Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email to financialmarkets@treasury.gov.au

Monday, 20 August 2012

Dear Sir/Madam

Submission on draft legislation

International Power-GDF Suez Australia (IPRA) appreciates the opportunity to comment on the exposure draft of the *Corporations Legislation Amendment (Derivatives Transactions) Bill 2012*.

Summary

- IPRA is emphatic that the electricity market and participants who utilise the market to manage risk associated with physical positions must be exempted from the legislative framework.
- The only effective way to provide this exemption for electricity market derivatives is to do so explicitly by amending the draft legislation.
- Without a legislated exemption, the electricity sector is left without regulatory certainty in relation to OTC derivative trading.
- The mandatory provisions made possible by the draft legislation would increase systemic risk rather than decrease it for the electricity sector.
- The draft legislation increases regulatory uncertainty for the electricity sector. For example, while S901J of the legislation requires ASIC to consult before making a derivative trade repository rule (DTR), it is also gives ASIC powers in S901K of the legislation to make a DTR without consultation and without consulting the relevant Minister.
- IPRA is aware that calling for a legislated exemption is almost a unanimous industry position amongst generators and also consistent with treatment of this issue in overseas jurisdictions.

About IPRA

IPRA entered the Australian energy industry in 1996 and has grown to become the largest private electricity generator in Victoria, in addition to holding assets in South Australia and Western Australia. The IPRA portfolio also includes Simply Energy, a significant second-tier gas and electricity retail business with more than 300,000 accounts in Victoria, South Australia and New South Wales. The business has invested around A$5 billion in the Australian energy market.

In February 2011, International Power combined with the international energy assets of GDF SUEZ to form a world leader in independent power generation, with more than 72,000 MW of power generation worldwide and a further 15,500 GW under construction.

International Power has participated internationally in asset backed trading operations in highly complex and sophisticated electricity, gas, coal and related markets in Australia for over fifteen years. IPRA relies heavily on over-the-counter (OTC) derivative markets to hedge 22 TWh of generation in the NEM from our Victorian and South Australian generation assets and to hedge the retail sales made by Simply Energy.

Background on derivative trading in the electricity sector

Derivative trading in the electricity sector is dominated by asset-backed businesses that have a prevailing or "natural" position. Generators hedge the exposure of their production to variable spot prices in order to secure revenue and reduce volatility in earnings. Correspondingly, retailers hedge their load to offer contracts to customers on fixed terms. Internal risk limits dictate minimum hedging levels which are in place to limit exposure to market prices. Non-asset backed participants in the OTC derivatives market (such as such as financial institutions) enhance overall liquidity and are themselves sophisticated trading entities. The complexity of trading in OTC electricity derivatives is a barrier to entry for participants without sufficient knowledge to participate, and hence the market is restricted to sophisticated participants. To our knowledge, there is no evidence that the OTC electricity derivatives markets in Australia pose a material risk to national or global financial stability.

OTC derivative transactions are inherently valuable to businesses because of their non-standardised nature. They provide opportunities for bilateral transactions which are tailored to the individual needs of businesses and are often the best products for optimal hedging. The addition of constraints or removal of the current flexibilities of the OTC market would represent a loss of capability and would reduce participants' ability to manage their own risk.

A specific example of the value of OTC derivatives markets has been in relation to forward trading post 1 July 2012, when the Clean Energy Future legislation has come into effect. The OTC derivatives markets have provided the best facility to manage carbon risk through individual "pass through" clauses in contracts and have been used extensively by participants. In contrast, exchange based contracts for the same periods have not given participants the same flexibility. There would have been a serious risk allocation issue for the sector, and a threat to market liquidity, and hence retailer risk, had the OTC market not been available.

Defence against financial contagion is already provided by a number of local regulatory measures which apply to businesses and personally to company directors, and the advanced internal risk management processes of individual businesses. These industry practices and regulations have protected the industry from severe impacts of financial contagion to date (even in the face of significant market shocks) and the probability of this occurring in the future remains very low.

In the NEM, participants have successfully managed risks to a variety of exposures. The main exposure is to a volatile spot market, but the industry has successfully managed to withstand a range of other disturbances in the market. These disturbances or price shocks have included physical loss of supply due to industrial action, mine collapses or plant failure, the loss of gas production facilities and the changes in underlying market dynamics that occurred during the peak of drought conditions.

The industry in Australia has also absorbed financial shocks, for example, the collapse of Enron, and the failure of two second-tier retailers, without significant disruption. Financial contagion did not follow any of these events and into the future has a very low probability of occurring due to industry practice and existing local regulations (which include Australian Financial Services Licenses regulations, retailer of last resort provisions, or "ROLR", and ASIC regulations).

Why should electricity sector OTC derivatives be given a specific exemption in the legislation?

The Treasury's explanatory paper published with the exposure draft outlines that the legislation would amend the Corporations Act by introducing a framework to allow the Minister for Financial Services and Superannuation (the Minister) to decide that mandatory obligations should apply to certain classes of over-the-counter (OTC) derivatives.

