



Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the Corporations Legislation Amendment
(Derivative Transactions) Bill 2012

October 2012

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ISBN 978-1-74229-699-9

Printed by the Senate Printing Unit, Parliament House, Canberra

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Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

- (a) to inquire into, and report to both Houses on:
 - (i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or
 - (ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and
- (b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and
- (c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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Abbreviations

ABA	Australian Bankers' Association
AEMC	Australian Energy Market Commission
AFMA	Australian Financial Markets Association
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUD	Australian dollar
CCP	Central counterparties
EM	Explanatory Memorandum
ESAA	Energy Supply Association of Australia
FSB	Financial Stability Board
FTA	Finance and Treasury Association
G20	Group of 20 (see chapter 1, footnote 7)
GFC	Global financial crisis
NEM	National Electricity Market
NFG	National Generators Forum
OTC	Over-the-counter
RBA	Reserve Bank of Australia

List of Recommendations

Recommendation 1

3.21 The committee recommends that Treasury and the Australian Securities and Investments Commission publish guidance material outlining the consultation process for the development of OTC derivatives regulations and rules. The material should be released by the commencement of the Corporations Legislation Amendment (Derivative Transactions) Act.

Recommendation 2

3.23 The committee recommends that the Australian Securities and Investments Commission release a regulatory guide explaining the derivative transactions and trade repository rules.

Recommendation 3

3.25 The committee recommends that the Australia Securities and Investments Commission provide regular updates on the development of OTC derivatives rules and the market's response to the new regulatory requirements. Updates can be provided as part of the committee's ongoing ASIC oversight process.

Recommendation 4

3.27 The committee recommends that ASIC issue guidance material on the confidentiality of data and trade repositories, and the use to which data may be put. ASIC should closely monitor the activities of derivative trade repository licensees regarding the use and disclosure of repository data.

Recommendation 5

3.50 The committee recommends that for matters relating to the energy sector, the Minister for Resources and Energy be consulted prior to the making of regulations, the mandating of derivatives or the consent to an ASIC rule.

Recommendation 6

3.51 The committee recommends that the bill be passed.

Chapter 1

Introduction

The referral

1.1 On 13 September 2012, the House of Representatives Selection Committee referred the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 to the Parliamentary Joint Committee on Corporations and Financial Services ('the committee') for inquiry and report.

Conduct of the inquiry

1.2 The inquiry was advertised in *The Australian* newspaper on 26 September 2012. Details of the inquiry, the bill and associated documents were placed on the committee's website.

1.3 The committee invited submissions by 3 October 2012. Submissions were received from eleven individuals and organisations, as listed in Appendix 1.

Acknowledgement

1.4 The committee thanks the organisations and individuals who made submissions to the inquiry, and those who gave evidence at the public hearing.

Notes on references

1.5 References to submissions are to individual submissions as received by the committee rather than to a bound volume. References to *Committee Hansard* are to the *Proof Hansard* transcripts available on the Parliamentary website. Please note that page numbers may vary between the proof and official *Hansard*. Copies of the submissions received and the *Committee Hansard* are available on the Parliamentary website.¹

Background

1.6 Following the collapse of the sub-prime mortgage market in the United States in August 2007, the International Monetary Fund reported that the 'world economy is now entering a major downturn in the face of the most dangerous shock to mature financial markets since the 1930s'.² The 'global financial crisis' (GFC) prompted calls

1 Parliamentary Joint Committee on Corporations and Financial Services, *Current inquiries*, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_cte/derivatives/index.htm (accessed 21 September 2012).

2 International Monetary Fund, *World Economic Outlook*, October 2008, p. 1.

for financial regulators to review the regulatory framework underpinning domestic and global economies.

1.7 One of the main culprits for the GFC was the rapid growth of a largely unregulated derivatives market.³ This market was conducted on both public stock exchanges and in private through over-the-counter (OTC) derivative transactions.⁴ As the Chairman of the US Commodity Futures Trading Commission noted:

[W]hile the crisis had many causes, it is evident that unregulated derivatives, called swaps, played a central role...[O]ver the last 30 years, the unregulated swaps market grew by orders of magnitude and is now seven times the size of the futures market. During its growth, the market lacked the transparency of the futures and securities markets, and risk accumulated. Swaps, which were developed to mitigate and spread risk, actually added leverage to the financial system – with more risk backed by less capital.⁵

1.8 The International Organization of Securities Commissions noted that the GFC 'highlighted a severe lack of transparency in the OTC derivatives markets'. Improving this lack of transparency has been the focus of the OTC derivatives reforms. Measures to increase transparency include the creation of trade repositories to act as centralised electronic registries of OTC derivatives transactions. Trade repositories are a departure from traditional forms of recording OTC derivative transactions, in which data is maintained by individual counterparties or institutions that provide services to market participants, such as central counterparties (CCP). Trade repositories are designed to improve market transparency through providing regulators and the public an accessible database of reliable information on the OTC derivatives market.⁶

3 A derivative is a security, in the form of a contract between two or more parties, based on an arrangement to buy one or more underlying assets for future delivery at a specified date or at a specified point in time. Common underlying assets are stocks, bonds, commodities, currencies, interest rates and market indexes. A derivative is a way for those parties to the contract to hedge their risk: their profit or loss will be determined by the value of the asset at the specified point in time.

4 Over-the-counter derivatives operate through a dealer network where dealer-brokers negotiate directly with each other. A dealer network is often used by small companies that are unable to meet exchange listing requirements.

5 Mr Gary Gensler, Chairman, Commodity Futures Trading Commission, 2 December 2011, as cited in Corporations and Markets Advisory Committee, *Derivatives: Report*, December 2011, p. 15. An option is a form of derivative whereby an investor purchases the right to buy a stock or a bond at a specified future date for a specified price. A swap is a form of derivative whereby two parties agree to exchange financial instruments—such as foreign exchange—at a specified future time at a pre-specified exchange rate

6 Committee on Payment and Settlement Systems–Technical Committee of the International Organisation of Securities Commissions, *Considerations for trade repositories in OTC derivatives markets: Consultative report*, May 2010, p. 1.

1.9 In its response to the GFC, the G20 noted the potential for trade repositories to reduce the opacity of the OTC derivatives market. In 2009, the G20 agreed to progress measures to strengthen the international financial regulatory system.⁷ The measures included reforms intended to increase the transparency of, and reduce the risks attached to, the OTC derivatives market.

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.⁸

1.10 The G20 continues to reaffirm, and refine, its commitment to OTC market reforms. The G20 has subsequently stated its expectation that the reforms will be 'internationally consistent', to effectively avoid loopholes, overlapping regulations, and discrimination between markets.⁹ It has maintained its expectation that jurisdictions will implement the reforms by the end of 2012, instructing jurisdictions to 'rapidly finalise their decision-making and put in place the needed legislation and regulations to meet the G20 commitment to central clearing'.¹⁰

1.11 In accordance with G20 directives,¹¹ the Financial Stability Board (FSB) has monitored the implementation of the OTC market reforms.¹² As part of this monitoring process, in October 2010 the FSB issued 21 recommendations to guide jurisdictions in implementing the reforms. The recommendations were designed to

7 The Group of 20, or G20, is a forum for international collaboration and coordination on matters affecting international financial stability. The G20 includes 19 member countries and the European Union. For further information, see G2012 Mexico, *What is the G20*, <http://www.g20.org/index.php/en/what-is-the-g20> (accessed 21 September 2012).

