



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 177

Electricity derivative market participants: Financial requirements

May 2012

About this paper

This consultation paper sets out ASIC's proposals on our proposed financial requirements for electricity derivative market participants that issue over-the-counter (OTC) derivatives to manage their financial risk.

The purpose of this paper is to seek feedback on these proposals from electricity derivative market participants, their advisers, counterparties and other interested parties.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 4 May 2012 and is based on the Corporations Act as at the date of issue.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on the financial requirements that electricity derivative market participants should meet. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section E, 'Regulatory and financial impact', p. 19.

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 29 June 2012 to:

Chloe Youl
Senior Lawyer
Strategic Policy
Australian Securities and Investments Commission
email: policy.submissions@asic.gov.au

What will happen next?

Stage 1	4 May 2012	ASIC consultation paper released
Stage 2	29 June 2012	Comments due on the consultation paper
	July 2012	Updates to Regulatory Guide 166 <i>Licensing: Financial requirements</i> (RG 166) drafted
Stage 3	September 2012	Updated RG 166 released

A Background to the proposals

Key points

Australian financial services (AFS) licensees are subject to licensee conduct obligations, including the obligation to maintain adequate financial resources and risk management systems.

Many market participants in the electricity sector deal or make a market in over-the-counter (OTC) derivatives relating to the wholesale price of electricity as part of the ordinary course of their business. They are therefore required to hold an AFS licence with appropriate authorisations, and to meet licensee conduct obligations.

We have decided to review the financial requirements applying to electricity derivative market participants to ensure that they are appropriate for this industry sector. In particular, we have initiated this review having regard to the fact that many of these participants only require an AFS licence in relation to a small proportion of their overall business.

This forms part of our broader review of financial requirements for all AFS licensees.

Our review of financial requirements for AFS licensees

- 1 All Australian financial services (AFS) licensees, unless they are a body regulated by the Australian Prudential Regulation Authority (APRA), are subject to the conduct obligations of Ch 7 of the *Corporations Act 2001* (Corporations Act). Among other things, this includes obligations to have:
 - (a) adequate resources available to provide the financial services covered by the licence and to carry out supervisory arrangements (s912A(1)(d)); and
 - (b) adequate risk management systems (s912A(1)(h)).
- 2 As part of our role as regulator of the financial services industry, we are responsible for setting the financial requirements that an AFS licensee must meet. These are set out in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) and apply to AFS licensees by way of conditions on their AFS licence.
- 3 RG 166 states that ASIC imposes financial requirements on AFS licensees to ensure that:
 - (a) they have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act (including carrying out supervisory arrangements);
 - (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and

(c) there are incentives for owners to comply with the Corporations Act through risk of financial loss.

4 RG 166 imposes various financial requirements on AFS licensees according to the types of financial services they provide. Many of the requirements in RG 166 were set in 2001, when the financial services regime was implemented, and have not been reviewed since this time.

5 We are now progressively reviewing the financial requirements applying to AFS licensees in various industry sectors.

6 In September 2010, we consulted on revised financial requirements for responsible entities of registered managed investment schemes: see Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140). Our amended requirements for responsible entities will commence in November 2012: see draft RG 166 *Financial requirements, including requirements for responsible entities that will apply from November 2012* at Appendix 1 to Report 259 *Response to submissions on CP 140 Responsible entities: Financial requirements* (REP 259).

7 Additionally, we are currently finalising revised financial requirements for issuers of retail over-the-counter (OTC) derivatives: see Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements* (CP 156).

8 We have also recently finalised financial requirements for persons providing financial services in relation to the carbon pricing mechanism established under the Clean Energy Legislative Package (including the Carbon Farming Initiative) as well as other carbon markets: see amended Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146).

Note: The Clean Energy Legislative Package includes the *Clean Energy Act 2011*, the *Carbon Credits (Carbon Farming Initiative) Act 2011*, and the *Australian National Registry of Emissions Units Act 2011*.

