



22 June 2012

Manager, Financial Markets Unit
Corporations and capital markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr. Mc Aulisse,

A: Introduction

TRUenergy welcomes the opportunity to comment on the Australian Federal Treasury's Consultation Paper "Implementation of a framework for Australia's G20 over-the-counter derivatives commitments. "

At the G20 Summit in 2009, the Australian Government committed to major changes to the way in which derivatives will be traded, reported on and settled. As a result of this, the Government intends to introduce legislation to amend the Corporations Act (2001) to implement these international commitments. The proposed legislative changes are intended to improve the transparency of over-the-counter (OTC) derivative markets and enhance the risk management practices of derivatives markets.

The Consultation Paper does not establish a case for implementing the proposed amendments to the Corporations Act (2001) for OTC trading in electricity. The application of the proposed measures to the electricity market would place additional compliance, systems and collateral costs on market participants and reduce the level of financial flexibility. In addition, it would reduce the ability to manage risk and potentially change the way in which electricity is traded in the NEM, increasing the overall level of risk to market participants. This would result in increased costs for consumers and an increased risk profile for the market, the opposite of the intended outcome.

We believe that policy makers should apply a detailed cost benefit analysis before enacting any of these changes to the OTC electricity trading market. The implementation of this policy framework, without demonstrated net benefits, would represent a poor policy outcome.

B: Key recommendations

TRUenergy considers that the changes outlined in the Consultation Paper should not apply to the OTC electricity market in the National Electricity Market (NEM).

Clearing of all standardised OTC derivatives through central counterparties

- The OTC electricity market in the NEM is largely domestic and small in a global context and any potential failure would not have a significant impact on global markets. Unlike other more significant interdependent international markets in financial derivatives, we do not consider that the electricity OTC market needs to be centrally cleared.
- The requirement for market transactions to clear through a centralised counter party would add another unnecessary capital constraint on the industry. As a result, market participants would be required to finance “margin calls” for all of these derivatives which could introduce serious financial strain. Potentially, this could change the way in which trading is conducted and increase the risk to all market participants.
- The OTC electricity market has resulted in a range of structured contracts that, by their nature, are not standardised. Market participants have developed a range of tailored contracts to deal with the specific risks that they are required to mitigate in the energy industry. Thus, they cannot be standardised and cleared through a centralised counter party. To do this would reduce the range of risk management contracts currently available to market participants and increase the overall level of risk.
- Most OTC electricity trading is underpinned by a physical product. A requirement to centrally clear derivative contracts to help recognise financial vulnerabilities and reduce the risk of financial contagion is unnecessary.

Reporting all OTC derivatives to a trade repository

- The risk management requirements that market participants adhere to as a pre-requisite to operating in the OTC electricity market ensures that they remain solvent. As a result of this, the requirement to report all OTC electricity market transactions to a centralised repository to help recognise any “market vulnerabilities” would be unnecessary.
- The proposed changes would require TRUenergy to pass confidential information in OTC derivative contracts to a centralised repository and breach key confidentiality provisions that form part of these contracts.
- Reporting all OTC derivatives to a trade repository would require us to put costly IT systems in place creating an unwanted cost burden on the industry.

Executing standardised OTC derivatives on exchanges or electronic trading platforms

- Electricity market participants already trade standardised derivatives on exchanges as a means of managing risk. However, non-standard OTC electricity trades are a critical alternative to managing non-standard risk.

C: Key Issues

The Consultation Paper's assumption that the OTC electricity market needs to be regulated in accordance with the G-20 commitments is without policy justification. A thorough investigation of the costs and benefits of implementing these changes in the OTC electricity market needs to be undertaken prior to any further consideration.

We deal with each of our specific concerns with the Consultation Paper in the rest of this submission.

A: Clearing of all standardised OTC derivatives through central counterparties

TRUenergy has some major concerns with the proposal to clear all standardised OTC derivative transactions through a central counter party.

The key reasons for this include:

- 1. The OTC trading market is largely domestic and small in a global context and a potential failure would not have a significant impact on global markets. Therefore, unlike other more significant interdependent international markets in financial derivatives, we do not consider that it needs to be centrally cleared.**

TRUenergy understands that policy makers and regulators would like to achieve a certain level of harmony in the rules that apply to derivative transactions around the world. By doing this, it could be that inter-related financial derivative markets of an international nature are made "safer" and less likely to suffer from financial contagion.

