21 August 2012

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

Corporations Legislation Amendment (Derivatives Transactions) Bill 2012

Dear Sir/Madam

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.

The NGF is concerned that the *Corporations Legislation Amendment (Derivatives Transactions) Bill 2012* as it is currently drafted for consultation, will impact on a range of derivatives markets well beyond the original policy intent of the G20 commitments made by the Australian Government.

There was a considerable response to the Treasury's Consultation Paper in April 2012, at least from the energy sector, regarding exemptions from the legislation. Energy companies and associated industry peak bodies detailed clear market and risk management reasons for exempting energy derivatives from the mandatory reporting, trading and clearing obligations. (Note any reference to energy derivatives throughout this response incorporates other related commodity derivatives, for example environmental and fuel).

We are therefore disappointed that these concerns have not been incorporated into the draft Bill by excluding or 'ring fencing' certain class of derivatives.

Both the European Union, through the European Market Infrastructure Regulation, and the United States of America, under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), provide for exclusions under certain circumstances. Specifically, the EU has identified certain quantitative thresholds, under which market participants are exempt from central clearing. Further, these thresholds exclude hedging operational risk from the relevant calculations. The Dodd-Frank Act provides for a "commercial end-user exception" from central clearing obligations for non-financial entities using OTC derivatives to hedge or mitigate commercial risk. Further information on these frameworks is included in Section 4 of the Paper and in Attachment A.

Australia's response, has taken an alternative approach in the draft legislation by providing the Minister and the Australian Securities and Investment Commission (ASIC) with broad powers to make determinations and rules applying to OTC derivatives.

No concerns have been raised during the consultation process which would identify OTC electricity derivatives as a target area for additional regulatory oversight.

ABN 83 113 331 623 PO Box 4155 Kingston ACT 2604 T 02 6232 7789 F 02 6232 7781 W ngf.com.au

The proposed legislation, as drafted, also creates another layer of regulatory uncertainty for the energy market, which is already operating in an environment where the future of climate change policy is unclear and impacting market liquidity.

Taking account of the design of the legislation proposed, we consider introducing an additional assessment process to targeting the appropriate set of derivatives in which to apply the mandatory obligations (i.e. those posing the greatest level of systemic risk). In addition to avoiding unnecessary and potentially distorting regulation, this would provide financial market participants with a clearer understanding of the Government's and ASIC's likely intentions moving forward.

Notwithstanding these comments, it remains our strong preference for explicit exclusions to be incorporated within the framework legislation for energy OTC derivatives, or indeed those businesses whose primary activities involve the generation or retailing of energy in the NEM.

The following discussion expands on these issues.

THE PROPOSED LEGISLATIVE PROCESS FOR MAKING DERIVATIVE TRANSACTION RULES

Given the proposed legislation does not explicitly exclude classes of derivatives (or participants), the primary concern is the mechanism by which a class of derivatives is captured by, and/or excluded from, one or more of the execution; reporting and clearing requirements. At a conceptual level, it is important that the process by which a class of derivatives is prescribed by the Minister, and then subsequently subject to a DTR by ASIC, is clear and transparent for derivative market participants (i.e. Division 2, Subdivision A and Subdivision C).

The draft legislation establishes a framework for the establishment of trade reporting, central clearing and/or trade execution obligations for OTC derivative transactions. The framework established in the draft legislation does not, in and of itself, create any obligations with respect to OTC derivative transactions. Instead, it provides for a two tiered process whereby:

1. The Minister may make a determination regarding classes of derivatives to which requirements may be imposed.

2. ASIC then has the power to make a DTR applying to the class of derivatives the subject of a ministerial determination, and then obtain the Minister's written consent prior to issuing a DTR.

The draft legislation provides that regulations may limit the persons to whom the requirements to report, clear or execute trades in accordance with the DTR may be imposed. For legislative purposes, the "class of persons" is described by reference to "any matter", with certain examples provided. Similar limitations or exclusions can also be applied to certain classes of derivatives.

Prior to making a determination and a DTR, the Minister and ASIC respectively must undertake consultation with relevant agencies and the public (only applies to ASIC). Apart from a broad set of issues, including the effects on the Australian Economy and the Australian Financial System and the likely regulatory impact, the draft legislation provides little guidance as to the basis for initiating consultation on a business segment or business class.

It is unclear as to the type of event or set of circumstances that would give rise to the Minister (and then ASIC) undertaking consultation on a proposed determination and/or a DTR. The process, timeframes, coverage and overall extent of consultation also has not been defined either in the framework legislation or provided for in the regulations. It is also unclear the process that would be applied to limit the classes of persons to whom the requirements might apply.

