European Securities and Markets Authority

Date: 31 July 2020
ESMA70-155-9765

OPINION on position limits on EEX NCG Natural Gas contracts

I. Introduction and legal basis

1. On 20 March 2020, the European Securities and Markets Authority (ESMA) received a notification from Federal Financial Supervisory Authority (BaFin) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits BaFin has set for EEX NCG Natural Gas Future 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. The contract used to be traded on Powernext until 1 of January 2020 when the trading has been moved to EEX following the merger between the two entities.

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: other (OTHR)

Name of trading venue: EUROPEAN ENERGY EXCHANGE

MIC: XEEE

Venue product code: G0B

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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. The EEX NCG Natural Gas contract is a derivatives contract referring to the future physical delivery of gas into the NCG transmission system. The contract used to be traded at Powernext. However, trading of derivatives contracts on gas has been moved to EEX end of 2019 and since 1 January all prior Powernext gas contracts are traded at EEX.

4. 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.

5. The German wholesale market for natural gas is split into two different but overlapping transmission systems - GPL and NCG. NCG is the transmission system and virtual marketplace operated by NetConnect Germany GmbH & Co.KG (NCG). Due to regulatory requirements GPL and NCG are going to be merged in October 2021 to form a single transmission system called Trading Hub Europe.

6. The German gas market is one of the biggest in Europe and relies mainly on pipeline imports (38% from Russia, 22% from Norway and 26% from the Netherlands and 14% from others). A variety of different privately-owned market participants is active in the German gas market ranging from transmission system operators, traders to storage operators.

7. Market participants at NCG contracts can be classified as:

   - Utilities, which have a gas portfolio (entry/exit capacities, storages capacities, consumption clients) and use the market for optimizing or sourcing;

   - Industrial consumers, which are essentially buyers in the wholesale market;

   - Municipalities, which aggregate final consumers and bring their needs to the wholesale market;

   - Operators (Transport system operators, storage system operators, LNG system operators) which enter the system for their own needs or for balancing purposes; or

   - Trading companies which do not have a shipper or supply agreement in the market (banks, commodities traders, investment firms).

8. All the contracts are physically delivered via a nomination to the relevant TSO. According to the Herfindahl-Hirschman-Index[4] there is a moderate market concentration in the gas supply market, and there is no evidence of market concentration in the gas retail market.

[4] https://ec.europa.eu/energy/sites/ener/files/documents/2014_energy_market_en.pdf, page 53

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

9. Deliverable supply amounts to 196,320,000 MWh.

10. The calculation of the deliverable supply is based on actual daily entry capacities of each of the source type described below to the NCG market area. While the capacities of the system are relatively stable during the year, the flows of gas depend on the consumption, which depends on the weather conditions. This calculation takes into account the following sources:

1) Entry pipeline capacity = 2,921 GWh/d in 2018[5]

2) LNG import capacity = 695 GWh/d[6]

3) Storage withdrawal capacity = 2,928 GWh/d in 2017[7]

4) Average indigenous production in 2018 = 0 GWh/d in 2018[8]

11. The total deliverable supply sums up to 6,544 GWh/d. This equates to 196,320,000 MWh/ month.

Spot month limit

12. Spot month limit amounts to 29,511,000 MWh which corresponds to 15% of deliverable supply.

Spot month position limit rationale

13. Since the EEX NCG Natural Gas contract is not a food contract, the baseline figure for the spot month, which is based on deliverable supply, was calculated as 25% of the estimated deliverable supply, i.e. 25% * 196,740,000 MWh = 49,185,000 MWh. There is only one market maker. Thus, the limit is to be set within a range of 5% - 50%.

14. BaFin considered the following factors relevant for adjusting the limit downwards:

- Article 18(3) of RTS 21: the deliverable supply is significantly larger than the open interest. BaFin has applied a reverse interpretation of Article 18(3) of RTS 21 and

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[5] https://www.entsog.eu/sites/default/files/2018-12/ENTSOG_GIE_SYSDEV_2017-2018_1600x1200_FULL.pdf
[6] https://www.entsog.eu/sites/default/files/2018-12/ENTSOG_GIE_SYSDEV_2017-2018_1600x1200_FULL.pdf
[7] https://www.gie.eu/maps_data/downloads/2018/Storage_DB_Dec2017.xlsx
[8] http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nrg_103m&lang=en

therefore adjusted the spot month limit downwards, in order to ensure that no position holder is able to hold excessive shares of overall open interest due to large deliverable supply / low open interest.

- 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 ICE Endex.

15. 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 BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

16. 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.

17. Given the characteristics of this contract, BaFin has decided to set a total downward adjustment of 10 percentage points resulted in an adjusted baseline of 15% of deliverable supply. This provides a spot month limit of 29,511,000 MWh.

Other months' position limit

Open interest calculation methodology

18. Open interest amounts to 40,520,088 MWh.

19. Open interest calculation methodology: The open interest value was calculated as the average of the daily open interest of all NCG futures from the 01 August 2019 to 31 October 2019. It was based on data provided by the European Commodity Clearing (ECC), i.e. the CCP of Powernext where the contract used to be traded before it was transferred to EEX in the course of a merger of Powernext with EEX. EEX had not listed the contract until 01 January 2020. From 31 December 2019 to 01 January 2020 all trading at Powernext ceased and started at EEX simultaneously. Accordingly, all positions held at Powernext were completely transferred to EEX.

20. The open interest has been calculated by aggregating all contracts across all maturities and converting them into MWh. Furthermore, the calculation is based on the assumption that the open interest at EEX will remain more or less the same as at Powernext. BaFin is closely monitoring the development of open interest.

