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Implementation of Australia's G-20 over-the-counter derivatives commitments

d-cyphaTrade appreciates the opportunity to provide feedback to the "Implementation of Australia's G-20 over-the-counter derivatives commitments" proposals paper. Feedback has been provided under each relevant question number below.

Feedback to questions

2. [Do you have comments on the proposal to mandate a broad range of derivatives subject to the phase-in and exceptions outlined in the document? Or is there another option you prefer? If so why?](#)

The preferred regulatory option for the OTC electricity derivatives market is detailed by d-cyphaTrade in Answer 10. This option would immediately achieve (i) full reporting of standardised electricity derivatives and (ii) substantial achievement of reporting of non-cleared electricity derivatives. This option would also simultaneously and immediately eliminate a significant amount of credit default risk in the electricity market system and automatically achieve the other desired G 20 OTC reform outcomes.

The OTC electricity derivative market is ideally suited for immediate adoption of the G 20 reforms, including trade reporting. There is a central clearing, reporting and exchange traded solution for standardised electricity derivatives already available (i.e. the ASX24 electricity futures and options market) but which systemically significant non-bank OTC counterparties will not migrate to in the absence of mandatory requirements, as evidenced by submissions to CFR reviews on this subject from non-bank OTC market participants. Improving transparency of the opaque OTC electricity market by utilising the available solution would result in significantly increased hedge liquidity on the fully transparent (i.e. lit) ASX24 electricity market, delivering improved physical asset investment signalling and tighter bid/offer price spreads in electricity futures hedges which should reduce the cost of electricity hedging for electricity companies and thus contribute to lower electricity prices paid by consumers.

As regulations cause a migration of standardised OTC trading to the lit exchange traded market, secondary liquidity benefits are likely to be achieved. Additional market participant liquidity (in the form of follow-on bids and offers) is more likely to occur when market transparency enables all market participants to be immediately informed of all trades. Transferring liquidity from the opaque OTC market to the lit futures exchange would also create a more level playing field for new entrant and independent electricity generators and retailers that can access hedge liquidity in the ASX market but may struggle to obtain adequate access to OTC markets. Reducing such barriers to entry supports increased competition amongst electricity retailers and generators which also contributes to lower electricity prices to consumers.

The “trade reporting” objective will be achieved by the regulatory solution detailed in Answer 10 because:

- a. **Cleared derivatives are automatically reported:** details of all electricity derivative transactions that are centrally cleared by ASX Clear (Futures) are automatically and publicly reported including traded price, volume, time of trade etc. ASX Participants are required to maintain customer-specific trade and position information which can be accessed by the appropriate financial regulators; and
- b. **Uncleared derivatives will be subject to improved record keeping requirements enabling improved regulatory oversight:** ASIC’s proposal of requiring uncleared and thereby unreported OTC electricity derivative positions to be subject to improved risk management and collateral support requirements under AFSL commitments¹ (which should include continuous mark-to-market-margining) is to be commended as it would necessitate OTC electricity derivative issuers to maintain accurate and timely trade and position records and daily credit risk valuation. Such improved record keeping discipline would enable regulators (and issuers of electricity derivatives themselves) to identify and quantify systemic default risk in a timelier manner² and lay the groundwork for an orderly transition to more centralised trade reporting via a licensed trade repository.

¹ Report 320. Response to submissions on CP 177 Electricity Derivative market participants: Financial Requirements, Australian Securities and Investments Commission, December 2012. Para 40. p.15.

² Ibid. Para 38. p.14.

3. [Do you have a preference for the timetable being prescribed in regulation or implemented by a phased approach to ASIC rule-making?](#)

See Answer 2.

4. [Do you have comments on the proposal timetable for implementing the trade reporting obligation? Or is there another option you prefer? If so, why?](#)

See Answer 2.

5. [For Phase 1, do you have a preference for referencing legal status, thresholds of activity, or size proxies? For Phases 2 and 3, do you prefer activity thresholds or size proxies?](#)

Regulations should ensure that all AFSL license holders that issue OTC electricity derivatives should be covered by the reforms. Alternatively covered entities could be limited to those AFSL license holders who may be systemically significant to a state electricity market.

6. [Do you have comments on the proposed regulations at Attachment A? Or is there another option you prefer? If so why?](#)

Another option is preferred. i.e. ASIC and other relevant CFR agencies should be permitted to monitor and regulate financial derivatives (including electricity derivatives) independently and without interference from other agencies/bodies which do not have the derivative risk system expertise or (potentially the) independence of the CFR agencies. See also Answer 8.

7. [Do you have comments on the proposal to wait until after review processes before making a decision on mandating trade reporting of electricity derivatives? Or is there another option you prefer? If so, why?](#)

Another option is preferred to delaying the reform process for at least 6 months until the AEMC finalises its review process. The AEMC is not a derivative system risk expert. The AEMC is being assisted in its review process by an industry working group comprised *exclusively* of energy companies, many of which have lobbied for exemptions from the G 20 OTC reforms. The AEMC's ongoing review agenda appears to exclude further analysis of the OTC electricity derivative market.

ASIC and the CFR have recently conducted and released their findings on two separate reviews³ of the electricity derivatives market which have both identified serious market risk concerns and persuasive reasons to immediately apply the G 20 OTC reforms to this market. Hence it is inappropriate for ASIC to be forced to delay necessary regulatory action for the electricity market until the AEMC has finalised its review. See also Answer 8.

8. Are there other bodies with responsibility for underlying assets upon which a derivative is based that should be also be specified under section 901J?

