Secretariat
Level 6
280 Pitt Street
Sydney NSW 2000
Telephone 61 + 2 9261 0141
Facsimile 61 + 2 9261 3153
Postal address
PO Box A2492
Sydney South NSW 1235

Melbourne office
Level 11
459 Little Collins Street
Melbourne Vic 3000
Telephone 61 + 3 9670 0188
Facsimile 61 + 3 9670 1069
Postal address
GPO Box 1823Q
Melbourne Vic 3001

Canberra office
Suite 7, Level 1
88-96 Bunda Street
Canberra ACT 2600
Telephone 61 + 2 6262 9577
Facsimile 61 + 2 6262 9578
Postal address
PO Box 925
Civic Square ACT 2608
ESAA website
http://www.esaa.com.au
ABN 98 052 416 083

8 November 2002

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Dear Mr Kluver

ESAA comments on the Proposal Paper

We refer to the recent CAMAC Insider Trading Proposals Paper (the Proposal Paper)

released in September 2002.

The Electricity Supply Association of Australia (the ESAA) is a peak industry body for the electricity supply industry in Australia. The ESAA is uniquely positioned to comment on the application of insider trading provisions to electricity hedging as its membership incorporates retailers, wholesalers and generators. This means that the ESAA's membership includes representatives from all of the various segments of National Electricity Market ("NEM") participants with a direct interest in the regulation of OTC electricity derivative contracts.

Because electricity hedge contracting is an extremely important part of the management of risks of trading in the wholesale electricity market a number of the ESAA's generation and retail businesses requested the ESAA to establish whether there was a common view across these sectors on issues raised by insider trading prohibitions on electricity hedge contracting, and if so, to respond to the paper expressing a collective view of both sectors. This submission is the outcome of that process. Across the generation and retail sectors support has been expressed for the views it outlines, although one member, Energy Australia, has indicated that its views differ with those set out in this response and I understand will write separately to you on its views.

1. INTRODUCTION

Electricity hedge contracts among participants in the NEM, such as generators and retailers, are now regarded as a universal and necessary feature of the participation of such parties in the NEM. The primary purpose of these contracts is to hedge the exposure of NEM participants to fluctuations in the spot price for electricity in the NEM.

2. REFORM

As you are aware, from March 2002, the effect of Part 7 of the Corporations Act introduced by the *Financial Service Reform Act 2001 (Cth)* ("**FSRA**") is to apply insider trading prohibitions to hedge contracts that are based on the price of electricity in the National Electricity Market ("**NEM**").

This appears to be part of a general policy to regulate all "financial products" in the same way. Whether or not it is intentional, because of the width of the definition of "financial products", electricity hedge contracts are now caught by the provisions.

There are two exemption mechanisms in the legislation which allow products or services to be declared not to be financial products. Section 765A of the Corporations Act relevantly provides for things to be declared not to be a financial product either by:
• regulation; or
• ASIC gazetting a notice to that effect.

We infer that these mechanisms were included in the legislation because of the likelihood that products which may be found to be unsuited to the new regime (such as electricity

hedge contracts) would be caught by the width of the new definitions.

3. EXECUTIVE SUMMARY

The ESAA supports and endorses the comments made by CAMAC in the Proposal Paper (at 1.63 to 1.65) about the inappropriateness of applying insider trading laws to OTC markets generally, and electricity derivative contracts in particular.

The ESAA notes that the application of insider trading laws to OTC electricity hedge contracts was not requested, needed, publicly debated or supported by industry participants. Moreover, the application of the insider trading provisions to electricity hedge contracts does not meet the policy objectives of those provisions, and is not necessary or desirable, because:

• NEM is a private market in which only sophisticated participants are involved;

• All participants are large Australian Corporates, therefore there is no "consumer protection" rationale for the changes;

• it is not necessary for market fairness; and

• it does not improve market efficiency.

