Additional comments from Coalition Members of the Committee

1.1 Coalition members of the committee are pleased that the majority report has recognised that the electricity sector does have a range of legitimate concerns in relation to the newly proposed regime under this legislation for over-the-counter (OTC) derivatives trading.

1.2 The Coalition is strongly supportive of an over-the-counter derivatives market.

1.3 We recognise that the new regime will increase transparency of OTC derivative markets and improve risk management practices. It will also give regulators and market participants access to valuable data. Standardised OTC derivatives do have the potential to reduce counterparty risk associated with OTC derivative transactions.

1.4 Coalition members of the Committee are however critical of the process.

1.5 The concerns raised by the electricity sector should have been dealt with much earlier through a properly responsive consultation process by the government.

1.6 Whilst the electricity generation sector raised their concerns during the consultation process, they were completely ignored by Treasury and by the executive government as a whole. No weight was given to entirely reasonable and well founded representations about the implications for the electricity sector in general and ultimately the cost of electricity for consumers and business in particular. Even government members of this Committee had to effectively recognise that the government had erred in not taking those concerns on board.

1.7 For example, the National Generators Forum (NGF) stated:

> The draft legislation we commented on and that the industry provided significant comment on raised a number of concerns. That draft legislation has not been altered for its introduction which is a concern and we are continuing those discussions now with members of parliament.[1]

1.8 Both the NGF and the Electricity Supply Association of Australia (ESAA) also pointed out that the Bill was addressing problems that are not present in the Australian OTC electricity derivatives market. In particular ESAA noted that the existing Australian OTC electricity derivatives market substantially differed from international markets targeted by the G20 initiated regulatory changes:

> The first of those reasons is that the (National Electricity Market) NEM is a mandatory gross market. That means that all electricity on the grid has to be

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1 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 5.

> sold and bought through the market mechanism that is controlled by the Australian Energy Market Operator. Many other markets around the world are net markets in which participants can trade bilaterally with each other and then simply settle any unders and overs through the spot market as they wish to. As a consequence, much of the selling of electricity and buying on the other hand can be done at a fixed price and with the kinds of non-standard that we need to use the OTC market for, so they would not be captured by this type of legislation, because there is no need to have derivatives involved because of the direct nature of the transaction.
>
> The other reason is that the NEM is an energy-only market, as Mr Everett has already pointed out. The consequence of that is that, for an energy-only market, it is particularly important that prices are allowed to rise and fall with as little constraint as possible. In particular, without occasional very high prices, you lack both the signals for new investment and the possibility for generators—which are very capital intensive—to recover their long-term costs. So the consequence of that is that prices are allowed to move between minus $1,000 per megawatt hour and up to $12,900 per megawatt hour. By comparison, the average is about $50 to $60, so it is a very significant multiple. In fact, the NEM may be the most volatile commodity market in the world. That puts a very significant premium on being able to manage the risks of the spot market.[2]

1.9 The NGF also pointed out the highly competitive nature of the Australian electricity sector:

> We have perhaps the most competitive wholesale market in the world. When you look at European markets and the domination by a number of players there, we do not have that same domination. In Australia we have a multiplicity of participants. If we look at generation in particular, we have government owned ones in a number of different states, we have private ones and we have renewables. If you go back to the start of the market, the price for generation was about $45 per megawatt hour. That was without carbon. So if you take it to a current without-carbon equivalent, we are about $40. So the price is actually lower, and that is in nominal terms, ignoring all the inflation impacts over that time. So we have an incredibly competitive market.[3]

1.10 The NGF also noted there was no underlying need to increase regulation of the existing OTC electricity derivatives market:

2 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 8.

3 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

> To our knowledge, there is no evidence that the OTC electricity derivative markets in Australia pose any risk or material concern to national or global financial stability. [4]

1.11 The NGF highlighted the potential costs of the new regulatory regime for the electricity generation sector:

> There are a couple of elements to costs that would be introduced by the regulation if it captured energy derivatives. One would be increasing compliance complexity….The second element of costs is around that collateral cost and the fact that it impairs what would otherwise be good risk management decisions.[5]
>
> We are concerned about there being an additional cost at a time when we are looking at electricity prices increasing by another 40 per cent over the next five years; we are concerned that this may flow through to an additional price increase on top of that.[6]

1.12 The NGF proposed a carve-out of the electricity sector from the provisions of the Bill.

1.13 The ESAA argued for special recognition of the sector's unique nature:

> ...our view would be that it would be useful if the legislation was able to make some explicit reference to the integrated nature of the physical and derivatives market in the case of electricity. In fact, that has been recognised in the courts from time to time where we included a quote from Justice French to that effect in at least one of our submissions to this process. Ways to do that might include that in the case of any regulations affecting electricity derivatives to perhaps specifically include the energy minister as chair of the Standing Council of Energy and Resources—which comprises the energy ministers of all the states and territories, as well as the Commonwealth—in the decision-making process. Also, to specifically name some of the expert energy market bodies, such as the Australian Energy Market Commission, as being either part of the decision-making process or at least part of the consultation process. So I think if some recognition of the importance of understanding the electricity market in evaluating the electricity derivatives market could be embedded in the bill then, whilst we would consider that a second-best outcome compared to outright exemption, that would go some way to addressing some of our concerns.[7]

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4 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 2.

5 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

6 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 4.

7 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 10.

1.14 Coalition members are pleased that the government members of the committee have at least gone some way in recognising the real concerns of the electricity sector and adopted at least part of ESAA's proposed approach in recommending a requirement that for matters relating to the energy sector the Minister for Resources and Energy be consulted prior to the making of regulations, the mandating of derivatives or consenting to an ASIC rule.

1.15 This requirement to consult the Minister for Resources and Energy should be formally enshrined in the legislation.

1.16 Coalition members of the committee, whilst supporting the majority report and the bill as a whole, remain concerned about the potential impact on the electricity sector and ultimately electricity consumers if not properly addressed.

1.17 Given that Treasury stated that the government has no plans to regulate OTC derivatives in the electricity sector, the current Bill is equivalent to calling the ambulance before you get sick just in case. The argument put by the electricity sector that if there are no plans by government to regulate OTC derivates in the electricity market[8] using the provisions in this Bill why the government would not consent to a carve-out of the electricity sector from the scope of this Bill. In particular given the potential implications it has for the cost of electricity.

1.18 We do recommend that the government more seriously consider the impact of this legislation on the electricity sector and ultimately the cost of electricity than it has so far. The government should consider the option of a full carve out of the electricity sector from these new provisions.

Senator Sue Boyce | **Senator Mathias Cormann**

Paul Fletcher MP | **Tony Smith MP**

8 The Treasury, *Submission 6*, p. 8.