The Consultation Paper states that many OTC derivative markets in banking and finance are highly international in nature. It is true that many Australian participants are active off-shore. At the same time, many significant participants operating in Australia are foreign entities which may be subject to foreign regulatory regimes. As a result, regulatory developments in off-shore jurisdictions are likely to have some spill-over effect on the configuration and activity of the domestic market.

However, there is little justification as to why the governance arrangements in the OTC electricity market in the NEM should mirror the arrangements in other financial markets that are currently being developed around the world. These other financial markets are highly international in their nature while the OTC market in the NEM is almost entirely domestic with its own characteristics and is not interdependent with other OTC derivative markets around the world. As such, it does not need to be developed in a manner that is consistent with other international financial markets.

- 2. The requirement for market transactions to clear through a centralised counter party would add another unnecessary capital constraint on the industry. As a result, market participants would be required to finance "margin calls" for all of these derivatives which could introduce serious financial strain. Potentially, this could change the way in which trading is conducted and increase the risk to all market participants**

Market participants may be forced to sell more of their electricity through the physical spot market in order to avoid selling electricity through a centrally cleared derivative market. They may do this to reduce the amount of "margin calls" that they are required to honour under their contracts. This could reduce the range of tailored contracts that are available to both generators and electricity retailers in the market to mitigate their risk. As a result of this, it could be that generators begin to reduce the amount of electricity that they hedge. This would reduce the amount of capacity available for electricity retailers to hedge their mass market load. In the long run, this policy could end up creating a significant risk for retailers and generators alike.

- 3. The energy industry is very capital intensive in its nature and viable projects are required to compete for scarce capital. The requirement for market transactions to clear through a centralised counter party would increase the working capital requirement faced by the industry and this could impact the level of investment at a time when there is a significant investment required.**

The requirement for all market transactions to clear through a centralised counter party will force market participants to finance “margin calls”. This will place a significant financial burden on market participants in the OTC electricity market at a time when the industry will be required to fund major investments and increases in working capital to facilitate the transition to a lower emission energy sector.

- 4. The OTC electricity market has resulted in a range of structured contracts that, by their nature, are not standardised. Market participants have developed a range of tailored contracts to deal with the specific risks that they are required to mitigate in the energy industry. Thus, they cannot be standardised and cleared through a centralised counter party. To do this would reduce the range of risk management contracts currently available to market participants and increase the overall level of risk.**

TRUenergy considers that electricity market participants need access to tailor made contracts to help mitigate the specific risks they face in the electricity industry. Therefore, the requirement to standardise these contracts and to clear them through a centralised counter party is not supported as it would lead to a greater level of risk for all participants.

The Consultation Paper argues that the mandating of central clearing for certain derivative transactions is directed at better managing counter party and operational risks associated with those transactions. Derivative contracts bind counterparties together for the duration of the contract. The obligations that build up under these contracts over their natural life gives rise to counter party credit risk. Clearing is the function by which these risks are managed over time.

The Consultation Paper argues that it makes sense to provide economic incentives to market participants to centrally clear. Thus, it could be that implementing measures that send a price signal to all market participants by increasing the relative costs of non-centrally cleared OTC derivatives might be a useful strategy. Whilst this policy appears to apply to banking and finance markets, under the proposed changes to the Corporations Act (2001) it could potentially apply to the OTC electricity trading market in the NEM. Therefore, we reiterate the key message that mandating market participants to clear all their transactions through a centralised counter party would be inappropriate in the OTC electricity market and would unnecessarily raise the cost of transactions.

- 5. Most OTC electricity trading is underpinned by a physical product. A requirement to centrally clear derivative contracts to help recognise financial vulnerabilities and reduce the risk of financial contagion is unnecessary.**

The vertically integrated nature of many energy businesses provides a “natural hedge” that can minimise exposure to the OTC electricity market in the NEM.

TRUenergy’s maximum exposure to the OTC market will reflect the amount of capacity that we sell in the OTC market which is “long” to our retail position.¹ TRUenergy will sell electricity in the OTC market up to a level that our risk management policy (RMP) allows if the price of energy is attractive. This could mean that we end up “short” to our retail position. However, most of the time, we will only be exposed to the OTC market for the generation capacity that we have that is “long” to our retail load. Therefore, we do not consider that the requirements for participants to trade all of their derivative contracts through a centrally cleared counter party to be necessary.