The ESAA submits that it is logical and appropriate that wholesale electricity hedging be exempt from the insider trading rules. Such rules are appropriate in multi-party, public, retail, anonymous, purely derivative markets where there is an expectation, market rule, legislation or need regarding continuous disclosure or equality of information. By contrast, asymmetric information is an accepted, and structurally embedded, element of the NEM.

Electricity hedge contracts are fundamentally different to the public, on-market transactions (such as ordinary share transactions) for which insider trading rules are properly intended to operate.

We note, in this regard, that electricity hedging is:

• specialised and undertaken by informed participants;

• bilateral;

• private;

• between identified counterparties (i.e., not anonymous), where there is a clear acceptance that there will be asymmetrical market knowledge and no assumption of full disclosure or equality of information;

The insider trading rules should also not be applied to electricity derivative contracts, as the rules are likely to conflict with the disclosure and bidding provisions of the Code. These provisions are designed to reduce the private sharing of market information between NEM participants and the risk of anti-competitive agreements between NEM participants in breach of the *Trade Practices Act 1974*. Requirements about disclosure of supply and demand information between electricity hedge counterparties may encourage such anti-competitive agreements, disadvantage other market participants and decrease the efficiency of the NEM.

In the past, all participants in the wholesale electricity market operated under exemptions from the futures trading provisions of the *Corporations Act.* The same rationales which supported those exemptions justify the exemption of wholesale electricity trading from the new insider trading provisions.

One of the key aims of regulating insider trading is the protection of unsophisticated consumers. There is no suggestion that such consumers are involved or at risk in relation to trading in electricity derivatives. It is entirely a wholesale market.

Of the various policy alternatives considered by the CAMAC, theESAA agrees that a full exemption for electricity derivative contracts is the approach which is the most intelligent and cost-effective, least intrusive and has the most public benefit.

The ESAA considers that alternative policies such as limiting the application of insider trading laws to linked OTC products or disclosable information, will not provide sufficient benefit, in the case of electricity derivatives, to warrant the greater complexity, risk and legal uncertainty these hybrid rules would bring to the market. In this regard, it may be necessary to distinguish electricity derivative contracts from other OTC products.

4. INSIDER TRADING – A GENERAL OVERVIEW

4.1 Scope

As the Committee would be aware, prior to the introduction of the new rules, the scope of the prohibition on insider trading was confined to dealings in "securities" (which consisted of shares, bonds, debentures, units in trusts, options etc). Dealings in derivatives and many other products or services, such as buying and selling real estate, were not regulated.

One of the continuing problems with the regulation of insider trading is the apparent arbitrariness of its scope. For many years in Australia, insider trading in shares was prohibited, whereas it was permitted in relation to share price index derivatives.

The recently passed FSR Act, repealed Chapters 7 and 8 of the Corporations Act and inserted a new Chapter 7 dealing with “financial services markets”. As part of this process, the FSR Act inserted new insider trading provisions, namely, Division 3, Part 7.10 of the Corporations Act, and expanded the coverage of those provisions by

extending their traditional operation from “securities” to all “relevant Division 3 financial products”.

The term “relevant Division 3 financial products” includes derivatives1, managed investment products, certain superannuation products, or any other financial products that are able to be traded on a financial market.

1 The term “derivative” is defined as an arrangement under which the following conditions are satisfied:

• a party to the arrangement may be required to provide at some future time consideration of a particular kind to someone;

• that future time is not less than the number of days, prescribed by the regulations, after the day on which the arrangement is entered into;

• the amount of the consideration (or value of the arrangement) is ultimately determined, derived from or varies by reference to the value or amount of something else, including for example a commodity.

A commodity is anything capable of delivery, which arguably includes electricity.

A relevant Division 3 financial product in relation to inside information is likely to include offering and entering into arrangements in the nature of electricity hedging contracts, unless such arrangements are exempted from the operation of those provisions.

