



3 October 2012

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Lodged (online): <https://senate.aph.gov.au/submissions/pages/index.aspx>

Corporations Legislation Amendment (Derivative Transactions) Bill 2012

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Corporations Legislation Amendment (Derivative Transactions) Bill 2012.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 51,000 people and contribute \$16.5 billion directly to the nation's Gross Domestic Product.

esaa is concerned that without amendment the Corporations Legislation Amendment (Derivative Transactions) Bill could impose costs on the energy industry – and ultimately increase the cost of electricity.

This Bill enables Australia to meet its G20 commitments in relation to over-the-counter (OTC) derivative markets. The Minister for Financial Services and Superannuation will have the power to prescribe various regulatory requirements for OTC markets including:

- the reporting of all OTC derivatives to trade repositories;
- the clearing of all standardised OTC derivatives through central counterparties; and
- the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

The Bill only sets the powers for the Minister, it does not directly impose any requirements on any OTC market.

Energy Industry concerns

The energy industry would be very concerned if electricity OTC markets are affected by the legislation. Electricity market OTC derivatives vary greatly and can be based on confidential underlying data such as forecast retailer sales.

Even the first level requirement – mandatory reporting of all OTC derivatives – could result in a substantial cost to the electricity industry for little benefit. If the electricity OTC market is included participants will lose flexibility in hedging arrangements as some OTCs will become unavailable. There is likely to be less forward contracting as a result. ACIL Tasman modelling commissioned by esaa found that if contracting was reduced by 5%, it could result in retail electricity prices increasing by up to 10% for small-users and 15% for large users.

The esaa believes that the electricity OTC market should be exempted from the legislative framework. The most effective way to exempt electricity market derivatives is to do so explicitly through an amendment to the Bill. This ensures that the energy sector has regulatory certainty rather than facing the prospect that it could be brought within the scope of the mandatory obligations on the Minister's whim at any time.

We request that the Committee make appropriate recommendations for amendments to deal with the specific circumstances in the energy market to avoid any impact on household power bills.

Additional information on the operation of the National Electricity Market, the associated financial markets and the impact of the Bill is provided in **Attachment 1**.

Any questions about our submission should be addressed to Kieran Donoghue,

Yours sincerely

Matthew Warren
Chief Executive Officer

Attachment 1

Design of the NEM

The National Electricity Market (NEM) is a gross pool in which the sale of all wholesale electricity must occur in a spot market. The market rules governing the operation of the NEM in Australia preclude a retailer from contracting directly with a generator for the purchase of electricity, resulting in separation of the physical dispatch of electricity from the price-related hedge contract.

Wholesale spot market

The Australian Energy Market Operator (AEMO) determines the spot price for each half hour interval during the trading day. The spot price is the market determined clearing price that matches supply with demand, and forms the basis for financial settlement of wholesale purchases and sale of electricity by NEM participants. Generators receive the spot price from AEMO for electricity sold in the NEM, and retailers and wholesale end-users pay the spot price for electricity consumed.

The spot market allows almost instantaneous matching of supply against demand. While this contributes to a safe, secure and reliable supply of electricity, the market can also be extremely volatile. This extreme volatility creates a strong motivation for participants to enter into contracts to manage this risk.

NEM financial markets

The electricity derivatives market is local to Australia and is dominated by physical participants. Unlike some other derivatives markets, the electricity derivative markets are used to manage risk associated with physical positions, rather than speculate on future movements. Generators and retailers manage their exposure to the wholesale spot price of the NEM by entering into contractual arrangements that operate independently of both the wholesale spot market and the AEMO. Market participants can contract through the over-the-counter (OTC) and exchange (standardised) markets.

Key differences between OTC and exchange markets

OTCs are confidential contracts largely between retailers and generators. As the contracts are negotiated between the two parties, it allows market participants the flexibility to structure the contract to reflect their specific risk exposure. For example, to manage 'volume risk'¹ retailers can design load following swaps tailored to the retailer's customers' demand, which will follow the actual usage of the retailer's customers over the agreed period. Alternatively, generators can use contracts to manage the risk around unscheduled outages, by including plant availability clauses or obtain outage protection from other generators. In comparison, exchange contracts are standardised products traded on the Australian Securities Exchange (ASX) which do not provide any flexibility to manage non standardised risks. It follows that any attempt to standardise the electricity derivatives market would result

¹ The risk that the retailer's customers' demand is higher than the retailer expected, requiring the retailer to pay spot prices for the additional electricity to meet that demand.

in electricity market participants losing the ability to enter into bespoke contracts to manage their risks. It would accordingly increase the risk profile of these businesses.

Impact of the Bill

Even the lightest approach suggested – reporting all OTC derivatives to trade repositories – could result in a substantial cost to the electricity industry for little benefit. While standardised contracts are relatively easy to report, OTC contracts are more flexible and can be more complex making it quite challenging to develop a central repository that will capture all the necessary information in a comparable form.

The requirement to centrally clear electricity OTC contracts would have two key outcomes:

- the forced standardisation of OTC contracts (a pre-requisite for central clearing), and corresponding reduction in the ability for participants to enter into flexible arrangements to manage their risk exposures; and
- a substantial increase in the credit collateral required to support risk management activities, with corresponding cost increases that must ultimately be borne by consumers.

Both of these are likely to have the unintended consequence of increasing systemic risk in the market as participants will lose flexibility in hedging arrangements and are also likely to face constraints due to limitations in credit collateral available.

Executing standardised OTC derivatives on exchange is essentially a further evolution of central clearing, which has the same issues as described above. It should be noted that this option is already available through the Australian Securities Exchange and is widely utilised by participants to manage electricity market risk.

In relation to the impact of reduced contracting, in August 2011 the esaa commissioned ACIL Tasman to model the impact of reduced contracting levels in the NEM. This was done in the context of design of the carbon pricing mechanism which raises the working capital burden for electricity generators. If contracting reduced by 5%, ACIL Tasman found that this would result in retail electricity prices increasing by up to 10% for small-users and 15% for large users. The impact of a reduction in contracting levels is the same, regardless of the source.

Recent developments in the USA

On 10 July 2012, the Commodity Futures Trading Commission (CFTC) released Final Rules and Interpretations for the definition of a swap². The swap definition in the Dodd-Frank Act excludes forward contracts for non-financial commodities that may be physically delivered. The CFTC affirmed the historical interpretation that forward contracts with respect to non-financial commodities are commercial merchandising transactions rather than swaps. The likely effect of the CFTC's

² <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf>.

determination is that nearly all transactions for purchase/sale of electricity will be excluded from the scope of the Dodd-Frank Act.

A strict interpretation of the USA exclusion for forward contracts would not cover transactions in the Australian OTC electricity market, as the design of the NEM as a gross pool prevents generators and retailers contracting directly for delivery of the physical good. However, the OTC electricity contracts in the NEM should not be viewed as separate transactions from the buying/selling of the physical output, but rather a mechanism for retailers and generators that buy/sell the physical output to lock-in a price for that output in advance of the physical delivery through the NEM dispatches. If the direct link between the two transactions is not recognised, it would mean that Australian transactions that are ultimately the same in substance as the USA are treated differently due to their different form.