9 Our purpose in conducting these reviews is to ensure that the financial requirements applying to each industry sector are appropriate and represent the most suitable mechanisms for achieving the objectives set out in paragraph 3. The approach we have taken for each of the reviews conducted to this point is aimed at:

- (a) ensuring that AFS licensees hold a sufficient stake in the business to warrant their commitment to the success of the business and compliance with their obligations under the Corporations Act;
- (b) ensuring that AFS licensees make adequate provision for expected expenses and carry sufficient financial resources to mitigate against operational risk that could lead to unexpected losses or expenses;
- (c) updating the financial buffer held by AFS licensees to decrease the risk of a disorderly or non-compliant wind-up if businesses fail; and
- (d) simplifying the financial requirements to decrease compliance and regulatory costs and burdens, and to provide certainty.

- 10 ASIC is not a prudential regulator. Therefore, our proposed financial requirements do not seek to prevent AFS licensees from:
- (a) becoming insolvent; or
 - (b) failing because of poor business models or cash flow problems.

The electricity derivative market

- 11 In most Australian states and territories, electricity is bought and sold through wholesale markets, including the National Electricity Market (comprising the eastern states, South Australia and the Australian Capital Territory), and the Wholesale Electricity Market in Western Australia.

Note: At present, there is no equivalent wholesale electricity market in the Northern Territory: Australian Energy Regulator, *State of the energy market 2009*, Australian Competition and Consumer Commission, Melbourne, 2009.

- 12 In the eastern states, South Australia and the Australian Capital Territory, entities generating, distributing, transmitting and selling electricity are subject to the National Electricity Law and the National Electricity Rules, which impose financial requirements as a condition to participating in the National Electricity Market. These requirements may include obtaining an undertaking to provide credit support from an entity under the prudential supervision of APRA. Entities performing similar functions in Western Australia are regulated under the *Electricity Industry Act 2004* (WA), and those participating in the Wholesale Electricity Market must also meet similar financial requirements.

Note 1: The National Electricity Law has been established under a cooperative legislative scheme, and is set out as a schedule to the *National Electricity (South Australia) Act 1996* (SA). The National Electricity Rules are made under the National Electricity Law: see www.aemc.gov.au for more details.

Note 2: Participants in the Wholesale Electricity Market must meet the requirements of the Electricity Industry (Wholesale Electricity Market) Regulations 2004 (WA): see www.imowa.com.au for more details.

- 13 Many of the participants in these wholesale electricity markets also deal and make a market in OTC derivatives relating to the wholesale price of electricity as part of the ordinary course of their business, and are therefore required to hold an AFS licence with appropriate authorisations. For many participants in the wholesale electricity market, derivatives trading is an essential part of managing their exposure to electricity spot prices.

Note: In this paper, we refer to persons incurring actual or contingent liabilities by dealing or making a market in OTC derivatives relating to the wholesale price of electricity as ‘electricity derivative market participants’: see proposal B1.

- 14 Under their current licence conditions, electricity derivative market participants are generally subject to two levels of financial requirements. These are:

- (a) the base level requirements of cash flow and balance sheet solvency and the cash needs requirement (see Section B of RG 166); and
- (b) because they incur actual or contingent liabilities by dealing or making a market in derivatives, the requirement to hold adjusted surplus liquid funds (ASLF) equal to the sum of:
 - (i) \$50,000; plus
 - (ii) 5% of adjusted liabilities between \$1 million and \$100 million; plus
 - (iii) 0.5% of adjusted liabilities for any amount of adjusted liabilities exceeding \$100 million,to a maximum requirement of \$100 million in ASLF.

Note: See Section F of RG 166 for more details on how ASLF is calculated.

Revised financial requirements for electricity derivative market participants

- 15 We have decided to review the financial requirements applying to electricity derivative market participants that deal or make a market in OTC derivatives relating to the wholesale price of electricity.
- 16 As noted above, for many participants in the wholesale electricity market, dealing and making a market in OTC derivatives relating to the wholesale price of electricity is an essential part of managing their exposure to electricity spot prices. Any disruptions to this hedging activity caused by unexpected events are likely to affect not only the AFS licensee concerned but also confidence in the wider market for electricity derivatives.
- 17 The financial requirements ASIC sets for AFS licensees are not prudential requirements; nor are they intended to remove all counterparty risk. However, in reviewing the financial requirements applying to electricity derivative market participants, we are seeking to develop financial requirements that promote the orderly operation of the OTC electricity derivative market by ensuring that AFS licensees make adequate provision for expected expenses and carry sufficient financial resources to mitigate against operational risk that could lead to unexpected losses or expenses.
- 18 The current requirements imposed on these persons include calculating ASLF, which can be complex. Therefore, in reviewing the requirements applying to this sector, we are also seeking to develop financial requirements that are simpler to calculate and apply.
- 19 In conducting this review, we are conscious that the electricity sector is also currently adapting to regulatory change from the introduction of the carbon pricing mechanism. We invite feedback from those affected on any specific implications that meeting these new requirements may have for our proposed financial requirements, including the timing of implementation.

