

ENERGY SECURITY BOARD CONSULTATION PAPER

OTC Transparency in the NEM
September 2018

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1 Introduction

The Energy Security Board (ESB) was asked to advise the COAG Energy Council on two recommendations made in the ACCC Retail Electricity Pricing Inquiry (June 2018)¹. These were Recommendations 6 and 7 concerning the wholesale market for electricity. This consultation paper has been prepared by the ESB to inform its advice to the COAG Energy Council on recommendation 6.

Recommendation 6

The NEL should be amended so as to require the reporting of all over-the-counter (OTC) trades to a repository administered by the AER. Reported OTC trades should then be disclosed publicly in a de-identified format that facilitates the dissemination of important market information without unintentionally revealing the parties involved.

The requirement should be implemented to align with (or be eligible for) any OTC reporting requirements under the NEG.

The AER, AEMC and AEMO should have access to the underlying contract information, including the identity of trading partners.

In developing its advice, the ESB has been asked to consider the interaction of recommendation 6 with the design of the reliability component of the Guarantee² and relevant recommendations of the Finkel Review.

1.1 Background

Market participants typically hedge their exposure to wholesale electricity price risk through either physical (generation owned or operated by the entity) or financial hedges contracted bilaterally between counterparties (OTC markets) or through a centrally traded platform; for example, the Australian Securities Exchange (ASX).

OTC markets provide greater flexibility in the financial instruments used to hedge spot price variability but typically expose participants to increased counterparty risk, price discrimination and higher transaction costs. As such, they are less utilised by small, standalone retailers. The Australian Financial Market Authority's (AFMA) recent analysis of OTC markets represent around 23% of traded volumes in the NEM (South Australia is the only state in which greater volumes are traded in the OTC market than the ASX). The vast majority of OTC traded contracts in the NEM is in swaps and caps³.

¹ Published July 2018

² The COAG Energy Council agreed to release exposure draft legislation for the National Energy Guarantee (NEG) at its 10 August 2018 meeting. The Energy Council is expected to consider next steps with this work later this year. While the emissions component of the NEG is not agreed, the reliability component continues to be considered and it is this part of the NEG which is relevant for recommendation 6.

³ AFMA Electricity Derivatives Turnover Report, August 2018, accessible at: <https://afma.com.au/data>

In contrast to derivatives traded on the ASX, information on OTC trade volumes and prices is not generally publicly disclosed at the individual trade level⁴, although limited aggregate information is publicly available⁵.

Several reviews and policy forums have identified concerns with the comparative lack of transparency of OTC markets; in particular, that lack of transparency impedes price discovery, contributes to barriers to entry by small retailers, creates uncertainty for market participants, the operator and policy makers, and increases the risk of financial contagion.

In 2009 at the G20 summit, Australia committed to practices to improve the transparency of OTC derivatives and risk management practices in the wake of the global financial crisis, including mandatory reporting of OTC derivatives to trade repositories – entities that centrally collect records of OTC derivatives. These requirements were introduced primarily to provide financial regulators with greater oversight of OTC market activity, supporting their role in managing the stability of the broader financial market. As part of the implementation process, the AEMC was asked to provide advice on the appropriateness of applying OTC reforms to electricity derivatives. The AEMC conducted this assessment as part of its NEM Financial Market Resilience Review. It concluded that the costs of implementing the G20 measures would outweigh any benefits, noting some key differences between the financial sector and the NEM which contributed to a low systemic risk profile of trading in the NEM. These included the fact that the majority of trading is conducted by physical participants, with relatively little speculative trading.⁶

The benefits of and potential mechanisms to improve electricity OTC markets transparency were re-examined in 2017-18 by the ACCC and AEMC (see below), following concerns regarding low levels of liquidity issues in South Australia and competition issues in some NEM regions, including barriers to entry for new retail participants.

In early 2018, the ESB also considered mandatory reporting of OTC contracts to trade repositories as part of the development of the detailed design of the National Energy Guarantee.

The ACCC examined OTC transparency as part of its Retail Electricity Pricing Inquiry, conducted over 2017-18⁷. It concluded that lack of transparency in the OTC market impedes the transmission of price signals in the market and introduces uncertainty for participants and policy makers; issues that it considered could be addressed through mandatory reporting to a registry, with relevant data published in a de-identified format. In particular, it noted that a registry would allow market participants to follow price trends and minimise uncertainty regarding the significance and causes of any changes in trading activity on the ASX.

