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Implementation of a framework for Australia's G20 over-the-counter derivatives commitments

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Treasury's consultation on implementing a framework for Australia's G20 over-the-counter (OTC) derivatives commitments.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 38 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 esaa considers that there is no clear rationale for implementing any of the proposed amendments to the *Corporations Act (2001)* for OTC trading in the electricity market. The OTC electricity market is local to Australia and is dominated by physical participants, for whom it is a critical means of managing risk. There is no evidence that this market poses a risk to national or global financial stability. The application of the proposed measures to the electricity market would place additional compliance, systems and credit collateral costs on participants and would 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 outcome. The esaa believes that the electricity market and participants who utilise the market to manage risk associated with physical positions should be exempted from all of the proposed mandatory obligations.

Prior to any of the three mandatory obligations being introduced, the objectives associated with their introduction should be clearly articulated 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.

Background

The Australian electricity market is dominated by the National Electricity Market (NEM).[1] The NEM is a gross pool electricity market where the sale of all wholesale electricity occurs in a spot market. 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. The maximum price is $12,500 per megawatt hour (this will increase to $12,900/MWh on 1 July 2012), while prices can sink as low as -$1000/MWh. This extreme volatility creates a strong motivation for participants to enter into contracts to manage this risk. This is achieved through participation in both OTC and exchange based markets.

Benefits of OTC Markets

The mandatory obligations proposed by Treasury appear to be based on the premise that both standardisation and central clearing of OTC markets would be risk reducing. This is not the case for the electricity market. OTC markets represent a competitive and complementary alternative to exchange and cleared markets. Removing the ability of participants to utilise OTC transactions could jeopardise the efficient functioning of the underlying market.

Market participants currently have ability to utilise both OTC and exchange (standardised) markets. The OTC market provides participants the ability to structure contractual arrangements to manage their risk exposures more effectively than via an exchange based market. A good example of this is the development of emissions pass through provisions which have been extensively used by participants to reduce risk associated with the Clean Energy Future legislation. Without this flexibility, there would have been less forward contracting due to the uncertainty that surrounded the passage of the Clean Energy Future legislation. This flexibility is not available with exchange based contracts.

In addition, the OTC market provides participants with flexibility on credit arrangements, which allows for less onerous requirements than 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 that associated with 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 risk. We set out below our more specific concerns with each of the potential mandatory obligations.

[1] There is also a smaller, Western Australian electricity market known as the South West Interconnected System (SWIS). The SWIS is a net pool with bilateral contracts supported by a day ahead short term energy market.

Reporting all OTC derivatives to trade repositories

Even the lightest approach suggested in the consultation paper – reporting all OTC derivatives to trade repositories – could result in a substantial cost to the industry for little benefit. While standardised contracts are relatively easy to report, OTC contracts are more flexible and can be more complex. Treasury should not underestimate the difficulties associated with the design and implementation of the systems necessary to monitor and analyse all OTC market transactions between participants.

It is unclear what would be done with the information provided and how this would contribute to reducing market risk. 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 will be significant and will ultimately need to be borne by the consumer.

Clearing of all standardised OTC derivatives through central counterparties

The requirement to centrally clear electricity OTC contracts would have two key outcomes:

1. The forced standardisation of OTC contracts (a pre-requisite for central clearing), and corresponding reduction in the ability for participants to enter into flexible arrangements to manage their risk exposures; and

2. A substantial increase in the credit collateral required to support risk management activities, with corresponding cost increases that must ultimately be borne by consumers.

Both of these are likely to 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 could also have a negative impact on investment in the sector. Additionally, there is a real risk that the increased collateral requirements will act as a barrier to entry into the market and will stifle business growth in the sector. This will have a flow-on effect in limiting competition in the market.

Executing standardised OTC derivatives on exchanges

This is essentially a further evolution of central clearing, which has the same issues as described above. It should be noted that this option is already available and is widely utilised by participants to manage electricity market risk.

The esaa considers that it is appropriate to exempt electricity market derivatives from the mandatory obligations. OTC trading in the electricity market is used as a risk management tool and there appears to be no justification for imposing any of the

proposed measures on the sector. In fact, they are likely to be risk increasing for the industry rather than risk reducing.

Some participants may even find that the increased cost burden and lack of flexibility entailed in the mandatory obligations lead them to lower levels of contracting. For NEM participants this will actually increase their risk profile and for generators in particular it may lead to different dispatch bidding patterns that may increase prices. For retailers it increases the risk of being unable to hedge their positions, increasing the risk of financial distress in the case of extreme market events.

In relation to the impact of reduced contracting, in August 2011 the esaa commissioned ACIL Tasman to model the impact of reduced contracting levels in the NEM. This was done in the context of design of the carbon pricing mechanism which raises the working capital burden for electricity generators. If contracting reduced by 5%, ACIL Tasman found that this would result in retail electricity prices increasing by up to 10% for small-users and 15% for large users. The impact of a reduction in contracting levels is the same, regardless of the source.

Legislative amendments

The most effective way to exempt electricity market derivatives is to explicitly do so via the relevant amendments made to the Corporations Act. This is to ensure that the sector has certainty rather than facing the prospect that it could be brought within the scope of the mandatory obligations at any time via the Derivative Transaction Rules.

An additional element of clarity could be provided by confirming the meaning of “derivative” for the purposes of this framework. Treasury has indicated that the starting point is the existing definition in the Corporations Act. However, other commonly used definitions, such as that used in International Accounting standards, also encompass some physical contracts. The esaa would be very concerned if the scope of the framework included non-financial OTC contracts such as fuel, emissions permits and environmental certificates. The implications for our members and the concerns highlighted above would be multiplied commensurately if this occurred.

Coordinated approach with other agencies

The esaa notes that the electricity derivatives market is the subject of several other regulatory processes at present. ASIC have recently consulted on financial requirements for market participants and we are expecting a further consultation by them on margin requirements. Meanwhile the Australian Energy Market Commission (AEMC) has published an issues paper on NEM financial market resilience. We urge Treasury to coordinate closely with these agencies to ensure a holistic approach to any regulations imposed on this market. Otherwise there is a risk of a disproportionate response if the market is subject to regulation from several different sources.

Conclusion

The Treasury's proposed amendments to the Corporations Act will only increase the working capital burden on these businesses. This will lead to increased costs and therefore, higher energy prices. The esaa considers that the energy industry should be explicitly excluded from the proposed arrangements for OTC trading.

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

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