



5th October 2012

Committee Secretary
Parliamentary Joint Committee Corporations and Financial Services
Parliament House
Canberra ACT 2600

Corporations Legislation Amendment (Financial derivative Transactions) Bill 2012

Supplementary Submission 1

d-cyphaTrade appreciates the opportunity to provide this supplementary submission in response to the Treasury submission. This supplementary submission will be limited to d-cyphaTrade's area of expertise which is the Australian electricity derivatives market. For further information regarding this submission, please contact Mr. Dean Price.

Executive Summary

d-cyphaTrade agrees with the Treasury recommendation that the draft legislation not be amended to exempt OTC electricity derivatives from coverage, despite lobbying from large electricity companies. However, other comments within the Treasury submission regarding the Government's intention to delay or not implement subsequent regulations covering the electricity market deserve review because this would provide a free ride to large electricity companies at the expense of the Australian public. Such a policy stance would:

1. Unnecessarily expose the Australian public to a potential financial bailout of one or more major electricity companies;
2. Appear to directly contravene the Australian government's G 20 commitments;
3. Conflict with US Dodd Frank legislation;
4. **Conflict with existing Australian Corporations Law** and regulations which **specifically carve in electricity derivatives** and carbon derivatives. For example:
 - a. Entities involved in the "issue and disposal of derivatives relating to the wholesale price of electricity" are specifically captured by Corps Regulation 7.6.01(1)(m) and are required to hold an AFSL; and
 - b. Carbon Units, Carbon Credits, and CERs are specifically deemed to be "financial products" under AFSL requirements.
5. Conflict with the previous IASB rejection of a request for exemption of derivative hedges of Australian power companies from capture under International Hedge Accounting Standards¹.

A critique of the Treasury submission in so far as it refers to the OTC electricity market is provided below and in d-cyphaTrade's previous submission to this Committee dated 3rd October 2012.

¹ See Energy Reform Implementation Group, Review of Energy Related Financial Markets, KPMG Report, November 2006, p.37.

Critique of Treasury submission regarding the regulation of the OTC electricity market.

A. Treasury quote: *"The Government has no plans to make rules relating to the energy sector...The Government has no plans to prescribe derivative classes used particularly by the energy sector or mandate rules in relation to those classes."*

This comment suggests that the Australian Government has already decided to renege on its G 20 commitments of:

1. The reporting of all OTC financial derivatives to trade repositories;
2. The clearing of all standardised OTC financial derivatives through central counterparties; and
3. The execution of all standardised OTC financial derivatives on exchanges or electronic trading platforms.

B. Treasury Paragraph 54: "It also should be noted that current or proposed clearing mandates in foreign jurisdictions are generally subject to exceptions for derivatives transactions for 'bona fide' hedging purposes or for hedging commercial risk."

In direct contrast to this statement, the US Dodd Frank end user (hedge) exemption specifically does not exempt hedging participants if they are deemed to be a "Financial Entity"² by virtue of being a "Major Swap Participant". Several large Australian electricity companies that hedge using OTC financial derivatives would logically qualify as "Major Swap Participants" under this US definition and therefore would not be exempted from central clearing, exchange trading or reporting obligations under reciprocal US legislation. I.e. A "Major Swap Participant" is defined as "A *person whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the [United States] banking system or financial markets.*"³ The default of a systemically significant electricity company in Australia is virtually assured of having **serious adverse effects on the financial stability of the Australian OTC electricity derivative markets**. E.g. at least one Australian electricity company has publicly reported OTC electricity financial derivative

² "Financial Entity" is defined under 2 (h) 7 (C) of the Commodity Exchange Act.

See also:

(a). Commodity Futures Trading Commission, 17 CFR Part 39, "End-User Exception to the Clearing Requirement for Swaps; Final Rule". 19th July 2012.

<http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2012-17291a.pdf> and

(b). "CFTC FINAL RULES ON END-USER EXCEPTION AND PROPOSED RULES ON COOPERATIVE EXCEPTION FROM SWAP CLEARING", Debevoise & Plimpton LLP, July 19 2012.

³ For the definition of Major Swap Participant, refer to: **Proposed Rules Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant"**, CFTC, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/defs_factsheet.pdf

exposure of \$6.16 billion⁴ and surveyed AFMA OTC data suggests that 3 counterparties were responsible for issues 64.5% of all OTC electricity derivatives during FY 2011. The default of one of these counterparties would be extremely destabilising to Australia's financial electricity markets.