8 G20 Information Centre, *G20 Leaders Statement: The Pittsburgh Summit*, 24 – 25 September 2009, <http://www.g20.utoronto.ca/2009/2009communique0925.html> (accessed 17 September 2012).

9 G20 Information Centre, *Cannes Summit Final Declaration – Building our common future: Renewed collective action For the benefit of all*, 4 November 2011, paragraph 24, <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html> (accessed 17 September 2012); G20 Information Centre, *G20 Toronto Summit Declaration*, 27 June 2010, paragraphs 24 – 26, <http://www.g20.utoronto.ca/2010/to-communique.html> (accessed 17 September 2012).

10 G20 Information Centre, *G20 Leaders Declaration*, 19 June 2012, paragraph 39, <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html> (accessed 17 September 2012).

11 G20 Information Centre, *G20 Leaders Statement: The Pittsburgh Summit*, 24 – 25 September 2009, <http://www.g20.utoronto.ca/2009/2009communique0925.html> (accessed 17 September 2012).

12 The Financial Stability Board is an international body that coordinates the activities of domestic financial authorities undertaken in response to international policies and standards. For further information, see, Financial Stability Board, *Overview*, <http://www.financialstabilityboard.org/about/overview.htm> (accessed 21 September 2012).

promote consistency across jurisdictions, minimise the potential for regulatory arbitrage,¹³ and increase the use of OTC derivatives in standardised form.¹⁴

1.12 Together with the G20 commitments, the recommendations form part of the international approach to reforming the OTC derivatives market. The FSB distilled the reforms into four core areas, issuing guidance on the scope of the application of the reforms, clearing arrangements, trade execution, and trade reporting requirements:

- **Application:** the proportion of the OTC market to be standardised;
- **Clearing arrangements:** including the factors for jurisdictions to consider when determining whether an OTC derivative is suitable for standardisation, and therefore central clearing; risk management requirements for the remaining non-centrally cleared markets; and supervision, oversight and regulation of CCP;
- **Trade execution:** recommendations regarding exchange or electronic platform trading for standardised OTC derivatives; and
- **Trade reporting:** guidance on reporting to trade repositories; including requirements for trade repository data to be comprehensive, uniform and reliable.¹⁵

Australia's implementation of the G20 OTC derivatives market reforms

1.13 Analysis undertaken by the Council of Financial Regulators, comprised of representatives of the Treasury, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (the RBA), indicates that Australia's current OTC derivatives market is small compared with international markets.¹⁶ The FSB also considers Australia's OTC market to be relatively small, with the largest markets in OTC derivatives operated by the European Union, Japan and the United States.¹⁷ The

13 In relation to financial markets, the Australian Securities and Investments Commission has defined 'arbitrage' as 'the process of seeking to capture pricing inefficiencies between related products or markets'. For further information, see, for example, Australian Securities and Investments Commission, *Report 125: Australian equity market structure*, November 2010, p. 103.

14 Financial Stability Board, *Implementing OTC derivatives market reforms*, 25 October 2010, p. iv.

15 Financial Stability Board, *Implementing OTC derivatives market reforms*, pp 12.

16 Council of Financial Regulators, *OTC derivatives market reform considerations*, March 2012, pp 18-19.

17 Financial Stability Board, *OTC derivatives market reforms: Third progress report on implementation*, 15 June 2012, p. 1.

Council's review also found that a portion of the Australian market is comprised of cross-border activity.¹⁸

1.14 As a G20 member, Australia is committed to implementing the G20's OTC derivatives market reforms.¹⁹ Since the G20 announcement in 2009, Australia's implementation of the reforms has been under consideration by Australia's regulators.²⁰ The Council of Financial Regulators issued its final report in March 2012, recommending Australia adopt the following policy approach:

- **Trade repositories:** The Council recommended the introduction of a legislative framework to enable the imposition of mandatory reporting requirements for certain products. The Council further recommended that reporting entities be authorised to report to offshore trade repositories provided certain conditions are met. Conditions would include that Australian regulators could access relevant data collected by offshore trade repositories.²¹ It was also concluded that cross-border activity 'poses significant jurisdictional oversight challenges, which need to be given careful consideration in developing reform proposals'.²²
- **Clearing arrangements:** The Council noted that moving to central clearing is a significant change for current market participants, and signalled its preference for the transition to CCP to be driven by economic factors rather than mandatory requirements. However, to ensure that the transition occurs within appropriate timeframes, the Council concluded that 'it is appropriate that there be a capacity to mandate central clearing if necessary'.²³ The Council also concluded that 'not all OTC derivatives will be able to be centrally cleared', however, all transactions should be 'robustly risk managed'.²⁴
- **Trade execution:** The Council recommended that primary legislation allow for the rules regarding trade execution to be developed through subordinate legislation.²⁵

18 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 18-19.

19 G20 information Centre, *G20 members*, <http://www.g20.utoronto.ca/members.html> (accessed 17 September 2012).

20 Mr Malcolm Edey, Assistant Governor (Financial Systems), Reserve Bank of Australia, 'Address to the ISDA Annual Australia Conference', 20 October 2011, http://www.rba.gov.au/or_speeches/2011/sp-ag-201011.html (accessed 18 September 2012).

21 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 25-25.

22 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 19.

23 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 26-27.

24 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 19.

25 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 28.

1.15 The final report builds on consultations undertaken in 2011 and a survey of the domestic OTC derivatives market published in 2009. The 30 submissions to the 2011 consultations were reportedly broadly supportive of the G20 reforms. However, concerns were raised with aspects of the practical measures required to introduce greater transparency for OTC derivative transactions.²⁶

1.16 Following the Council's report, on 18 April 2012 the government released for public comment options for policy and legislative reform to implement Australia's G20 OTC derivatives commitments.²⁷ The consultation period ran for approximately 2 months and generated 37 submissions.²⁸ This was followed by the release of exposure draft legislation on 25 July 2012. Sixteen stakeholder organisations provided comment.²⁹

1.17 The FSB has monitored Australia's progress with implementing the G20 reforms. Released in June 2012, the FSB's *Third progress report on implementation* notes that at the time of the report jurisdictions with the largest OTC derivatives markets were the most advanced in implementing the reforms. Australia is among the jurisdictions that remain in the initial stages of reform implementation. While noting the government's announcement that Australia will adopt legislation on trade reporting by the end of 2012, the FSB concluded that implementation of requirements relating to central clearing, exchange/platform trading and reporting has not moved beyond the public consultation stage. However, it was also noted that Australia had developed draft legislation for reforms relating to capital requirements and measures to increase the use of standardised products.³⁰ The FSB's report predates the release of exposure draft legislation and the introduction of the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 to the House of Representatives.

26 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 7.

27 The Hon Bill Shorten MP, Minister for Financial Services and Superannuation; the Hon Bernie Ripoll MP, Parliamentary Secretary to the Treasurer, 'Implementing G20 commitment on OTC derivative reforms' Media release 024, 18 April 2012.

28 Treasury, *Consultation and submissions – Implementation of a framework for Australia's G20 over-the-counter derivatives commitments: Consultation paper*, <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Over-the-counter-derivatives-commitments-consultation-paper/Submissions> (accessed 18 September 2012).

