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

By email to: financialmarkets@treasury.gov.au

Friday, 15 June 2012

Dear Sir/Madam

Private Electricity Generators Submission to Treasury paper on implementation of a framework for Australia's G20 over-the-counter derivatives commitments

The private generators operating in the National Electricity Market have established an informal network to deal with issues of common concern. The generators listed on the side-bar welcome the opportunity to make a submission to the Treasury paper on implementation of a framework for Australia's G20 over-the counter derivatives commitments.

AGL Energy

Alinta Energy

Energy Brix

Intergen

International Power GDF Suez

LYMMCO

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Origin Energy

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Summary

The over-the-counter (OTC) electricity market is local to Australia and is dominated by physical participants, for whom it is a critical means of managing risk. To our knowledge, there is no evidence that this market poses a risk to national or global financial stability.

The private generators listed believes that the proposed regulations arising from amendments to *Corporations Act (2001)* will 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. The increased requirement for credit collateral would be a significant burden on an already capital intensive industry and it is likely have a negative impact on investment in the sector.

The application of the proposed measures to the electricity market will place additional compliance, systems and credit collateral costs on participants and will also reduce their flexibility and ability to manage risk. Ultimately, this will result in increased costs for consumers and is very likely to increase the risk profile for the market, the opposite of the intended outcomes.

The private generators believe that the electricity market and participants who utilise the OTC derivatives market to manage risk associated with physical positions must be exempted from any new regulations that are envisaged by the changes to the *Corporations Act (2001)* outlined in the Treasury paper. Such an exemption for

the electricity sector must be extended to financial OTC derivatives contracts for power and gas but also for physical OTC derivatives contracts, for example carbon, whole-of-gas transactions and environmental certificate deals.

The private generators recommend that this occurs by way of an explicit exemption within the amendments proposed to the *Corporations Act (2001)*. To do otherwise would ensure ongoing uncertainty and exposure to regulatory risk.

It is essential for electricity businesses to continue to be able to use tailored (or so-called bespoke) OTC derivative contracts to optimally hedge risk. The proposed regulations to mandate the use of standardised OTC derivatives remove the inherent advantages of OTC derivatives. Standardising these products eliminates this capability and businesses will essentially be left more exposed to risk rather than less exposed.

The private generators do not accept that the proposed changes to the Corporations Act provide any benefit to the electricity sector. Furthermore, we contend that these proposed regulatory changes will be risk increasing for our industry rather than risk decreasing.

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

This view has been supported in the AEMC's recent issues paper on the National Electricity Market (NEM) financial market resilience. The paper states "financial relationships and markets that underpin the efficient operation of the NEM are generally robust, which means that there is likely to be a low probability of financial contagion occurring in the NEM[1]." Furthermore, the paper concluded that the "key risks relate to the operation of the failure of a large retailer and the consequences of the operation of the Retailer of Last Resort mechanism[2]." The AEMC, in assessing NEM financial resilience, has chosen to focus on existing regulations rather than to explore new ones. This outcome supports our view that existing obligations are adequate and supports our call for an exemption for the electricity sector from the proposed Treasury regulations.

The impact of these proposed OTC derivative regulations increase greatly collateral requirements across the industry and will lead to practices where hedging strategies are driven by available cash reserves 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 will feed through to cost increases to customers for no apparent or actual benefit.

[1] *AEMC "NEM financial market resilience issues paper" p. 29*
[2] *Ibid, p. 43*

Another damaging outcome of this approach will be to discourage investment in the sector, particularly from new-entrant parties as there will be fewer parties who are able to hold the cash reserves required to operate in the electricity sector.

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 their production to secure revenue and reduce volatility in earnings while retailers hedge their load to offer contracts to customers on fixed terms. Internal risk limits dictate minimum hedging levels that are in place to limit exposure to prices in the spot market.

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 only.

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.

A good example of the value of OTC derivatives markets has been in relation to forward trading beyond 1 July 2012 when a carbon price will 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.

Another advantage that OTC transactions offer to electricity businesses over centrally cleared ones is the reduced collateral requirements. The OTC market provides participants with flexibility on credit arrangements, which are onerous 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 credit risk associated with participants who are hedging an underlying physical position can be lower than speculative participants.
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.

It is understood that the definition of derivative for the purposes of the proposed Mandatory Requirements is as detailed in the *Corporations Act (2001)*. This is a relatively limited definition when compared to other definitions in use such as International Accounting Standards, which also encompass some physical contracts. The private generators listed are therefore concerned that the scope of the any new mandatory requirements could be increased over time to include non-financial OTC contracts such as gas, emissions and environmental products. The implications for the sector and the concerns highlighted would be multiplied commensurately if this occurred.