Further the draft legislation states that a failure to consult by either the Minister or ASIC does not invalidate a determination or a DTR and also provides for ASIC to make an emergency DTR without undertaking the requisite consultation with the public or obtaining consent from the Minister.

Section 4 of this paper discusses the issues this approach presents to the market and the possible options to address the uncertainty it creates for energy sector. ***At an absolute minimum, however, provisions relating to the emergency rules and the ability to make a determination or DTR without the requisite consultation should be removed.*** The requirement for these types of provisions has not been clearly articulated. The uncertainty (and flow-on market impacts) around how they will be applied is unlikely to outweigh any flexibility or streamlining benefits they provide. We consider the outlined determination and DTR process provides sufficient flexibility to tailor a consultation process to specific requirements.

While, at this stage, our concerns relate to the overall legislative approach, other aspects of the draft legislation raise issues such as the specific arrangements applying to trade repositories. Regardless of the OTC's captured under the proposed framework, all trade repositories need to be licensed and have strict compliance obligations regarding the management of confidential information.

RATIONALE FOR EXEMPTING ENERGY DERIVATIVES

There is no clear rationale for implementing the proposed amendments to the Corporations Act in respect to OTC derivative transactions executed by NEM participants. The energy derivatives market is relatively small, domestically focused market that is dominated by physical participants. NEM participants primarily enter OTC transactions to hedge their market risk exposures to electricity, environmental commodities and fuel, rather than take speculative positions.

OTC derivatives executed by NEM participants are not highly speculative, internationally mobile financial products traded by financial institutions that were the focus of the G20 commitments or parallel legislation established in other G20 member economies.

As mentioned, we were disappointed given the level of interest from the energy sector, that the draft legislative framework (and accompanying documentation) did not explicitly exclude certain classes of derivatives or persons from the mandatory obligations. We consider it is important to revisit these arguments to highlight the reasons why further refinements to the draft legislation are necessary. A summary of these arguments is detailed below.

1. **Energy Market Participants essentially hedge to manage market risk** - The majority of participants in the energy OTC market are asset-backed businesses seeking to reduce volatility of revenues and/or costs relating to an underlying physical portfolio. Businesses operating in the sector are typically large sophisticated players with significant long term capital investments and hence have a commercial imperative to understand and appropriately manage financial risks resulting from trading, operational and credit risk.

   Other energy OTC market participants are highly sophisticated trading entities. There is no evidence to suggest that the energy OTC market poses a risk to national or global financial stability.

2. **Existing risk management frameworks within the NEM are working** - The existing framework has effectively protected the electricity industry during past market shocks such as the failure of electricity retailers and the 2006-08 drought. This view has been recognised in the Australian Energy Market Commission's (AEMC) first round report on the Review of the NEM's Financial Market Resilience by the Australian Energy Market Commission (AEMC). The AEMC found that the financial relationships and markets that underpin the efficient operation of the NEM are generally robust, and there is likely to be a low probability of financial contagion occurring in the NEM.

3. **The introduction of mandatory obligations would change the risk profile of the sector** - Energy OTC derivatives meet specific needs of NEM counterparties that are not be adequately addressed through standard exchange traded products. These points of differentiation would be lost if the energy OTC market was subject to the proposed mandatory obligations. This would result in a loss of hedging flexibility and thus the ability to tailor cost effective market risk management strategies to individual business needs and impact credit collateral requirements, which appears counter to the overarching policy objectives.

   Another reason NEM participants primarily use OTC derivatives to hedge their commercial risks is that the timing of payments/receipts on these instruments are typically matched with the underlying revenue/expense. Mandating the margining of a NEM participants' sizeable OTC derivative position (typically terms of 3-5 years) would effectively bring forward all receipt and payment obligations. This would result in an increase in business cash flow risk that few NEM participants could bear in the medium to long term.

   Moreover, further reform will place additional compliance, systems and credit collateral costs on energy market participants. Importantly, forced standardisation and margining of OTC contracts, and the corresponding reduction in the flexibility of market participants to manage market risks and materially increase cash flow risk profiles. This will increase the overall risk profile of the market.

4. **Flow on impacts could result in higher end customer prices** - A decline in hedging flexibility could result in reduced contracting by parties operating in the NEM and / or increased credit collateral costs and flow through to higher spot prices and potentially and flow through to higher spot prices and potentially materially increase the cost of energy to consumers.

ADDITIONAL MECHANISMS FOR DETERMINING DERIVATIVES THAT ARE "IN-SCOPE"

The open nature of the legislative framework ensures that uncertainty will continue in the energy derivatives market, in the absence of some form of specific exemption.

