European Securities and Markets Authority

Date: 29th January 2021
ESMA70-155-11512

OPINION on position limits on ICE Endex NCG natural gas contracts

I. Introduction and legal basis

1. On 2 December 2020, the European Securities and Markets Authority (ESMA) considered that sufficient information was received to assess 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"). The notification is 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.

3. On 31 July 2020, ESMA issued a first opinion regarding the exact position limits AFM intended to set for the ICE Endex German NCG natural gas commodity contracts. The position limits considered by AFM in October 2019 were 19,767,000 MWh for the spot month limit and 2,096,643 MWh for the other months' limit. In this opinion, ESMA concluded that the position limits considered by AFM 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 in deliverable supply or open interest, or any other significant change on the market, and reset the position limits. Since the level of open interest has significantly increased compared to the level of open interest underpinning the other months' position limit set out in AFM's initial submission, AFM considered that the position limits should be reset. The new position limits have started applying from 16 November 2020.

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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).

5. In this opinion, ESMA is assessing whether the new position limits AFM intends to set for the NCG natural gas commodity 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: NCG (NCGG)

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

MIC: NDEX

Venue product codes: GNM, GNP

III.Market description

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 the 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 into 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 the Gas Act which forces the network operators to establish a single market area and one virtual trading hub by April 2022 at the latest.

9. 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.

10. 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 Option 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.

11. 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 was 1168 lots in Q1 2019 and 2334 lots in Q2 2019 whereas it amounted to 4701 lots in Q1 2020 and 6417 lots in Q2 2020. It is therefore a quickly developing contract, which has to be taken into account when setting the limit.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

12. Deliverable supply amounts to 206,850,000 MWh.

13. Deliverable supply was calculated by the sum of the internal production in Germany, the storage capacity and the import capacity. The internal production was 0 MW[4] in 2019, the storage facilities represented 2,973 Gwh/d[5] as of 2018, and interconnection with other countries and LNG represented 3,922 GWh/d[6] for the year 2019.

14. 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 6,895 Gwh/d*30 = 206,850,000 MWh.

Spot month position limit

15. The spot month limit amounts to 20,685,000 MWh, which represents 10% of deliverable supply. The spot month limit applies to NCG Futures and Options contracts. The spot month includes one monthly contract.

Spot month position limit rationale

16. The baseline for the spot month 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% and 35%, according to the Article 14 of RTS 21.

[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/2020-01/ENTSOG_GIE_SYSDEV_2018-2019_1600x1200_FULL_063_clean.pdf

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

- Article 16(1) of RTS 21: For NCG natural gas there are contracts available with relatively short maturities.

- 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.

- 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. The AFM has considered all other 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.

19. 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 20,685,000 MWh.

Other months' position limit

Open interest

20. Open interest amounts to 5,787,881 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).

21. The daily average open interest figures are extracted from the AFM's 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. A daily overview of the contract open interest was made by repeating this process for each publication date for September 2020. The aggregated daily open interest average over September 2020 for the German NCG Gas contract is 5,787,881 MWh.

Other month's position limit

22. The other months' limit amounts to 2,893,941 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

23. 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.

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

- Article 16(2) of RTS 21: When there is a large number of separate expiries in the other month, the limit shall be adjusted upwards. There is a large amount (59 consecutive months) of separate expiries in the contracts.

- Article 18(3) of RTS 21: When the open interest is significantly lower than the deliverable supply, the other months' limit shall be adjusted upwards. In the contract, the open interest is less than 3% of deliverable supply.

25. 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.

26. 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.

27. 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 2,893,941 MWh.

V. ESMA's Assessment

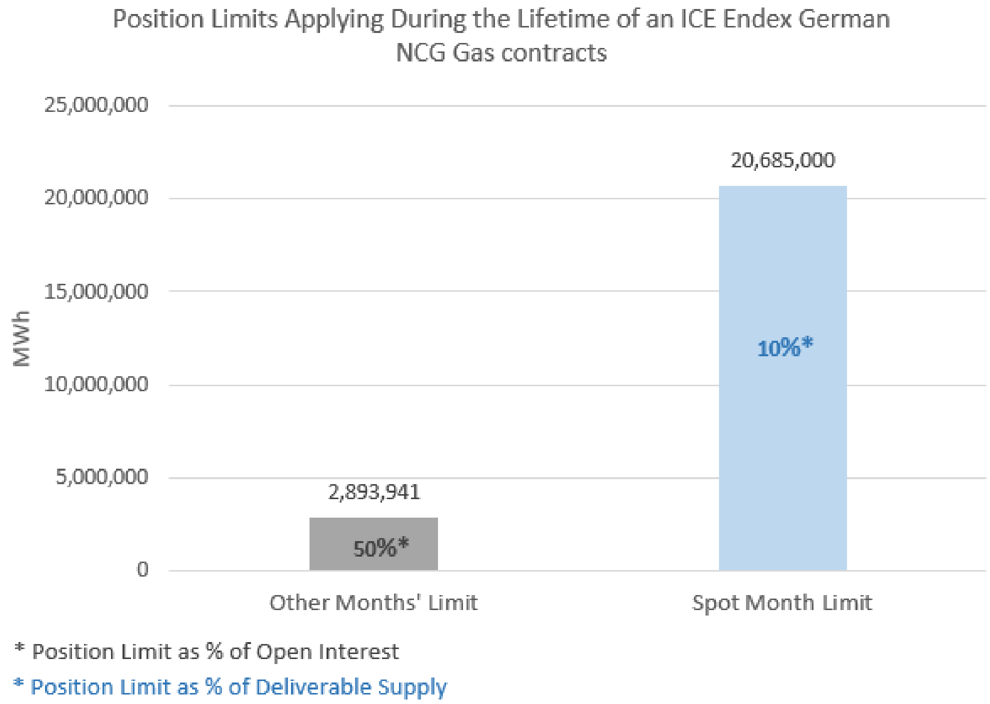
28. This Opinion concerns positions held in ICE Endex German NCG Gas contracts.

29. ESMA has performed the assessment based on the information provided by the AFM. ESMA notes that the ICE Endex German NCG Gas contract is a recently liquid contract for which open interest continues to grow.

30. 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

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



<u>Spot month position limit</u>

32. Deliverable supply was calculated by the sum of the internal production in Germany, the storage capacity and the import capacity according to the latest available data. 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.

33. 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."

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

35. 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".

36. 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.

37. ESMA considers that, since the deliverable supply is significantly larger than the open interest, 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.

38. ESMA also agrees that a further downward adjustment is justified under Articles 16 and 17 of RTS 21, since there are relatively short maturities of the ICE Endex NCG contracts, and the deliverable supply is used for other contracts in the market.

Other months' position limit

39. The open interest has been calculated by AFM based on position reporting data where 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 month of September 2020. 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 is also of the view that taking the most recent available month in 2020 as a reference period is sensible in this case due to quickly growing open interest in this contract and considers such approach consistent with Article 12 of RTS 21.

40. 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.

41. 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.

42. 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

43. 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.

44. With respect to the spot month limit, ESMA notes that the limit is substantially higher than the overall open interest.

45. ESMA understands the need to avoid the risk of unduly constraining trading in this increasingly growing contract, where participants active in the underlying commodity market can have naturally large positions. 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.

46. 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.

47. 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

48. 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, 29th January 2021

Steven Maijoor

ESMA Chair