The AEMC made a similar recommendation in its 2018 Reliability Frameworks Review and 2018 Retail Energy Competition Review⁸, noting that it intends to work with the industry on OTC

⁴ Some energy market participants currently use trade repositories to report their green and gas market exposures, however there is no mandatory reporting requirement.

⁵ Aggregate OTC data has been published by AFMA on an annual basis based on a voluntary survey of industry. The most recent data available covers the 2016-17 financial year.

⁶ AEMC 2015 NEM Financial Market Resilience Review, Final Report (March 2015) – www.aemc.gov.au/markets-reviews-advice/nem-financial-market-resilience

⁷ ACCC Retail Electricity Pricing Inquiry – Final Report, June 2018 (www.accc.gov.au/publications/restoring-electricity-affordability-australias-competitive-advantage)

⁸ AEMC 2018 Retail Energy Competition Review, Final Report (June 2018) – www.aemc.gov.au/markets-reviews-advice/2018-retail-energy-competition-review; AEMC 2018 Reliability Frameworks Review, Final Report (July 2018) – <https://www.aemc.gov.au/our-work/our-current-major-projects/system-security-and-reliability/reliability-frameworks-review>

transparency measures, including reintroduction and enhancements to the Australian Financial Market Authority's (AFMA) historic, voluntary survey of OTC wholesale electricity markets to include data on costs and contract terms equivalent to the de-identified data published on the ASX⁹. The AEMC noted that, in the absence of a survey or other industry-led initiatives to collect data on OTC electricity trading, it will consider whether electricity OTC products should continue to be exempt from the G20 derivative trade reporting requirements as part of the AEMC's review, to be done in 2019, of these reporting arrangements.

Both reviews cited the New Zealand hedge transaction reporting regime (see **Box 1**) as a potential model for consideration.

Box 1: Electricity hedge market disclosure requirements in New Zealand

Electricity hedge market disclosure requirements in New Zealand are set out in Part 13 of the regulatory Code that applies to industry participants and the Electricity Authority of New Zealand. The Code sets out the reporting requirements for different types of risk management contracts.

For example, for options contracts, participants are required to report trade dates (transaction, effective and end) and quantity, while for contracts-for-difference and physical supply contracts they are required to report the nature of the contract, trade dates, quantity, clauses covering adjustment, force majeure, suspension and pass-through of costs, levies, taxes, and contract prices (calculated in accordance with the methodology set out in the Code).

Data must be disclosed via the electricity hedge contracts website – an online database which allows interested parties to view and compare hedge contract details across the market, assisting them to negotiate their own contracts. To ensure anonymity, each individual hedge price is adjusted with a location factor and then entered into the website as if it was assigned to a representative node in one of five zones. The actual price of each individual hedge is not published.

Industry participants are required to certify their disclosed information to the Electricity Authority via an annual certificate.

2 Establishing and administering a Trade Repository

Under the current ASIC requirements introduced as part of G20 reforms, the choice of trade repository is up to the participant and must be licensed by ASIC. Data in trade repositories is private and is accessed only by ASIC for the purpose of monitoring the risks of financial contagion.

The ACCC, in Recommendation 6, suggests a more targeted reporting regime for electricity OTC trades and broader regulatory oversight and data dissemination; in particular, mandatory reporting to an industry-specific repository administered by the AER, with access to underlying contract information available to the AER, AEMC and AEMO, and publication of important market information in a de-identified format.

⁹ AFMA has recently recommenced this survey and publication, including gap years (with data collected through the 2017 survey of industry) to provide an unbroken data series. See 2017 Electricity Derivative Turnover Survey at <https://afma.com.au/data> (published 31 August 2018).

Establishing a Trade Repository

The ACCC recommended an industry-specific trade repository as its preferred model to meet its priority objective; enhancing transparency of electricity OTC market activity and price trends.

Establishing a new, industry-specific trade repository would involve considerable development lead-times and significant up-front costs which would need to be managed by a relevant industry or market body and recovered from market participants. However, it would enable fit-for-purpose reporting and operation arrangements to be established (including cost-recovery arrangements for ongoing operation), which could better support price discovery and monitoring of market developments.

