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Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
Parkes ACT 2600

Lodged by email: financialmarkets@treasury.gov.au

Corporations Legislation Amendment (Derivative Transactions) Bill

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to Treasury's consultation on the draft *Corporations Legislation Amendment (Derivatives Transactions) Bill 2012* (the Bill).

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 51,000 people and contribute \$16.5 billion directly to the nation's Gross Domestic Product.

The draft Bill sets out the proposed legislative framework to enable Australia to meet its G20 commitments in relation to over-the-counter (OTC) derivative markets. The Bill proposes giving the Minister for Financial Services and Superannuation the power to prescribe various regulatory requirements for OTC markets. esaa acknowledges that the Bill only establishes the legislative framework and does not in of itself impose any additional regulation on any given OTC market.

The OTC electricity market is local to Australia and is primarily used by physical market participants¹, for whom the OTC market is a critical means of managing risk. There is no evidence that this market poses a risk to national or global financial stability.

The esaa believes that the electricity market and participants who utilise the market to manage risk associated with physical positions should be exempted from the legislative framework. The most effective way to exempt electricity market derivatives is to do so explicitly through an amendment to the draft Bill. This ensures that the energy sector has regulatory certainty rather than facing the prospect that it could be brought within the scope of the mandatory obligations at any time. The lack of detail on the application of the framework that is currently available makes this a real risk for energy market participants.

The application of the proposed framework to the electricity market would reduce participants' flexibility and ability to manage risk and would also place additional

¹ It is unlikely that an OTC contract would be executed by two non-physical players.

compliance, systems and credit collateral costs on participants. 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 outcome.

The design of the National Energy Market requires the use of derivative contracts

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.

The Australian Energy Market Operator (AEMO) determines the spot price for each half hour interval during the trading day. The spot price is the market determined clearing price that matches supply with demand, and forms the basis for financial settlement of wholesale purchases and sale of electricity by NEM participants. Generators receive the spot price from AEMO for electricity sold in the NEM, and retailers and wholesale end-users pay the spot price for electricity consumed.

The spot market allows almost instantaneous matching of supply against demand. While this contributes to a safe, secure and reliable supply of electricity, the market can also be extremely volatile. This extreme volatility creates a strong motivation for participants to enter into contracts to manage this risk. Spot price volatility and the potential for high spot prices is an intentional and important feature of the design of the NEM. Periods of high spot prices provide a market signal that new investment is required.

Market participants can contract through the over-the-counter (OTC) and exchange (standardised) markets. In risk management terms:

- generators seek to swap out their exposure to the NEM spot price for a fixed price, to support their long term, capital intensive investment in generation assets; and
- retailers seek to match sales of electricity under fixed price supply contracts to contestable or franchise customers with purchases of electricity from the NEM.

In both cases, the underlying risk management objective is to reduce or minimise exposure to volatile spot prices by setting a fixed price for electricity purchased or sold through the NEM.

Key differences between OTC and exchange markets

The overarching difference between the two markets is that the OTC market provides flexibility, while the exchange market is standardised.

OTCs are confidential contracts, primarily between retailers (or large users) and generators. As the contracts are negotiated between the two parties, market participants are able to structure the contract to reflect their specific risk exposure.

For example, to manage 'volume risk'² retailers can design load following swaps tailored to the retailer's customers' demand, which will follow the actual usage of the retailer's customers over the agreed period. Alternatively, generators can use contracts to manage the risk around unscheduled outages, by including plant availability clauses. In comparison, exchange contracts are standardised products traded on the Australian Securities Exchange (ASX) through financial intermediaries.

OTCs also allow the parties to take their own view on appropriate credit limits and collateral arrangements³. This means that parties that are contracting with a physical participant can take account of the fact that the counterparty is typically offsetting their exposure to the wholesale price. Parties who are participants in the physical market have made a long-term commitment to that market and so have a core interest in the stability of both the physical market and the associated derivatives market.

For exchange contracts, the ASX is liable to meet any contract position. The ASX manages this risk by requiring margin payments determined by the level of exposure. Given the volatility of the NEM spot price, it follows that the derivative instruments based on it are equally volatile and so margin requirements can be very substantial.

Recent developments in the USA

On 10 July 2012, the Commodity Futures Trading Commission (CFTC) released Final Rules and Interpretations for the definition of a swap⁴. The swap definition in the Dodd-Frank Act excludes forward contracts for non-financial commodities that may be physically delivered. The CFTC affirmed the historical interpretation that forward contracts with respect to non-financial commodities are commercial merchandising transactions rather than swaps. The CFTC noted that "regulatory scheme(s) for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity". The likely effect of the CFTC's determination is that nearly all transactions for purchase/sale of electricity will be excluded from the scope of the Dodd-Frank Act.

A strict interpretation of the USA exclusion for forward contracts would not cover transactions in the Australian OTC electricity market, as the design of the NEM as a gross pool prevents generators and retailers contracting directly for delivery of the physical good. However, the OTC electricity contracts in the NEM should not be viewed as separate transactions from the buying/selling of the physical output, but rather a mechanism for retailers and generators that buy/sell the physical output to lock-in a price for that output in advance of the physical delivery through the NEM dispatches. If the direct link between the two transactions is not recognised, it would

² The risk that the retailer's customers' demand is higher than the retailer expected, requiring the retailer to pay spot prices for the additional electricity to meet that demand

³ The Australian Energy Market Commission in the *NEM financial market resilience review* (<http://www.aemc.gov.au/Media/docs/Issues-Paper-d67a2f10-7cb5-445b-9815-99880c37ac45-0.pdf>) stated that the financial relationships and markets that underpin the efficient operation of the NEM are generally robust and energy businesses have well established risk management practices.

⁴ <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf>. CFTC is still consulting on one element in relation to forward contracts.

mean that Australian transactions that are ultimately the same in substance as the USA are treated differently due to their different form.

Conclusion

If the electricity sector is not excluded from increased regulation of OTC markets, the esaa expects the risk profile of the market to increase alongside the compliance costs for energy businesses. This will lead to increased costs and therefore, higher energy prices for not net market benefit. The esaa considers that the energy industry should therefore be explicitly excluded from the proposed OTC derivative reforms, consistent with the approach in the USA.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Matthew Warren', with a long horizontal flourish extending to the right.

Matthew Warren
Chief Executive Officer