European Securities and Markets Authority

Date: 31 July 2020
ESMA70-155-9808

OPINION on position limits on Italian Power Financial Base contracts

I. Introduction and legal basis

1. On 7 May 2020, the European Securities and Markets Authority (ESMA) received a notification from the 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 the AFM intends to set for Italian Power Financial Base 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: Electricity (ELEC)

Commodity further sub product: Base Load (BSLD)

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

MIC: NDEX

Venue product codes: IPB, DIF

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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 1.12.2016 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 by the competent authority

3. Italy's total electricity consumption was 319,597 GWh in 2019[4]. Italy has a high share of electricity in the total final energy consumption. The industry and the tertiary sectors accounted for most of the consumption followed by the household sector. The agricultural sector recorded the lowest level of electricity consumption. The share of primary energy dedicated to electricity production is above 35% and grew steadily since the 1970s.

4. The Italian electricity market is well connected with the grids of its neighbouring countries, including non-EU countries in Northern Africa. Italy's power generation capacity stems from various sources of which renewable energy becomes increasingly important. In 2019 its electricity production mix was comprised of 60% thermal and 40% renewables. To meet the EU renewable energy targets, Italian electricity regulations give priority to energy produced by renewable energy sources.

5. The Electricity and Gas Authority (ARERA) is the independent body that regulates, controls and monitors the electricity market in Italy. The sole operator of the national power transmission system is Terna that operates around 98% of the Italian high-voltage power transmission grid. The most important shareholder is the Italian State via Cassa Depositi e Prestiti. Power generation is mainly in the hands of several major entities, e.g. Enel, the former state monopolist, Eni and Edison. The biggest six operators produce nearly 50% of the Italian power generation. Compared to other countries in the EU the average price of electricity is relatively high.

6. Contract size: The underlying of the Italian Power Financial Base and the Italian Power Financial Base Daily contract is the delivery or acceptance of delivery of Italian electricity with a constant output of 1 MW x days in the contract period (i.e. day, month, quarter or year) x 23, 24 or 25 hours (summer / winter time).

7. Listing cycle: With respect to the Italian Power Financial Base Futures (IPB) contract, the following maturities can be traded: for “Month futures” up to 59 consecutive month contracts can be traded. For “Quarter futures”: up to 9 consecutive quarters. Quarters are strips of three individual and consecutive contract months. Quarters always comprise a strip of Jan-Mar, Apr-Jun, Jul-Sep or Oct-Dec. For “Year futures”: up to 4 consecutive years. Years are strips of twelve individual and consecutive contract months comprising Jan - Dec. Months, quarters and years are listed in parallel.

8. With respect to Italian Power Financial Base Daily Futures (DIF) contract, the following maturities can be traded. For the “Daily products”: up to 92 consecutive daily contracts. For the ‘Weekend futures”: 5 consecutive weekends. Weekends are strips of 2 consecutive daily

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[4] source: https://download.terna.it/terna/Monthly%20Report%20on%20the%20Electricity%20System_January%202020_8d7c1d39fc55531.pdf page 8

contracts (Saturday and Sunday). For the 'Week futures": 5 consecutive weeks. Weeks are strips of 7 consecutive daily contracts (Monday through Sunday).

9. Both contracts IPB and DIF are financially settled monthly futures contracts based on the Single National Price ("Prezzo Unico Nazionale" or "PUN") for the purchase of electricity in Italy, as published by Gestore dei Mercati Energetici ("GME"). The final settlement takes place on the last (clearing) business day of the delivery period.

IV. Proposed limit and rationale by the competent authority

Spot month position limit

Deliverable supply

10. Deliverable supply amounts to 98,933,760 MWh.

11. The deliverable supply was estimated based on statistics displayed in the Statistical Factsheet of ENTSO-E (European Network of Transmission System Operators for Electricity) for the year 2018. It is composed of the domestic Net Generating Capacity (NGC) of Italy (130,935 MW) and of the average import capacities in relation to interconnectors with neighbouring countries in Greece, Montenegro, Switzerland, France, Slovenia, Austria and Malta 9 (6,473 MW). Total capacity therefore amounts to 137,408 MW.

