. The Phelix DE/AT Power Futures and Options contracts are cash settled derivatives contracts referring to the average power spot market prices of future delivery periods of the German/Austrian market area. The underlying of these contracts is the Physical Electricity Index determined by EPEX Spot Exchange on a daily basis. Trading Participants have the option of arranging physical delivery on the spot market for monthly and weekly contracts.

8. Phelix DE/AT Power Futures are available as base load, peak load and off-peak contracts. The Phelix DE/AT Base Power Futures contract is the average price of the hours 1 to 24 for electricity traded on the spot market. It is calculated for all calendar days of the year as the simple average of the Auction prices for the hours 1 to 24 in the market area Germany/Austria.

9. Maturities in the Phelix DE/AT Base Power Futures include Day, Week, Weekend, Month, Quarter and Year contracts. The furthest maturity to trade is 6 years.

10. EEX also offers trading in options on the Phelix-Base DE/AT Base Power Future contract (Month, Quarter, Year). Regardless of the different maturities, the corresponding futures position of the underlying asset is booked upon exercising of the option.

IV. Proposed limit and rationale

Spot month position limit

<u>Deliverable supply calculation methodology</u>

11. Deliverable supply amounts to 170,371,780 MWh.

12. The deliverable supply was estimated based on statistics provided by ENTSO-E (European Network of Transmission System Operators for Electricity). It is composed of the domestic Net Generating Capacity (NGC) of Germany and Austria for the year 2017 and the average yearly import capacities of these countries for 2017. These values of ENTSO-E have been converted from MW to MWh per year. The overall value was then divided by 12 in order to align the deliverable supply to the time frame of one calendar month for the spot month period (30 days).

<u>Spot month position limit</u>

13. The Spot Month limit is set at 46,000,381 MWh, which represents 27% of the deliverable supply. The spot month limit applies to Phelix Base DE/AT Futures and Options contracts. It includes daily contracts, weekend contracts, weekly contracts and monthly contracts.

<u>Spot month position limit rationale</u>

14. As the daily average open interest in 2016 is above 20,000 lots, European Energy Exchange Phelix Base AT/DE Power is classified as a 'liquid' contract with a baseline limit of 25%. The baseline figure therefore was calculated as 25% of the deliverable supply, i.e. 25% * 170,371,780 MWh = 42,592,945 MWh.

15. From the baseline, BaFin considered the following factors relevant for adjusting the limit upwards:

16. BaFin made an upward adjustment under Article 20(2)(d) of RTS 2 due to the lack of storage capacity, leading the underlying market to be less prone to market manipulation.

17. As deliverable supply is significantly lower than open interest, BaFin also adjusted the spot month limit upward based on Article 18(2) of RTS 21.

18. As most positions are regularly concentrated on the monthly contract resulting in a stable amount of positions during the spot month period, BaFin has decided not to apply a downward adjustment due to short maturities under Article 16(1) of RTS 21.

19. All other factors have been considered by BaFin and are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, 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. Based on the above, BaFin increased the spot month limit by 2 percentage points over the baseline, which results in a spot month limit of 46,000,381 MWh representing 27% of the deliverable supply.

Other months' position limit

Open interest

21. The open interest amounts to 3,752,171,400 MWh, as provided by the exchange. Open interest was calculated by aggregating all contracts across all maturities and converting them to MWh. The number provided is the average size of daily open interest throughout three consecutive months (May, June and July) in 2017 to better reflect the declining open interest in the contract since the launch of the Phelix Base DE Power Futures contract. Option positions have been delta adjusted.

Other months' position limit

22. The other months' limit amounts to 825,477,708 MWh, which represents 22% of Open Interest. The other months' limit applies to Phelix Base DE/AT Futures and Options contracts.

Other months' position limit rationale

23. The baseline figure for the other months' limit amounts to 25% of open interest, i.e. 938,042,850 MWh, as required by Article 11(1) of RTS 21.

24. BaFin considered the following factors relevant for adjusting the baseline downwards.

25. There is a large volume of overall open interest. Therefore, BaFin adjusted the baseline downwards in accordance with Article 18(1).

26. Open interest is more than 20 times higher than the deliverable supply. BaFin therefore made a further downward adjustment in accordance with Article 18(2) of RTS 21.

27. BaFin considered that an upward adjustment was justified under Article 20(2)(d) of RTS 21 due to the lack of storage capacity, leading the underlying market to be less prone to market manipulation.

28. BaFin also considered that an adjustment upward was justified under Article 16(2) due to the large number of separate expiries (11 quarterly contracts and 6 yearly contracts). In contrast to daily and weekly contracts that fall into the spot month, quarterly and yearly contracts are traded in significant volumes.

29. All the other potential adjustment factors set out in RTS 21 have been considered by BaFin and are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, 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.

30. Given the characteristics of this contract, BaFin considers that the downward adjustment factors weigh higher than the upward adjustment factors and therefore adjusted the limit downwards by 3 percentage points from the baseline. This results in a limit of 825,477,708 MWh representing 22% of the open interest.

