International Power
GDF SUEZ

Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email to financialmarkets@treasury.gov.au

Friday, 15 June 2012

Dear Sir/Madam

Submission on Treasury paper on implementation of a framework for Australia's G20 over-the-counter derivatives commitments

International Power-GDF Suez Australia (IPRA) appreciates the opportunity to comment on options for the implementation of a legislative framework to meet Australia's G20 commitments on over-the-counter (OTC) derivatives.

About IPRA

IPRA entered the Australian energy industry in 1996 and has grown to become the largest private electricity generator in Victoria, in addition to holding assets in South Australia and Western Australia. The IPRA portfolio also includes Simply Energy, a significant second-tier gas and electricity retail business with 300,000 accounts in Victoria, South Australia and New South Wales. The business has invested around A$5 billion in the Australian energy market.

In February 2011, International Power combined with the international energy assets of GDF SUEZ to form a world leader in independent power generation, with more than 72,000 MW of power generation worldwide and a further 15,500 GW under construction.

International Power has participated internationally in asset backed trading operations in highly complex and sophisticated electricity, gas, coal and related markets in Australia for over fifteen years. IPRA relies heavily on OTC derivative markets to hedge 22 TWh of generation in the NEM from our Victorian and South Australian generation assets and to hedge the retail sales made by Simply Energy.

Summary

The OTC electricity market is local to Australia and is dominated by physical participants, for whom it is a critical means of managing risk. To our knowledge, there is no evidence that this market poses a material risk to national or global financial stability.

IPR - GDF SUEZ Australia
Level 37, Rialto North Tower, 525 Collins Street
Melbourne, Victoria 3000, Australia
Tel. +61 3 9617 8400 Fax +61 3 9617 8401
www.iprplc-gdfsuez-au.com
INTERNATIONAL POWER (AUSTRALIA) PTY LTD
ABN 59 092 560 793

IPRA believes that the proposed regulations arising from amendments to the *Corporations Act (2001)* will have the unintended consequence of increasing systemic risk in the market, as participants will lose flexibility in hedging arrangements and also likely 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 may also have a negative impact on investment in the sector.

The application of the proposed measures from amendments to the *Corporations Act (2001)* 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 cost for consumers and is very likely to increase the risk profile for the market, the opposite of the intended outcomes.

IPRA does not believe that any tangible benefits in terms of material reduction in systemic risk will be achieved from the application of the proposed regulations to the electricity sector in Australia.

IPRA therefore believes that the electricity market and participants who utilise the OTC derivatives market to manage risk associated with physical positions must be exempted from any new regulations which are envisaged by the changes outlined in the Treasury paper. Such an exemption for the electricity sector must also be extended to financial OTC derivatives contracts for power, gas and emissions.

IPRA recommends this occur by way of an explicit exemption within the amendments proposed to the *Corporations Act (2001)*.

It is essential for electricity businesses to continue to be able to use tailored (or so-called bespoke) OTC derivative contracts to optimally hedge their risk. The proposed regulations which will have the impact of mandating the use of standardised OTC derivatives, removes their inherent advantages. Standardising these products eliminates this tailoring capability and would therefore be risk-increasing rather than risk decreasing for businesses.

Defence against financial contagion is already provided by a number of local regulatory measures which apply to businesses and personally to company directors and the advanced internal risk management processes of individual businesses. These industry practices and regulations have protected the industry from severe impacts of financial contagion (even in the face of significant market shocks) and the probability of this occurring in the future remains very low. The industry in Australia has absorbed, for example, the collapse of Enron, and the failure of two second-tier retailers, without significant disruption.

The proposed regulations will lead to practices where hedging strategies are driven by available cash and working capital reserves and not by sound risk management approaches. Ultimately it will lead to less contracting, greater spot market volatility and higher risks for the sector. Increasing the risk profile for the industry will ultimately feed through to cost increases to customers for no apparent or actual benefit.

Background on derivative trading in the electricity sector

Derivative trading in the electricity sector is dominated by asset-backed businesses that have a prevailing or "natural" position. Generators hedge their production to secure revenue and reduce volatility in earnings while retailers hedge their load to offer contracts to customers on fixed terms. Internal risk limits dictate minimum hedging levels which are in place to limit exposure to market prices.