Leveraging existing, ASIC-endorsed trade repositories would provide market participants with greater flexibility in where and how they report their data, could involve minimal establishment costs (arrangements would still need to be put in place to support access of the AER and public reporting of de-identified data), and could serve a broader range of purposes, including monitoring of systemic market risk. But fees imposed to recover costs involved in capturing and reporting contracts could be greater than those required to support a more targeted, industry-specific repository. In addition, specific reporting requirements may lead to a higher compliance burden for market participants which is in turn passed on to consumers.

Questions

What costs and/or other risks need to be considered in the establishment of a new, industry-specific trade repository? How would these compare with leveraging an existing, generic trade repository? How might costs best be managed?

Are there any timing issues with establishment of a new, industry-specific trade repository? If so, what transitional arrangements could be put in place to deliver targeted benefits in as timely a manner as possible?

Role of the AER in administering a Trade Repository

The ACCC recommends that an industry-specific trade repository, if implemented, should be administered by the AER.

Oversight and access of regulators to underlying contract information in any trade repository is essential to the delivery of transparency benefits. Key regulatory functions which the AER would perform, if responsible for administering an industry-specific trade repository, would include (but not be limited to):

- Monitoring and enforcing compliance of market participants with their reporting obligations.
- Analysing and (where appropriate) acting on identified market trends and/or developments.
- De-identification and aggregation of relevant data for public dissemination purposes.
- Public dissemination of relevant market data in summary form.

These functions align with the current role and responsibilities of the AER, including its existing role in wholesale market monitoring. They also align with the AER's recommended anti-manipulation powers (ACCC Recommendation 4) and recommended future role in

monitoring, analysing and reporting on the performance of electricity contract markets (ACCC Recommendation 41) and proposed responsibilities for ensuring market participants' compliance with obligations under the Reliability Obligation part of the National Energy Guarantee.

Alternative entities which might be considered to perform the role of regulatory administrator include the ACCC and ASIC. Both of these bodies possess broad ranging powers with respect to financial markets. But resources and expertise are not specifically targeted to energy markets.

Questions

Is the AER the most appropriate body to perform the role of administrator of the Trade Repository?

Accessibility of underlying contract information

The ACCC has recommended that access to underlying contract information be provided to the AER, AEMC and AEMO.

Extending access to contract market information contained in a Trade Repository could potentially assist the AEMC and AEMO in their market design / rule development and grid management roles. A more detailed understanding of the health and characteristics of risk management strategies adopted by market participants can assist in the design of new mechanisms, such as the rationale for, and design of short-term forward financial markets. For example, the AEMC's Reliability Frameworks Review recommended a voluntary, short-term forward market that allows trading of financial contracts closer to real time¹⁰. To the extent that short-term (e.g. one-day-ahead) contracts are already being traded, as revealed by the proposed trade-repository, this may obviate the need to design and introduce such markets.

However, considering the highly sensitive nature of contract information reported to a Trade Repository and potential for market participants to discontinue use of OTC markets if confidentiality protections within the repository were deemed insufficient, the costs of extending access to market bodies beyond the AER may outweigh the benefits.

Questions

Are there any specific issues or concerns with the AEMC and AEMO being provided access to information reported to a Trade Repository? If so, what limitations should be placed on their use and dissemination of data?

3 Reporting

Reporting requirements would need to be carefully designed and consulted on to ensure they're useful, not misleading, and do not distort competitive behaviour. For example, it can be difficult to accurately report all the terms of bespoke transactions, and when summarised for public reporting, at best may provide little useful information, and at worst may have the potential to misinform.

¹⁰ <https://www.aemc.gov.au/sites/default/files/2018-07/RFR%20recommended%20actions.pdf>

Individual Contract Trade Reporting

The reporting could include every trade, like the reporting requirements in New Zealand. This information could be made available to interested parties via a web-based display.

The publication of data related to standard OTC products would allow for direct comparison with the relevant market and could be used to inform the contracting decisions of market participants and customers. However, many OTC contracts are non-standard and the publication of information such as MWh quantity and price may not reveal critical factors that can affect the price such as the shape of the load that is being hedged, the maximum volume, and any embedded options.