Given that an electricity hedging contract is a derivatives contract and therefore a Division 3 financial product, the prohibitions under section 1043A of the new Part 7.11 will apply to entering into such contracts if one of the parties:

(a) possesses information that is not generally available;

(b) knows, or ought reasonably to know, that the information is not generally available; and

(c) knows, or ought reasonably to know, that a reasonable person would expect the information, if it were generally available, to have a material effect on the price or value of the relevant hedge contract.

The ‘inside’ information can include matters of supposition and other matters that are insufficiently definite to warrant being made known to the public, and matters relating to the intentions, or likely intentions, of a party.

Specifically, section 1043A says that the insider must not:

(d) apply for, acquire, or dispose of relevant Division 3 financial products, or enter

into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

(e) procure another person to apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

(f) (f) if the relevant Division 3 financial product is able to be traded on a financial market in Australia, communicate inside information to another person, or cause it to be communicated, if the insider knows, or ought reasonably to know, that the other person would be likely to:

(i) apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

(ii) procure another person to apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products.

The new Chapter 7 is intended to eliminate the current distinction between securities and futures contracts by implementing a more flexible regulatory framework for financial markets. However, the new regime readily recognises that many "financial products" might not be appropriately regulated by the insider trading prohibition. Not only are many things excluded from the definition of "financial product", but there is both a power in ASIC and a regulation making power enabling certain "financial products" to be excluded from the regime.

In our submission, electricity derivatives are a ready and important candidate for exemption.

4.2 Policy Rationale for Insider Trading

Various theories are put forward in support of regulating insider trading. They range from the "market efficiency" and "market fairness" rationales, to concepts of fiduciary duty and misappropriation (canvassed by the CASAC in Chapter 1 of the Discussion Paper).

As discussed below, the ESAA does not consider that any of these various rationales support the overreach of Part 7 into OTC electricity derivative contacts.

4.3 Penalties

The insider trading provisions carry the highest penalties of any offence under the *Corporations Act* (ie a maximum fine of $220,000 or imprisonment for 5 years for a natural person and a maximum fine of $1,100,000 for a corporation). It is an extremely serious offence.

There should, therefore, be a clear reason for the application of the prohibition in relation to a particular market or trading activity.

4.4 A BRIEF COMPARISON OF OTC DERIVATIVE CONTRACTS AND ONEXCHANGE SHARE DEALINGS

The classic context for regulating insider trading is dealings in ordinary shares. The market value/price of shares generally involves a mixture of:

(a) An assessment of future maintainable earnings;
(b) Analysis of the track record of the company;
(c) Net tangible asset backing per share;
(d) Market and industry factors;
(e) Quality of management, business plan etc;
(f) Assessment of foreseeable risks affecting the company; and
(g) Intangible factors, rumour and speculation.
(h)

With so many intangible factors affecting the assessment of the value of shares in a company, it is easy to see why it is necessary to regulate insider trading in shares.

Electricity, on the other hand, as a commodity, is not subject to as many "intangibles". It is a professional market. Rumours, tips and market "hype" are not mischief that the law should be seeking to regulate in the context of electricity hedging.

4.5 What is Price Sensitive Information Regarding a Share?

Price sensitive information, in the context of shares, can include all kinds of subjective information (for example, the identity of a person about to be appointed as a director). In the context of electricity hedging, inside information relates directly to the commodity being traded and is generally confidential to the party involved.

4.6 What is Price Sensitive Information in an electricity market?

Information in the possession of one of the parties to an electricity derivative knows, or ought reasonably to know, is not generally available will constitute inside information if a reasonable person would expect it to have a material effect on the price or value of the relevant hedge contracts.

By virtue of their roles as major producers, purchasers and traders of electricity, those parties will at times be in possession of information of this nature. This will include data such as plant availability, generation and demand levels, load curtailability, new generation proposals, price forecasting, market analysis, weather forecasts, regulatory uncertainty, operating and capital cost conditions, general electricity trading conditions and details of some existing contracts. This is no different from a producer of other commodities with expert knowledge about their business (eg oil, sugar, wool, interest etc).

