

19th October 2018

Dr Kerry Schott AO
Energy Security Board

Submitted via e-mail to: info@esb.org.au

Dear Dr Schott,

OTC Transparency in the NEM

The Australian Energy Council (the “**Energy Council**”) welcomes the opportunity to make a submission in response to the Energy Security Board’s (“**ESB’s**”) *OTC Transparency in the NEM Consultation Paper*.

The Energy Council is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over ten million homes and businesses.

Discussion

The National Electricity Market (“**NEM**”) is defined in terms of the national electricity system and the wholesale exchange operated and administered by the Australian Energy Market Operator (“**AEMO**”).¹ More than this however, the framework of the NEM allows market participants to use direct contracts and financial derivatives with other market participants, as well as third parties, to mitigate their physical and financial risks.

Those non-physical markets have developed organically and innovated progressively more efficient ways to manage market risk, in order to subsequently underpin investments and operations that ultimately provide reliable and cost effective supplies to customers. For example, an important means of mitigating risk is to engage with specialised reinsurers, such as those offering weather derivatives and other exotic products, to craft bespoke arrangements which allow counterparties to assume the level of risk with which they are comfortable, and which match their corporate risk appetites.

Given the evident success of the current organic approach, the Energy Council is sceptical of measures to be introduced to mandate disclosure, since it:

- will add costs and compliance concerns for every contract trade, thereby inhibiting turnover. Before entering any trade, traders will first need to contemplate, “Is the benefit of this transaction really worth the effort and disclosure risks associated with having to report it to the repository?”. This kind of burden adds a deadweight loss that is well known to inhibit efficient financial markets and will be observed through greater bid-offer spreads.
- may stifle product innovation, and reduce opportunities to provide the best possible products to the market. For example, parties contemplating transacting a new style of instrument will need to consider how the instrument complies with the obligation to report to the repository. As the repository cannot be designed to accommodate instruments yet to be invented, a catch-22 will develop that will enduringly force the industry to trade only the instruments in existence prior to the repository’s creation.

The Energy Council is firmly of the belief that collateral and prudential requirements are inhibiting smaller firms from trading in the market, not a lack of transparency in OTC markets.

¹ Section 2(1) of the National Electricity Law

In a different direction, a mandated repository might also encourage *inefficient* innovation. This is because it requires legally defining the activities which are subject to the disclosure obligation. This will inevitably lead to parties intentionally, and inefficiently, designing products to sidestep it. For example, the current proposal appears to only capture those parties already captured by the National Electricity Law, which is an invitation to transact through parties not captured in this way.

The existing markets have already organically developed a range of disclosure mechanisms, with brokers and other intermediaries publishing anonymous bids and offers for over-the-counter (“**OTC**”) trades, as well as subscription trade services publishing data, and the Australian Financial Markets Association (“**AFMA**”) developing its historical survey of OTC volumes. It is acknowledged that the AFMA survey was temporarily suspended for several years, an unfortunate development that was a key driver for the recommendation the ESB is presently considering. At the behest of the Energy Council’s members the AFMA survey has been successfully re-launched, and the Energy Council feels that it should be permitted to reconsolidate before progressing any mandated approaches. Incremental improvements, such as an increase in the frequency of its reporting to quarterly, may be sufficient to address the currently perceived shortcoming in the availability of wholesale market statistics. The Energy Council’s members are willing to work with AFMA to improve the report to the satisfaction of regulators.

One of the Energy Council’s primary concerns is that introducing a mandated trade repository will incur significant development costs (for the repository provider and industry) and material ongoing compliance costs for industry (as well as increased monitoring costs for the Australian Energy Regulator (“**AER**”). The ultimate burden for these costs will be the consumer, and there is no evidence to suggest, in a market which is currently projecting lower future prices, that the introduction of the repository will lower them further. In addition, market changes such as Five Minute Settlement (due for commissioning in July 2021), will have market effects, and the impetus for the change may be diminished.

With respect to ownership of a mandatory trade repository, the Energy Council suggests the Australian Securities and Investments Commission (“**ASIC**”), or an existing repository such as a licensee engaged by it, is better suited to this sort of activity, since it may already report on OTCs in other financial markets, and will be bound by existing confidentiality arrangements.

Access to confidential information from the trade repository is also a source of major disquiet for the Energy Council and its members. While it is appreciated that aggregated data from the trade repository could inform bodies such as the Australian Energy Market Commission in its market reviews, the risk of inadvertent disclosure and the consequential financial impacts to businesses, particularly fledgling retailers, is too great a risk to be contemplated. Similarly the Energy Council does not believe that access to data is necessary for AEMO to perform its statutory functions. Accordingly the Energy Council recommends that should any trade repository be established under ASIC, energy market institutions, including the AER, should only be able to access aggregated data, and its use limited to the purposes for which its collection was intended.

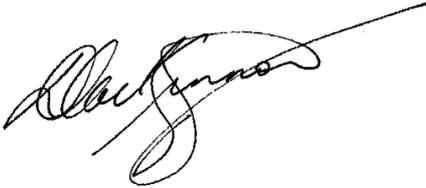
Once the data is collected, it then becomes a question of how it can be disseminated to provide maximum utility, while simultaneously protecting the confidentiality of those who provided the information. The Energy Council would not like to see any data disclosed which, although nominally anonymous, would allow competitors, the media or those with market knowledge to deduce the identity of those reporting trades, or infer competitor behaviour from the information presented. The aggregated data reported by AFMA provides a useful benchmark for helpful, anonymous statistics on the state of the market.

Conclusion

In conclusion, the Energy Council sees little utility in the establishment of a trade repository, particularly when the implementation costs and ongoing compliance burden are taken into account. Instead it is preferred that the Energy Council's members work with AFMA to improve the existing report to the standard necessary to provide the data required. In addition, it is important that any reporting does not expose market participants to possible confidentiality breaches, or stifle the development of innovative product offerings, with a consequential increase in consumers' costs.

Any questions about this submission should be addressed to the writer, by e-mail to Duncan.MacKinnon@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,

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

Duncan MacKinnon
Wholesale Policy Manager
Australian Energy Council