V. ESMA’s Assessment

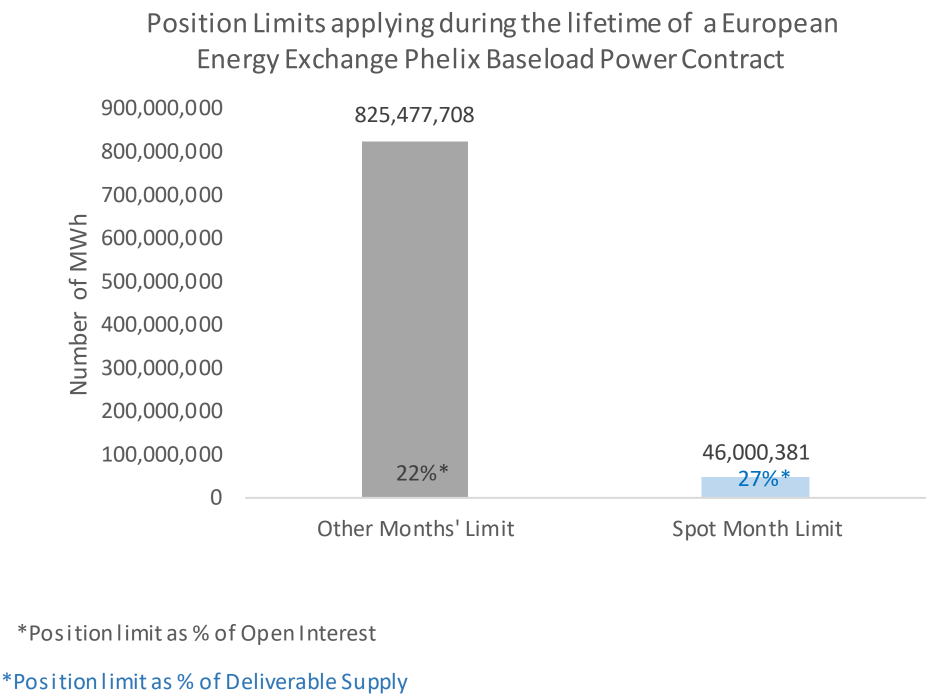
31. This Opinion concerns positions held in the Phelix DE/AT Base Power contracts.

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

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

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



Spot month position limit

35. The calculation of the deliverable supply is based on ENTSO-e figures for 2017. ESMA agrees with using data from ENTSO-e to calculate deliverable supply, as this ensures publicly available figures consistent at the European level.

36. ESMA also agrees with the methodology used to include both domestic generation plus imports into Austria and Germany, as this approach is consistent with Article 10(2) of RTS 21 that 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".

37. Whilst the physical delivery of power depends on the actual days of the month, ESMA agrees with using 30 days (average calendar days in a month) and 24h per day to calculate monthly deliverable supply, in order to standardize the monthly deliverable supply of power for these baseload contracts.

38. ESMA considers as a reasonable approach to have slightly adjusted the spot month limit upwards under Article 20(2)(d) of RTS 21 to take into account the lack of possibility to store the underlying market, which makes it less prone to market manipulation.

39. ESMA also considers that, since the deliverable supply is only 4.5% of the open interest, an upward adjustment to the spot month limit could reasonably be made under Article 18(2) of RTS 21. ESMA considers that the rationale underpinning Article 18(2) with respect to the

other months' enables the national competent authority to adjust the spot month limit upwards in case the open interest is significantly higher than deliverable supply.

Other months' position limit

40. The open interest was calculated as the average of daily open interest for three consecutive months in 2017 available shortly before setting the position limit and aggregating all contracts across all maturities and converting them to MWh. ESMA considers such an approach sensible in this case as it allows better taking into account the declining trend in open interest in the contract. ESMA also considers such approach consistent with Article 12 of RTS 21.

41. ESMA considers it is a reasonable approach to have considered upward adjustments based on the number of separate expiries, which are heavily traded, in accordance with Article 16(2) and based on the specific characteristics of the underlying market under Article 20(2)(d) of RTS 21 as due the lack of storage makes the derivative market less prone to market manipulation.

42. ESMA agrees that a downward adjustment of the position limit from the baseline is justified for the other months' limit in accordance with Article 18(1) and (2) of RTS 21 given the very large volume of open interest, both in absolute number and compared to deliverable supply.

43. Given the very large size of open interest, ESMA also agrees that the downward adjustment factors ultimately far outweigh the potential upward adjustments and consider that it was reasonable to adjust the baseline limit downwards.

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. ESMA notes, based on the information provided by the competent authority, that open interest in the Phelix DE/AT Base Power contracts has continue to decrease since the position limits were set. 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 other months' is well above the positions held by market participants.

47. In light of the assessment above, ESMA considers that the position limits set for the spot month and for the other months 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 power market and the liquidity of the Phelix DE/AT Base Power futures and options contracts are not hampered

48. 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 Phelix DE/AT Base Power contracts should be carefully monitored by the competent authority, in particular during the other month's, and that the limits should be reviewed on a timely basis.

VI. Conclusion

49. 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. The other months' position limit does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris, 24 September 2018

Steven Maijoor

Chair

For the Board of Supervisors