B Scope of our proposed financial requirements

Key points

We propose to introduce new financial requirements for electricity derivative market participants—that is, persons incurring actual or contingent liabilities by dealing or making a market in OTC derivatives relating to the wholesale price of electricity.

However, if any other requirement contained in RG 166 applies to these persons because of other activities they undertake, and this imposes a higher financial requirement, we propose that these persons would meet the higher requirement.

Proposal

B1 We propose that our requirements for cash flow projections and amended financial requirements, as set out in proposals C1–C3, would apply to any electricity derivative market participant, which we will define as a person incurring actual or contingent liabilities by dealing or making a market in OTC derivatives relating to the wholesale price of electricity.

However, if any higher net tangible assets (NTA) requirement contained in RG 166 applies to these persons because of other activities they undertake, they will instead need to meet the higher NTA requirement. Additionally, if RG 166 imposes other, different financial requirements for other licensed activities (e.g. an adjusted surplus liquid funds (ASLF) requirement), they will also need to meet these requirements, although there would be no need to hold separate assets to meet each requirement.

Your feedback

B1Q1 Do you agree with this proposal? Why or why not?

B1Q2 Is there anyone to whom our amended requirements should apply that is not included within the scope outlined in this proposal? Please give details.

B1Q3 Is there anyone to whom our amended requirements should *not* apply that is included within the scope outlined in this proposal? Please give details.

B1Q4 Should ASIC apply different financial requirements to electricity generators and/or electricity retailers that deal and make a market in derivatives relating to the wholesale price of electricity?

B1Q5 Will the approach outlined in this proposal add undue complexity to ASIC's financial requirements? Will you find it difficult to determine which requirements you should meet?

Rationale

- 20 A diverse range of persons are involved in dealing and making a market in OTC derivatives relating to the wholesale price of electricity, including those that undertake this trading to maintain a physical position in the electricity market, and those that trade only for investment purposes.
- 21 We propose to limit the scope of our current proposals for amended financial requirements. If any higher net tangible assets (NTA) requirement contained in RG 166 applies to persons caught by our definition of ‘electricity derivative market participant’ because of other activities they undertake, they will instead need to meet the higher NTA requirement. If other, different requirements of RG 166 apply to because of other activities they undertake (e.g. an ASLF requirement because they deal or make a market in other types of OTC derivatives), electricity derivative market participants would also need to meet these requirements, although there would be no need to hold separate assets to meet each requirement.
- 22 We think that it is appropriate to limit the scope of our proposed new financial requirements in this way. Australian wholesale electricity markets are highly regulated, and we are keen to limit the compliance burden applying to these persons only undertaking financial services activities relating to the wholesale electricity market by ensuring that our financial requirements are as simple and clear as possible, and are appropriate for the nature of this industry sector.

C Our proposed financial requirements for electricity derivative market participants

Key points

We propose to:

- introduce a requirement for longer cash flow projections for electricity derivative market participants; and
- amend the current financial requirements to impose an NTA requirement on electricity derivative market participants, including holding a portion of this NTA in cash or cash equivalents.

Requiring rolling 12-month cash flow projections

Proposal

- c1 We propose that electricity derivative market participants should be required to:
- (a) prepare, on a quarterly basis, rolling cash flow projections with anticipated revenue and expenses over at least 12 months at an individual entity level in a 'business-as-usual' situation;
 - (b) make the cash flow projections available to ASIC on request; and
 - (c) have the cash flow projections approved by the directors of the electricity derivative market participant.

Similarly to the current Option 2 for meeting the cash needs requirement in RG 166, electricity derivative market participants would need to:

- (d) document their calculations and assumptions, and describe in writing why they are the appropriate assumptions;
- (e) update the cash flow projection if they have reason to suspect that an updated projection would show they were not meeting their AFS licence conditions; and
- (f) show, based on the cash flow projection, that they will have access, as needed, to enough financial resources to meet their liabilities over the projected term of at least the next 12 months, including any additional liabilities they might incur during that term.