Non-asset backed participants in the OTC derivatives market (such as such as financial institutions) enhance overall liquidity and are themselves sophisticated trading entities. The complexity of trading in OTC electricity derivatives is a barrier to entry for participants without sufficient knowledge to participate, and

hence the market is restricted to sophisticated participants only. OTC derivative transactions are inherently valuable to businesses because of their non-standardised nature. They provide opportunities for bilateral transactions which are tailored to the individual needs of businesses and are often the best products for optimal hedging. 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 own risk.

A good example of the value of OTC derivatives markets has been in relation to forward trading for periods beyond 1 July 2012 when a carbon price will come into effect. The OTC derivatives markets have provided the best facility to manage carbon risk through individual "pass through" clauses in contracts and have been used extensively by participants. In contrast, exchange based contracts for the same periods have not given participants the same flexibility. There would have been a serious problem for the sector had the OTC market not been available.

Another advantage that OTC transactions offer to electricity businesses over centrally cleared ones is the reduced collateral requirements. The OTC market provides participants with flexibility on credit arrangements, which allows for tailored, and generally 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 the credit risk associated with participants who are hedging an underlying physical position can be lower than speculative participants.

It is understood that the definition of derivative for the purposes of the proposed mandatory requirements is as per the Corporations Act. This is a relatively limited definition when compared to other definitions in use such as International Accounting Sandards, which also encompass some physical contracts. IPRA is therefore concerned that the scope of the mandatory requirements could be increased over time to include non-financial OTC contracts such as physical gas, emissions and environmental products. The implications for our company and the concerns highlighted would be multiplied commensurately if this occurred.

Scope and application of the proposed amendments

IPRA is emphatic that the electricity sector must be exempted from the proposed amendments to the Corporations Act which will lead to regulations mandating reporting of OTC derivatives in trade repositories and central clearing of standardised OTC derivatives.

Electricity businesses in Australia are sophisticated entities that manage complex operational and financial risks on a daily basis. The concerns regarding financial contagion which have spurred these proposals are not warranted for our sector in our view.

In the NEM, participants have successfully managed risks to a variety of exposures. The main exposure is to a volatile spot market but the industry has successfully managed to withstand a range of other disturbances in the market. These disturbances or price shocks have included physical loss of supply due to industrial action, mine collapses or plant failure and the loss of gas production facilities and the changes in underlying market dynamics that occurred during the peak of drought conditions. The industry in Australia has also absorbed financial shocks, for example, the collapse of Enron, and the failure of two second-tier retailers, without significant disruption.

Financial contagion did not follow any of these events and into the future has a very low probability of occurring due to industry practice and existing local regulations (which include Australian Financial Services Licenses regulations, retailer of last resort provisions, or "ROLR", and ASIC regulations).

This view has been supported in the AEMC's recent issues paper on NEM financial market resilience. The paper states "financial relationships and markets that underpin the efficient operation of the NEM are generally robust, which means that there is likely to be a low probability of financial contagion occurring in the NEM[1]." Furthermore, the paper concluded that the "key risks relate to the operation of the failure of a large retailer and the consequences of the operation of the ROLR mechanism[2]." The AEMC, in assessing NEM financial resilience, has chosen to focus on existing regulations rather than to explore new ones. This outcome supports our view that existing obligations are adequate and supports our call for an exemption for the electricity sector from the proposed Treasury regulations.

The proposed regulatory measures come across as a reaction to events which occurred in the lead up to the global financial crisis of 2008. The trade of OTC derivative contracts in the electricity sector had no bearing on these events, yet the sector is now facing a range of heavy-handed regulations which subscribe to a one-size fits all approach.

For example, at the same time as the Treasury is undertaking this review, ASIC is conducting a review on financial requirements for electricity derivative market participants and the AEMC is also conducting a review on NEM financial resilience.

Notwithstanding our request for an electricity sector exemption, as a general regulatory practice, IPRA would argue any new proposed mandatory requirements being introduced must have clearly articulated objectives associated with their introduction for each market and participant class. A detailed analysis should be undertaken to ensure that there is a net benefit – ie that the benefit associated with the potential reduction in financial contagion risk outweighs the increase in compliance burden, credit collateral cost and reduction in risk management flexibility for market participants.

Our comments on the specific obligations and their application to the electricity sector and our business are outlined below.