29 Treasury, *Consultations and submissions – corporations legislation and (derivative transactions) Bill*, <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Derivative-Transactions> (accessed 18 September 2012).

30 Financial Stability Board, *OTC derivatives market reforms: Third progress report on implementation*, p. 7.

Chapter 2

Overview of the bill

2.1 As noted in the Second Reading Speech to the bill, the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 is intended to address Australia's G20 commitments regarding 'the reporting of OTC derivatives to trade repositories; the clearing of standardised OTC derivatives through central counterparties; and the execution of standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate'.¹ The legislative amendments are intended to 'provide a high degree of flexibility' to facilitate the adjustment of Australia's OTC derivative requirements in response to international regulatory developments.²

2.2 The bill would amend the *Corporations Act 2001* to implement a legislative framework that would allow the operational details of the new OTC derivatives scheme to be largely established by subordinate legislation.³ That is, the bill would not introduce new requirements for OTC derivatives transactions. Rather, the bill would introduce a framework under which obligations may be imposed through subordinate legislation and regulatory rules.⁴

The proposed legislative framework of the bill

2.3 Schedule 1 would amend the Corporations Act to introduce a legislative scheme that would promote 'graduated measures to respond proportionately in managing risks in Australian OTC derivatives markets'.⁵ The bill would delegate regulation and rule-making powers to the responsible minister and ASIC. Accordingly, the Minister and ASIC would determine the nature and extent of the regulatory framework governing OTC derivatives transactions.

2.4 The Minister would determine which classes of derivatives would be subject to OTC derivative rules. The Minister's determinations would be subordinate legislative instruments, subject to the Parliamentary disallowance process.⁶ In

1 The Hon Bill Shorten MP, *House of Representatives Hansard*, 12 September 2012, pp 4–6.

2 The Hon Bill Shorten MP, *House of Representatives Hansard*, 12 September 2012, pp 4–6.

3 The Hon Bill Shorten MP, *House of Representatives Hansard*, 12 September 2012, pp 4–6.

4 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.24.

5 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.23.

6 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.108.

exercising the delegated authority, the Minister would be required to consider the determination's likely regulatory impact, the effect on the Australian economy and the integrity of the financial system, and any other matters the Minister considers relevant. In finalising a determination, the Minister would be required to consult with ASIC, APRA, and the RBA. However, failure to consult would not invalidate the determination.⁷ Accordingly, the requirement to consult would not necessarily circumscribe the Minister's exercise of the delegated authority or the validity of the subordinate legislation affecting the prescribed class of derivatives.

2.5 Following the Minister's determination, proposed Part 7.5A of the Corporations Act would authorise ASIC to make rules to govern the prescribed classes of OTC derivatives. The rules would establish execution requirements, reporting requirements and clearing requirements.⁸ While the rules would be determined by ASIC, the Commission's authority would not be unfettered but would be subject to two avenues of ministerial and parliamentary oversight. First, the rules would be legislative instruments subject to parliamentary disallowance.⁹ Second, the bill includes a regulation making power that would authorise regulations to limit the requirements that could be imposed on certain classes of derivative transactions or persons.¹⁰

2.6 Additionally, the bill would impose restrictions on the requirements that the rules may impose. Proposed subsection 901A(8) would effectively prevent derivative transaction rules from applying retrospectively. As noted in the Explanatory Memorandum (EM) '[t]he derivative transaction rules do not impose requirements retrospectively [and] are limited in the obligations they can impose prospectively in relation to transactions entered into prior to their creation'.¹¹ Proposed subsection 827D(2A) would also limit the operation of the rules, providing that the RBA financial stability standards would prevail to the extent of any inconsistency with the derivative transaction rules.¹²

2.7 It is expected that ASIC will provide rules of sufficient detail to allow the new OTC derivatives requirements to be effectively implemented. For example, the EM advises that '[t]he rules would be expected to contain precise details specifying who in

7 Proposed Section 901B, Corporations Act 2001.

8 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.95.

9 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.95.

10 Proposed Sections 901C-901D, Corporations Act 2001.

11 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.107.

12 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.79.

relation to the given transaction must (or may) comply with a requirement'.¹³ ASIC would be responsible for determining execution requirements, reporting requirements, clearing requirements, and any incidental or related requirements. In addition, ASIC may specify in the rules classes of transactions subject to particular requirements, the persons to whom the rules apply, and exemptions from compliance requirements.¹⁴

2.8 Failure to comply with the rules would attract a civil penalty.¹⁵ The EM advises that the new OTC derivative transactions regime would utilise the existing civil penalty regime under the Corporations Act.¹⁶ In addition, the bill would allow regulations to establish alternatives to civil penalty proceedings. Alternatives may include fines, remedial measures, such as education programs, sanctions other than the payment of a fine, and enforceable undertakings.¹⁷

Trade repositories

2.9 The Second Reading Speech notes that the bill would introduce a new licensing regime for trade repositories.¹⁸ Consistent with ASIC's role as the corporate, markets, and financial regulator, the new licensing regime would fall within ASIC's regulatory responsibilities. ASIC would be authorised to disqualify persons from obtaining, or retaining, an Australian derivative trade repository licensee where ASIC has declared the individual to be unfit or otherwise disqualified from involvement in a corporation.¹⁹ The bill would provide procedural fairness in the disqualification process, through requiring, among other matters, ASIC to notify licensees or applicants of the intended disqualification and provide an opportunity to respond. The EM notes that the procedures are modelled on existing disqualification procedures in the Corporations Act.²⁰ It is evident that the new licensing system is drawn from existing licensing regimes but modified to address 'the different roles of this new form of market infrastructure entity will play'.²¹

13 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.98.

14 Proposed Section 901A, Corporations Act 2001.

15 Proposed subdivision B, Part 7.5A, Corporations Act 2001.

16 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.114.

17 Proposed Section 901A, Schedule 1, Corporations Act 2001.

18 The Hon Bill Shorten MP, *House of Representatives Hansard*, 12 September 2012, pp 4-6.

19 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.82.

20 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.83.

21 The Hon Bill Shorten MP, *House of Representatives Hansard*, 12 September 2012, pp 4-6.

2.10 The bill would confer on ASIC responsibility to determine rules to regulate the operation of trade repositories. The rules may canvass issues including the manner in which licensed derivative trade repositories provide their services, the handling or use of derivative trade data, the governance, management and resources of licensed review trade repositories. Additionally, ASIC would have authority to monitor the integrity of the electronic platforms operated by licensed derivative trade repositories. Rules may include requirements concerning the integrity and security of computer systems, operational reliability, business continuity planning, operational separation of functions, and the outsourcing of functions to other entities.²²

2.11 The bill recognises that Australia's OTC derivatives markets include cross-border transactions. Accordingly, the bill would authorise ASIC to inquire into the regulatory regime applying in the foreign market and the adequacy of the supervision the regulations provide.²³ The EM advises that the rules 'can be tailored to operate in a coordinated and consistent way to varying overseas requirements'.²⁴

Application of the Legislative Instruments 2003

2.12 The bill would authorise the responsible Minister and ASIC to amend determinations, regulations, derivative transaction rules and derivative trade repository rules to incorporate written instruments or any matter contained in writing. An instrument or matter contained in writing may be incorporated if in force or existing at a particular time or from time to time.²⁵ This is contrary to the general prohibition in the *Legislative Instruments Act 2003* against incorporating documents that may exist after the legislative instrument has commenced and documents with a limited lifespan. Accordingly, the bill would effectively modify the Legislative Instruments Act's application to the OTC derivatives regulatory framework.