The suggestion put forward by some large electricity companies that their cost of complying with the G 20 credit risk reduction regulations might actually increase the market's systemic default risk is analogous to a driver of a motor vehicle speeding out of control down a hill suggesting that he is going too fast to apply the brakes.

C. Treasury paragraph 55.1: "The AEMC has been asked to provide advice to the Standing Council on Energy and Resources (SCER) on the resilience of the financial relationships and markets that underpin the operation of the National Electricity Market (NEM). The AEMC expects to consider OTC electricity derivatives markets as part of this assessment in the first half of 2013. 55.1.1. The AEMC released an issues paper on 8 June 2012. While the AEMC states that their initial view is that financial relationships in the NEM are generally robust, there may be risks to system security created through the financial interdependencies between market participants."

The AEMC issues paper referred to by Treasury was "*prepared...with assistance and input from an industry working group. The working group has assisted us to develop our understanding of the nature of the financial relationships between participants, the potential risks arising from those relationships and the measures that participants currently adopt to manage those risks.*"⁵ The industry working group advising the AEMC exclusively includes large electricity companies⁶ who, like the Wall Street banks and US energy companies (which lobbied aggressively but unsuccessfully for sweeping exemptions under the US Dodd Frank legislation) may not wish to be subject to regulations that (i) increase market transparency and (ii) force them to fund their own credit default risks, despite such regulation being in the public interest. d-cyphaTrade queries why the Australian government would consider relinquishing its regulatory decision making authority regarding electricity derivatives to the AEMC (which is not a financial derivative risk expert and which itself is being advised by energy companies lobbying for exemptions from the G 20 reforms). d-cyphaTrade suggests that the government's own independent financial derivative and credit risk experts (the agencies of the Council of Financial Regulators⁷) are far better qualified to determine if it is prudent and consistent with

⁴ AGL Annual Report 2007. p.89. Comprising electricity financial derivative assets of \$6.16 billion and electricity financial derivative liabilities of \$2.2 billion.

⁵ NEM Financial Market Resilience, AEMC, 2012. p.iii

⁶ The companies represented on the AEMC working group are: AGL Energy, Alinta Energy, Australian Power and Gas, International Power GDF Suez, Loy Yang Marketing Management Company, Origin Energy and TRUenergy. See Issues Paper, NEM Financial Market Resilience, Australian Energy Market Commission, 8 June 2012.

⁷ The CFR agencies include: Treasury, ASIC, RBA and APRA.

Australia's G 20 commitments to introduce regulations covering the OTC electricity derivatives markets.

D. Treasury paragraph 56: "It is expected that each of these market assessments will be completed by the end of the first half of 2013 and together they should provide for a greater understanding of the bilateral risk management practices and exposures in the OTC electricity derivatives markets."

It should not be necessary for Treasury to wait at least until July 2013, beyond Australia's 2012 implementation commitment date in order to adequately understand the appropriateness of bilateral risk management practises in the OTC electricity derivatives market. The CFR agencies should already be entirely aware of the need for ASIC to implement G 20 credit risk reduction regulations for electricity. There is no reason to wait for the AEMC assessment because its findings can only reiterate one of two inevitable outcomes which Treasury should already know, being:

1. **AEMC assessment outcome 1:** the electricity market already adheres to the G 20 standards of OTC risk management including (i) central clearing of all standardised OTC electricity derivatives and (ii) mark-to-market margining of all non-standardised OTC electricity derivatives (which it clearly does not, as evidenced by audited financial statements and public submissions from energy companies to this and other reviews); or
2. **AEMC assessment outcome 2:** the electricity market does not currently adhere to the G 20 standards of OTC risk management. It would be disappointing if the CFR agencies were persuaded by energy company lobbyists that Australian OTC electricity market participants apply better credit default risk mitigation practises than those adopted by far more sophisticated, prudentially supervised and higher credit worthy banks. Even bank OTC risk management practices failed spectacularly during the GFC and triggered taxpayer funded financial bailouts of OTC market participants. The G 20 governments agreed to universally implement the OTC reforms to avoid a repeat of large bank and non-bank OTC participants being financially bailed out by taxpayers when their OTC counterparties default. Banks are not excluded from the G 20 OTC reforms, so it is difficult to understand why systemically significant non-bank electricity companies with multi-billion dollar OTC credit risk exposures should be given a free ride at the expense of the Australian public, rather than funding their own credit default risk exposures mandatorily via regulation.

