



15 February 2013

Mr Daniel McAuliffe
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Dear Mr McAuliffe

Implementation of G-20 OTC Derivatives Commitments Proposal Paper

The National Generators Forum (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 welcomes this opportunity to comment on aspects of the Proposals Paper: Implementation of G-20 over-the-counter derivatives commitments, December 2012. The NGF is primarily concerned with the implementation of the Government's G20-OTC commitments with respect to electricity derivatives.

The NGF supports the adoption of minimal effective government regulation. Regulation should only be imposed where necessary to correct market failure and it should be sufficiently flexible to enable sound business practices. Consideration of all alternative (including light touch) regulatory responses should be considered prior to the imposition of regulation.

The NGF is not aware of any analysis that identifies a market failure in electricity market derivatives or any indication of instability or unnecessary consumer risk.

The NGF was very supportive of the changes incorporated into the *Corporations Law Amendment Bills 2012* with respect to the treatment of electricity derivatives. We also note the statement in the Proposals Paper which states: "no decision on any mandate relating to electricity derivatives will be taken until after completion of the reviews of the sector currently underway."

The NGF is supportive of this position and notes that existing regulation and oversight of electricity generators has provided a reliable supply of electricity despite many financial and environmental challenges.

The Proposals Paper establishes a process for a broad-ranging ministerial determination to be made in the first quarter of 2013 that will require the reporting of all five derivative classes (that is, interest rate, foreign exchange (FX), credit, equity and commodity) to a licensed trade repository where one is available and that the trade reporting regime will be in place by mid-2013. Further, the paper states that in line with the Government's earlier commitments no decision on any mandate relating to electricity will be taken until after the completion of the reviews of the sector is underway. The NGF has provided responses to each of the relevant questions raised in the Paper below.

Question 2 – Do you have comments on the proposal to mandate a broad range of derivatives subject to the phase-in exemptions outlined?

The NGF is concerned with the proposal to “mandate a broad range of derivatives” as proposed in the Paper.

Identification of individual derivatives in which there is an establishment market failure should be subject to further analysis and consideration of market intervention.

Question 7 – Do you have comments on the proposal to wait until after the review processes before making a decision on mandating trade reporting of electricity derivatives? Or is there another option you prefer?

Our concerns regarding the issuing of the Determination relate to the treatment of electricity derivatives. The NGF agrees, given it is a broad-ranging determination incorporating commodity OTC derivatives, the most appropriate option (given the additional considerations and consultation that relate to electricity derivatives) would be to explicitly exclude electricity in the Determination.

We consider, however, this exemption should not be driven by the timing of the current review processes, which are focused on a related but separate set of issues. While the Australian Energy Market Commission (AEMC) is undertaking a review into Financial Resilience in the National Electricity Market (NEM) it is heavily focused on the specific issue of the Retailer of Last Resort Regime (ROLR) and its ability to manage any contagion risk resulting from the failure of a large electricity retailer. Further, this review is contained to the electricity sector and is not focused on the relationships with the broader financial system.

Longer-term, due to broader risk management impacts, the NGF remains strongly of the view that electricity derivatives should not be subject to any mandatory requirements (including reporting). Any consideration to incorporate electricity derivatives would need to be triggered by a detailed assessment of the market (and potential risks) and whether the benefits outweigh costs of mandatory reporting. We would expect this would form part of the consultation process with the Minister for Energy and Resources.

Further to these points, the Report on the Australian OTC Derivative Market Report recently released by the Council of Financial Regulators in October 2012 noted:

....If there is many of the contracts traded within these product classes – particularly electricity – are bespoke and not currently suitable for central clearing. Regardless, based on the evidence available, the aggregate exposures associated with these product classes would not appear to present immediate concerns for the financial system.

Given that OTC electricity derivatives are unlikely to be suitable for the application of mandatory clearing arrangements, it is unclear why mandatory reporting of electricity derivatives provides any notable benefit and whether these would outweigh the costs.

Moving forward, as electricity derivatives are identified as requiring separate treatment, it would be appropriate that the NGF (and other relevant stakeholders) is provided the opportunity to view the Draft Determination or, if this is not achievable, Treasury at least consults the sector regarding the relevant sections.

Ordinary course of business dealings

Another implementation issue that has come to light is the treatment of derivatives transacted in the ordinary course of business. The NGF is of the view that “ordinary course of business” derivative or foreign exchange transactions should be excluded from the reporting requirements and it would be helpful that this is incorporated into this current Determination (or at least in the Derivative Transaction Rules if more appropriate). The “ordinary course of business” exemption refers to transactions executed to manage a person’s risk profile in relation to key financial and commodity input costs (e.g. foreign exchange trades to manage the price risk associated with the international procurement of fuel or large capital purchases). As “ordinary course of business” transactions are undertaken across a range of derivatives classes, the exemption should apply across entire range of derivatives captured by the determination.

This would be consistent with the exemption provided under the Australian Financial Services (AFS) provisions of the Commonwealth Corporations Legislation and the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) (AML Act). Regulation 7.6.01(1)(m) of the Corporations Regulation (see below) provides an exemption from the requirement to hold an AFSL in connection with the provision of certain financial services:

- (m) a financial service provided by a person in the following circumstances:
 - (i) the service consists only of either or both of:
 - (A) dealing in derivatives; and
 - (B) dealing in foreign exchange contracts;
 - (ii) the service does not involve the making of a market for derivatives or foreign exchange contracts;
 - (iii) the dealing is entered into for the purpose of managing a financial risk that arises in the ordinary course of a business;
 - (iv) the person does not deal in derivatives or foreign exchange contracts as a significant part of the person’s business;
 - (v) the dealing is entered into on the person’s own behalf;

Example of financial service to which paragraph (m) applies

A series of forward foreign exchange contracts entered into by a gold mining company to hedge against the risk of a fall in the price of gold.

Example of financial service to which paragraph (m) does not apply

The issue and disposal of derivatives relating to the wholesale price of electricity are not transactions to which this paragraph applies.

Item 35, Table 1 of Section 6 of the AML Act also requires that to be a designated service captured by that part there must be an “issuing or selling [of] a security or derivative to a person, where... the issue or sale is in the course of carrying on a business of issuing or selling securities or derivatives...”

Question 6 – do you have any comments on the proposed regulations regarding consultation with the Australian Energy Market Commission?

The draft regulation in Attachment A would require the Australian Securities and Investments Commission (ASIC) to seek the views of the AEMC prior to making Derivative Transaction Rules relating to an electricity derivative, if the rule is about a matter connected with the AEMC’s functions. While the NGF considers that the operation of financial markets falls outside the AEMC’s key functions and expertise, we do not have any significant concerns with the regulation as drafted. We would, however, expect that in practice any consultation with the AEMC would be transparent and where appropriate industry consulted throughout the process.

We would welcome the opportunity to work with the Government to identify any market failures that may exist with the operation of OTC Derivatives within the industry.

I will be in contact to further discuss these issues.

Yours sincerely

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

Tim Reardon
Executive Director