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Manager
Banking and Capital Markets Regulation Unit
Financial Systems and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Lodged email: financialmarkets@treasury.gov.au

OTC Derivatives Central Clearing and Single-Sided Trade Reporting – Draft Regulations

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Treasury on the OTC Derivatives Central Clearing and Single-Sided Trade Reporting.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 37 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 59,000 people and contribute \$24.1 billion directly to the nation's Gross Domestic Product.

Treasury is currently consulting on the Government's commitment to provide relief to certain businesses from trade reporting, by relying on single-sided reporting. This commitment was announced by the Minister for Finance on 12 December 2014¹. As part of this press release the Government also committed to permanently exempt end users from the regulatory framework, on the basis that:

end users, in particular non-financial corporates, do not play a systemically significant role in over the counter derivatives markets in Australia...

This permanent exemption provides certainty for end users that they can continue to use over the counter derivatives to hedge their business risks without incurring unnecessary compliance costs.

Electricity businesses are likely to be classed as either Phase 3B or 3A² entities, due to them holding an Australian Financial Services Licence (AFSL). The single-sided reporting will provide some relief from reporting for Phase 3B entities. Certain derivatives relating to the costs of fuel or environmental schemes are still likely to be

¹ Press Release: Senator the Hon Mathias Cormann, Minister for Finance, *Making over-the-counter derivatives markets safer*, 12 December 2014.

² The esaa notes that while electricity derivatives are exempt from reporting requirements, their value is included in the calculation which determines a business's class of exemption – this may mean that some electricity businesses do not benefit from the single sided reporting exemption.

captured by reporting requirements, if they are transacted between two Phase 3B entities, though. These include derivatives transactions entered into in relation to gas, oil, coal, diesel, carbon and various other green schemes, collectively referred to as “other commodity based OTCs” If an electricity business falls into the Phase 3A category they will need to report on these trades as well. This is despite the fact that the original intention of exempting electricity derivatives from reporting requirements was in light of the low systemic risk posed by electricity businesses.

Electricity businesses need to have an AFSL to manage their risk. The National Energy Market (NEM) is a gross pool in which the sale of all wholesale electricity must occur in a spot market. The market rules governing the operation of the NEM in Australia preclude a retailer from contracting directly with a generator for the purchase of electricity, resulting in separation of the physical dispatch of electricity from the price-related hedge contract.

Generators and retailers manage their exposure to the wholesale spot price of the NEM by entering into contractual arrangements that operate independently of the wholesale spot market. Market participants can contract through OTC and exchange markets. If electricity businesses did not have AFSLs for this purpose they would likely be covered by the end user exemption to trade reporting for their other commodity based OTCs.

The draft regulations limit reporting requirements to the derivatives listed in the AFSL. For example, if an entity holds an AFSL with authorisation only for electricity derivatives, the Australian Securities and Investments Commission could not make rules requiring reporting of trades in other derivative classes by that entity. Given the very broad description in some AFSLs, this limitation is unlikely to exempt the industry from reporting requirements in relation to other commodity based OTCs entered into by these business as “end users”.

The industry is of the view there are no benefits to requiring trade reporting for other commodity based OTCs for electricity businesses in either the Phase 3A or 3B classes, as they do not pose any risk to the financial stability of Australia. But there are costs. We would note that it was accepted that electricity OTCs did not pose a risk to financial stability and the value of gas and other commodity OTCs are a fraction of the value of electricity OTCs, let alone financial OTCs.

After assessing whether electricity OTCs should be subject to the G20 reforms the Australian Energy Market Commission (AEMC) concluded that:

*transaction-level trade reporting would place significant costs and regulatory burdens on electricity participants' OTC derivatives activities while the benefits of such a measure as a tool to analyse risks to financial system stability are less clear.*³

The AEMC was concerned that G20 reforms would adversely affect risk management in the NEM. They noted that:

risk management in the NEM involves a continuous trade-off between various sources of risk, of which counterparty risk is only one. The G20 reforms are primarily

³ AEMC, *NEM financial resilience – Final Report*, 6 March 2015.

*focussed on addressing counterparty risk under OTC derivatives contracts. Accordingly, they may have the unintended effect of discouraging participants from using OTC derivative instruments in favour of, say, taking more spot market exposure. The reforms could result in participants changing their risk management practices so that they become less exposed to credit risk, but are more exposed to other types of risk.*⁴

Given it was accepted that electricity OTCs should be exempt from reporting, and the volume of other commodity based OTCs entered into by electricity businesses is a fraction of the size, it would be counterintuitive to apply reporting requirements to these transactions for Phase 3A and 3B classes.

The industry would be happy to work with the department to find a way to achieve the exemption that is consistent with the legislative framework.

Any questions about our submission should be addressed to Fergus Pope, by email to fergus.pope@esaa.com.au or by telephone on (03) 9205 3107.

Yours sincerely



Kieran Donoghue
General Manager Policy

⁴ Ibid.