Date: 18 January 2019
ESMA70-155-5088

OPINION on position limits on ICE Low Sulphur Gasoil contracts

I. Introduction and legal basis

1. On 9 February 2018, the European Securities and Markets Authority (ESMA) received a notification from the Financial Conduct Authority (FCA) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits FCA intends to set for ICE Low Sulphur Gasoil 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: oil (OILP)

Commodity further sub product: gasoil (GOIL)

Name of trading venue: INTERCONTINENTAL EXCHANGE - ICE FUTURES EUROPE

MIC: IFEU

Venue product code: G[4]

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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).
[4] This is the primary venue product code (VPC) for this contract. However, the position limits set will apply to other associated VPCs as well. For a complete and updated list of VPCs to which the same limit applies, please check the FCA website at https://www.fca.org.uk/markets/mifid-ii/commodity-derivatives/position-limits.

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III.Market description

3. Gasoil is also known as diesel oil. Gasoil is primarily a medium distillate, distilling between 180°C and 380°C. Several grades are available depending on uses. The underlying physical market for Low Sulphur Gasoil is diesel barges delivered in the ARA (Amsterdam, Rotterdam, Antwerp including Flushing and Ghent) region.

4. Gasoil is a product of crude oil and is used for heating purposes and for generating power. It accounts for about 25% of the yield from a barrel of crude oil. This represents the second largest "cut" after petrol. Low sulphur gas oil has less than 0.1% of sulphur content. In the UK, it is also known as red diesel.

5. Gasoil includes transport diesel, heating oil and other gasoil. Transport diesel oil is used to power diesel engines in ships, buses, trucks, trains, cars and other industrial machinery.[5]

6. Gas oil is traded widely in Europe as a hedging tool for the physical industry. Gas oil trading futures are used by companies to hedge against diesel and jet fuel costs. They are used as the pricing reference for all distillate trading across Europe.

7. The ICE Low Sulphur Gasoil Future is a monthly physically settled future based on the ICE daily settlement price for Low Sulphur Gasoil Futures. The ICE Low Sulphur Gasoil Future is used as the pricing reference for all distillate trading in Europe and beyond. ICE Low Sulphur Gasoil plays the same role for middle distillate oil that ICE Brent Crude plays for the crude oil market.

8. Trading in the ICE Low Sulphur Gasoil Future contracts takes place in lots. One lot is equivalent to 100 metric tonnes (MT). 96 consecutive months are available for trading.

9. ICE also offers trading in Low Sulphur Gasoil Options. The ICE Low Sulphur Gasoil Options Contract is based on the underlying futures contract and if exercised will result in a corresponding futures position. Contracts are for American-style exercise, allowing the buyer to exercise an option anytime up to and including expiry day.

10. ICE further offers trading in Bullet Futures, which is a variation of the main contract. The Bullet contract shares specifications with the whole month contract (the principal) and is priced off the same underlying. However, settlement for bullet contracts is based on the price on the penultimate trading day of the main future contract and has a minimum price fluctuation and settlement price quotation of $0.001 per barrel, as opposed to of $0.025 per barrel for the principal contract, which may assist in refining.

11. During the final month of trading in the ICE Low Sulphur Gasoil Future contract, the Exchange contacts holders of Low Sulphur Gasoil positions to confirm their intent and

[5] Source: International Energy Agency, Oil Market Report Glossary & European Commission, Energy Statistics Manual

capability of making or taking delivery and may require that positions be reduced to limit position concentration, ensure price convergence with the physical market, and maintain market integrity.

12. Contracts are for the future delivery of low sulphur gasoil from the seller to the buyer onto a barge (or coaster up to 10,000 dwt) or by in-tank or inter-tank transfer from an Exchange Recognised Customs and Excise bonded storage installation or refinery in the Amsterdam, Rotterdam, Antwerp (ARA) area (including Flushing and Ghent) nominated by the seller and on a day nominated by the buyer within a mutually agreed 5 day delivery range between the 16th and the last calendar day of the delivery month. Quantity and quality is verified by one Exchange approved inspector selected from two nominated by the buyer. Buyers and sellers adhere to strict deadlines set out in the Exchange Contract Rules and Procedures.

13. Physical deliveries between the months of October and March must be of winter grade quality with deliveries outside of these months (i.e. from April to September) being of summer grade quality. Full quality specifications are published in the ICE Futures Europe Rulebook[6]. Product of any origin is deliverable under the contract.

14. The International Maritime Organisation announced in October 2017 that it will implement a global sulphur cap of 0.5% on marine fuels starting from January 1, 2020. This has led the oil majors to announce that they will offer a range of fuel solutions to comply with the cap.