No, with regard to electricity derivatives. Australian financial derivative market regulation including regulations dealing with electricity derivatives should be the exclusive responsibility of the relevant CFR agencies which are derivative and prudential risk system experts. Energy specific government agencies are not derivative risk system experts and should not be allowed to block or water-down regulatory responses that have been identified by the relevant CFR agencies as being necessary and prudent. This is particularly relevant where energy bodies may be overly influenced by lobbying from major energy companies seeking exemptions from derivative markets reforms that the CFR agencies have determined are in the national interest. For example, the G 20 OTC reforms would ensure that OTC electricity counterparties better manage their own credit default risk exposures pre-emptively to *prevent* an electricity market default crisis, rather than exposing electricity consumers and/or Australian tax payers to the much larger cost of bailing out the financial derivative losses of major energy companies after a catastrophic OTC market failure occurs.

Recent submissions from large electricity companies to the AEMC support cost recovery i.e. increases in electricity prices paid by consumers to protect (i.e. bail out) large electricity companies from losses associated with the credit default of an electricity retailer⁴. It would be far more prudent for ASIC to pre-emptively prevent (or substantially reduce the risk and materiality of) a cascading counterparty default crisis within this essential service market in advance, by immediately implementing the G 20 financial derivative market reforms for electricity. No other bodies (including the AEMC) should compromise the CFR agencies autonomy to independently and expertly assess

³ Report 320. Response to submissions on CP 177 Electricity Derivative market participants: Financial Requirements, Australian Securities and Investments Commission, December 2012.

Report on the Australian OTC Derivatives Market, Australian Prudential Regulation Authority, Australian Securities and Investments Commission, Reserve Bank of Australia, October 2012.

⁴ See submissions to Options Paper, Market Review: NEM financial market resilience, Australian Energy Markets Commission, Dec 2012. <http://aemc.gov.au/Market-Reviews/Open/nem-financial-market-resilience.html>

derivative system risks and implement appropriate regulatory responses that are in the national interest.

9. Do you have comments on the proposal to implement the trade reporting and trade repository licensing regime expeditiously, but not to impose interim reporting obligations ahead of this? Or is there another option you prefer? If so, why?

See Answer 10.

10. Do you have comments on the proposal to not impose central clearing obligations at this stage? Or is there another option you prefer? If so, why?

The preferred option for achieving critical reforms of the OTC electricity market is for ASIC to immediately:

1. Implement mandatory central clearing (as futures and exchange traded options) of all standardised OTC electricity derivatives for which a materially similar centrally cleared product exists; and concurrently
2. Implement AFSL-related margining obligations (e.g. initial margins and continuous variation margins) on non-cleared electricity derivatives exposures held between electricity counterparties.

The fast tracked implementation by ASIC of these 2 requirements would practically achieve all of Australia's G 20 commitments with regards to the electricity derivatives market while simultaneously de-risking the OTC electricity market which separate reviews by CFR agencies have identified as being of systemic importance and susceptible to significant risk of default.⁵

Electricity is an essential service market and ASIC has identified that "**the electricity sector is systemically important**"⁶ It is therefore essential that regulation of the OTC electricity derivatives market is substantially improved in order to avoid market failures. "**ASIC remains of the view that market participants could benefit from some enhanced risk**

⁵ Report 320. Response to submissions on CP 177 Electricity Derivative market participants: Financial Requirements, Australian Securities and Investments Commission, December 2012.

Report on the Australian OTC Derivatives Market, Australian Prudential Regulation Authority, Australian Securities and Investments Commission, Reserve Bank of Australia, October 2012.

⁶ ASIC media release summarising REPORT 320. Thursday 13 December 2012.

management due to the highly concentrated nature of the OTC derivatives electricity market. However, we don't want to pre-empt the process of implementing the G20 reforms to OTC derivative markets in Australia and have decided to delay our review until this process is completed.' If electricity derivatives are ultimately not included in these reforms, ASIC will consult on applying similar new requirements through the Australian financial services (AFS) licensee financial requirements."⁷

ASIC's implementation of necessary G 20 reforms of the electricity sector should not be delayed unnecessarily (e.g. by having its implementation timetable aligned to that of other markets) merely because clearing, reporting or trading solutions may not yet be available in other OTC markets.

While CFR agencies delay these reforms for electricity, there is an ongoing moral hazard and increased probability that an OTC electricity derivative market default crisis results in electricity price increases paid by consumers or a tax payer funded bailout of one or more too-big-to-let-fail electricity companies. Australian financial regulators should not be complacent given the lessons learned from cascading OTC electricity market failures that have disastrously affected US and European energy market systems and required significant government intervention.

The exchange traded, cleared electricity market solution already exists and cleared (futures and option) transactions exceed standard non-cleared transactions in the poorly regulated OTC electricity derivatives market. Centrally cleared ASX electricity transaction volume also exceeds 200% of underlying physical electricity consumption. However, because the OTC electricity market is dominated by systemically significant non-bank electricity companies which are not subject to or incentivised by Basel III capital requirements, **systemically significant OTC electricity issuers will not migrate to centrally cleared solutions** or more prudent risk management controls for uncleared OTC **unless ASIC implements regulations to mandate such outcomes.**

Given a critical need for reform and with trading, clearing and in-built reporting solutions already available, the OTC electricity market should be the first market that Australian regulators cover. This would also provide an immediate demonstration of Australia's commitment to its G 20 obligations.

⁷ REPORT 320, "Response to submissions on CP 177 Electricity derivative market participants: Financial requirements", Australian Securities and Investment Commission, December 2012. p.10.



11. Do you have comments on the proposal to not impose trading obligations at this stage? Or is there another option you prefer? If so, why?

Trading obligations for standardised electricity derivatives can and should be implemented immediately either directly as standalone ASIC regulations or indirectly (but with immediate and complete effect) by mandating central clearing of standardised electricity derivatives via existing solutions. See also Answer 10.

Yours sincerely,

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