This requirement would replace all five options currently available to electricity derivative market participants to meet the cash needs requirement: see RG 166.24.

Your feedback

- C1Q1 Do you agree with this proposal? If not, why not?
- C1Q2 What additional costs will be incurred by your business as a result of these proposals? Will there be any cost savings?
- C1Q3 Are there any issues with limiting the options electricity derivative market participants have to meet the cash needs requirement?
- C1Q4 Are there any practical problems with the implementation of this proposal? Please give details.

Rationale

- 23 Cash flow projections are an important tool in identifying potential risks to a business. We propose to introduce a requirement for longer cash flow projections for electricity derivative market participants.
- 24 The electricity market is a dynamic one, and electricity derivative market participants need to anticipate and meet changing conditions. Cash flow projections can assist an electricity derivative market participant to ensure it can meet anticipated expenses.
- 25 This proposal would replace the current cash needs requirement set out in RG 166.22(c). Currently, as part of the base level financial requirements, an AFS licensee must comply with one of the following options (broadly stated):
- (a) show, based on the cash flow projection and on an individual or, in certain cases, group basis, that it will have access to enough financial resources to meet its liabilities over the projected term of at least the next three months, including any additional liabilities that may be incurred during this time;
 - (b) show that an Australian authorised deposit-taking institution (ADI) has given the licensee an enforceable and unqualified commitment to meet the licensee's financial obligations; or
 - (c) if the licensee is a subsidiary of an Australian ADI, or an entity approved for this purpose in writing by us, show:
 - (i) that it reasonably expects (based on funds from related bodies corporate) that it will have adequate resources, when needed, to meet its liabilities for at least the next three months, including any additional liabilities that may be incurred during this time; and
 - (ii) that the basis for the expectation is appropriately documented.
- 26 Requiring rolling 12-month cash flow projections addresses expected operating expenses and should, in many cases, result in a higher level of focus and governance around cash flow projections and cash planning than currently exists.

- 27 We acknowledge that any projection is only as sound as the assumptions on which it is based and the rigour with which it is prepared. For this reason, we think it is important for directors of an electricity derivative market participant to review its cash flow projections. Additionally, we believe that longer cash flow projections would assist the directors of an electricity derivative market participant to identify potential cash flow problems at an earlier stage than they otherwise would under the current financial requirements, providing a greater opportunity to take corrective action.
- 28 Cash flow projections would need to be updated when material changes occur to the cash flow projection assumptions.
- 29 We would maintain the right to request a copy of the cash flow projections at any time and would exercise this right when appropriate. This should increase the likelihood that projections are prepared with the requisite detail, and provide us with a useful tool to more fully understand the workings of an electricity derivative market participant that finds itself in financial distress.
- 30 AFS licensees are required to prepare certain annual financial reports, and to have these audited: Pt 7.8, Div 6 of the Corporations Act. RG 166 provides substantial guidance on the audit requirements for cash flow projections. Currently, there is a requirement for positive assurance on compliance with financial conditions of the AFS licence other than the cash needs requirement. For cash flow projections, however, negative assurance is required on the reasonableness of the assumptions used and positive assurance on their calculation. It is our intention to maintain this approach to the audit requirements.

Changing the financial resource requirements

Proposal

- c2** We propose that electricity derivative market participants should be required to hold net tangible assets (NTA) equal to the greater of:
- (a) \$150,000; or
 - (b) 10% of average revenue (as defined in the key terms).

Eligible undertakings that may be included in the NTA calculation would be limited to those provided by an Australian ADI, an Australian government (as defined in RG 166.185(c)), a foreign deposit-taking institution regulated by an ASIC-approved regulator, a clearing and settlement facility licensee, or an entity that is otherwise approved by us.

Your feedback

- C2Q1 What benefits do you consider will result from this proposal?
- C2Q2 What disadvantages do you consider will result from this proposal?
- C2Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?
- C2Q4 Are there any characteristics specific to the electricity sector that we should consider in the treatment of intangible assets—for example, goodwill relating to retail customers?
- C2Q5 Would complying with this proposal require you to restructure your business in any way?
- C2Q6 What impact will this proposal have on your business costs? How will you manage these changes?
- C2Q7 Are there any practical problems with the implementation of this proposal?
- C2Q8 Will this proposal have any impact on competition?