To address these concerns, taking account of the design of the legislation proposed, we consider introducing an additional assessment process (which could be in the form of a of set principles) to assist the Minister and ASIC in targeting the appropriate set of derivatives/class of persons in which to apply the mandatory obligations (i.e. those posing the greatest level of systemic risk). We do, however, still consider it would be preferable to include explicit exclusions within the framework legislation for energy OTC derivatives, or indeed those businesses whose primary activities involve the generation or retailing of energy in the NEM.

The decision to make a determination and then apply a DTR should commence with markets that pose a greater probability of systemic risk. For example, entities operating in a highly speculative market, with international participants and that represent a significant potential impact from participant default, should be the immediate focus of regulators, rather than markets where derivative transactions are utilised to manage commercial risks associated with the operation of underlying physical assets.

In the event that the proposed legislative amendments are implemented without any exemptions for specific asset classes or participants, it is imperative that the decision to prescribe certain classes of derivatives is made within a clearly articulated framework. As detailed in section 2, the framework apart from a broad set of issues including the effects on the Australian Economy and the Australian Financial System and the likely regulatory impact, provides little guidance as to the basis for initiating consultation on a business segment or business class.

Ideally, this initial assessment process would take place prior to the Minister making a determination. It would guide the Minister in identifying the relevant classes of derivatives prior to engaging in a detailed consultation process. We would also suggest that a similar mechanism would apply to the process undertaken by ASIC with respect to making DTR.

Options that could be developed further and included within the draft legislation framework range from a form of market assessment on a case by case basis, through to categorising market participants based on the nature of the derivative transactions in which they trade.

While the specific content of a "scoping" framework would need to be developed through detailed consultation with industry and regulators, it should be noted that the approach adopted by the United States of America and the European Union, provides an appropriate context. In particular, consideration should be given to the nature of the derivative transactions themselves. Non-financial entities that undertake OTC derivatives for the purposes of hedging risk arising from underlying commercial activities, as is the case for energy companies, should be excluded from central clearing.

The NGF is considering the implementation of these options and would welcome the opportunity to discuss this issue in more detail.

CONCLUDING COMMENTS

The NGF is disappointed that this legislation has not sought to target specific categories of OTC's and instead has provided a broad approach to regulation that could facilitate regulatory creep into unintended markets.

We do not believe that this legislation appropriately targets the stated policy objectives and could lead to unnecessary cost increases to the price of electricity through unnecessary regulation of a well-functioning market.

We would encourage amendments to this draft legislation to narrow the scope of products to which this legislation applies and in doing so provide more certainty to the financial markets regarding targeted financial instruments.

I will be in contact to further discuss these issues.

Yours faithfully

Tim Reardon
Executive Director

ATTACHMENT A

International Developments in relation to the regulation of OTC Derivatives

The European Market Infrastructure Regulation (EMIR), as passed by the European Parliament, introduces significant changes to the OTC derivatives market in the European Union, consistent with G20 commitments around central clearing and reporting of OTC derivatives. Under the EMIR, if a market participant falls below certain quantitative thresholds, it is exempt from the compulsory settlement of derivatives transactions through central clearing houses. Further, the EMIR clearly distinguishes between speculation and hedging. The threshold (i.e. the nominal value of derivatives entered into by the market participant) for commodity derivatives such as energy derivatives has been set at EUR 3 billion. It is important to note that the calculation of the threshold is based on speculative transactions only, with derivatives entered into to hedge operational risk excluded from the threshold altogether.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted in 2010 as a response to the Global financial Crisis, resulted in significant changes to financial regulation in the United States. Title VII of the Dodd-Frank Act changes the ways in which OTC derivatives are regulated. Title VII provides for the central clearing of most standardised swap transactions, as well as mandatory reporting obligations for certain market participants. The Dodd-Frank Act provides for a "commercial end-user exception", whereby a non-financial entity using OTC derivatives to hedge or mitigate commercial risk, who has notified the relevant commission how it generally meets its financial obligations associated with such transactions, is not subject to central clearing. Instead, the entity must provide itemised information to a registered swap data repository.

The Financial Stability Board (FSB), established after the 2009 G-20 London Summit, is an international body that monitors and makes recommendations about the global financial system. In its paper 'Implementing OTC Derivatives Market Reforms' (2010), the FSB stated that 'requiring all non-financial entities to comply with mandatory clearing requirements may not be necessary to reduce systemic risk'. Further, the FSB identified that some non-financial entities may trade OTC derivatives predominantly to hedge risk arising from their commercial activities and this usage of OTC derivatives typically represents a lower probability that the hedging firm's failure would create a significant loss to the system where the firm to default. While being generally supportive of exemptions from standardised clearing for non-financial entities trading in derivatives to hedge commercial risk, the FSB considered it essential that all transactions of all market participants be reported to trade repositories.