



20 August 2012

Mr Daniel McAuliffe
Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email – financialmarkets@treasury.gov.au

Dear Mr McAuliffe

Corporations Legislation Amendment (Derivative Transactions) Bill 2012

Alinta Energy welcomes the opportunity to make a submission in response to exposure draft of the Corporations Legislation Amendment (Derivative Transactions) Bill 2012.

Company information

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), with retail energy customers in Western Australia, Queensland, New South Wales, South Australia and Victoria and a commitment to growth across the National Electricity Market.

Entities within the Alinta Energy corporate structure hold an Australian Financial Services License and are active participants in Australian electricity derivatives markets, and trade over-the-counter (OTC) and Australian Stock Exchange electricity products (exchange traded products).

Based on the earlier consultation paper and the exposure draft and explanatory document, Alinta Energy expects to be directly and significantly impacted by the proposed legislation should energy market and related derivatives be captured by the proposed regulatory framework.

The purpose of this submission is to:

- outline Alinta Energy's perspectives on the framework and general issues;
- detail the likely consequences for the energy markets and Alinta Energy; and
- discuss possible options for treatment of energy markets within the context of the existing framework.

Perspectives on the framework

Alinta Energy appreciates the G20 commitments made by the Australian Government to implement a framework to regulate practices in OTC markets with the three keys areas of reform being: (1) reporting of all OTC derivatives to trade repositories; (2) clearing of all standardised OTC derivatives through central counterparties; and (3) execution of all standardised OTC derivatives on exchanges or electronic trading platforms.

Obligations on derivative market participants

Alinta Energy understands that the framework does not, of itself, create any additional obligations for participants at this time; however, it is apparent that obligations will arise as a consequence of the new powers granted to the Australian Securities and Investment Commission (ASIC). While the framework is relatively straight-forward, there are a few areas where Alinta Energy recommends re-consideration of the current approach.

First, the legislation provides for the Minister to make a determination and for ASIC to subsequently make a derivatives transaction rule (DTR) subject to the said Ministerial determination and with the Minister's written consent. This approach is considered workable but requiring some additional protection to encourage regulatory best practice.

Unfortunately, there is no guidance as to what threshold needs to be passed for the Minister to make a determination or what set of conditions needs to be satisfied for ASIC to propose a determination or issue a DTR. In essence, this leaves industry exposed to the internal policy considerations of Government and ASIC regardless of any external factors driven by the actual market. Such an approach lacks transparency and drives uncertainty that at any stage ASIC or Government may be minded to pursue a regulatory position that was otherwise considered unnecessary. Such uncertainty creates a risk; such risk needs to be priced into market transactions.

Alinta Energy would be comfortable with an approach that introduced specific thresholds. For example, it is understood the European Union arrangements have specific quantitative thresholds under which exemptions apply. Likewise, we understand the United States of America rely on thresholds under which hedging for operational risk is excluded. Both these arrangements should be applied in a form agreed with industry to the proposed Australian framework.

Additionally, Alinta Energy suggests that the degree to which a market is exposed to international trade may be a worthy threshold. Clearly, exposure to international financial contagion is a potential driver but is not an issue for domestic operational based hedging, but is likely to be of concern for highly leveraged internationally exposed markets.

Second, the consultation process is undermined by a blanket exemption which provides that failure to consult does not invalidate a determination or a DTR. This exemption is considered less than ideal and should be removed from the draft bill. Given the initial Australian Government commitment was made in 2009 and DTRs may not arise for some time, arguments regarding expediency, or significant risk needing to be quickly regulated discounting the need for consultation would appear spurious and should not undermine regulatory best practice which requires appropriate dialogue with parties directly impacted by regulatory instruments.

Finally, Alinta Energy is particularly uncomfortable with the emergency rules under section 901L. Alinta Energy does not support ASIC being permitted to make a DTR in the absence of a Ministerial determination that has been consulted on. There is little evidence to suggest this emergency power is necessary, it could be exercised inappropriately, it has the potential to create unintended disruption to the market at costs unquantifiable by ASIC and creates a disorderly relationship between the Minister and ASIC in the issuance of determinations and DTRs.

Alinta Energy appreciates the Australian Government's G20 commitment in relation to creating a regulatory framework for OTCs. Nevertheless, the Australian OTC market continues to operate effectively in the absence of this framework, and while its introduction has merit, it should not be implemented in a way which creates unnecessary complications or risks. Thus, Alinta Energy encourages consideration of the proposed amendments to the framework.

While Alinta Energy supports a number of general changes there is also a case for additional provisions for energy market derivatives. These matters are dealt with below.

Implications of energy markets

Alinta Energy notes that the considerable feedback from the energy sector appears not to have influenced the exposure draft issued by Treasury; there is no ring fencing or exclusions for certain asset classes which arguably will not benefit from inclusion in the proposed framework.