Much of that data could reasonably be expected to have a material effect on the price at

which the counterparty will be willing to enter into the hedge contract.

Accordingly, contracting parties would be required to disclose information about plant availability, production and demand, and the myriad of other details (above) with other parties before engaging in bilateral hedging. Many of these matters are outside the scope of, and most likely in conflict with, the statutory disclosure requirements in the National Electricity Code and the authorization of the Code which has been granted by the Australian Competition and Consumer Commission under the *Trade Practices Act*, as well as being beyond the scope of market regulation generally regarded as being efficient.

4.7 CASAC Discussion Paper

CASAC circulated a Discussion Paper on Insider Trading in June 2001 (the Discussion Paper). The Discussion Paper supports the view that the market fairness and market efficiency rationales for prohibiting insider trading are only concerned with the impact on public markets. The extension of the prohibition to privately traded commodity derivatives is less logical.

In the case of electricity hedge contracts, although the NEM spot market (the pool price) is technically a public market, the relevant market for electricity hedge contracts is a quite distinct bilateral market between large corporates. Therefore, requiring public disclosure so that parties may engage in bilateral hedge contracts is misguided.

Electricity hedge contracts are private transactions, not transactions conducted on a public market. In other words, it is more like a property or asset sale than trading in a security. Private transactions are regulated by private and statutory contract law (such as the *Trade Practices Act 1974*), which prohibits misleading and unconscionable conduct. This is currently and in the future a more limited and appropriate basis for regulation of electricity hedge contracts.

5. The Proposal Paper

Most recently, CAMAC considered the appropriateness of the application of insider trading laws to OTC financial markets in the Proposal Paper. The ESAA endorses the comments made by CAMAC in relation to the OTC derivative market, and especially in the context of electricity derivatives.

The ESAA notes with approval the contrasting features of OTC and exchange markets identified by CAMAC (at paragraphs 1.56-1.59):

• Unlike public markets, OTC markets are personalised and bilateral with very little opportunity for any retail participation.

• OTC transactions are subject to negotiation between the parties, rather than standard, fungible on-market securities (in that the terms of the ISDA may be varied by the parties).

• It is accepted by the parties that the terms and prices of many OTC contracts may never be disclosed and (subject to the limited disclosure requirements under the Code) are not required to be disclosed.

The ESAA agrees with CAMAC that the insider trading laws should not seek to interfere with or override mutually agreed contractual terms relating to disclosure in private, bilaterally negotiated contracts (at paragraph 2.31).

The ESAA also accepts the comments made by CAMAC (at paragraph 1.63) about the potential for insider trading laws to substantially interfere with the portfolio management and risk management functions of all parties to OTC electricity contracts. The ESAA is concerned about the increased compliance costs and legal uncertainty (including possible criminal sanctions) which may face its members when negotiating OTC contracts in an environment in which current insider trading rules apply.

6. ELECTRICITY TRADING – REGULATORY CONTEXT

6.1 NEL, NEM, CODE – A Mandated Market

The *National Electricity Law* (and the *National Electricity Code* ("***the Code***") thereunder) requires spot electricity to be sold by generators to the market manager, NEMMCO.

6.2 NEMMCO & the Pool Price Algorithm (SPD)

NEMMCO then sells that electricity to electricity retailers for the *pool price,* which is set every half hour based on the highest accepted bid submitted to NEMMCO by the generators and determined by an algorithm (the "**SPD**").

The electricity wholesale market is volatile. Unlike many commodities, electricity cannot be stored pending favourable market conditions. Electricity retailers are forced to manage the consequent risk of price volatility through hedging with generators. The unavailability of hedging, for example because of the imposition of insider trading restrictions prohibiting market participants who hold price-sensitive information from transacting hedges, would inevitably lead to market participants seeking additional risk premiums in their pricing. Some jurisdictions have responded to such price escalation with artificial regulatory price "capping", however there are a number of shortcomings in that approach.

