European Securities and Markets Authority

Date: 31 July 2020
ESMA70-155-8812

OPINION on position limits on ICE Endex German NCG Gas contracts

I. Introduction and legal basis

1. On 15 October 2019, the European Securities and Markets Authority (ESMA) received a notification from Netherlands Authority for the Financial Markets (AFM) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits AFM intends to set for futures and options in ICE Endex German NCG Gas 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.

II. Contract classification

Commodity base product: energy (NRGY)

Commodity sub product: natural gas (NGAS)

Commodity further sub product: NCG (NCGG)

Name of trading venue: ICE ENDEX DERIVATIVES B.V.

MIC: NDEX

Venue product codes: GNM, GNP

[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, p. 84).

III. Market description

3. The ICE Endex German NCG Gas Futures contract refers to the trading of natural gas produced in Germany and received from the countries Germany is connected to. The contracts are traded in lots for which 1 lot equals 1 MW (1,000,000 Watts). The minimum trading size is 5 lots for electronic futures, 1 lot for Exchange for Physical (EFP) and 1 lot for exchange for swaps (EFS). There are monthly, quarterly, half-yearly and yearly future contracts available and the contracts are physically settled. Months, quarters, half-years and years are listed in parallel.

4. The ICE Endex NCG Gas Options contract is an option on the ICE Endex NCG Gas Futures contract. At expiry, one lot of NCG Gas Options will exercise into one lot of NCG Gas Futures. NCG Gas Options are European style, such that In-The-Money options, unless abandoned, are automatically exercised at expiry. The contracts are traded in lots for which 1 lot equals to 1 MW (1,000,000 Watts). The minimum trading size is 5 lots.

5. The market of ICE Endex German NCG Natural Gas contracts has been developing from an illiquid market to an 'in development' market. The daily average open interest in Q3 2018 was 350 lots, in Q4 2018 439 lots, in Q1 2019 1,168 lots and in Q2 2019 2,334 lots. On 10 September 2019 the daily open interest reached 6,590 lots and AFM decided to set a bespoke position limit not to block the growth of this contract.

6. 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.

7. The fundamentals of the gas markets are based on the supply and demand of gas in Europe. On the supply side, the key drivers are the availability of gas production (especially those from Norway, the Netherlands, Russia, North Africa and Middle East), transportation and storage (pipelines maintenances or outages). On the demand side, the consumption is mainly driven by the weather (heating needs). Germany is divided in two market areas; Gaspool (GPL) & NetConnect Germany (NCG) each of which has a virtual hub on which network users can trade gas. The NCG market area is larger in size and traded volume as compared to GPL.

8. Because the Dutch TTF hub is the preferred venue for forward trading, trading on NCG and Gaspool is mostly focused on the short term and balancing. Recently the German Federal Government has tendered the ideas of merging the GPL and NCG hubs and has introduced an amendment of Gas Act which forces the network operators to establish a single market area and one virtual trading hub by April 2022 at the latest.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

9. Deliverable supply amounts to 197,670,000 MWh.

10. Deliverable supply was calculated by the sum of the internal production in Germany, the storage capacity and the import capacity. For 2018, the internal production was 0 MW[4], the storage facilities represented 2,973 Gwh/d[5], interconnection with other countries represented 2,921 GWh/d[6] and LNG terminals amounted to 695 Gwh/d[7].

11. Because deliverable supply is calculated per standard month (30 days), the capacity needs to be multiplied by 30 (days), resulting in an estimation of deliverable supply of 6,589 Gwh/d*30 = 197,670,000 MWh.

Spot month limit

12. Spot month limit amounts to 19,767,000 MWh, which represents 10% of deliverable supply. The spot month limit applies to NGC Futures and Options contracts. The spot month includes one monthly contract.

Spot month position limit rationale

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

14. The contract can have a position limit set between 5-50% as set out in Article 19(2)(a) and (b) of RTS 21 as the average number of market participants holding a position in the commodity derivative is lower than 10 and there are less than 3 investment firm acting as a market maker in accordance with Article 4(1)(7) of Directive 2014/65/EU.

15. The AFM has considered the following factors for adjusting the spot month limit downwards from the baseline:

- Article 18(3) of RTS 21: The deliverable supply is significantly higher than the open interest. Based on the rationale of Article 18(3) of RTS 21, the AFM has applied a reverse interpretation of Article 18(3) of RTS 21 and adjusted the spot month limit downwards.

- 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 EEX.