2.13 The EM argues that this is necessary to ensure that regulations applying to transactions conducted on Australian exchange platforms can take account of international developments and thereby promote international coordination and open markets.²⁶

Consequential amendments

2.14 The bill contains consequential amendments to the *Australian Prudential Regulation Authority Act 1998*, the *Australian Securities and Investments Commission*

22 Proposed Section 903A, Corporations Act 2001.

23 Proposed Section 902A, Corporations Act 2001.

24 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.136.

25 Proposed Section 907B, Corporations Act 2001.

26 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.230.

Act 2001, the *Mutual Assistance in Business Regulation Act 1992*, and the *Reserve Bank Act 1959*. The amendments would extend information sharing protocols between relevant domestic regulators to allow a coordinated regulatory approach for the proposed OTC derivative transaction requirements.²⁷

2.15 The proposed amendments are also intended to further Australia's commitment to international regulatory cohesion, with amendments to the Mutual Assistance in Business Regulation Act designed to permit Australian regulators to respond to requests by foreign regulators for information, documents and evidence from persons in Australia.²⁸

Consideration of the bill by the Senate Standing Committee for the Scrutiny of Bills

2.16 The Senate Standing Committee for the Scrutiny of Bills has considered the bill and raised two key concerns:

- First, the Scrutiny of Bills Committee expressed concern with the general framework of the bill that would effectively delegate overall regulatory authority to the responsible Minister and to ASIC (Part 7.5A). In particular, the committee highlighted proposed sections 901A-D and 903A-903C, which would authorise ASIC to establish derivative transaction rules and derivative trade repository rules.
- Second, the proposed modification of the application of the Legislative Instruments Act (clause 907B).²⁹

2.17 While drawing the Senate's attention these matters, the Scrutiny of Bills Committee did not seek the Minister's advice regarding the appropriateness of the proposed regulatory framework. Rather, the Scrutiny of Bills Committee referred to the Senate the question of whether the proposed delegation of legislative power is inappropriate.³⁰

27 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraphs 1.263-1.264.

28 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraphs 1.277-1.279.

29 Senate Standing Committee for the Scrutiny of Bills, *Alert Digest 11/12*, 19 September 2012, pp 34.

30 Senate Standing Committee for the Scrutiny of Bills, *Alert Digest 11/12*, p. 4.

Chapter 3

Views on the bill

3.1 This chapter summarises submitters' views on the provisions of the bill and proposes recommendations to ensure that stakeholders' concerns are adequately addressed. There are three areas of concern:

- the exercise of delegated power by the Minister;
- the safeguards to ensure the proper exercise of delegated authority; and
- arguments put by the electricity sector that they should be exempted from the OTC regulatory framework.

3.2 Submitters generally approved of the objectives of the G20 OTC derivatives reforms. d-cyphaTrade commended the introduction of legislation to implement the G20 reforms in the Australian market.¹ The Australian Financial Markets Association (AFMA) submitted that industry supports international regulatory coordination, and endorsed the passage of the bill.² While not supporting the proposed application of the OTC reforms to the National Electricity Market (NEM), representatives of the electricity sector acknowledged that the bill provides the framework for Australia to honour the G20 commitment to improve the operation of the derivatives market.³

3.3 Submitters did not challenge the proposed timeframe for the commencement of the legislative reforms. Rather, it was acknowledged that the end of 2012 commencement date is necessary to ensure that Australia fulfils its G20 obligations.⁴ Further, AFMA submitted that the draft legislation is required to promote parity between Australian markets and international markets and, therefore, a level playing field for Australian-based businesses.⁵

3.4 However, concerns were raised with aspects of the legislative framework proposed by the bill.

Exercise of delegated power

3.5 Submitters to the inquiry recognised that, if passed, the proposed legislation would not impose new requirements on Australia's financial markets. Rather,

1 d-cyphaTrade, *Submission 8*, p. 1.

2 Australian Financial Markets Association, *Submission 9*, pp 1–2.

3 See, for example, Origin, *Submission 1*, Attachment A, p. 1; TRUenergy, *Submission 11*, Attachment A, p. 1.

4 See, for example, Finance and Treasury Association, *Submission 7*, p. 1.

5 Australian Financial Markets Association, *Submission 9*, p. 3.

submitters acknowledged that the bill would provide a mechanism by which additional requirements may be imposed.⁶ However, views differed as to the appropriate exercise of delegated authority by the responsible Minister and the Australian Securities and Investments Commission (ASIC).

3.6 AFMA endorsed the proposed framework under which the scope and content of the OTC derivatives reforms would be determined under delegated legislation. Noting that 'Australian authorities have been responsive and understanding of the issues facing industry', AFMA supported the delegation of power.⁷ It argued that the contemplated framework provides the necessary flexibility to appropriately respond to changing market conditions:

The framework provides an open competitive environment for market infrastructure while giving the regulators the tools to manage systemic risk. The framework recognises the need for a flexible regime that can cope with the rapid evolution that is occurring around the globe that enables market participants to adopt appropriate risk management and business decisions based on cost and liquidity.⁸

3.7 However, AFMA questioned whether the extent of the proposed delegation to ASIC is appropriate. Arguing that the scope and content of regulatory obligations are matters to be determined by Parliament or the responsible Minister, AFMA submitted that ASIC's authority should be limited to the administrative and procedural aspects of the regulatory regime. Accordingly, AFMA recommended that the bill be amended to allow regulations to determine the broad parameters for derivative transaction rules such as clearing requirements, reporting requirements and execution requirements.⁹

3.8 The Australian Bankers' Association (the ABA) recognised that 'flexibility in the regulatory regime is necessary to allow Australia to accommodate ongoing international developments'.¹⁰ However, the ABA also questioned the extent of the delegated authority, submitting that 'the primary legislation should set out the scope of the regime'.¹¹

3.9 Treasury explained that the framework is necessary to allow Australia's financial markets to evolve in response to changes to the international market:

This flexibility is necessary to ensure the regime can be implemented in a proportional and targeted way in Australia, and can be readily adapted overseas to regulatory developments so as to ensure a coordinated approach

6 See, for example, Australian Bankers' Association, *Submission 12*, p. 2; National Generators Forum, *Submission 10*, p. 2.

