Date: 15 May 2018
ESMA70-155-3509

OPINION on position limits on ICE Low Sulphur Gasoil 1st Line 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 1st Line Future and Option 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: diesel (DSEL)

Name of trading venue: INTERCONTINENTAL EXCHANGE - ICE FUTURES EUROPE

MIC: IFEU

[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 code: ULA[4]

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 is so called because during the refining process it moves literally from being gas condensing on the chamber to a liquid. It sits in the middle of the range of densities in the barrel and 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. The ICE Low Sulphur Gasoil 1st Line Future is a monthly cash settled future based on the ICE daily settlement price for Low Sulphur Gasoil Futures. The physically settled 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.

7. Trading in the ICE Low Sulphur Gasoil 1st Line Future contracts takes place in lots. One lot is equivalent to 100 metric tonnes (MT). 74 consecutive months are available for trading. At expiry, the ICE Low Sulphur Gasoil 1st Line Future is cash-settled. There is no provision in the contract for physical settlement.

8. The final settlement price is a price in USD and cents per metric tonne based on the average of the settlement prices as made public by ICE for the front month Low Sulphur Gasoil Future for each business day in the determination period.

9. ICE also offers trading in Low Sulphur Gasoil Average Price Options. The Low Sulphur Gasoil Average Price Option is based on the underlying ICE Low Sulphur Gasoil 1st Line Future and will automatically exercise into the settlement price of the 1st Line Future on the day of expiry of the options contract if they are "in the money". The Swap Future resulting from exercise

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
5 Source: International Energy Association (IEA), Oil Market Report Glossary & European Commission, Energy Statistics Manual

immediately goes to cash settlement. If an option is “out of the money”, it will expire automatically.

10. ICE further offers trading in ICE Low Sulphur Gasoil 1st Line Balmo Futures. A Balmo (“balance of the month contract “) is a future contract taken out on any day of the spot month and is settled on the last trading day of that month. The Balmo shares contract specifications with the whole month contract (the principal) and is priced off the same underlying.

11. This contract is available for trading on ICE Futures Europe. In the US, Nasdaq Futures offers a cash settled low sulphur gasoil 1st line financial futures contract based on the daily settlement price of the ICE Low Sulphur Gasoil Futures.

12. The estimated number of market participants is 111. There are no market makers.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

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

14. Deliverable supply data for the ICE Low Sulphur Gasoil Future contract has been used as a reference for this Low Sulphur Gasoil 1st Line Future. The physically deliverable futures contract, on expiry, can be delivered by barge in the Amsterdam-Rotterdam-Antwerp (ARA) corridor of the Netherlands and Belgium into recognised delivery installations. For delivery, the trading venue takes into account low sulphur gasoil from Belgium and the Netherlands which is easily transported to the ARA delivery points.

15. The deliverable supply data has been calculated using production, 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 metric tonnes. 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.[6]

16. 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

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

17. The spot month limit amounts to 33,850 lots, which represents 25% of deliverable supply. The position limit applies to the ICE Low Sulphur Gasoil 1st Line Future and Option contracts and to other Balmo 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.

18. The FCA is of the view that if separate limits are applied to Balmo 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 aggregated Balmo 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 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.

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

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

20. After considering all the characteristics of the contract, the FCA has decided not to make any adjustments under any of the Articles of RTS 21. No factors that would justify an adjustment from the baseline have been identified.

21. 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.

22. As no adjustments were made to the baseline at 25%, this provides a figure in lots of 33,848, which has been rounded down to a figure of 33,800 lots. This equates to a final limit as a percentage of deliverable supply of 25.0%.

Other months' position limit

<u>Open interest</u>

23. Open interest amounts to 90,941 lots. For the calculation of open interest, the FCA has aggregated open interest in Balmo 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.

24. Open interest in this contract was highly variable over 2017 with peak open interest 45% greater than the average. The FCA is of the view that taking average open interest as the baseline for the position limit might prevent the market working adequately during peak periods. Therefore, for the core contract, the FCA has applied the open interest figure on the day representing the 95th percentile for the open contracts, delta-adjusted options, and balmo contracts which have not been closed out or expired.

Other months' position limit

25. The other months' limit amounts to 24,550 lots, which represents 27.0% of open interest. The position limit applies to the ICE Low Sulphur Gasoil 1st Line Future and Option contracts and to other Balmo contracts that 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 19 above.

Other months' position limit rationale

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

27. As open interest is significantly lower than deliverable supply (67%), the FCA has made an upward adjustment of 2 percentage points under Article 18(3) of RTS 21.

28. All other potential adjustment 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 upward adjustment of 2 percentage points was made resulting in an adjusted position limit of 27.0%. This provides a figure in lots of 24,554, which has been rounded down to a figure of 24,550 lots. This equates to a final limit as a percentage of open interest of 27.0%.