Given the absence of specific concerns with OTC trading in the energy sector, Alinta Energy is disappointed by this position and encourages further consideration of the merits of ring fencing or exclusion. The energy industry involves participants hedging physical positions with domestic players. The proposed framework would have limited value and is likely to increase costs to consumers and increase risks carried by energy market participants. On this basis, amending the draft bill would appear appropriate.

Alinta Energy notes that the issue of the nature of the energy sector has already been covered in detail in earlier industry submissions and is likely to be again in response to the exposure draft. Alinta Energy endorses many of those arguments and thus does not seek to replicate them here. Instead, this section provides some more specific information that is considered relevant to the Treasury's analysis.

Understanding the purpose for which energy market participant's trade OTCs

The National Electricity Market is the most well known energy market in Australia. Exchange in the market occurs between producers and consumers through the pool, also referred to as the spot market, where the output for all generators in each individual region are aggregated, ranked by price in a merit order, and dispatched to provide the lowest cost generation to meet demand at that point in time. The pool price, or spot price, is set every 5 minutes and settled half-hourly for each region at prices between -\$1000 and \$12,900. The spot market is driven by short-run incentives which ensure cost-efficient outcomes. This cost-efficient process underpins much of the success of the National Electricity Market in utilising assets and promoting efficiency.

Nevertheless, the spot market creates risk for participants, both exposure to unmanageable costs for retailers and generators and a limited ability to recover fixed costs for generators that encourages contracting between market participants. This management of market risk is the key driver of energy market hedging and is a reason that the vast majority of participants are domestic based and physical participants.

Alinta Energy estimates less than 10% of exchange traded products would be traded internationally, and that is considered a high estimate, while very few OTC trades are conducted with international participants - Alinta Energy staff, drawn from a range of companies, could only identify a few such known trades in recent years.

The way in which a retailer uses OTC and futures provides an insight into what drives derivatives trading in the electricity market and suggests the proposed framework may be superfluous.

Example of retailer contractual coverage

Alinta Energy has used publicly available net system load profile (NSLP) data to present a stylised overview of retailer contracting. These charts have previously been used in the Australian Energy Market Commission's *NEM Financial Resilience* discussion paper.

Chart 1: NSLP, Average load, by day type quarter 1

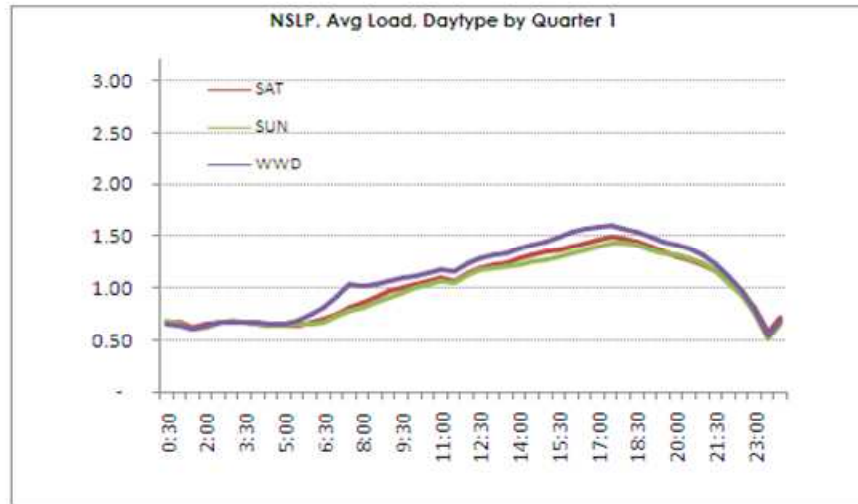
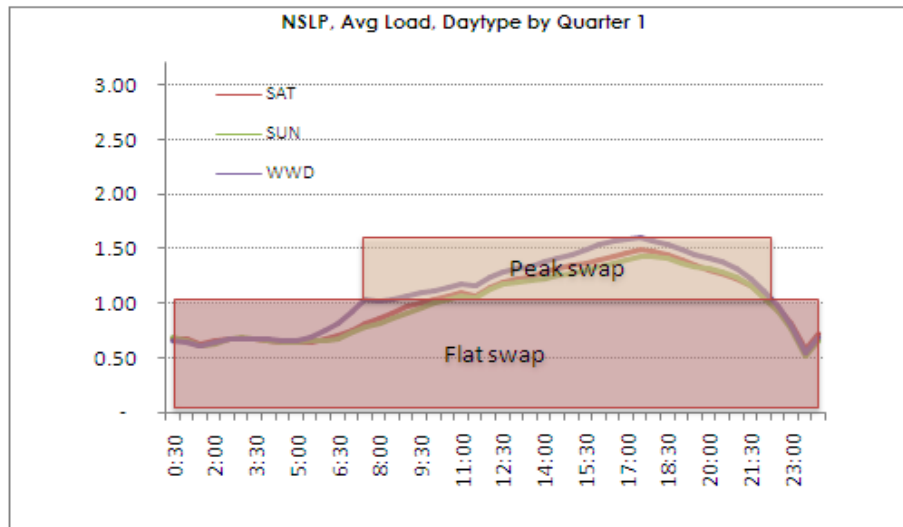