¹ A vertically integrated energy business will have both energy generation and a retail customer base. The vertically integrated energy business will use its generation as a “natural hedge” from which to serve its retail customer base. Where both the energy generation and the retail customer base are perfectly matched then this business is said to have a perfectly naturally hedge. However, where an energy business has generation capacity in excess of its customer base, then it is said to be “long” in generation. Vice versa, where an integrated energy business has less generation capacity than its retail customer base, then it is said to be “short”.

B: Reporting all OTC derivatives to a centralised repository

TRUenergy has some concerns with the proposal to report all OTC derivative transactions in the NEM to a centralised repository.

The key reasons for this include:

- 1. TRUenergy considers that the sound risk management requirements that market participants adhere to as a prerequisite to operating in the OTC electricity market in the NEM ensures they remain solvent. Therefore, the requirement to report all OTC electricity market transactions in the NEM to a centralised repository to help recognise any “market vulnerabilities” is unnecessary.**

The financial requirements that are placed on market participants, as a pre-requisite to operating in the OTC electricity market in the NEM, are high. This ensures that the credit worthiness of an entity and its ability to pay off its anticipated debts remain strong. For this reason, our view is that the probability of an event of default in our market by a market participant to be low. Therefore, the requirement to make it compulsory for all market participants to report all of their trades to a centralised repository in order to help regulators identify and recognise vulnerabilities is unnecessary.

Some of the characteristics of the market that ensure the financial worthiness of market participants in the OTC electricity market in the NEM includes:

1.1 Risk Management Policy (RMP)

Market Participants put in place a Risk Management Policy (RMP) that includes strong internal controls and guarantees it maintains its financial strength to mitigate against operational risk that could lead to unexpected loss.

A RMP is required to:

- articulate the risk management principles and describe the risk management approach to be adopted by all the business units
- outline the risk management framework process and activities required by TRUenergy and each business unit
- assign responsibility for management and responsibility of risk internally
- state requirements for compliance, approval and review of the risk management policy and subsidiary risk policies.

At TRUenergy the RMP sets out the appropriate level of trading risks that apply to an entity. It sets risk limits on the value of counter party trades, the credit risk of acceptable counter parties, energy trading risks, individual deal limits and overall position limits. Therefore, it controls the amount of risk that a company can take in the course of trading electricity derivatives.

Whilst we are not privy to the RMP of other organisations, most responsible entities will set conservative trading limits for all of these parameters. Therefore, we believe that companies with a responsible RMP can mitigate the anticipated expenses that they might incur in the next 12 months. In addition, we suggest that these companies can mitigate their medium and long term financial obligations given the responsible trading limits set out in their RMP.

1.2 NEM Prudential requirements

TRUenergy is required to provide credit security in the form of prudential guarantees that are worth millions of dollars to offset the risk posed by their potential default on monies owed.

The National Electricity Rules (NER) contain a suite of prudential requirements designed to oblige retailers to post an amount of collateral (bank guarantees and cash deposits) to offset the risk posed by their potential default on monies owed. Though they are normally creditors in the NEM, generators are sometimes required to post collateral under the requirements.

The amount of collateral that participants are required to comply with is calculated by the Australian Energy Market Operator (AEMO). The calculation is made using two clear values that include the Maximum Credit Limit (MCL) and the Prudential Margin (PM). These are calculated separately for each participant every few months. AEMO continually assesses the amount owed by a participant against the amount of collateral posted, and when the difference becomes lower than the PM, act to rectify this by issuing a call notice. The failure of a participant to address a call notice can lead to an event of default.

1.3 Cumulative Price Threshold (CPT)

The CPT minimises the financial risk that electricity derivative market participants are exposed to. It does this by minimising their exposure to protracted levels of high prices in the wholesale spot market. This reduces the risk that electricity market participants will be seriously impaired financially as a result of being exposed to high electricity prices for long periods.

The CPT is an explicit risk management mechanism designed to limit a market participant's exposure to protracted levels of high prices in the wholesale spot market. This minimises the protracted level of financial exposure that a derivative market participant would be potentially exposed to.

