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To Whom it May Concern

Australia's G20 commitments on over-the-counter (OTC) derivatives

The NGF is the national industry association representing private and government owned electricity generators. NGF members operate across all states and territories and all generation technologies, including coal-fired plant, gas-fired plant, solar, bio-waste, hydroelectric plant and wind farms.

Background to the electricity financial market

The National Electricity Market is a competitive wholesale market where spot prices can vary between -\$1,000/MWh to \$12,500/MWh. Daily prices average between \$25-40/MWh, although price volatility due to the higher price and low floor creates significant risks. Generators face a risk of sustained low prices and electricity retailers face the opposing risk that prices may increase above that accounted for in their customer tariff. National Electricity Law mandates that all generators and retailers must sell and purchase electricity from the spot markets. Participants can only manage price risk by entering separate derivative contracts whereby counterparties agree a fixed strike price against the spot market price. The end result is parties pay the difference between the strike price and the spot price, depending on whether the strike price is higher or lower than the spot price. This ensures the participants have fixed cash-flows and stable earnings.

Participants in electricity derivatives markets include generators, retailers, financial intermediaries and speculators. Brokers facilitate transactions between contracting participants, although participants also develop and agree large contracts bilaterally.

In Australia, two distinct financial markets support the wholesale electricity market:

- over-the-counter (OTC) markets: bilateral contracts between counterparties, often assisted by a broker;
- exchange traded market, where d-cyphaTrade futures and options are traded on the Sydney Futures Exchange (SFE). Licensed brokers trade contracts on behalf of client counterparties.

The Australian Financial Markets Association's "2011 Australian Financial Markets Report", shown in Figure 1 below, shows a steady increase in financial market turnover in the electricity sector. In addition there has been more rapid increase in exchange based trades on the Sydney Futures Exchange. The AFMA OTC data is from an annual survey with OTC trades reported every financial year, with most electricity participants responding. Those reported deals include those executed within the year. So for example a 100MW 3 year deal starting 2010 would be reported in 2010, with all volume 300MW attributed to that year.

The NGF believes the survey is a fair reflection of the OTC derivative market. However, as with any survey, the data is only as good as the response from participants.

OTC contracts are priced on NEM "regions", which follow the state boundaries. The regions with significant traded volumes are QLD, NSW and VIC. The published volumes from SA and TAS are small by comparison.

A recent development in electricity derivatives has been the development of AFMA carbon exclusive contracts in addition to the standard AFMA electricity contracts. These contracts allow for the cost of carbon to be passed through by the seller of the contract to the buyer on the basis of a pre-agreed formula. Such contracts were primarily required by sellers when there was a risk of the carbon legislation being implemented and are now being sought by buyers. By contrast futures prices listed by d-cyphaTrade on the SFE are inclusive of carbon costs. This is an example where the OTC market adapted to suit participants' need and to manage a risk to participants that would have otherwise prohibited the trade in derivatives.

The OTC market developed the carbon pass through clause through an addendum to the standard ISDA after discussion at the AFMA electricity committee. The very fact that futures traded on the SFE did not accommodate this need suggests the utility of the OTC derivatives helps ensure efficient management of risks in the electricity industry.

Response to the consultation

The NGF understands this consultation proposes mandatory obligations with respect to OTC derivatives. The NGF's view is that electricity financial market participants and electricity OTC transactions should be excluded from the scope of the Derivative Transaction Rules in respect of each mandatory requirement.

The NGF considers electricity derivatives be considered a small, domestic market which is primarily for hedging market risks rather than speculation. We do not consider it likely that the electricity OTC market will lead to significant risk to the greater economy. For these reasons the NGF believes electricity derivatives should not be prescribed by the Minister and included in these regulations.

The NGF considers the benefits of central clearing and trade execution would be to reduce transaction costs. The NGF suspects the electricity OTC market, with its regional trade and differing, specific contract terms, would not provide the economies of scale required to recoup the costs of central clearing and trade execution. It also seems strange to develop central clearing and trade execution given the electricity participants already have this option in trading electricity futures on an exchange.

There has been a significant increase in the volume of electricity derivatives traded on the Sydney Futures Exchange, which proves participants in the electricity market have an option for exchange based trades instead of bilateral, OTC derivatives. This would suggest the rationale for such OTC deals is because either counterparty has a specific requirement that may be unsuitable for a standard "vanilla" trade on an exchange.

There are some products / contracts that are tailored to the buyers' needs, especially where counterparty has a specific wholesale electricity risk that others do not. This may be due to a particular characteristic of their customer base, generating facility, finance structure, company structure or risk appetite. For example a certain electricity retailer may desire a "load-following hedge", where a generator would agree to a fixed strike price for a variable volume of an electricity retailer's customers. Similarly so a bespoke contract would be required for generators with a particular physical risk that needs to be hedged.

OTC contracts are settled against the NEM settlement calendar and participants in the NEM will have offsetting pool revenues at the same time. This is quite different to futures contracts on the SFE where variation margins are required prior to settlement of pool revenues or expenses. If central clearing were required for all OTC contracts, with here-to-be decided margining arrangements, operational risk may arise.

These points of differentiation and competition would be lost if the OTC market was subjected to significant Ministerial oversight and transaction rules. The NGF suspects that in implementing heavy handed DTRs, the policy maker would be limiting the function of the OTC market and therefore leaving participants with "unhedgeable" spot market risks. This could be worse than any perceived problem the DTRs are trying to solve.

The NGF can see no reason for the Minister to prescribe electricity OTC derivatives subject to one or more mandatory obligations: trade reporting; central clearing; or trade execution.

We understand regulators or policymakers may have concerns over the lack of transparency of OTC electricity derivatives. We advise that ICAP publishes prices every day, with forward curve and trade volumes made available. These prices are an amalgam of screen prices, brokers' prices reflecting the closing price on the day. The prices in the OTC market are presented on screens during the trading day, such as through the Reuters screens. As previously mentioned, AFMA publishes information on market turnover in its annual financial markets review survey.

The Standing Council of Energy and Resources has requested the NEM's regulatory body, the Australian Energy Market Commission (AEMC) review financial market resilience within the NEM. The Commission has recently published an Issues Paper and has stated that "*Our initial view is that the financial relationships and markets that underpin the efficient operation of the NEM are generally robust*"¹. The NGF concurs with this initial view the Commission believes the ability to enter into bilateral over-the-counter electricity derivatives should be preserved with the Minister deciding this class of OTC derivatives is excluded from being prescribed under the legislation.

Yours faithfully

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

Timothy Reardon
Executive Director

¹ Australian Energy Market Commission, NEM Financial Market Resilience, Issues Paper, AEMC, 8 June 2012, Sydney

FIGURE 1: ANNUAL TURNOVER