Chart 1 shows a standard net system load profile of average daily load for quarter 1 (January to March) by day type (load varies noticeably by day type). The load ranges from the value of 1, being the average energy usage of a single energy user/connection point/other over the course of any given day with separate measures by working week day ('WWD'), Saturdays and Sundays.

These average load profiles (and each region has a different profile by quarter) can be broken into two components, the peak and the flat, and linked to the requisite swap products needed to cover the load. A swap could be standardised OTC or exchange traded. This is illustrated below in Chart 2.

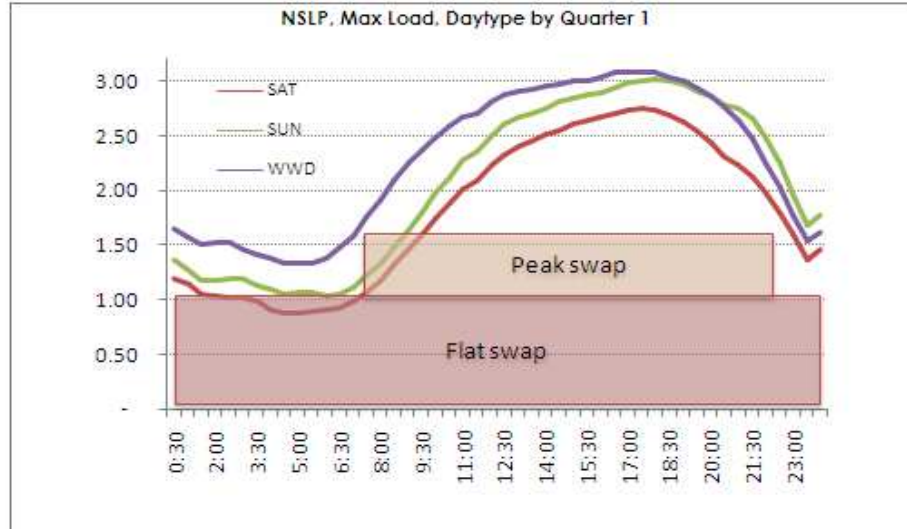
Chart 2: NSLP, Average load, by day type quarter 1, Swap contract coverage



However, Chart 2 also illustrates that using standard block size swaps results in significant 'overs' and can also produce 'unders' – that is periods of over-hedging and potentially under-hedging. This is because standardised OTC and exchange traded swap hedges cover periods that are not necessary despite being incorporated into the standard product hedge cost. This incentivises use of a mix of standard OTCs, exchange traded and tailored OTCs.

A more significant problem is that these standard products do not capture the 'flex' period; the period where load reaches maximum demand. Expected maximum load for quarter 1 is illustrated below in Chart 3. It is essential that retailers are covered for the financial exposure of maximum load days as not doing so could be financially catastrophic.

Chart 3: NSLP, Maximum load, by day type quarter 1, Swap contract coverage



As can be seen the variation from the average of 1, is significant on a maximum load day. On these days, both the peak swap and the flat swap would not provide sufficient cover. They would at these times provide minimal value for a retailer. Therefore, standard hedging practice for retailers is to cover the flex period with caps, as illustrated in Chart 4 below.