If the sum of the half hourly wholesale market spot prices over a rolling seven day period exceeds this threshold, then AEMO must initiate an administered price cap (APC). The APC is specified in a schedule that is developed, authorised, published and varied by the AEMC. The APC is currently set at \$300/MWh for all regions of the NEM, for all time periods.

2. TRUenergy would be required to pass confidential information from OTC derivative contracts to the centralised repository in breach of key confidentiality requirements under these transactions

TRUenergy considers the requirement to report on each OTC derivative transaction to a centralised repository may result in a breach of key confidentiality provisions in current bilateral OTC electricity contracts in the NEM.

The Consultation Paper postulates that the reporting of derivative transactions to trade repositories will facilitate the maintenance of a reliable and comprehensive source of information on participant trading activity that will be useful to regulators in performing their respective duties. It is expected that this increased transparency will assist authorities to recognise vulnerabilities in the financial system, and more broadly, to develop well informed policies to promote financial stability. Information from trade repositories will be useful in times of financial distress, where rapid and reliable access to accurate data may assist prudential and systematic regulators in their function.

We consider that bilateral OTC electricity contracts in the NEM are, by their very nature, confidential contracts between two counter parties. Most bilateral contracts in the OTC electricity market are confidential. Therefore, the requirement to report on these trades to a centralised repository may lead to a clear breach of the confidentiality provisions which are embedded in these contracts. For this reason, we consider that the Australian Government needs to be clear that the benefits of implementing this policy outweigh the costs.

3. TRUenergy will be required to put costly IT systems in place in order to pass data to a centralised repository creating an unnecessary cost burden on the industry

TRUenergy enters into thousands of OTC electricity derivative trades in the NEM every year. We specifically make these transactions in order to hedge our portfolio of generation and put contracts in place to hedge our mass market load for our retail business and our large Industrial and commercial customers.

We understand that underpinning the Australian Government's G-20 commitments for derivative markets is the desire to improve the transparency of the bilateral OTC markets. Following its implementation, governments and regulators would be able to gather information on the range of trades that were made in bilateral OTC derivative markets. It is expected that this increased transparency will assist authorities to recognise vulnerabilities in the financial system, and more broadly, to develop well informed policies to promote financial stability.

In order to comply with this requirement, market participants in OTC electricity markets in the NEM would be required to invest in expensive IT infrastructure to be capable of reporting on every single OTC derivative trade to a centralised repository. The IT costs and the additional costs required to hire staff to implement the proposed changes to our systems would also be expensive. In the long run, these costs would need to be passed through to electricity customers leading to higher electricity prices without providing any real tangible upside benefits. Given the cost of this exercise, we urge the Australian government to carefully consider the tangible net benefits of this policy before further considering it.

C: Clearing of all standardised OTC derivatives through central counterparties

Electricity market participants already trade standardised derivatives on exchanges as a means of managing risk. However, non-standard OTC electricity trades are a critical alternative to managing non-standard risk.

D: Conclusion

TRUenergy looks forward to working with the Australian Treasury on its proposal to enact the "Implementation of a framework for Australia's G20 over-the-counter derivatives commitments" as part of its G-20 commitments. We consider that the proposal to enact mandatory reporting, clearing and execution of trading is inappropriate for OTC electricity markets in the NEM.

The OTC electricity market in the NEM is a specialised market that has no tangible direct impact on international derivative markets. Therefore, TRUenergy suggests that it should not be developed in the same way that other OTC international derivative markets are. If the Australian treasury proceeds to enact the sorts of changes that are being proposed in the Consultation paper, then this will just add risk to all market participants.

We believe that defence against financial contagion is strong in the NEM because of the characteristics of the market and the number of advanced internal risk management processes of individual businesses. These industry practices and regulations have protected the industry from any episodes of financial contagion (even in the face of significant market shocks) and the probability of this occurring in the future remains very low.

We understand that 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." This outcome supports our view that existing obligations are adequate and supports our call for an exemption for the electricity sector from the proposed regulations

We thank the Australian Treasury for the opportunity to make this submission. We would welcome the opportunity to come and discuss this proposal with you. For any enquiries regarding this submission, please feel free to contact Mr. Con Noutso - Regulatory Manager at TRUenergy on Tel: 03 8628 1240.

Regards

Signed for email

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TRUenergy