- Position Paper -

MiFIR Pre-Trade Transparency: Call for a Methodology for the Conversion of LIS Notional Values to Lots

Brussels, 15 July 2019 | Europex and its members are committed to working with ESMA and the NCAs to ensure that markets continue to become more transparent in line with the policy objectives of MiFID II/MiFIR. In this context, we take note of the recently published "ESMA Supervisory Briefing on compliance with MiFIR pre-trade transparency requirements in commodity derivatives" and welcome ESMA's commitment to review the currently inappropriately calibrated pre-trade transparency regime.

As stated at earlier occasions, the enforcement of full compliance should be postponed until after the review of RTS 2 as otherwise irreparable damages would be caused to existing markets, leading to significant volume shifts from cleared trading to purely bilateral trading which would be contrary to the policy objectives of MiFID II/MiFIR.

For the interim period until RTS 2 will have been revised, however, it is crucial that exchanges are able to use an appropriate calculation methodology for the conversion of LIS notional values to lots. With this in mind, **Europex strongly recommends, *inter alia*, the usage of a LIS notional value conversion methodology based on the highest price which has occurred in a recent full year.**[1] Inadequately set LIS thresholds could result in an aggravation of the negative impact of the inappropriately calibrated pre-trade transparency regime threatening the orderly functioning of energy derivatives markets in Europe.

Energy markets are indeed fundamentally different from financial markets and are characterised by a wide range of different contract types, including former swaps, forwards, futures and options with various combinations of quality, location, delivery type, duration, size, etc. Brokers play an important role in the pre-negotiation workflow in a number of these markets which are used by professional investors to hedge their risk.

Unreasonably high LIS threshold levels may lead to disorderly trading conditions and can seriously harm the efficiency of energy markets operated in Europe in the interim period before the recalibration of RTS 2. As the latter does not prescribe a methodology for the conversion of notional values to lots, including which period is to be used and which methodology for calculating the price levels in the selected period should be applied, exchanges should be able to make use of the flexibility allowed by the legislation when converting notional values to lots.

[1] For clarity, the timeframes used for LIS, SSTI and liquidity assessments should be aligned.

In the following, we discuss the LIS conversion methodology as well as different related aspects, including the occurrence of fast moving markets and the effect of varying energy commodity prices on LIS levels.

LIS conversion methodology

The LIS levels for energy derivative contracts are based on notional values as set out in RTS 2. In order to translate the notional value into a block threshold, exchanges have to convert the notional value to lots by dividing it by the price of a futures or options contract in a certain historical period. A block threshold that takes into account and varies based on the price levels of a contract, rather than having regard to how the physical underlying trades, is highly problematic and risks creating a disconnect between the physical underlying and the futures contract, thereby reducing the utility of the futures contract. Therefore, using the maximum flexibility (e.g. a max price) in a fraught methodology will create some room to align the block levels with the standard size of the physical underlying which market participants are seeking to hedge.

As explained in more detail below, for certain contracts, in particular those characterised by high volatility, only a conversion methodology based on the highest price can ensure that different market conditions (including fast moving markets) and the varying prices of energy commodities are accommodated.

1. The LIS conversion methodology needs to enable an efficient risk transfer at all times but especially during times of volatility, including in fast moving markets

Market participants rely on exchanges to provide an effective means to transfer risk and hedge exposure, especially in times of volatility. In order to provide for orderly trading conditions, the calculation methodology for the conversion of the LIS notional values (as detailed in RTS 2) to lots needs to be able to accommodate significant price volatility which can occur in fast moving markets. Inappropriately calculated LIS thresholds would thereby hamper the ability of market participants to hedge their exposure and make use of clearing services, at a time when they need it the most.

A conversion methodology based on the average price in a certain period is thereby highly unsuitable, as it effectively offsets relatively high and low prices which were observed in a given market. In changing market conditions, a methodology based on average prices may result in a LIS level (expressed in lots) which significantly deviates from existing market practice and what is acceptable to market participants, depending on the direction of price signals in a market. The price indicator resulting from an approach based on average prices also fails to take in account rapid price movements that could occur in fast moving markets.

Substantial price volatility has for example been observed in the Belgian power market and neighbouring hubs from October 2018 to January 2019. In this period, a shortage of supply occurred in the Belgium power market, which also impacted the market price of neighbouring hubs, such has the German bidding zone. For example, a transaction in German power futures of 5 lots in a June 2019 contract would have had a notional value of 183,822 EUR, whilst a transaction of identical size (5 lots) in the September 2019 German Power Futures contract had a notional value of 256,928 EUR. This represents an increase of 40% in notional value in the same futures contract directly resulting from fast moving markets which occurred in the Belgian market.