[4] Source: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nrg_103m&lang=en
[5] Source: https://www.gie.eu/maps_data/downloads/2018/Storage_DB_Dec2018.xlsx
[6] Source : https://www.entsog.eu/sites/default/files/2018-12/ENTSOG_GIE_SYSDEV_2017-2018_1600x1200_FULL.pdf
[7] Source: https://www.entsog.eu/sites/default/files/2018-12/ENTSOG_GIE_SYSDEV_2017-2018_1600x1200_FULL.pdf

16. The AFM has considered all potential factors, including the volatility in the contract as required by Article 21 of RTS 21, and none of them have been regarded as material or relevant to require an adjustment, either up or down for the spot month limit.

17. Given the characteristics of this contract, the AFM decided to set a spot month limit of 10% of deliverable supply. This provides a figure of 19,760,000 MWh.

Other months' position limit

Open interest

18. Open interest amounts to 4,193,285 MWh. For the German NCG Gas market, the related contracts that fit the aggregation criteria of identical settlement and delivery terms are German NCG Gas Futures (GNM) and NCG Natural Gas Options (Futures Style Margin) (GNP).

19. The daily average open interest is calculated by adding the open interest from each identified related contract that can be aggregated. Open interest figures are published on the ICE Endex website Report Center[8] of each contract month of the same publication day. The resulting figure is the daily open interest of the relevant contract for the selected publication date. A daily overview of the contract open interest was made by repeating this process for each publication date for August 2019. Then an average was calculated resulting in the August 2019 daily open interest figure. For options, positions have been delta adjusted. The aggregated daily open interest average over August 2019 for the German NCG Gas contract is 4,193,285 MWh.

Other month's position limit

20. The other months' limit amounts to 2,096,643 MWh. The other months' limit applies to ICE Endex German NGC Futures and Options contracts. It includes, monthly, quarterly, half-yearly and yearly contracts.

Other months' position limit rationale

21. The baseline for the other months limit has been set at 25% as required by Article 9(1) of RTS 21. The contract can have a position limit set between 5-50% as set out in Article 19(2)(a) and (b) of RTS 21 as the average number of market participants holding a position in the commodity derivative is lower than 10 and there are less than 3 investment firm acting as a market maker in accordance with Article 4(1)(7) of Directive 2014/65/EU.

22. AFM considered the following factors relevant for adjusting the baseline upwards:

[8] https://www.theice.com/marketdata/reports/159, for options: https://www.theice.com/marketdata/reports/160

- Article 16(2) of RTS 21: According to Article 16(2) of RTS 21, when there is a large number of separate expiries in the other month, the limit shall be adjusted upward. There is a large amount (59 consecutive months) of separate expiries in the contracts. Therefore, there is merit in adjusting the other months' limit upward.

- Article 18(3) of RTS 21: According to article 18(3) of RTS 21, when the open interest is significantly lower than the deliverable supply, the other months' limit shall be adjusted upward. In the contract, the open interest (4,193,285 MWh) can be considered as significantly lower than the deliverable supply (325,630,800 MWh). Therefore, there is merit in adjusting the other months' limit upward.

23. 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 the AFM has not found evidence that this is excessive or that lower position limits would reduce volatility.

24. 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.

25. Given the characteristics of this contract, the AFM has decided to set a total upward adjustment of 25 percentage points resulted in an adjusted baseline of 50% of open interest. This provides another months' position limit of 2,096,643 MWh.