V. ESMA's Assessment

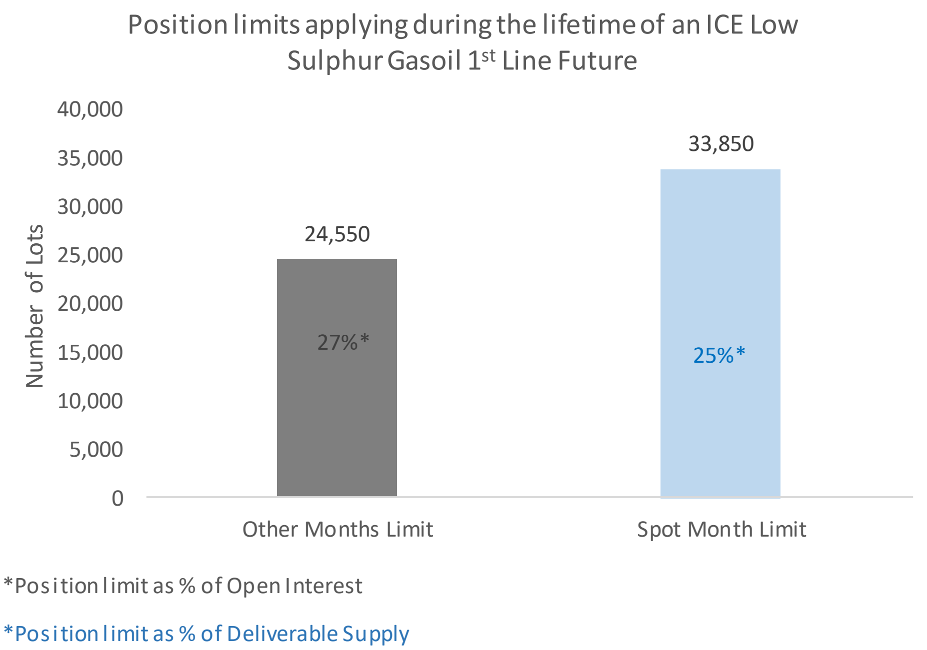
30. This Opinion concerns positions held in ICE Low Sulphur Gasoil 1st Line Future and Option contracts as well as in other Balmo contracts that are based on identical core (underlying) contractual specifications, terms and conditions, as shown on the FCA's website.

31. 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

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



Spot month position limit

33. 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".

34. Compared to the baseline of 25% of deliverable supply for derivative contracts where the underlying does not qualify as food intended for human consumption, the spot month limit has not been adjusted except to accommodate a rounded number of lots.

35. ESMA agrees that many of the adjustment factors set out in RTS 21 for the spot month are linked to the underlying commodity and the underlying commodity market and that those adjustment factors do not appear to be relevant for cash settled contracts such as the ICE Low Sulphur Gasoil 1st Line Future.

36. In particular, 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 Nasdaq Low Sulphur Gasoil 1st Line Future cash-settled contract as those two contracts with the same underlying commodity are 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.

Other months' position limits

37. The open interest was calculated as the open interest on the day representing the 95th percentile in terms of the level of activities in the calendar year 2017. ESMA considers that such an approach is sensible in this case as it allows taking into account the peak activities in the ICE Low Sulphur Gasoil 1st Line Future contracts and the upward trend in open interest. ESMA also considers this approach consistent with Article 12 of RTS 21.

38. ESMA considers that it is appropriate to aggregate open interest in Balmo and principal ICE Low Sulphur Gasoil 1st Line contracts and to set a single position limit both for the spot month and the other months' for these aggregated contracts as they are based on identical core (underlying) contractual specifications, terms and conditions. ESMA considers that this approach is compliant with the objectives of the MiFID II position limit regime and RTS 21.

39. As open interest is significantly lower than deliverable supply, ESMA considers it is appropriate to adjust the other months' limit upwards, in accordance with Article 18(3) of RTS 21.

40. ESMA agrees that compared to some other commodity derivative contracts, the number of expiries in the other months (74) does not appear large and thus does not require an upward adjustment under Article 16(2) of RTS 21.

41. ESMA also agrees that compared to other globally traded UK commodity derivative contracts, the number of market participants (111) does not appear high and consequently does not require a downward adjustment under Article 19(1) 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, based on the information provided by the competent authority, that the limit is higher than open interest in the spot month throughout 2017.

45. ESMA understands the need to avoid the risk of unduly constraining trading in this relatively less liquid commodity derivative market where underlying market participants have a key presence. However, there is scope to lower the spot month limit without constraining market activity given that it is well above the positions held by market participants.

46. In light of the assessment above, ESMA considers that 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 1st line Futures 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 Low Sulphur Gasoil 1st line Futures 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

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. 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, 15 May 2018

Steven Maijoor

Chair

For the Board of Supervisors