15. In addition to ICE Futures Europe, trading for European Low Sulphur Gasoil Futures contracts is conducted on New York Mercantile Exchange (NYMEX). The price of this cash-settled NYMEX Low Sulphur Gasoil Futures contract is based on the first nearby contract month settlement price of this ICE contract.

16. Factors influencing the price of Gasoil Low Sulphur futures include the price of crude oil, amounts in storage, and currency fluctuations. In addition, the price may be affected by geopolitical concerns, consumer trends and alternative sources of fuel such as green energy.

17. There is a large number of market participants. The vast majority of market participants are entities with exposure to the underlying physical market for the commodity which use the futures market to hedge the risks associated with such exposure. Examples would include oil exploration and drilling firms, specialist commodity trading firms with physical exposures, producers, exporters/importers, coffee roasters, cocoa processors, sugar refiners, food and confectionary manufacturers, millers, crushers, utility companies who consume oil to generate power. There are less than three market makers as defined in Article 4(1)(7) of MiFID II.

[6] https://www.theice.com/publicdocs/contractregs/15_SECTION_J1.pdf

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

18. Deliverable supply amounts to 135,391 lots. A lot is equivalent to 100 MT.

19. On expiry, the physically deliverable futures contract can be delivered by barge in the Amsterdam-Rotterdam-Antwerp (ARA) corridor of the Netherlands and Belgium into recognised delivery installations. Deliverable supply takes into account low sulphur gasoil from Belgium and the Netherlands which is easily transported to the ARA delivery points.

20. The deliverable supply data has been calculated using production (refinery output), import and stock data from Eurostat for 2016. Total production and imports for 2016 was 61,351,000 metric tonnes for total gas/diesel oil (blended with bio components). This is then divided by 12 for an average monthly figure of 5,112,583. The average monthly stock figure for 2016 was 8,426,500 metric tonnes. When combined this provides a deliverable supply figure of 13,539,083 metric tonnes[7].

21. The final monthly deliverable supply figure is then converted into lots by dividing the above figure by 100 resulting in 135,391 lots.

Spot month position limit

22. Spot month limit amounts to 58,850 lots, which represents 43,5% of deliverable supply. The spot month limit applies to the ICE Low Sulphur Gasoil Futures and Options contracts as well as to Bullet contracts which are based on identical core (underlying) contractual specifications, terms and conditions. The FCA's website provides an updated list showing the names and codes for these contracts.

23. The FCA is of the view that if separate limits are applied to Bullet futures and other types of closely related contracts, the overall position of a participant on the same underlying may not be clearly represented. The FCA also considers that setting a single position limit for Bullet and principal contracts traded on the same venue where there are identical contract specifications, terms and conditions, is compliant with the objectives of the MiFID II regime and of RTS 21. It avoids the creation of multiple limits for identical commodities and the potential undermining of the overall intentions of the regime. In particular, it enhances the approach already established with the aggregation of positions under Article 57 of MiFID II and Articles 5 and 6 of the RTS 21 for same commodity derivatives and EEOTCs, where positions are also aggregated with the primary on-venue contracts and become subject to

[7] Source: Eurostat: All (closing) stocks on national territory, Imports, Transformation output from refineries, http://ec.europa.eu/eurostat/data/database

one position limit. It also appears consistent with Article 3 of RTS 21, which provides for position holders to calculate their option positions on a delta adjusted basis by commodity derivative and then aggregate these with the principal commodity derivative contract.

Spot month position limit rationale

24. The baseline for the spot month limit has been set at 25% of deliverable supply as required by RTS 21 Article 9(1).

25. Although gasoil is also traded on NYMEX, no adjustment has been made under Article 17 of RTS 21 to the deliverable supply as that NYMEX contract is financially settled and will not cause disorderly physical settlement of the ICE contract.

26. In accordance with Article 18(1) of RTS 21, a downward adjustment of 4 percentage points was made for the very large open interest in the contract (913,452 lots). A further downward adjustment of 2.5 percentage points was made for the significant number of participants holding positions (514), in accordance with Article 19 (1) of RTS 21.

27. The situation set out in Article 19(2)(b) of RTS 21 applies in respect of this contract as the number of investment firms acting as a market maker in accordance with Article 4(1)(7) of Directive 2014/65/EU in the commodity derivative at the time the position limit is set or reviewed is lower than three. This factor means that a higher maximum position limit is available. Analysis of market data on the composition and role of market participants under Article 20(2)(d)) also indicated that although there are a significant number of small positions held by market participants there are also commercial positions in excess of the 25% baseline. The FCA has therefore made an upward adjustment of 25 percentage points to reflect the criterion and factors described in Articles 19(2)(b) and 20(2)(d) of RTS 21 in order to avoid the risk of unduly constraining normal trading in this derivative market and preventing it from working adequately. The upward adjustment will in particular allow commercial market participants, who may be unwilling to apply for an exemption, to hedge their positions. Once the position reporting regime is in place and has enabled analysis of a longer run of data, including information on the speculative/commercial breakdown of positions, the FCA will be able to give further consideration to adjustments for this contract.