Proposal

c3 We propose that:

- (a) at least 50% of the required NTA (as set out in proposal C2) should be held in cash or cash equivalents; and
- (b) the remainder of the required NTA should be held in liquid assets (as defined in the key terms).

Additionally, an electricity derivative market participant affected by this proposal should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70 *Australian financial services licensee profit and loss statement and balance sheet*.

Your feedback

- C3Q1 What benefits do you consider will result from this proposal? Is holding more liquid assets likely to assist you to improve your credit rating?
- C3Q2 What disadvantages do you consider will result from this proposal?
- C3Q3 Are there any characteristics specific to the electricity sector that we should consider in setting requirements relating to liquidity—for example, particular ways in which cash flows are managed?
- C3Q4 Would complying with this proposal require you to restructure your business in any way?
- C3Q5 What impact will this proposal have on your business costs? How will you manage these changes?
- C3Q6 Are there any practical problems with the implementation of this proposal?
- C3Q7 Will this proposal have any impact on competition?

Rationale

- 31 NTA is a measure of financial strength currently used in the financial resource requirements applicable to responsible entities, operators of investor directed portfolio services, providers of custodial or depository services, issuers of margin lending facilities and trustee companies providing traditional services: see Section C of RG 166.
- 32 NTA essentially includes all tangible assets less liabilities (excluding certain related party receivables and subordinated debt).
- 33 Electricity markets are complex and dynamic, and persons operating in these markets may be exposed to the risk of financial loss due to operational failures. As well as technical operating failures, loss can arise from information technology system malfunctions or documentation errors, or from unhedged exposure to spikes in electricity prices. While our financial requirements are not intended to provide resources to meet all contingencies, they are intended to provide an increased buffer to assist electricity derivative market participants to meet these kinds of operational risks.
- 34 Setting the required minimum level of NTA at 10% of revenue (determined as the average per year of the actual revenue for the preceding two years and the amount of 12-month revenue predicted in the cash flow projection current at the time) will ensure that the level of financial resources each electricity derivative market participant holds corresponds to the size of its business, and therefore to the size of its operational risk exposure.
- 35 NTA is also a simpler measure of financial resources than either of the other two measures used in RG 166—that is, surplus liquid funds (SLF) or adjusted surplus liquid funds (ASLF). While SLF is NTA excluding non-current assets and liabilities, the ASLF calculation requires AFS licensees to make certain adjustments for the risks affecting certain assets and liabilities. Imposing a requirement based on NTA rather than ASLF is intended to simplify the financial requirements for electricity derivative market participants, and therefore reduce compliance costs for these AFS licensees, as well as making it easier for ASIC and others to assess whether they are complying with their AFS licence conditions.
- 36 To ensure that electricity derivative market participants hold financial resources that can be used effectively to meet unexpected financial losses, we believe that NTA must be held in a highly liquid form. Requiring at least 50% of the required NTA to be held in cash or cash equivalents, with the remainder held in liquid assets, will ensure that these AFS licensees can make appropriate use of their financial resources as and when required.

D Proposed implementation period

Key points

While we consider that it is appropriate to implement the new financial requirements outlined in Section C as soon as possible, we understand that some businesses may require time to prepare to meet the new requirements, including undertaking some restructuring in certain cases.

We propose to implement the new requirements via a staged implementation process.

Proposal

D1 We propose a staged implementation as follows:

- (a) after 12 months, electricity derivative market participants would need to hold NTA equal to the greater of:
 - (i) \$150,000; or
 - (ii) 5% of average revenue (as defined in the key terms);
- (b) after 24 months, electricity derivative market participants would need to hold NTA equal to the greater of:
 - (i) \$150,000; or
 - (ii) 7% of average revenue (as defined in the key terms); and
- (c) after 36 months, electricity derivative market participants would need to meet the proposed requirements in full.

We propose that the cash flow requirements (see proposal C1), and the liquidity requirements (see proposal C3), would apply from the commencement of the staged implementation process.