6.3 The need for hedging - Price Volatility and Capping (VoLL)

As electricity cannot be stored, electricity retailers are always obliged to buy it from the pool at the prevailing pool price. As a result of this obligation, retailers are subject to an unmitigated price volatility risk and can be obliged to pay up to the maximum pool price (which is known as ("**VoLL**") which, as of April 2002 went from $5,000 to $10,000/MWh.

The only mitigation strategy available for retailers or generators to manage this price volatility is to enter into bilateral electricity derivatives. This is usually done in a standard OTC form with written confirmations under an ISDA contract and special electricity terms included by way of schedule.

Such a contract might be struck at, say, $50/MWh so that the retailer would pay the wholesale generator the difference between the pool price and the $50/MWh contract price at all times during the life of the contract when the pool price was below $50/MWh and the generator would pay the retailer the difference between the pool price and the $50/MWh contract price when the pool price was above $50/MWh. This exchange of different payments achieves a net *pool plus contract price* to the retailer of $50/MWh which is of inestimable value to the retailer in immunising itself from raw pool price volatility. Even if the pool price goes to $10,000/MWh (ie VoLL), the retailer will still only end up paying in effect, $50/MWh.

Such contracts may be unworkable if the insider trading rules apply to wholesale electricity hedges because one of both counterparties may effectively be prohibited from entering into the necessary contract. Generators always risk having some confidential and potentially price sensitive information about generation capacity and bidding strategies. Retailers will always risk having confidential and potentially price sensitive information about load, curtailability of load and demand side management.

6.4 Adequate Existing Disclosure Requirements - Disclosure of Generation Capacity under the Code

The ESAA also notes that disclosure and use of information is already appropriately regulated in the NEM and the agreed terms of OTC contracts.

The National Electricity Code requires generators to provide a large quantity of information to NEMMCO in order for NEMMCO to plan the operation of the NEM and identify potential power system security problems. This information includes 2-year advance notification of the availability of each generating unit for each day and energy constraints applying to each generating unit.

NEMMCO is required to collate this information and publish information in order to assist Market Participants to plan scheduled work on plant and to inform them of any possible power system security problems. This information includes aggregate generating unit availability for each region and days when low reserves of generation capacity are expected.

Although much of the longer-term information refers to the electricity regions rather than individual generators, the nature of the electricity industry is such that, if a reduction in generating capacity for the region is indicated, it is not difficult to identify which generating unit(s) may be responsible for that reduction, simply on the basis of the lost generating capacity.

In addition, generators are effectively prevented from taking advantage of their knowledge of plant availability because generators are obliged to publicly disclose plant availability through the NEMMCO Projected Assessment of System Adequacy ("**PASA**) process.

6.5 Asymmetric Information as Between Generators and Retailers is Accepted in the NEM

Asymmetric information is an embedded and accepted feature of the NEM.

Electricity generators, traders and retailers will often be in possession of confidential information which is likely to affect the price of electricity in the National Electricity Market or the prices at which counterparties are willing to enter into electricity hedge agreements. This information is unavoidably acquired by those parties by virtue of their roles in the National Electricity Market. It includes information about the availability or likely availability of generation capacity, changes in the demand for electricity and the curtailability of that demand and the existence and details of other significant electricity hedge contracts (and the other information outlined above).

Under the insider trading provisions, generators and retailers in possession of such information would be prohibited from entering into electricity hedge agreements without disclosing the information to the prospective counterparty.

This disclosure of information would be:

(a) inconsistent with the provisions in the Code which require generators to disclose real-time information about the amount of generation capacity available but does not require retailers to provide any real-time information regarding the likely demand for electricity or the curtailability of that demand;
(b) inconsistent with the intention and terms of the authorization of the National Electricity Code by Australian Competition and Consumer Commission;
(c) unnecessarily prejudicial to the commercial interests and confidentiality of the party required by the insider trading provisions to disclose the information; and
(d) not necessary to meet the objectives and rationale of the insider trading provisions.