Chart 4: NSLP, Maximum load, by day type quarter 1, Cap contract coverage

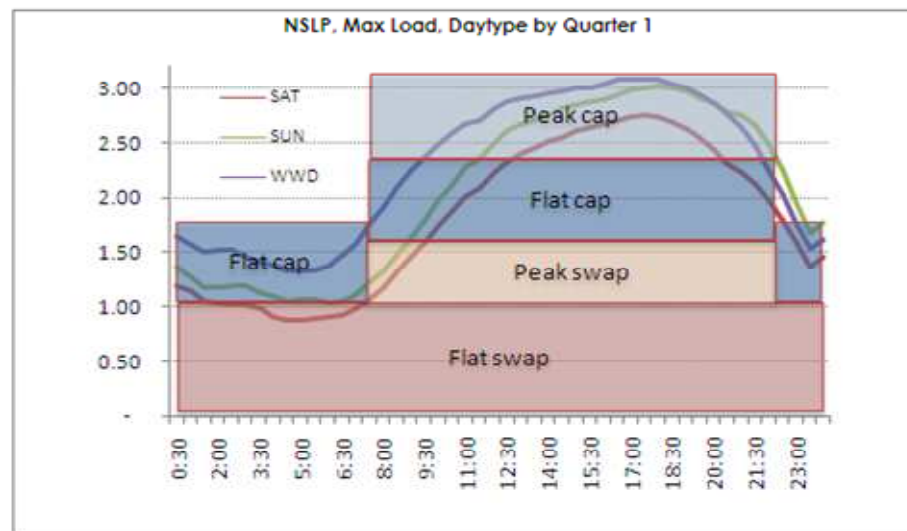


Chart 4 shows that adequate cover requires the purchase of a greater range of products and illustrates the contractual complexity that needs to be entered into across quarters and regions each year. An additional layer of insurance usually overlays the peak cap (not shown above) given flex uncertainty. However, insurance is not purchased in megawatt hours but usually based on other conditions, like weather outcomes, or unit failure.

Importantly, while a cap could also be a standardised OTC or exchange traded products this is even less likely than using standardised products to cover the entire swap portion of exposure as each retailer's flex expectations and load profile will differ. Each individual retailer will have a different mass market customer profile, different exposure to high-use commercial and industrial customers, different weather expectations based on location of customers, different risk appetites, and may have

generation assets that serve to cover an amount of the 'swap' portion of the load and another degree of the 'cap' portion, depending on the form of generation assets.

Existing sound risk management arrangements make the proposed framework difficult to apply

It is not clear how including energy market derivatives in the framework will improve risk management in the sector. Energy market participants have sophisticated enterprise risk management and contractual management processes and the requisite expertise which leads to appropriate trade-offs between operational, basis, and credit risk drawing on OTCs, exchange traded products and other mechanisms. The proposal is likely to hamper those existing risk trade-offs which have served the market and its participants well.

For example, given the unique contracting position of each market participant, and the variables which determine a participants contracting are not apparent, it is unclear what value a trade repository would serve as contractual positions will be difficult to interpret and impossible to act upon. Likewise, central clearing in a manner dictated by regulations, as opposed to evolved by industry voluntarily, may be unsuccessful given the use of tailored OTCs or perversely may push participants to use standardised contracts which do not meet their risk management needs. Alinta Energy opposes any measure to impede the use of tailored OTCs.

Interestingly, Treasury should note that individual relationships between counterparties, for instance those covered by International Swaps and Derivatives Association master agreements, can already include margining requiring for OTCs which may also be mark-to-market. These practices continually evolve to meet risks and at present are often driven by the credit ratings of individual counterparties (i.e. a party with an strong credit rating will place such obligations on a party with a lesser rating). These developments, which are industry lead, should be given preference to blunt determinations by Government agencies.

Alinta Energy's experience suggests that the additional costs associated with the proposed framework are likely to be at least in the order of 4 to 5% in total costs with margins in the order of 50 cents or more per MWh for individual electricity transactions. These costs will need to be recouped up the supply chain.

Option for consideration by Government

In the absence of an energy sector exclusion, and in addition to the earlier proposed amendments covering the framework universally, Alinta Energy proposes that the Minister for Energy be consulted by the responsible Minister prior to the making of a determination covering energy derivatives and that the Minister for Energy be required to approve the form of the DTRs given the critical importance of the energy sector to Australia's economic prosperity.

The energy sector's strong response to the proposed framework may ultimately be misplaced given the responsible Minister may never be minded to make a determination covering energy derivatives. Nevertheless, the potential impost for no discernable benefit has caused significant concern. On this basis, Alinta Energy proposes an arrangement whereby stakeholders concerns would be assuaged by the inclusion of the Minister for Energy in the process. Given the Minister for Energy is traditionally closely engaged with the energy industry such an option may be considered equally beneficial to Government.

Reduction in the use of futures contracts

Alinta Energy understands that separate to this process, but related and worth discussing, is the view that margining for OTCs is needed to ensure that OTCs are not given preference over exchange traded products and that additionally, allowing reallocations and offsets will create a further impetus for participants to preference OTCs over exchange traded products.

Alinta Energy does not share this view.



Alinta Energy believes this issue ignores the fundamental reason why there already exists both OTCs and exchange traded products. Each fills a different, but related, role in the market. Whether a participant chooses to negotiate a multi-year direct bi-lateral, use a standardised or tailored OTC for a fixed term, or exchange traded products depends on the needs of the participant. Each, in the absence of any impediments, will continue to be important instruments for market participants to manage risk and pursue their commercial objectives.

If you have any queries in relation to this matter please do not hesitate to contact me on telephone, (03) 9372 2633.

Yours sincerely

A handwritten signature in blue ink, appearing to read "J. Lowe", written in a cursive style.

Jamie Lowe
Manager, Market Regulation