If trade-by-trade reporting was adopted, additional measures (for example, rules that provide confidence that trades which would identify disclosing party will not be reported) may be necessary to manage confidentiality concerns. Although counterparty names could be withheld, sophisticated market participants may be able to identify structured hedges often used by new entrant retailers potentially impacting any competitive benefits of those deals.

Aggregated Standardised Trade Reporting

An alternative approach could require the AER to provide reporting of aggregated summary positions for standardised products at set intervals.

The Australian Financial Markets Report (AFMR) covers electricity derivative volumes that were traded 'OTC' and on the ASX. The AFMR ceased surveying the electricity market in 2014-15, however as previously noted, this survey was reinstated this year, with data published for the years 2015-16 and 2016-17¹¹, with the intent to publish 2017-18 data in the next few months.

Published data currently include OTC and ASX turnover (MWh traded) by year, state, instrument (e.g. swaps, caps, swaptions and other options), liquidity ratios (NEM aggregate turnover to system demand), OTC trading concentration and transaction characteristics.

Aggregated standardised trade reporting could capture data covered in the existing AFMR plus pricing information, such as volume weighted strike prices¹² to provide greater transparency of transactions and underlying market liquidity performance.

¹¹ The latest report includes data contributed by survey participants for 2015-16 and 2016-17.

¹² Inclusion of such data would require some ex-post analysis by the AER, similar to that conducted by AFMA in producing its AFMRs.

Questions

What level of disclosure of OTC-traded products is appropriate? What information would be most useful to market participants, regulators and policy makers?

To what extent will the level of disclosure impact on the choice of trade repository (i.e. new, industry-specific versus leveraging existing trade repositories, on a transitional basis or otherwise)?

How frequently should the information be updated and publicly reported?

Does AFMA restarting its voluntary survey of OTC electricity derivative trading have any implications for the need for a trade repository? If so what are the implications?

To what extent, if any, would trade-to-trade reporting and publication compromise confidentiality of OTC transactions? How could any risks be mitigated?

4 Obligation

4.1 Implementing the obligation and affected parties

The ACCC has proposed that its recommendations would be implemented through changes to the NEL. Implementing a trade repository and reporting requirement using this approach may mean that market participants that solely operated in the financial markets would not need to comply with any trade repository and reporting requirements (i.e. as they would not be registered participants, they would not be subject to regulatory obligations set out in the NEL).

The New Zealand Electricity hedge market disclosure requirements oblige parties to register their trades within a given timeframe. In New Zealand the obligation resides with the seller if they are a participant or on the buyer if the seller is not a participant. Adopting a similar approach under the NEL would mean that the only non-reported trades would be between non-NEL parties (e.g. intermediaries such as banks).

Alternatively, consideration could be given to implementing a trade repository and reporting requirement through the Corporations Act or through other legislation in consultation with the Commonwealth Government/ASIC.

4.2 Other considerations

Should an industry-specific trade repository be implemented, a number of detailed compliance rules would need to be established to provide confidence in the integrity of the data reported. For example, the New Zealand Electricity hedge market disclosure requirements include a verification process, involving counterparty confirmation of all trades reported. Dependent upon the frequency of trade reporting, such measures could place a significant compliance burden on all market participants resulting in higher costs potentially being passed on to consumers.

Questions

If recommendation 6 were implemented should it occur through changes to the NEL?
If it was implemented using the NEL, how could it be designed to minimise the volume of non-reported trades?

Could obligations and reporting arrangements established for an industry-specific trade repository be streamlined with other regulatory processes?

Alternatively, are there specific approaches which could be adopted to minimise the compliance burden on market participants? For example, should trading intermediaries be allowed to report on behalf of liable entities?

5 Consultation timetable

The ESB invites comments from interested parties on the issues and questions set out in this paper by **19 October 2018**. Feedback received will inform the ESB's advice to the COAG Energy Council on implementation options by December 2018.

Submission close date	19 October 2018
Lodgement details	Email to: info@esb.org.au
Naming of submission document	[Company name] Response to OTC Transparency in the NEM Consultation Paper
Late submissions	Late submissions will not be accepted
Publications	Submissions will be published on the COAG Energy Council's website, following a review for claims of confidentiality.

Contact details:

Energy Security Board

E: info@esb.org.au

W: <http://www.coagenergycouncil.gov.au/energy-security-board>