28. All other factors have been considered and are not regarded by the FCA 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 the FCA has not found evidence that this is excessive or that lower position limits would reduce volatility.

29. A total upwards adjustment was made of 18.5 percentage points resulting in a limit of 43.5%. This provides a figure in lots of 50,895 which has been rounded down to a figure of 50,850 lots. This equates to a final limit as a percentage of deliverable supply of 43.5%.

Other months' position limit

Open interest

30. 33. Open interest amounts to 913,452 lots. A lot is equivalent to 100 MT. For the calculation of open interest, the FCA has aggregated open interest in Bullet and principal contracts traded on the same venue where there are identical contract specifications, terms and conditions and where those contracts are subject to the same position limits. The FCA considers that aggregating open interest in all these contracts provides a simpler, more consistent overview of market participant activity in accordance with the objectives of Article 57 of MiFID II and RTS 21.

31. The open interest figure has been reported by the trading venue and is the daily average over Q4 2017 of the number of open contracts, which have not been closed out or expired. The period used is Q4 2017.

Other months' limit

32. The other months' limit is set at 132,450 lots, which represents 14,5% of open interest. The other month's limit applies to the ICE Low Sulphur Gasoil Futures and Options contracts and to other Bullet contracts which are based on identical core (underlying) contractual specifications, terms and conditions. The FCA's website provides an updated list showing the names and codes for these contracts. See also paragraph 22 above.

Other months' limit rationale

33. The baseline for the other months has been set at 25% of open interest as required by RTS 21 Article 11.

34. In accordance with Article 18(1) of RTS 21, a downward adjustment of 4 percentage points was made for the very large open interest in the contract (852,711 lots). An additional downward adjustment of 4 percentage points was made in accordance with Article 18(2) of RTS 21 as open interest is significantly larger than deliverable supply (675%).

35. A further downward adjustment was made of 2.5 percentage points for the significant number of market participants holding positions over a year in accordance with Article 19(1) of RTS 21.

36. All other factors have been considered and are not regarded by the FCA 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 we have not found evidence that this is excessive or that lower position limits would reduce volatility.

37. A total downwards adjustment was made of 10.5 percentage points resulting in a limit of 14.5%. This provides a figure in lots of 132,451 which has been rounded down to a figure of 132,450 lots. This equates to a final limit as a percentage of deliverable supply of 14.5%.

V. ESMA's Assessment

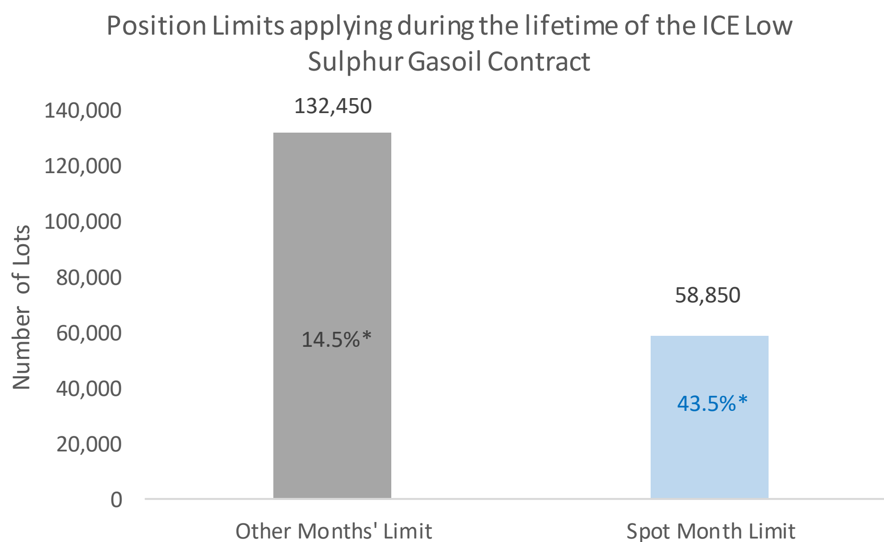
38. This Opinion concerns positions held in ICE Low Sulphur Gasoil Futures and Options contracts.