7 Australian Financial Markets Association, *Submission 9*, p. 3.

8 Australian Financial Markets Association, *Submission 9*, p. 3.

9 Australian Financial Markets Association, *Submission 9*, p. 4.

10 Australian Bankers' Association, *Submission 12*, p. 3.

11 Australian Bankers' Association, *Submission 12*, p. 4.

to regulation of global OTC derivatives markets between Australia's financial regulators and international counterparts.¹²

3.10 Treasury reiterated the view that the adaptability and flexibility that subordinate legislation provides is necessary to ensure that Australian businesses can effectively compete in international markets:

Consistent implementation by all major economies is important to reduce systemic risk and the risk of regulatory arbitrage that could arise if there are significant gaps in implementation. International cooperation and flexibility will also help to avoid unintended consequences of national laws such as the burden on businesses of duplicated or conflicting rules and the cost of reduced access to international markets.¹³

Checks and balances—industry consultation processes

3.11 Some submitters questioned whether the bill contains appropriate safeguards to ensure the proper exercise of delegated authority. Representatives of the energy sector strongly questioned whether the bill would facilitate appropriate industry consultation on regulatory requirements. The National Generators Forum (NFG), notably, challenged the appropriateness of not specifying in the legislation detailed consultation processes that would require the views of all stakeholders to be properly canvassed.¹⁴ Origin submitted that the bill 'lacks appropriate checks and balances around the Minister's and ASIC's discretionary decision-making powers'.¹⁵ It argued that the bill would 'leave open the very real possibility that decisions impacting on the energy sector could be made without adequate consultation with industry or energy market institutions'.¹⁶ It was put to the committee that the bill would not ensure that the responsible Minister and ASIC would give due regard to the circumstances unique to the NEM.¹⁷

3.12 Representatives of the energy sector argued that the absence of a requirement to consult properly would create an uncertain market environment.¹⁸ The extent of concern is evident in ESAA's assertion that the sector would be 'facing the prospect that it could be brought within the scope of the mandatory obligations on the Minister's whim at any time'.¹⁹

12 Treasury, *Submission 6*, p. 3.

13 Treasury, *Submission 6*, p. 3.

14 National Generators Forum, *Submission 10*, p. 2.

15 Origin, *Submission 1*, p. 1.

16 Origin, *Submission 1*, Attachment A, p.7.

17 See, for example, National Generators Forum, *Submission 10*, pp 56.

18 See, for example, International Power-GDF SUEZ, *Submission 4*, p. 3.

19 Energy Supply Association of Australia, *Submission 3*, p. 2.

3.13 Accordingly, representatives of the energy sector recommended that the bill be amended to require industry consultation. The NFG recommended that scoping studies be undertaken before determinations are made.²⁰ Origin went further, calling for the bill to be amended to give joint authority to the Minister for Resources and Energy for derivative decisions affecting the NEM.²¹

3.14 More broadly, several measures were recommended to expand the consultation requirements. Norton Rose recommended that proposed section 901J be amended to require ASIC to undertake public consultations prior to adopting OTC derivatives rules.²² The importance of consultation to gauge the regulatory and financial impact of proposed regulations and rules was also noted, with the Finance and Treasury Association (the FTA) and TRUenergy recommending that a cost benefit analysis be undertaken prior to the enactment of new regulatory requirements.²³ The FTA strongly advocated for industry consultation on the basis that successful registry development and implementation 'must involve experts of the industry and representative bodies rather than regulators operating in isolation'.²⁴ Similarly, the ABA submitted that the minister should be required to undertake public consultation before prescribing classes of derivatives.²⁵

3.15 Clearly, it is important that the proposed consultation process entails appropriate industry consultations. Treasury advised that the bill, and the Minister's and ASIC's intended administration of the OTC derivatives framework, would provide for proper consideration of market risks and stakeholders' views. The committee's attention was drawn to Part 3 of the *Legislative Instruments Act 2003*,²⁶ which requires all appropriate and reasonably practicable consultation to occur prior to enacting regulations or rules that will affect business or restrict competition.²⁷ Treasury also advised that, as disallowable instruments, the regulations would be subject to Parliamentary scrutiny. Further, as the bill requires regulatory impact analysis to be undertaken, the financial impact of the proposed regulations and rules will be assessed prior to their enactment.²⁸

20 National Generators Forum, *Submission 10*, p. 5.

21 Origin, *Submission 1*, Attachment A, p. 8.

22 Norton Roads, *Submission 5*, p. 3.

23 TRUenergy, *Submission 11*, Attachment A, p. 1; Finance and Treasury Association, *Submission 7*, pp 2-3.

24 Finance and Treasury Association, *Submission 7*, p. 4.

25 Australian Bankers' Association, *Submission 12*, p. 5.

26 Treasury, *Submission 6*, p. 14.

27 *Legislative Instruments Act 2003*, s. 17.

28 Treasury, *Submission 6*, p. 14.

3.16 In response to industry concerns, in evidence before the committee an undertaking was given to ensure that the Minister for Resources and Energy is consulted regarding decisions affecting the energy sector:

The Government will further ensure that should any future decision be taken by the Minister for Financial Services in relation to either the making of regulation, the mandating of a derivative or the consent to an ASIC rule, this will require the written approval of the Minister for Resources and Energy, where that decision relates to the energy sector.²⁹

Checks and balances – confidentiality of registry data

3.17 Submitters also questioned whether the bill would impose sufficiently robust processes to ensure the confidentiality of data held on trade repositories. Origin argued that the trade reporting requirements 'could expose the commercial decisions of individual companies'.³⁰ Similarly, International Power–GDF Suez Australia expressed 'serious concerns' that the reporting requirements would result in the release of commercially sensitive information and, thereby, undermine market competition.³¹ The FTA commented that licenses to operate trade repositories should not confer on licensees property rights over trade data.³² Origin called for the bill to be amended to expressly require strict data handling procedures.³³

3.18 Proposed section 904B would limit the disclosure of registry data. As noted in the Explanatory Memorandum (EM) to the bill, the use and disclosure of information would generally be permitted for the purpose of providing trade repositories services.³⁴ Accordingly, as stated in the EM, the bill would not absolutely prohibit the commercialisation of trade data.³⁵ However, as explained in the EM, it is anticipated that the regulations may impose additional limits on the use and handling, including the disclosure, of data.³⁶ Further, as indicated in the note to proposed subsection 904B(5), unauthorised disclosure would be an offence. Under section 1131 of the Corporations Act, the offence would be subject to a maximum penalty of 1000 penalty

29 Treasury, *Submission 6*, pp 89.

30 Origin, *Submission 1*, Attachment A, p. 6.

31 International Power-GDF SUEZ, *Submission 4*, Attachment A, p. 4.

32 Finance and Treasury Association, *Submission 7*, p. 4.

33 Origin, *Submission 1*, Attachment A, p 9.

34 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.170.

35 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.174.

36 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.173.

units, or 5000 penalty units in the case of a body corporate. The EM advises that this is a 'significant penalty'.³⁷

Committee view

3.19 The bill implements the G20 commitment that responds to clear evidence that financial markets were exposed to systemic risk at the international level by inappropriate domestic regulation of OTC derivative transactions. The G20 view is clear: international stability requires international coordination. The committee is satisfied that the delegated legislative framework proposed is the appropriate mechanism to ensure continued international coordination and ultimately promote market security.

3.20 However, the committee acknowledges industry concerns regarding the consultation process for the development of subordinate regulations and rules. For regulatory requirements to provide necessary safeguards, the requirements must actually reflect the market. An accurate understanding of the market requires industry analysis and consultation. The committee commends the government's commitment, indicated in its evidence to the committee, to include industry in the regulatory development process. To ensure stakeholders can effectively engage with the process, Treasury and ASIC should publish guidance material that outlines the consultation process and provides contact details for the relevant officers. This material should be available by the commencement of the proposed amendments to the *Corporations Act 2001*.