V. ESMA's Assessment

26. This Opinion concerns positions held in ICE Endex German NCG Gas contracts.

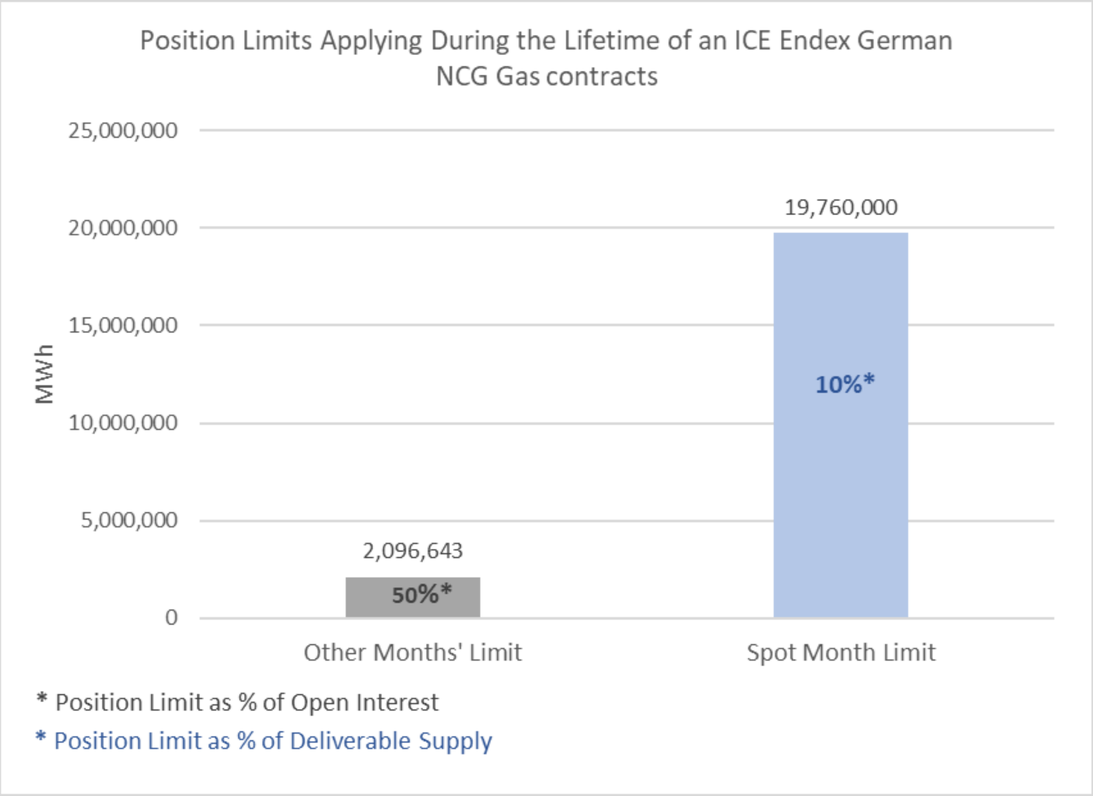
27. ESMA has performed the assessment based on the information provided by the AFM.

28. ESMA notes that the ICE Endex German NCG Gas contract is a recently liquid contract for which bespoke position limits are established by the AFM for the first time.

29. 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

30. AFM has set one position limit for the spot month and another position limit for the other months.



<u>Spot month position limit</u>

31. Deliverable supply was calculated by the sum of the internal production in Germany, the storage capacity and the import capacity for the year 2018. The source of data used to calculate deliverable supply (ENTSO-e statistics and Eurostat) ensures publicly available figures that are consistent at the European level.

32. 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.”

33. The monthly deliverable supply figure has been calculated by converting the capacity (expressed in MW) to MWh per month.

34. 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”.

35. Compared with the baseline figure of 25% of deliverable supply, the spot month position limit has been adjusted downwards and set at 10% of deliverable supply.

36. ESMA considers that, since the deliverable supply (197,670,000 MWh) is significantly larger that the open interest (4,193,285 MWh), a downward adjustment to the spot month limit can be made under Article 18(3) of RTS 21. Indeed, ESMA considers that the rationale underpinning Article 18(3) of RTS 21 with respect to the other months' limit enables the national competent authority to adjust the spot month limit downwards in case the deliverable supply is significantly higher than the open interest.

37. ESMA also agrees that a further downward adjustment is justified under Article 17 of RTS 21.

<u>Other months' position limit</u>

38. The open interest was calculated as the daily average open interest over the course of August 2019. It was calculated by adding the open interest from each identified related contract that can be aggregated and then an average was calculated resulting in the August 2019 daily open interest figure. For options, positions have been delta adjusted. ESMA considers such an approach consistent with Article 12 of RTS 21.

39. Compared to the baseline figure of 25% of overall open interest, the other months' position limit has been adjusted upward and set at 50% of open interest.

40. 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 large number of separate expiries in the contract (Article 16(2) of RTS 21).

41. 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

42. 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.

43. With respect to the spot month limit, ESMA notes that, based on the information provided by the competent authority, that the limit is substantially higher than the open interest in the spot month during the reference period and even than the overall open interest during that same period.

44. 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. ESMA also notes that the ICE Endex German NCG Gas contract is a recently

liquid contract where the size of open interest sharply contrasts with the size of deliverable supply. 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.

45. 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 ICE Endex German NCG Gas contracts are not hampered.

46. 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 ICE Endex German NCG Gas contracts should be carefully monitored by the competent authority, in particular during the spot month, and that this spot month limit should be reviewed on a timely basis

VI. Conclusion

47. 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 does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris,

Steven Maijoor

ESMA Chair