However, IPRA strongly recommends that the electricity sector be given an explicit exemption by amending the draft legislation. This exemption should apply to all of the proposed mandatory provisions:

- Reporting of all OTC derivatives to trade repositories;
- Clearing of all standardised OTC derivatives through central counterparties; and
- Execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

Without a legislated exemption, the draft legislation creates a framework that adds significantly to regulatory uncertainty affecting the sector. For example, while S901J of the legislation requires ASIC to consult before making a derivative trade repository rule (DTR), S901L of the legislation also gives ASIC powers in to make a DTR without consultation and without consulting the relevant Minister. Without a legislated exemption the electricity sector faces uncertainty in relation to OTC derivatives regulation.

Arguments against mandatory provisions

Whilst standardised contracts would in principle be relatively easy to report, OTC derivatives contracts are more flexible and thus can be more complex. Treasury should not underestimate the complexities and challenges associated with the design and implementation of the systems necessary to monitor and analyse all OTC market transactions between participants. There is likely to be a high cost for both Government and market participants associated with the development, implementation and ongoing management and reporting of such systems, ultimately increasing costs for consumers.

It is impossible to assess the risk position of an electricity market participant simply by reference to the large and continually evolving number of individual contracts transacted to create a risk-adjusted optimised trading portfolio. Portfolios need to be examined in aggregate, with reference to, *inter alia*, reference node, bespoke aspects of the contracts themselves, and aggregate credit positions. This evaluation would require systems similar in nature to those employed in the management of the portfolio for each business, hence duplicating systems, but perhaps more importantly, duplicating risk assessment processes already in place, and for the same ultimate purpose.

IPRA also has serious concerns around the release of commercially sensitive information which has the risk of undermining competition, particularly given that no underlying problem has been demonstrated.

The industry has considered central clearing of OTC derivatives, but issues remain that are considered harmful to the electricity sector. Firstly, it would force standardisation of OTC contracts, with the adverse consequences articulated above; and secondly add significantly to the credit collateral requirements for market participants. This requirement would be an inefficient use of limited collateral, with no material benefit to market participants or consumers, particularly the former, who currently have sufficient regulatory and commercial incentives to manage financial risks.

Greatly increasing collateral requirements across the industry will lead to practices where hedging strategies are driven by available collateral and not by sound risk management approaches. Ultimately it will lead to less contracting, greater spot market volatility and higher risks for the sector. Increasing the risk profile for the industry would feed through to cost increases to customers for no apparent benefit.

Due to the large volumes of credit involved in the electricity sector, there is likely to be an overall reduction in credit available to other parts of the economy which is not conducive to overall economic growth. For example, if IPRA were to hedge its annual Victorian generation through a mandatory central clearing process, it could need to post around $1 million in credit support for every $1 increase in the underlying power price. This requirement would be an unproductive and wasteful use of cash or working capital headroom for a situation where a generator has not taken a position on price and simply hedged the output of its stations.

To further put the collateral requirements into context, for a contract position of 10TWh (much smaller than IPRA would expect to have) that was exchange traded, the initial margins required would be $32M and a $5/MWh adverse movement in price would require a further $50M in variation margin.

A pre-requisite for central clearing would be forced standardisation of OTC contracts and a corresponding reduction in the ability for participants to enter into flexible arrangements to manage their risk exposures. A further damaging outcome of this approach will be to discourage investment in the sector, particularly from new-entrants, as there will be fewer parties who are able to provide the necessary credit collateral required to operate in the electricity sector.

Standardised centrally cleared/exchange traded products are complementary to the OTC market. They have advantages and disadvantages and participants should be allowed the flexibility to utilise both market arrangements to optimise their risk management activities. It would be a significant retrograde step to force the market into a standardised and credit collateral intensive market environment.

Another advantage that OTC transactions offer to electricity businesses over centrally cleared derivatives is the reduced collateral requirements. The OTC market provides participants with flexibility on credit arrangements, which allows for tailored, and generally less onerous requirements than for exchange based contracts. Participants can take their own view on appropriate credit limits and collateral arrangements, to achieve an appropriate balance between credit and market risk exposure. This is important as the credit risk associated with participants who are hedging an underlying physical position can be lower than speculative participants. Regulations which increase collateral requirements will ultimately lead to greater costs being imposed on electricity customers.

It is essential for electricity businesses to continue to be able to use tailored (or so-called bespoke) OTC derivative contracts to optimally hedge their risk. Without an electricity sector exemption, the proposed mandatory provisions would have the impact of mandating the use of standardised OTC derivatives.

Standardising these products eliminates this tailoring capability and would therefore be risk-increasing rather than risk decreasing for businesses.

It is understood that the definition of derivative for the purposes of the proposed mandatory requirements is as per the Corporations Act. This is a relatively limited definition when compared to other definitions in use such as International Accounting Standards, which also encompass some physical contracts. IPRA is therefore concerned that the scope of the mandatory requirements could be increased over time to include non-financial OTC contracts such as physical gas, emissions and environmental products. The implications for our company and the concerns highlighted would be multiplied commensurately if this occurred.

Conclusion

IPRA argues that OTC derivative trading in the electricity sector is governed by sophisticated risk management practices and should not be the target of the *Corporations Legislation Amendment (Derivatives Transactions) Bill 2012*. We seek a legislated exemption for our sector.

If you have any questions in relation to this matter please feel free to contact Mr Greg Hannan, on +61 3 9617 8405.

Yours sincerely

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