Reporting of all OTC derivatives in trade repositories

Whilst standardised contracts would in principle be relatively easy to report, OTC derivatives contracts are more flexible and thus can be more complex. Treasury should not underestimate the complexities and challenges associated with the design and implementation of the systems necessary to monitor and analyse all OTC market transactions between participants. There is likely to be a high cost for both Government and market participants associated with the development, implementation and ongoing management and reporting of such systems, ultimately increasing costs for consumers.

In any event, it is not clear that this captured data would provide any useful information for Government. IPRA does not believe that there is any evidence that the proposed repository would be able to provide an "important role in providing information that supports risk reduction (including: assessing systemic risks; conducting market surveillance and enforcement; supervising market participants; and conducting resolution activities) and operational efficiencies for both individual entities and the market as a whole". We fear that any data set would be so vast and diverse as to almost be unmanageable.

Further, it is impossible to assess the risk position of a participant by reference to the large number of individual contracts transacted to create a risk-adjusted optimised trading portfolio. Portfolios need to be examined in aggregate, with reference to *inter alia* nodal issues, bespoke aspects of the contracts themselves, and aggregate credit positions. This evaluation would require systems similar in nature to those

[1] *AEMC "NEM financial market resilience issues paper" p. 29*
[2] *Ibid, p. 43*

employed in the management of the portfolio for each business, hence duplicating systems, but perhaps more importantly, duplicating risk assessment processes already in place, and for the same ultimate purpose.

Finally, IPRA also has serious concerns around the release of commercially sensitive information.

The objectives and deliverables of any central repository and associated reporting requirements must be articulated by Treasury and a clear net benefit should be identified before implementation of this measure is even contemplated. The compliance cost may be significant and will ultimately need to be borne by consumers.

Central clearing of all standardised OTC derivatives and execution on trading platforms

Central clearing of all standardised OTC derivatives would be harmful to the electricity sector. Firstly, it would force standardisation of OTC contracts, with the adverse consequences articulated above; and secondly add significantly to the credit collateral requirements for market participants. This requirement would be an inefficient use of limited collateral, with no material benefit to market participants or consumers, particularly the former, who currently have sufficient regulatory and commercial incentives to manage financial risks.

Greatly increasing collateral requirements across the industry would lead to practices where hedging strategies are driven by available collateral and not by sound risk management approaches. Ultimately it will lead to less contracting, greater spot market volatility and higher risks for the sector. Increasing the risk profile for the industry would feed through to cost increases to customers for no apparent benefit.

Due to the large volumes of credit involved in the electricity sector, there is likely to be an overall reduction in credit available to other parts of the economy which is not conducive to overall economic growth. For example, if IPRA were to hedge its annual Victorian generation through a mandatory central clearing process, it would need to post $1 million in credit support for every $1 increase in the underlying power price. This requirement would be an unproductive and wasteful use of cash or working capital headroom for a situation where a generator has not taken a position on price and simply hedged the output of its stations.

To further put the collateral requirements into context, for a contract position of 10TWh (much smaller than IPRA would expect to have) that was exchange traded, the initial margins required would be $32M and a $5/MWh adverse movement in price would require a further $50M in variation margin.

A pre-requisite for central clearing would be forced standardisation of OTC contracts and a corresponding reduction in the ability for participants to enter into flexible arrangements to manage their risk exposures. A further damaging outcome of this approach will be to discourage investment in the sector, particularly from new-entrants, as there will be fewer parties who are able to provide the necessary credit collateral required to operate in the electricity sector.

Standardised centrally cleared/exchange traded products are complementary to the OTC market. They have advantages and disadvantages and participants should be allowed the flexibility to utilise both market arrangements to optimise their risk management activities. It would be a significant retrograde step to force the market into a standardised and credit collateral intensive market environment.

International Power
GDF SUEZ

Conclusion

IPRA is alarmed by the consequences of the Treasury for the electricity sector. We therefore seek an exemption for the electricity sector from any new regulations which arise from the proposed amendments to the Corporations Act.

If you have any questions in relation to this matter please feel free to contact Mr Greg Hannan, on +61 3 9617 8405.

Yours Sincerely

Stephen Orr
Strategy and Regulation Director
International Power GDF SUEZ Australia