Recommendation 1

3.21 The committee recommends that Treasury and the Australian Securities and Investments Commission publish guidance material outlining the consultation process for the development of OTC derivatives regulations and rules. The material should be released by the commencement of the Corporations Legislation Amendment (Derivative Transactions) Act.

3.22 Stakeholder education is fundamental to ensuring the effective operation and administration of regulatory requirements. The effectiveness of the new regulatory framework will be dependent on industry understanding its new regulatory requirements. Accordingly, the committee emphasises the need for ASIC to release a regulatory guide detailing the new OTC derivative rules.

37 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.175.

Recommendation 2

3.23 The committee recommends that the Australian Securities and Investments Commission release a regulatory guide explaining the derivative transactions and trade repository rules.

3.24 Under section 243 of the *Australian Securities and Investments Commission Act 2001* the committee is authorised to inquire into, and to report to both Houses of Parliament on, ASIC's activities. Accordingly, the committee regularly inquires into ASIC's activities and related matters. The committee will monitor the exercise of ASIC's delegated authority as part of the committee's ongoing ASIC oversight process.

Recommendation 3

3.25 The committee recommends that the Australia Securities and Investments Commission provide regular updates on the development of OTC derivatives rules and the market's response to the new regulatory requirements. Updates can be provided as part of the committee's ongoing ASIC oversight process.

3.26 The committee notes the concerns expressed by some stakeholders regarding the confidentiality of data held on OTC derivative trade repositories. Unauthorised disclosure and misuse of data would undermine the principles of commercial certainty and security that the bill is seeking to uphold. On the basis of information provided to the committee, it does not appear that express amendments to the bill are warranted. However, the committee considers that it would be appropriate for ASIC to develop guidance material on the use of data by derivative trade repository licensees. Additionally, ASIC should closely monitor the licensees use of data. The committee notes the advice in EM that ASIC may revoke a derivative trade repository licence if ASIC has declared the individual to be unfit.³⁸ The committee is of the view that it would be appropriate for ongoing monitoring of licensees' use of data to be taken into account when determining whether a licensee continues to be fit to operate a trade repository.

Recommendation 4

3.27 The committee recommends that ASIC issue guidance material on the confidentiality of data and trade repositories, and the use to which data may be put. ASIC should closely monitor the activities of derivative trade repository licensees regarding the use and disclosure of repository data.

38 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012, paragraph 1.82.

Exemptions from the OTC G20 derivatives requirements

3.28 Both the non-financial and the energy sectors put to the committee that the bill should be amended to exempt their industry from the OTC derivatives regulatory requirements. In both instances, it was argued that the rationale underpinning the G20's recommendation and, therefore, the bill, is not applicable to its use of derivative transactions. Similarly, the ABA also sought to limit the kinds of derivatives that may be included within the OTC derivatives regulatory framework, arguing that the policy intent underlying the legislation may be achieved without all classes of derivatives being captured by the regulatory framework.

Use of OTC derivatives by non-financials (particularly corporations)

3.29 The FTA submitted that derivative transactions undertaken by non-financials, particularly corporations, should be excluded from the new OTC derivatives framework. It argued that as OTC derivatives by non-financials are 'a tiny part of the derivative market here and abroad', the industry does not present a systemic risk to market stability. Accordingly, it claimed that additional regulatory safeguards are not required.³⁹

Classes of derivatives other than AUD interest-rate swaps

3.30 The ABA submitted that classes of derivatives, outside AUD interest-rate swaps, should be exempt from the proposed OTC derivatives regulatory regime. The ABA identified that the Council of Financial Regulators did not highlight any risks posed by classes of derivatives outside AUD interest-rate swaps. Accordingly, the ABA argued that the intent of ensuring market stability and transparency would be achieved were the OTC derivative rules to be limited to AUD interest-rate swaps.⁴⁰

Arguments to exempt the electricity derivatives market from the bill

3.31 Representatives of the electricity sector strongly opposed the application of the new OTC derivatives regulatory requirements to participants in the NEM. They gave the following arguments.

3.32 First, it was claimed that the electricity market does not pose a systemic risk to market stability. The NGF highlighted that electricity derivatives 'were not identified as a concern warranting regulation through the Australian government's commitment to the G20'. Further, it noted that the consultation process did not raise concerns with the stability and integrity of the electricity derivatives market.⁴¹

39 Finance and Treasury Association, *Submission 7*, p. 3.

40 Australian Bankers' Association, *Submission 12*, p. 5.

41 National Generators Forum, *Submission 10*, p. 5.

3.33 Second, it was argued that the NEM is a sophisticated market that operates well within existing regulatory safeguards. International Power GDF SUEZ stated that 'the sector has developed and applied sophisticated risk management practices to manage financial risk'.⁴² The NGF claimed that there is recognition among Australia's regulators that existing arrangements 'are working'. It cited the view of the Australian Energy Market Commission which found that the financial relationships and markets that underpin the efficient operation of the NEM generally robust, and there is likely to be a low probability of financial contagion occurring in NEM.⁴³

3.34 Third, it was argued that standardisation of the electricity OTC derivatives market would reduce the capacity for contracts to be tailored to minimise risk. ESAA commented that 'any attempt to standardise the electricity derivatives market would result in electricity market participants losing the ability to enter into bespoke contracts to manage the risk'.⁴⁴

3.35 Fourth, the committee heard that Australia's energy market is different to that in most other G20 countries. ESAA argued that for an energy-only market, it is 'particularly important that prices are allowed to rise and fall with as little constraint as possible'. It noted that without occasional very high prices, there are not the signals for new investment and the possibility for generators to recover their long-term costs. ESAA surmised that in many other markets around the world, the impact of restrictions on the electricity derivatives market 'would not be on anywhere near the same scale as here in Australia'. Accordingly, it put to the committee that there 'is a case...to exempt the energy sector which would be a 'very defensible position for Australia to put to its G20 colleagues'.⁴⁵

3.36 Fifth, it was argued that if the energy sector is subject to OTC derivative regulations, there would be a negative impact on competition in the NEM. The NGF claimed that when a new entrant enters the retail market, it may be able to get the support of a generator to cover the new entrant and leave the volume and the profile fairly flexible to encourage that new entrant.⁴⁶ It claimed that if this is not possible, it is less likely that there will be new entrants into the market, thereby affecting competition.⁴⁷

42 International Power-GDF SUEZ, *Submission 4*, p. 1.

43 National Generators Forum, *Submission 10*, p. 3.

44 Energy Supply Association of Australia, *Submission 3*, p. 4.

45 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 8.

46 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 1.