Scope and application of the proposed amendments

The private generators are emphatic that the electricity sector must be explicitly exempted from the proposed amendments to the *Corporations Act (2001)* that will lead to regulations mandating reporting of OTC derivatives in trade repositories and central clearing of standardised OTC derivatives.

Electricity businesses in Australia are sophisticated entities which manage complex operational and financial risks on a daily basis. The concerns regarding financial contagion that have spurred these proposals are not warranted for the sector and reflect an absence of experience with the dynamic and complex nature of the electricity sector by policy makers.

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 loss of supply due to industrial action, mine collapses (e.g. the current Yallourn Mine flooding) or plant failure, the loss of gas production facilities, the collapse of some small retailers and the changes in underlying market dynamics that occurred during the peak of drought conditions. Financial contagion did not follow any of these events and into the future has an extremely low probability of occurring due to industry practice and existing local regulations (which include Australian Financial Services Licenses regulations, Retailer of Last Resort provisions and ASIC regulations) to the extent that the cost of the current proposal far exceeds any potential benefit.

The proposed regulatory measures come across as a reaction to events that occurred in the lead up to the global financial crisis of 2008. The trade of OTC derivative contracts in the electricity sector had no bearing on these events, yet the sector is now facing a range of heavy-handed regulations that subscribe to a one-size fits all approach.

For example, at the same time as the Treasury is undertaking this review, ASIC is conducting a review on financial requirements for electricity derivative market participants and the AEMC is also conducting a review on NEM financial resilience.

Notwithstanding our request for an electricity sector exemption, as a general regulatory practice, the private generators listed would argue any new proposed mandatory requirements being introduced must have clearly articulated objectives associated with their introduction for each market and participant class. A detailed analysis should be undertaken to ensure that there is a net benefit – i.e. that the benefit associated with reduction in financial contagion risk outweighs the increase in compliance burden, credit collateral cost and reduction in risk management flexibility for market participants.

Reporting of all OTC derivatives in trade repositories

It is not clear to the private generators listed the advantage that reporting of all OTC derivatives in trade repositories has. We see this as a request for information without an accommodating need for the information. Due to the complexity of the electricity sector and OTC contracts, the cost of developing a trade repository would be significant for both the Government and individual

businesses. The private generators do not believe that this initiative would pass a cost/benefit analysis.

The scale of a system to capture all Australian derivative transactions, let alone electricity sector transactions, is vast. The amount of time and resources that would be required to be invested in this task would be enormous for the Government and would add significant compliance costs to individual businesses.

It is not clear how the Government would make of this data if in fact if could be reported. Private generators also fear that data sets would be so vast and diverse as to almost be unmanageable. It also raises questions around the release of commercially sensitive information that is a critical concern in the electricity sector given the importance of contractual positions to operational decisions.

Whilst standardised contracts are relatively easy to report, OTC derivatives contracts are more flexible and can be more complex. Treasury should not underestimate the complexities associated with the design and implementation of the systems necessary to monitor and analyse all OTC market transactions between participants.

Furthermore, it is unclear what could be done with the information provided and how this would contribute to reducing market risk. Clearly, the objectives and deliverables of any reporting requirements should be articulated by Treasury and a clear net benefit should be identified before implementing this measure. The compliance cost would be significant and would ultimately need to be borne by consumers. On this basis, a general desire for more information by government is not justification enough to warrant implementing the current proposal for the electricity sector.

Central clearing of all standardised OTC derivatives

Central clearing of all standardised OTC derivatives would be harmful to the electricity sector as it would add significantly to the working capital requirements. This requirement would be an unproductive and wasteful use of cash and delivers no value to participants in the market who currently have sufficient regulatory and commercial incentives to manage financial risks.

Greatly increasing collateral requirements across the industry would lead to practices where hedging strategies are driven by available cash reserves 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.

The substantial increase in the credit collateral required to support risk management activities from mandatory central clearing would lead to corresponding increases in costs for generators. These costs would ultimately be borne by consumers.

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 and this is not conducive to overall economic growth.

A prerequisite 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 would be to discourage investment in the sector, particularly from new-entrants as there would be fewer parties who are able to hold the cash reserves required to operate in the electricity sector.

Conclusion

The private generators listed are concerned by the probable consequences of the OTC regulatory proposal for the electricity sector. We therefore seek an exemption for the electricity sector from any new regulations that arise from the proposed amendments to the *Corporations Act (2001).*

If you have any questions in relation to this matter, require further information or wish to discuss the issues raised please feel free to contact the undersigned on 03 9499 4249 or 0413 623 043 or by email Harry.Schaap@tpg.com.au .

Yours sincerely

Dr Harry Schaap
(on behalf of the listed generators)