Other months' limit

21. Other months limit amounts to 14,182,031 MWh which corresponds to 35% of open interest.

Other months' position limit rationale

22. The open interest amounts to 40,520,088 MWh. The baseline figure for the other months limit amounts to 25% of open interest, i.e. 10,130,022 MWh.

23. The following factors were considered relevant for adjusting the baseline upwards:

- Article 16(2) of RTS 21: For a given trading day, there is a large number of separate expiries (EEX lists future contracts for the next 6 months, the next 7 quarters, the next 6 seasons and the next 6 calendar years). In total, EEX lists 25 future contracts each day.

- Article 18(3) of RTS 21: the overall open interest is significantly lower than the deliverable supply (the open interest is almost five times lower than the deliverable supply).

24. 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.

25. 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.

26. Given the characteristics of this contract, BaFin has decided to set a total upward adjustment of 10 percentage points resulted in an adjusted baseline of 35% of open interest. This provides another month's position limit of 14,182,031 MWh.

V. ESMA's Assessment

27. This Opinion concerns positions held in EEX NCG Natural Gas Futures.

28. ESMA has performed the assessment based on the information provided by BaFin.

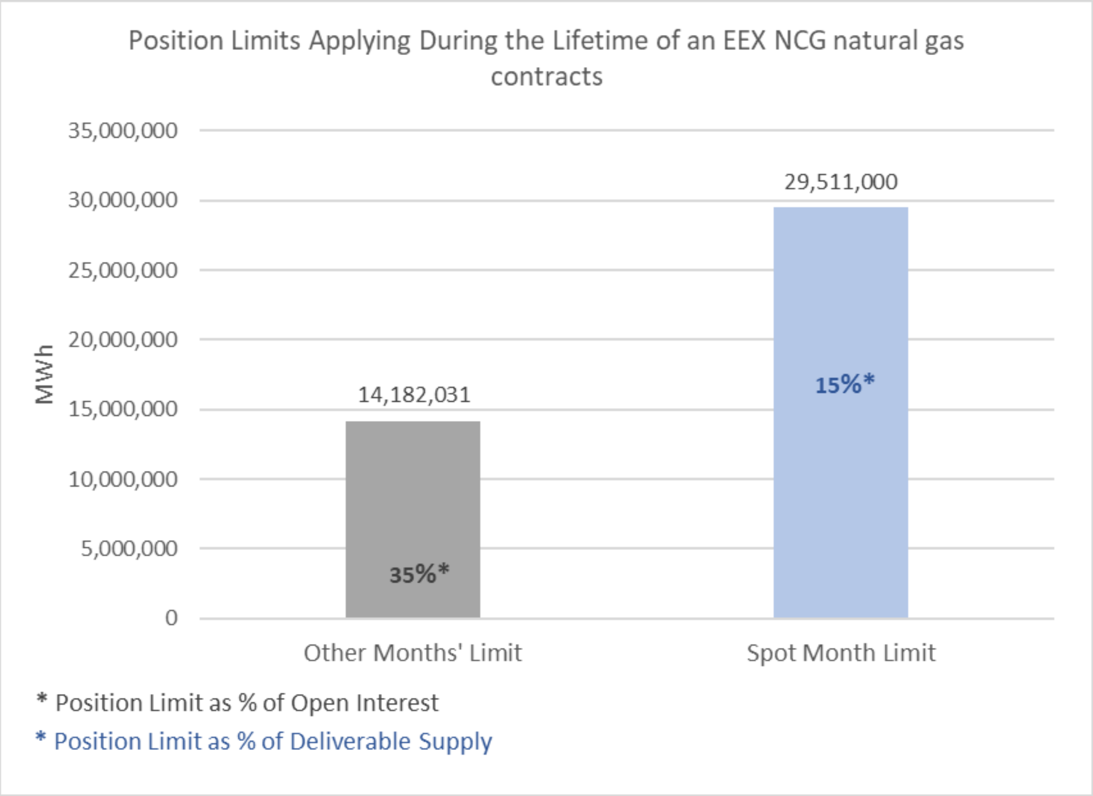
29. ESMA notes that when BaFin notified ESMA, the position limits for EEX NCG Natural Gas Futures contracts had already been set and active.

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.

31. Since the contract was traded before on Powernext until the end of 2019, when the merger between EEX and Powernext took place, ESMA considers that this is a continuation of trading in the previously existing contract, rather than a new contract. Therefore, it seems appropriate to use the previously observed OI level on Powernext, for the purpose of setting the relevant position limits.

Compatibility with the methodology for calculation of position limits established in RTS 21 in accordance with Article 57(3) of MiFID II

32. BaFin has set one position limit for the spot month and another position limit for the other months.



<u>Spot month position limit</u>

33. The calculation of the deliverable supply is based on the average entry pipeline capacity for Germany in 2018 and the storage withdrawal capacity for the year 2017. The source of data used to calculate deliverable supply (ENTSO-e statistics) ensures publicly available figures that are consistent at the European level.

34. 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.”

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

36. 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".

37. Compared to the baseline figure of 25% of deliverable supply, the spot month position limit has been adjusted downward and set at 15% of the deliverable supply.

38. ESMA agrees that a downward adjustment of the spot month position limit is justified in accordance with Article 18(3) of RTS 21 given that the deliverable supply is significantly larger than the open interest. ESMA also agrees that a further downward adjustment is justified under Article 17 of RTS 21.

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

39. The open interest was calculated as the daily average over three consecutive months of the number of open contracts that have not been closed out or expired. ESMA considers such an approach sensible in this case as an average for a period of time gives a more stable measure of open interest 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 35% of the 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 is a large number of separate expiries (Article 16 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, 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.

45. 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. 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 EEX NCG Natural Gas 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 EEX NCG Natural Gas Futures 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,

Steven Maijoor

Chair

For the Board of Supervisors