47 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

3.37 Sixth, the energy sector argued that OTC derivative regulations would increase its costs and the costs for consumers. In terms of the costs to the industry, NGF identified the cost of increasing compliance complexity and collateral costs to the extent that good risk management decisions are impaired.⁴⁸ The NGF also told the committee of its concern that, in addition to the current and future upward cost pressures facing the industry, regulations may 'flow through to an additional price increase on top of that'.⁴⁹

The nature of the electricity sector's concern with the bill

3.38 The committee asked the NGF the precise nature of its concerns given that the proposed legislation only establishes a framework for regulation, as opposed to actually applying any regulations. It responded:

The nature of the legislation provides the power to the minister to direct ASIC to inquire into the need for regulation of a particular type of derivative and see that as a fairly quick response to result in ASIC concluding that there may be a need for regulation of that particular derivative and see at this stage that legislation being drafted is far broader than the policy it was intended to achieve. So we would like to see that this legislation has minimal effective regulation for the policy principles it is seeking to achieve, without any concern having been raised around electricity derivatives specifically. It would not seem appropriate that legislation covering electricity derivatives would be introduced and passed by parliament.⁵⁰

3.39 The same question was put to ESAA. It gave the following response:

...we are subject to a whole range of inquiries at the moment, some of which may lead to further regulations being imposed on the industry and our experience has often been that many such inquiries and many such subsequent regulations have been carried out possibly in response to political issues, rather than sound underlying policy drivers, and that from time to time they have been carried out with limited or insufficient consultation. So we are perhaps predisposed to be very wary of even the possibility of additional regulation on the sector. I would also observe that the matter could be equally well considered in reverse, and that if the government has no plans to regulate the sector there would seem to be little harm to be done by exempting the sector.⁵¹

48 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

49 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 4.

50 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 5.

51 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 8.

Support for including the electricity sector in the legislation

3.40 Not all submitters shared the view that the bill should expressly exempt the electricity sector. d-cyphaTrade argued that, as an essential service, it is necessary for the electricity derivatives market to come within the broader G20 OTC derivatives regulatory framework.⁵² d-cyphaTrade did not share the view that the market is currently subject to adequate safeguards. It strongly argued that 'regulations are needed to prevent systemic default risk because the multimillion dollar OTC electricity derivatives market is dominated by non-bank, non-regulated OTC issuers'.⁵³

3.41 It is clear in evidence before the committee that, as at the time of this report, the government does not intend to prescribe the electricity sector as a class of derivatives to which the new OTC derivatives framework would apply. Treasury advised that 'the government has no plans to make rules relating to the energy sector.' However, it is further evident that the government does not support amending the Bill to exempt the electricity sector. Treasury noted that '[n]o particular derivative market has been written out of the regime that will be supported by the proposed amendments'. Treasury noted in its submission that while the Government has no plans to make rules relating to the energy sector, it is important that electricity derivatives be included in the legislative framework:

Applying the legislative framework to all derivatives (including electricity derivatives) ensures that the ongoing market assessment being conducted by the financial regulators is on clear legislative footing.⁵⁴

3.42 Treasury submitted that amending the bill to expressly exclude the energy sector from the OTC derivatives regulatory framework would not be best practice, and would restrict regulatory capacity to respond to changing market conditions:

The bill establishes the legislative underpinnings of what will be an ongoing process. Over time reassessments may occur in response to changing regulatory or marketing environment. The appropriateness of any regulatory approach that has been adopted may be reassessed and adjusted accordingly. The bill seeks to set up a regime that does not merely reflect industry practice or regulatory arrangements at one point in time.

Although the electricity derivative market, based on information currently available, is traded largely between electricity generation, transmission and retailing entities, this may change in the future...It will therefore be important to have the capacity to better understand and respond to any changes in the market for electricity derivatives.⁵⁵

52 d-cyphaTrade, *Submission 8*, p. 2.

53 d-cyphaTrade, *Supplementary submission 8*, p. 6.

54 Treasury, *Submission 6*, p. 10.

55 Treasury, *Submission 6*, p. 10.

Current inquiries into the electricity sector

3.43 The committee draws attention to several current inquiries into the electricity sector. The Senate Select Committee on Electricity Prices is due to report in November this year. In addition:

There are three processes currently underway that will further the understanding of the Australian OTC derivatives energy market.

The AEMC has been asked to provide advice to the Standing Council on Energy and Resources (SCER) on the resilience of the financial relationships and markets that underpin the operation of the National Electricity Market (NEM). The AEMC expects to consider OTC electricity derivatives markets as part of this assessment in the first half of 2013.

The AEMC released an issues paper on 8 June 2012. While the AEMC states that their initial view is that financial relationships in the NEM are generally robust, there may be risks to system security created through the financial interdependencies between market participants.

APRA, ASIC and the RBA initiated a targeted survey of derivatives markets participants on 6 July 2012, as part of a market assessment of Australia's derivative markets. This survey is expected to provide for increased understanding of the bilateral risk management practices and exposures of derivatives markets participants. This survey extends to electricity derivative markets.

On 4 May 2012 ASIC commenced consultation on revised financial requirements for market participants in wholesale electricity markets dealing in OTC derivatives, to ensure that they make adequate provision for expected expenses and carry sufficient financial resources to mitigate against operational risk that could lead to unexpected losses or expenses.

It is expected that each of these market assessments will be completed by the end of the first half of 2013 and together they should provide for a greater understanding of the bilateral risk management practices and exposures in the OTC electricity derivatives markets.⁵⁶

3.44 The committee believes that it is important for these inquiries to reach their conclusions. These findings will be important to understand the exact nature of the pressures facing the energy sector, and in particular its cost structure, competitive tension, prudential needs and risk profile.

56 Treasury, *Submission 6*, pp 9–10.

Committee view

3.45 The makes the following four observations about the electricity sector's claims to be exempted from the bill.

3.46 The first relates to the issue of extraterritoriality. Treasury has noted that the electricity market should be included in bill given the strong likelihood of international regulations applying to electricity derivatives. These regulations would have extraterritorial effect and require a further domestic legislative response.⁵⁷ The committee finds this argument convincing and does not support the NGF's position that if Australia is party to an international commitment to regulate electricity derivatives, this should be done through separate legislation.⁵⁸

3.47 Second, the committee emphasises the point made by d-cypha that the electricity market is a central and essential service and as such, electricity derivatives should properly fall within the broader G20 OTC derivatives regulatory framework. It is appropriate that the electricity sector is subject to the provisions of the legislation.

3.48 Thirdly, the committee has confidence in the process established in the bill to delegate power to the Minister and ASIC. It agrees with AFMA's assessment that Australian authorities have been responsive and understanding of the issues facing industry. Further, the committee believes that in any future consideration of whether OTC derivative regulations should apply to the electricity market, there will be a careful assessment of the possible impact on the industry.

3.49 Finally, the committee notes the comments of ESAA that it would be 'useful' for the legislation to reference the integrated nature of the physical and derivatives market in the case of electricity. ESAA argued that one way to do this would be to specifically include the Energy Minister as chair of the Standing Council of Energy and Resources in the decision-making process.⁵⁹ The committee agrees that this approach would be prudent and recommends accordingly.

Recommendation 5

3.50 The committee recommends that for matters relating to the energy sector, the Minister for Resources and Energy be consulted prior to the making of regulations, the mandating of derivatives or the consent to an ASIC rule.

Recommendation 6

3.51 The committee recommends that the bill be passed.

57 Treasury, *Submission 6*, p. 9.

58 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 5.

59 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 10.

Ms Deborah O'Neill
Chair

Additional comments from Coalition Members of the Committee

1.1 Coalition members of the committee are pleased that the majority report has recognised that the electricity sector does have a range of legitimate concerns in relation to the newly proposed regime under this legislation for over-the-counter (OTC) derivatives trading.

1.2 The Coalition is strongly supportive of an over-the-counter derivatives market.

1.3 We recognise that the new regime will increase transparency of OTC derivative markets and improve risk management practices. It will also give regulators and market participants access to valuable data. Standardised OTC derivatives do have the potential to reduce counterparty risk associated with OTC derivative transactions.