39. ESMA has performed the assessment based on the information provided by FCA.

40. 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

33. The FCA has set one position limit for the spot month and another position limit for other months'.



Spot month position limit

41. The calculation of deliverable supply is based on Eurostat data for refinery production, import and stock data for 2016 from Belgium and the Netherlands for gas/diesel oil (blended with bio components), divided by twelve to reach an amount of monthly deliverable supply per

delivery. Considering that such gas/diesel oil is the best available proxy to assess deliverable supply for Low Sulphur Gasoil, 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".

42. ESMA considers that the downward adjustment to the baseline under Article 18(1) of RTS 21 is appropriate given the very large open interest and the status of the ICE Low Sulphur Gasoil Future as a global benchmark contract used for hedging for a large number of market participants across the world.

43. ESMA also agrees that, even compared to other globally traded UK commodity derivative contracts, the number of market participants on this contract (514) appears high and consequently requires a further downward adjustment under Article 19(1) of RTS 21.

44. As market participants include less than three market makers, and as the market data also indicated commercial positions in excess of the 25% baseline, the FCA adjusted the spot month limit upwards by 25 percentage points to avoid unduly constraining trading in this derivative market. ESMA considers that this approach is consistent with Articles 19(2) and 20(2)(d) of RTS 21.

45. ESMA considers as a reasonable approach not to have adjusted the spot month limit downwards based on Article 17 of RTS 21 to take into account the NYMEX European Low Sulphur Gasoil contracts with the same underlying commodity as the NYMEX contract is cash settled. There is therefore no risk to orderly settlement arising from low or insufficient deliverable supply, which Article 17 of RTS 21 aims at addressing.

46. ESMA notes that the trading venue currently applies a mandatory delivery limit of 2,000 lots to the Low Sulphur Gasoil contract. This limit of 2,000 lots is part of the position management powers of the trading venue. ESMA notes that this limit is significantly lower than the spot month limit of 58,850 lots.

47. The reason provided for this discrepancy is that the spot limit applies to the whole of the spot month while the trading venue delivery limit applies on the day of expiry. ESMA agrees that the two limits are complementary and will work together without duplication to ensure orderly trading and settlement.

48. It is not considered necessary to duplicate the existing venue expiry limit controls where these are believed to be established and effective as the objective of the expiry limit of the trading venue is only to manage the physical delivery process and to ensure that market participants meet their delivery commitments.

Other months' limit

49. The open interest was calculated based on the Q4 2017 daily average number of open contracts that have not been either closed out or expired. ESMA considers such an approach sensible in this case as Q4 2017 takes into account the growing open interest in the ICE Low Sulphur Gasoil Bullet Future contract.

50. As for the spot month limit, ESMA considers that the downward adjustment to the baseline under Article 18(1) of RTS 21 is appropriate given the very large open interest. ESMA also agrees that, even compared to other globally traded UK commodity derivative contracts, the number of market participants on this contract (514) appears high and consequently calls for another downward adjustment under Article 19(1) of RTS 21.

51. ESMA notes that an upward adjustment factor could be considered under Article 16(2) of RTS 21. The FCA has noted the relatively large number of separate expiries. However, because of the other factors pointing to a downward adjustment from the baseline, it decided not to make an upward adjustment in this case.

52. ESMA agrees with the FCA that the downward adjustment factors weigh higher than the large number of separate expiries given the characteristics and the global nature of the contract, in itself and compared to other UK commodity derivative global contracts, and therefore concurs with the total downward adjustment from the baseline set by the FCA.

53. 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

54. 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.

55. With respect to the spot month limit, ESMA notes that the limit has been adjusted upwards significantly to ensure that commercial market participants can hedge their positions and to avoid unduly constraining normal trading in the ICE Low Sulphur Gasoil contracts. However, ESMA also notes that under Article 57(2) of MiFID II, position limits do not apply to positions held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly relating to the commercial activity of that, provided that non-financial entity applies for a hedging exemption in accordance with Article 8 of RTS 21.

56. ESMA understands the need to avoid the risk of unduly constraining trading in this commodity derivative market where underlying market participants have a key presence., but also notes that a lower spot month limit could have been set without unduly constraining trading should commercial market participants had applied for a hedging exemption under Article 8 of RTS 21.

57. In light of the assessment above, ESMA considers that these position limits have been set in accordance with the above-mentioned objectives and are suitable for the conditions under which they will be active. The position limit set for the spot month and the other months, in conjunction with the position management powers of the trading venue, 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 Low Sulphur Gasoil market and the liquidity of the ICE Low Sulphur Gasoil contracts are not hampered

58. However, to help ensure that the objectives set out in Article 57(1) of MiFID II are achieved, ESMA considers that the competent authority should further encourage commercial participants to apply for a hedging exemption.

VI. Conclusion

59. Based on all the considerations and analysis presented above, it is ESMA's opinion that the 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, 18 January 2019

Steven Maijoor

Chair

For the Board of Supervisors