12. Because the Deliverable Supply must be calculated in MWh per standard month (30 days), the capacity needs to be multiplied by 24 (hours) and 30 (days). Therefore, a unit conversion of 720 is required resulting in a total deliverable supply of 98,933,760 MWh (137,408 MW x 720 hours).

Spot month limit

13. The spot month limit amounts to 11,872,051 MWh, i.e. to 12% of the deliverable supply.

Spot month position limit rationale

14. In line with Article 19(2)(b) of RTS 21, the relevant range for position limits should be between 5% and 50% as there are less than three Investment Firms acting as a market maker on the Italian Power Financial Base contract.

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

16. Article 16(1) of RTS 21: If the commodity derivative has a short maturity, competent authorities shall adjust the position limit downwards. However, the existing daily futures have no open interest, therefore there is no position within the short maturity contracts.

17. 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.

18. All other factors have been considered by the AFM 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 the AFM has not found evidence that, under normal market conditions, this is excessive or that lower position limits would reduce volatility.

19. When taking into account the relevant adjustment factors in line with RTS 21, the AFM has considered that it would be appropriate to adjust the limit downwards from the baseline for Italian Power Financial Base contract and has set the spot month limit at 12% of the reference amount, i.e. at 11,872,051 MWh.

Other months' position limit

<u>Open interest</u>

20. The open interest amounts to 4,560,585 MWh.

21. The Italian Power market is rapidly developing from an illiquid market to a market in development, whereby daily open interest reached of 6,522 lots on 20 January 2020, representing an increase of 1136% in open interest compared to 25 February 2019. Therefore, the reference period selected for the calculation of open interest is 1 to 29 February 2020.

22. Open interest calculation methodology: There are overlapping contracts for the Italian Power financial base market. The overlapping contracts are identified based on the contract specifications. To be aggregated, the contracts must have identical settlement and delivery terms for the same hub. As a consequence, related contracts with cash settlement and physical settlement cannot be aggregated and therefore have their daily open interest calculated separately.

23. For the Italian Power Financial Base contract, there are five related contracts that fit the aggregation criteria of identical settlement and delivery terms. The ICE Endex applicable contracts for this Other Months limit are: Italian Power Financial Base 1x Cal Options, Italian Power Financial Base 1x Qtr Options, Italian Power Financial Base Daily Futures, Italian Power Financial Base Options and Italian Power Financial Base Futures.

24. The daily average open interest figures are extracted from the AFM position reporting system. The daily average open interest is calculated by adding the open interest from each identified related contract that can be aggregated. The resulting figure is the daily open interest of the relevant contract for the selected publication date. Using the definitions as

detailed in RTS 21 and the ESMA Questions and Answers on MiFID II and MiFIR commodity derivatives topics, the aggregated daily open interest average, from 1 February until 29 February 2020, for the Italian Power Financial Base is 4,560,585 MWh

Other months' position limit

25. The other months' limit amounts to 2,280,292.50 MWh, which represents 50% of the open interest.

Other months' position limit rationale

26. In line with Article 19, Paragraph 2(a) of RTS 21, the relevant range for position limits may be set between 5% and 50% as the Italian Power Financial Base market has a small number of market participants which trade on and daily basis. Also in line with Article 19, Paragraph 2(b) of RTS 21, there are less than three investment firms acting as a market maker on Italian Power Financial Base.

27. The AFM has considered the following factors relevant for adjusting the other months' limit upwards:

28. Article 16(2) of RTS 21: The Italian Power Financial Base contract has a relatively large amount (59) of separate expiries in the Other Months contracts;

29. Article 18(3) RTS 21: The highest daily open interest in the Italian Power Financial Base contract in 2019 is significantly lower than the relevant deliverable supply figure (less than 5% of the deliverable supply).

30. All the other potential adjustment factors set out in RTS 21 have been considered by the AFM 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, the AFM has noted that there has been some variation in the price of the commodity derivative but has not found evidence that this is excessive or that lower position limits would reduce volatility.

31. Based on the above, the AFM has decided to increase the other months' limit by 25 percentage points over the baseline, which results in an other months' limit of 2,280,292.50 MWh representing 50% of the open interest.