1.4 Coalition members of the Committee are however critical of the process.

1.5 The concerns raised by the electricity sector should have been dealt with much earlier through a properly responsive consultation process by the government.

1.6 Whilst the electricity generation sector raised their concerns during the consultation process, they were completely ignored by Treasury and by the executive government as a whole. No weight was given to entirely reasonable and well founded representations about the implications for the electricity sector in general and ultimately the cost of electricity for consumers and business in particular. Even government members of this Committee had to effectively recognise that the government had erred in not taking those concerns on board.

1.7 For example, the National Generators Forum (NGF) stated:

The draft legislation we commented on and that the industry provided significant comment on raised a number of concerns. That draft legislation has not been altered for its introduction which is a concern and we are continuing those discussions now with members of parliament.¹

1.8 Both the NGF and the Electricity Supply Association of Australia (ESAA) also pointed out that the Bill was addressing problems that are not present in the Australian OTC electricity derivatives market. In particular ESAA noted that the existing Australian OTC electricity derivatives market substantially differed from international markets targeted by the G20 initiated regulatory changes:

The first of those reasons is that the (National Electricity Market) NEM is a mandatory gross market. That means that all electricity on the grid has to be

1 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 5.

sold and bought through the market mechanism that is controlled by the Australian Energy Market Operator. Many other markets around the world are net markets in which participants can trade bilaterally with each other and then simply settle any unders and overs through the spot market as they wish to. As a consequence, much of the selling of electricity and buying on the other hand can be done at a fixed price and with the kinds of non-standard that we need to use the OTC market for, so they would not be captured by this type of legislation, because there is no need to have derivatives involved because of the direct nature of the transaction.

The other reason is that the NEM is an energy-only market, as Mr Everett has already pointed out. The consequence of that is that, for an energy-only market, it is particularly important that prices are allowed to rise and fall with as little constraint as possible. In particular, without occasional very high prices, you lack both the signals for new investment and the possibility for generators—which are very capital intensive—to recover their long-term costs. So the consequence of that is that prices are allowed to move between minus \$1,000 per megawatt hour and up to \$12,900 per megawatt hour. By comparison, the average is about \$50 to \$60, so it is a very significant multiple. In fact, the NEM may be the most volatile commodity market in the world. That puts a very significant premium on being able to manage the risks of the spot market.²

1.9 The NGF also pointed out the highly competitive nature of the Australian electricity sector:

We have perhaps the most competitive wholesale market in the world. When you look at European markets and the domination by a number of players there, we do not have that same domination. In Australia we have a multiplicity of participants. If we look at generation in particular, we have government owned ones in a number of different states, we have private ones and we have renewables. If you go back to the start of the market, the price for generation was about \$45 per megawatt hour. That was without carbon. So if you take it to a current without-carbon equivalent, we are about \$40. So the price is actually lower, and that is in nominal terms, ignoring all the inflation impacts over that time. So we have an incredibly competitive market.³

1.10 The NGF also noted there was no underlying need to increase regulation of the existing OTC electricity derivatives market:

2 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 8.

3 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

To our knowledge, there is no evidence that the OTC electricity derivative markets in Australia pose any risk or material concern to national or global financial stability.⁴

1.11 The NGF highlighted the potential costs of the new regulatory regime for the electricity generation sector:

There are a couple of elements to costs that would be introduced by the regulation if it captured energy derivatives. One would be increasing compliance complexity....The second element of costs is around that collateral cost and the fact that it impairs what would otherwise be good risk management decisions.⁵

We are concerned about there being an additional cost at a time when we are looking at electricity prices increasing by another 40 per cent over the next five years; we are concerned that this may flow through to an additional price increase on top of that.⁶

1.12 The NGF proposed a carve-out of the electricity sector from the provisions of the Bill.

1.13 The ESAA argued for special recognition of the sector's unique nature:

...our view would be that it would be useful if the legislation was able to make some explicit reference to the integrated nature of the physical and derivatives market in the case of electricity. In fact, that has been recognised in the courts from time to time where we included a quote from Justice French to that effect in at least one of our submissions to this process. Ways to do that might include that in the case of any regulations affecting electricity derivatives to perhaps specifically include the energy minister as chair of the Standing Council of Energy and Resources—which comprises the energy ministers of all the states and territories, as well as the Commonwealth—in the decision-making process. Also, to specifically name some of the expert energy market bodies, such as the Australian Energy Market Commission, as being either part of the decision-making process or at least part of the consultation process. So I think if some recognition of the importance of understanding the electricity market in evaluating the electricity derivatives market could be embedded in the bill then, whilst we would consider that a second-best outcome compared to outright exemption, that would go some way to addressing some of our concerns.⁷

4 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 2.

5 Mr Gregory Everett, Director, Electricity, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 3.

6 Mr Timothy Reardon, Executive Director, National Generators Forum, *Proof Committee Hansard*, 5 October 2012, p. 4.

7 Mr Kieran Donoghue, General Manager, Policy, Energy Supply Association of Australia, *Proof Committee Hansard*, 5 October 2012, p. 10.

1.14 Coalition members are pleased that the government members of the committee have at least gone some way in recognising the real concerns of the electricity sector and adopted at least part of ESAA's proposed approach in recommending a requirement that for matters relating to the energy sector the Minister for Resources and Energy be consulted prior to the making of regulations, the mandating of derivatives or consenting to an ASIC rule.

1.15 This requirement to consult the Minister for Resources and Energy should be formally enshrined in the legislation.

1.16 Coalition members of the committee, whilst supporting the majority report and the bill as a whole, remain concerned about the potential impact on the electricity sector and ultimately electricity consumers if not properly addressed.

1.17 Given that Treasury stated that the government has no plans to regulate OTC derivatives in the electricity sector, the current Bill is equivalent to calling the ambulance before you get sick just in case. The argument put by the electricity sector that if there are no plans by government to regulate OTC derivatives in the electricity market⁸ using the provisions in this Bill why the government would not consent to a carve-out of the electricity sector from the scope of this Bill. In particular given the potential implications it has for the cost of electricity.

1.18 We do recommend that the government more seriously consider the impact of this legislation on the electricity sector and ultimately the cost of electricity than it has so far. The government should consider the option of a full carve out of the electricity sector from these new provisions.

Senator Sue Boyce

Senator Mathias Cormann

Paul Fletcher MP

Tony Smith MP

⁸ The Treasury, *Submission 6*, p. 8.

Appendix 1

Submissions received

- 1 Origin Energy
- 3 Energy Supply Association of Australia
- 4 International Power-GDF SUEZ Australia
- 5 Norton Rose
- 6 The Treasury
- 7 The Finance and Treasury Association
- 8 d-cyphaTrade Limited
- 9 Australian Financial Markets Association
- 10 National Generators Forum
- 11 TRUenergy
- 12 Australian Bankers' Association

Appendix 2

Public Hearing

Friday 5 October 2012

Witnesses

National Generators Forum

Mr Tim Reardon, Executive Director

Mr Greg Everett, Director, Electricity

Energy Supply Association of Australia

Mr Kieren Donoghue, General Manager, Policy

The Treasury

Mr Daniel McAuliffe, Manager, Financial Markets Unit

Mr Brenton Thomas, General Manager, Infrastructure Division