Regardless of which of the two outcomes above the market assessment indicates, there is no valid reason for the Australian Government to delay implementation of regulations to cover electricity derivatives. Furthermore, even if Australian CFR agencies came to the independent conclusion that there is not a high level of credit default risk in the OTC electricity market, **Australia's G 20 obligation is not limited to regulating only those OTC swap markets with substantial credit default risk. E.g. Australia has committed to "The clearing of all standardised OTC financial derivatives through central counterparties"**.

Either the new regulations will make no change to participant behaviour (outcome 1) or, and in any case regulations need to be implemented to mandatorily change participant behaviour to be consistent with Australia's G 20 commitment. d-cyphaTrade strongly recommends that the relevant CFR agencies rely more on their own independent expert knowledge of derivative markets generally when determining if or when to introduce regulations, rather than outsourcing that assessment process and implementation timing to the OTC market participants that are seeking exemption.

- E. Treasury paragraph 58: "ASIC is also currently consulting on financial requirements for electricity market participants and the Government will also take into account any possible interplay between financial resource requirements and potential G-20 mandates."

d-cyphaTrade's submission to the Committee dated 3rd October, provides detailed calculations referencing transparent electricity derivative price data (from the ASX electricity futures market) to numerically illustrate the manifest inadequacy of the proposed AFSL net tangible assets requirements in mitigating OTC credit default risk during volatile electricity market conditions.

- F. Treasury paragraph 63. "The framework would also provide a legislative basis for mandatory information gathering if voluntary surveys are unsuccessful. The voluntary survey currently being conducted by APRA, ASIC and the RBA requested response by 31 August. However, as at 24 September, the information sought from some participants had not been received, including that of a major energy market participant. At this stage there is some cause for concern that the voluntary survey may not be sufficient to develop the analysis necessary to make recommendations on the imposition of future mandates in the energy sector or to demonstrate the accuracy of assertions made about the electricity derivatives market by the Energy sector, in particular that it does not create systemic risk and is primarily in use to hedge underlying positions."

The fact that Treasury (and other CFR agencies) cannot even ascertain enough information about the electricity market to determine if assertions made by the Energy Sector are accurate illustrates precisely why the G 20 commitments include mandatory reporting obligations. This lack of market transparency and inability on the part of regulators to assess OTC credit default risk provides an extremely persuasive argument to regulate the OTC electricity market, not an excuse to delay regulatory reforms (as intimated by Treasury). The lack of transparency in the Australian electricity derivative market would also be substantially resolved even prior to a trade repository for non-standard OTC electricity being established, if Australia adheres to its G 20 commitment to mandate the trading of standardised derivatives on exchange and the margining of non-cleared OTC. This is because the introduction of mandatory exchange trading obligations for standardised derivatives as futures will encourage a transition from non-transparent, high risk OTC



dealings to highly transparent, lower risk futures contracts. This is precisely one of the key objectives of the G 20 OTC commitments as cited by US regulators.

G. Treasury paragraph 61. "Although the electricity derivative market, based on information currently available, is currently traded largely between electricity generation, transmission and retailing entities, this may change in the future. For instance, in some other jurisdictions (such as the United States or Europe) financial institutions play a role in intermediating or holding electricity derivatives positions. It will therefore be important to have the capacity to better understand and respond to any changes in the market for electricity derivatives."

It is encouraging that Treasury acknowledges that the OTC electricity market is dominated by entities which are not financial institutions. I.e. most OTC default risk would appear to exist between systemically significant electricity companies, which are not prudentially regulated like banks or of the credit worthiness of banks. It is less encouraging that Treasury implies that only if bank involvement increases would Australia attempt to honour its G 20 commitments by introducing regulations for the electricity market. Such a policy stance is counter-intuitive and misses the point that regulations are needed to prevent systemic default risk because the multi-billion dollar OTC electricity derivatives market is dominated by non-bank, non-regulated OTC issuers. The Australian government is obligated to implement such regulations in the public interest and in accordance with its own G 20 commitments.

Yours sincerely,

Dean Price.
General Manager.



Appendix 4

Glossary of Abbreviations

AEMC	Australian Electricity Market Commission;
AFMA	Australian Financial Markets Association;
AFSL	Australian Financial Services License;
ASIC	Australian Securities and Investment Commission;
CFTC	Commodity Futures Trading Commission (US);
GFC	Global Financial Crisis;
IASB	International Accounting Standards Board;
NEM	National Electricity Market (comprising electricity pool markets NSW, VIC, QLD, SA and TAS);
OTC	Over the Counter (financial derivative);