V. ESMA's Assessment

32. This Opinion concerns positions held in the Italian Power Financial Base futures and option contracts

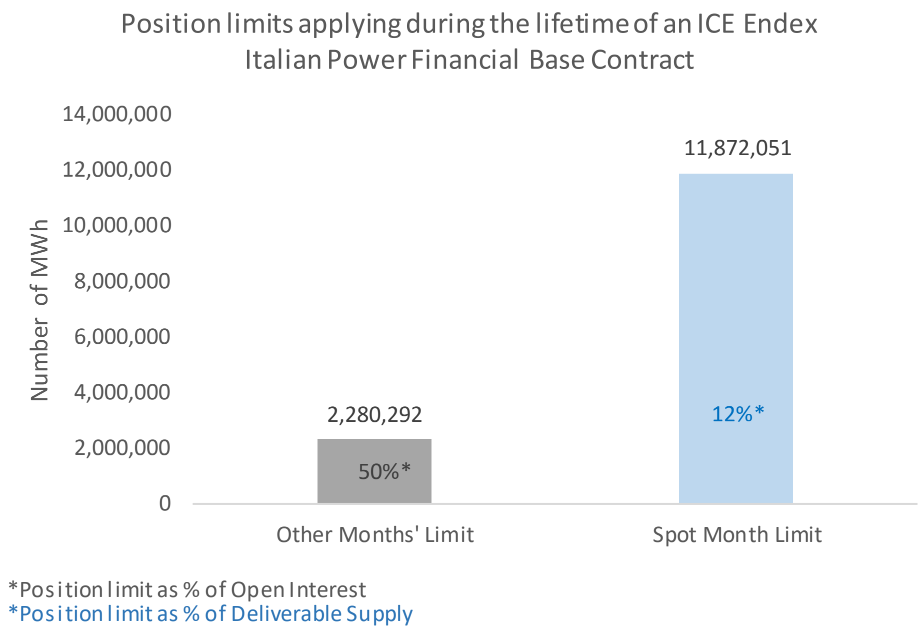
33. ESMA has performed the assessment based on the information provided by AFM.

34. ESMA notes that the ICE Endex Italian Power Financial Base contract is a recently liquid contract for which bespoke position limits are established by the AFM for the first time.

35. 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

36. The AFM has set one position limit for the spot month and one for the other months.



<u>Spot month position limit</u>

37. The calculation of the deliverable supply is based on ENTSO-e figures for 2019.

38. ESMA agrees with the methodology used for the calculation which include both the Net Generating Capacity of Italy and the average import capacities from neighbouring countries. Whilst the physical delivery of power depends on the actual number of days of the month, ESMA also 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. 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

39. Compared with the baseline figure of 25% of deliverable supply, the spot month position limit has been adjusted downwards and set at 12% of deliverable supply.

40. ESMA considers that, since the deliverable supply (98,933,760 MWh) is significantly larger that the open interest (4,560,585 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) 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.

41. Taking into account all of the above, ESMA considers reasonable to have adjusted the spot month limit downwards.

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

42. The open interest was calculated by the AFM based on position reporting data. As calculated, the open interest is the daily average of open interest during the most recent month in 2020 prior to the setting of the position limit by the AFM after aggregating all relevant contracts across all maturities. ESMA considers such an approach sensible in this case as the open interest in the Italian Power Financial Base contracts has been increasing extremely rapidly over the period prior to the setting of the position limit. ESMA also considers such approach consistent with Article 12 of RTS 21.

43. ESMA agrees that an upward adjustment was justified under Article 16(2) of RTS 21 due to the large number of separate expiries.

44. ESMA also agrees that a further upward adjustment of the position limit from the baseline was justified under Article 18(3) of RTS 21 as the open interest (4,560,585 MWh) is significantly lower than the deliverable supply (98,933,760 MWh).

45. 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

46. 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.

47. 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 of 1-29 February 2020 and even than the overall open interest during that same period.

48. 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 Italian Power Financial Base 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.

49. 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 Italian Power Financial Base contracts are not hampered.

50. 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 Italian Power Financial Base contracts should be carefully monitored by the competent authority, in particular during the spot month, and that the spot month limit should be reviewed on a timely basis.

VI. Conclusion

51. Based on 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 also 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

Chair

For the Board of Supervisors