To provide for sufficient flexibility in order to accommodate for changing market conditions (including fast moving markets), it is more appropriate to allow for conversion of the LIS notional value by using the highest price that has occurred in a recent full calendar or trading year.

2. Energy commodity prices vary significantly over time

The price of energy commodities may vary significantly over time due to continuously changing market fundamentals. As illustrated in Figure 1 below by way of example, the price distribution of the ICE Endex Italian power baseload futures contract changes considerably over the period 2016 to 2019. What could be considered a relatively high price in 2016 (around 45 EUR) for electricity in Italy becomes a rather average price in the following year. Also, within each year the price of the Italian power baseload contract changes considerably as prices range from 39 EUR to 84.50 EUR in the most recent full year (2018). Figure 1 also demonstrates that some years have higher price volatility than others. A similar pattern is observed in other power futures contracts.

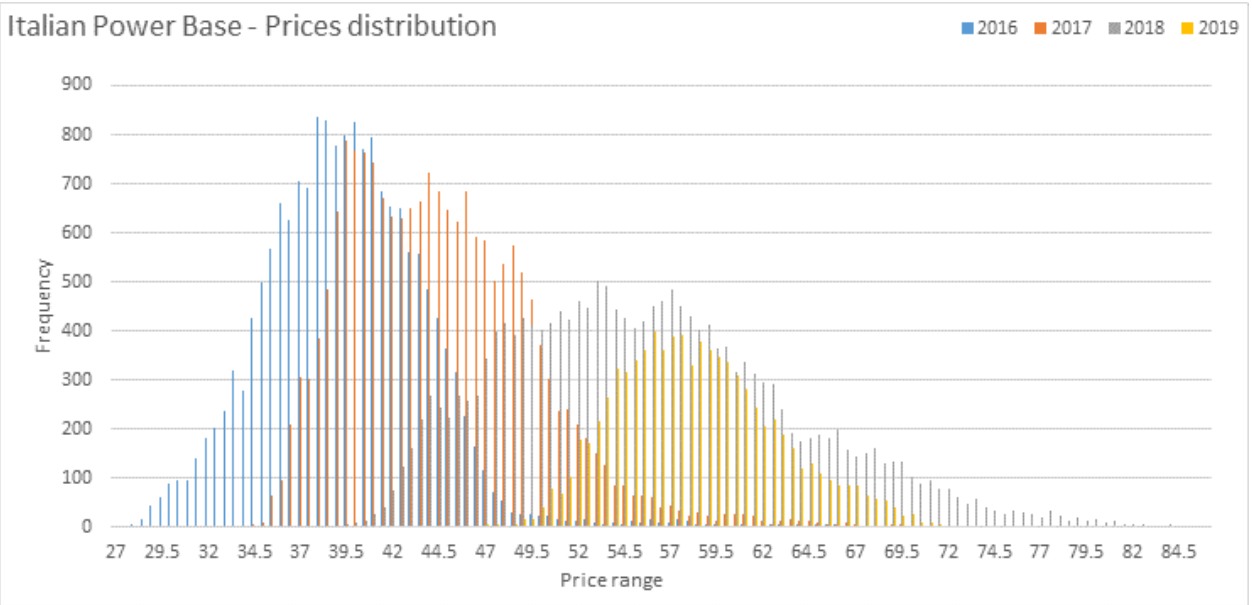

Figure 1. Price distribution in Italian Baseload power contract.

Given that the conversion of notional value to lots is dependent on the price of the underlying commodity, price levels to a greater extent determine the levels of the block thresholds that exchanges need to implement under the MiFIR pre-trade transparency requirements. If prices in an underlying commodity change, LIS thresholds could be set at levels which are not supported by the market and thereby impede the development of exchange-traded energy contracts. As it is unlikely that LIS thresholds are instantly revised following changing market conditions, the conversion methodology needs to ensure that it provides for sufficient flexibility in order to prevent negative consequences. The usage of the maximum price from a recent twelve-month period should accommodate for this. It would furthermore ensure that seasonality effects are taken into account that may occur in the underlying of the contract.

About

Europex is a not-for-profit association of European energy exchanges with 27 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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