7. LACK OF POLICY RATIONALE REGARDING ELECTRICITY HEDGING

There is simply no point in subjecting some financial activities to an insider trading prohibition. In the case of electricity derivatives, where consumer protection and market integrity concerns are not present, the ESAA submits that there is no adequate policy rationale supporting the application of insider trading laws.

8. APPLICATION TO ELECTRICITY FUTURES

The ESAA also submits that a number of arguments in support of an exclusion for OTC derivatives may also apply to market traded electricity futures (currently traded on the SFE).

9. DETRIMENTAL EFFECTS OF EXPANDED APPLICATION

9.1 Retailers Might Not be Able to Get Funding Support

The unavailability of hedging has the potential to create other regulatory compliance issues for market participants. The National Electricity Code provides that NEMMCO can require retailers to lodge a security in the form of a bank guarantee to cover the retailer's exposure to the pool. With the increase in the maximum pool price from $5,000/MWh to $10,000/MWh, the potential exposure of retailers to the pool has increased. Providers of bank guarantees may be reluctant to provide the security on behalf of market participants who are unable to manage price risk effectively, or may be inclined to add a significant risk premium to their fees, with an inevitable flow-on to the cost of electricity.

9.2 Retailers Could Fail or Consumers Would Suffer

The ESAA submits that it is likely that, if electricity hedging remains subject to an insider trading prohibition, a premium necessary to absorb unhedged risk may be passed on to consumers.

10. POSSIBLE RESPONSES TO THE NEW PROVISIONS

10.1 Chinese Walls Would Not be Financially Prudent

Chinese walls are often a first port of call solution to insider trading problems. The idea is that an organisation isolates the securities trading operations from other areas that would be likely to be in possession of price sensitive information.

CAMAC noted in the Position Paper that the Chinese wall defence is generally not practical or available to parties involved in OTC electricity contracts (as well as standard commodity market futures). The ESAA agrees with CAMAC that the use of Chinese Walls when negotiating OTC electricity hedges would, to a very large extent, defeat the purpose of these contracts.

11. POLICY OPTIONS

CAMAC has raised, in the Proposal Paper, several policy alternatives for consideration in relation to this issue. Of these, the ESAA strongly supports the exemption of all electricity derivative transactions from the application of insider trading laws, for the reasons stated in this submission.

11.1 Exemption for OTC electricity derivatives

The exercise of this power by the ASIC, with the consent of the retailers in the market, would be a low cost solution to enable the private electricity market to continue to provide a legitimate hedge function and to prevent artificial and burdensome risk premiums being passed on to electricity consumers.

The ESAA agrees with the view expressed by CAMAC, that a total exemption is "more cost-effective, less intrusive and more consistent with OTC market practices and expectations than reliance on an external insider trading regime." (at paragraph 1.69)

11.2 Other policy options

The ESAA submits that limiting the application of insider trading laws to linked OTC products or disclosable information will not provide sufficient benefit to warrant the greater complexity and uncertainty these hybrid insider trading rules would provide.

In relation to the use of information disclosable under the Code, the ESAA submits that matters such as front running by generators in advance of the PASA are better dealt with by the NEM regulators specifically under the Code, rather then by applying unnecessarily broad insider trading rules.

12. CONCLUSION

Given the nature of the market for electricity hedge contracts in Australia, a prohibition of insider trading in relation to electricity derivatives is inappropriate. The extent of public disclosure of information would be overly onerous on large Corporate trading parties without any benefit to the market, participants in the market or the general public.

The ESAA submits that electricity derivatives should be excluded from the insider trading prohibitions in the *Corporations Act*.

If you have any questions in respect of this submission, please contact Ian Israelsohn on (03) 9670 1017.

Yours faithfully

Keith Orchison
Managing Director