Your feedback

- D1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this paper?
- D1Q2 When do you think you could be ready to meet the proposals in this paper? Do you require a staged implementation to ensure that you have adequate arrangements in place to meet the proposed requirements?
- D1Q3 Are there any specific implications arising out of the introduction of the carbon pricing mechanism for meeting our proposed financial requirements, including the timing of implementation?

Rationale

- 37 While we consider that our proposals for new financial requirements for electricity derivative market participants are more appropriate than the current requirements applying to these persons, we understand that some businesses may need time to prepare to meet the new requirements, including undertaking some restructuring in certain cases.
- 38 A staged implementation process will enable electricity derivative market participants to put in place appropriate arrangements over a significant period of time.
- 39 However, we consider that, because cash flow projections provide an important tool to anticipate and manage potential risks to the business, electricity derivative market participants should begin to prepare longer cash flow projections as soon as possible.
- 40 Likewise, holding financial resources will only assist electricity derivative market participants to meet unexpected financial losses or expenses if they are held in a highly liquid form. Therefore, we propose that the liquidity requirement outlined in proposal C3, to hold at least 50% of the required NTA to in cash or cash equivalents, with the remainder held in liquid assets, should also apply from the commencement of the staged implementation process.

E Regulatory and financial impact

- 41 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us, we think they will strike an appropriate balance between:
- (a) ensuring that electricity derivative market participants that issue OTC derivatives to manage their financial risk have adequate financial resources to conduct their business in compliance with the Corporations Act and in a responsible manner; and
 - (b) implementing financial requirements in a way that is not overly burdensome.
- 42 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
 - (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
 - (c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 43 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 44 To ensure that we are in a position to properly complete any required RIS, we ask you to provide us with as much information as you can about our proposals or any alternative approaches:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits.

See 'The consultation process' p. 4.

Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASLF	Adjusted surplus liquid funds
Australian ADI	Australian authorised deposit-taking institution—has the meaning given in s9
average revenue	For licensees up to and including the second year of operation—means the average per year of: <ul style="list-style-type: none"> the actual annualised revenue for the current year; and the amount of 12-month revenue predicted in the cash flow projection current at the time. For licensees after the first two years of operation—means the average per year of: <ul style="list-style-type: none"> the actual revenue for the preceding two years; and the amount of 12-month revenue predicted in the cash flow projection current at the time
cash or cash equivalents	Has the meaning given in the Australian accounting standards—that is, ‘cash’ is cash on hand and demand deposits; and ‘cash equivalents’ are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
electricity derivative market participant	A person incurring actual or contingent liabilities by dealing or making a market in OTC derivatives relating to the wholesale price of electricity
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act

Term	Meaning in this document
financial services business	A business of providing financial services <p>Note: This is a definition contained in s761A. The meaning of 'carry on a financial services business' is affected by s761C.</p>
liquid assets	Means an AFS licensee's assets that are free from encumbrances, and, in the case of receivables, free from any right of set-off, and that are: <ul style="list-style-type: none"> • money in an account or money on deposit with a bank that is available for withdrawal immediately, or otherwise on maturity of a fixed term not exceeding six months during the normal business hours of the bank; • a bank bill with a maturity date not exceeding six months; or • assets the AFS licensee can reasonably expect to realise for their market value within six months
NTA (net tangible assets)	Means an AFS licensee's adjusted assets less adjusted liabilities, as defined in RG 166
OTC derivatives	Over-the-counter derivatives
retail client	A client as defined in s761G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations
RG 148 (for example)	An ASIC regulatory guide (in this example numbered 148)
s766E (for example)	A section of the Corporations Act (in this example numbered 766E), unless otherwise specified
SLF	Surplus liquid funds
wholesale client	A client as defined in s761G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations

List of proposals and questions

Proposal	Your feedback
<p>B1 We propose that our requirements for cash flow projections and amended financial requirements, as set out in proposals C1–C3, would apply to any electricity derivative market participant, which we will define as a person incurring actual or contingent liabilities by dealing or making a market in OTC derivatives relating to the wholesale price of electricity.</p> <p>However, if any higher net tangible assets (NTA) requirement contained in RG 166 applies to these persons because of other activities they undertake, they will instead need to meet the higher NTA requirement. Additionally, if RG 166 imposes other, different financial requirements for other licensed activities (e.g. an adjusted surplus liquid funds (ASLF) requirement), they will also need to meet these requirements, although there would be no need to hold separate assets to meet each requirement.</p>	<p>B1Q1 Do you agree with this proposal? Why or why not?</p> <p>B1Q2 Is there anyone to whom our amended requirements should apply that is not included within the scope outlined in this proposal? Please give details.</p> <p>B1Q3 Is there anyone to whom our amended requirements should <i>not</i> apply that is included within the scope outlined in this proposal? Please give details.</p> <p>B1Q4 Should ASIC apply different financial requirements to electricity generators and/or electricity retailers that deal and make a market in derivatives relating to the wholesale price of electricity?</p> <p>B1Q5 Will the approach outlined in this proposal add undue complexity to ASIC’s financial requirements? Will you find it difficult to determine which requirements you should meet?</p>
<p>C1 We propose that electricity derivative market participants should be required to:</p> <ul style="list-style-type: none"> (a) prepare, on a quarterly basis, rolling cash flow projections with anticipated revenue and expenses over at least 12 months at an individual entity level in a ‘business-as-usual’ situation; (b) make the cash flow projections available to ASIC on request; and (c) have the cash flow projections approved by the directors of the electricity derivative market participant. <p>Similarly to the current Option 2 for meeting the cash needs requirement in RG 166, electricity derivative market participants would need to:</p> <ul style="list-style-type: none"> (d) document their calculations and assumptions, and describe in writing why they are the appropriate assumptions; (e) update the cash flow projection if they have reason to suspect that an updated projection would show they were not meeting their AFS licence conditions; and (f) show, based on the cash flow projection, that they will have access, as needed, to enough financial resources to meet their liabilities over the projected term of at least the next 12 months, including any additional liabilities they might incur during that term. <p>This requirement would replace all five options currently available to electricity derivative market participants to meet the cash needs</p>	<p>C1Q1 Do you agree with this proposal? If not, why not?</p> <p>C1Q2 What additional costs will be incurred by your business as a result of these proposals? Will there be any cost savings?</p> <p>C1Q3 Are there any issues with limiting the options electricity derivative market participants have to meet the cash needs requirement?</p> <p>C1Q4 Are there any practical problems with the implementation of this proposal? Please give details.</p>

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<p>requirement: see RG 166.24.</p>	
<p>C2 We propose that electricity derivative market participants should be required to hold net tangible assets (NTA) equal to the greater of:</p> <ul style="list-style-type: none"> (a) \$150,000; or (b) 10% of average revenue (as defined in the key terms). <p>Eligible undertakings that may be included in the NTA calculation would be limited to those provided by an Australian ADI, an Australian government (as defined in RG 166.185(c)), a foreign deposit-taking institution regulated by an ASIC-approved regulator, a clearing and settlement facility licensee, or an entity that is otherwise approved by us.</p>	<p>C2Q1 What benefits do you consider will result from this proposal?</p> <p>C2Q2 What disadvantages do you consider will result from this proposal?</p> <p>C2Q3 Do you think a requirement to hold NTA equal to 10% of average revenue is unreasonable? If so, why?</p> <p>C2Q4 Are there any characteristics specific to the electricity sector that we should consider in the treatment of intangible assets—for example, goodwill relating to retail customers?</p> <p>C2Q5 Would complying with this proposal require you to restructure your business in any way?</p> <p>C2Q6 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>C2Q7 Are there any practical problems with the implementation of this proposal?</p> <p>C2Q8 Will this proposal have any impact on competition?</p>
<p>C3 We propose that:</p> <ul style="list-style-type: none"> (a) at least 50% of the required NTA (as set out in proposal C2) should be held in cash or cash equivalents; and (b) the remainder of the required NTA should be held in liquid assets (as defined in the key terms). <p>Additionally, an electricity derivative market participant affected by this proposal should report its NTA position, together with detailed workings, to ASIC as part of its annual submission of Form FS70 Australian financial services licensee profit and loss statement and balance sheet.</p>	<p>C3Q1 What benefits do you consider will result from this proposal? Is holding more liquid assets likely to assist you to improve your credit rating?</p> <p>C3Q2 What disadvantages do you consider will result from this proposal?</p> <p>C3Q3 Are there any characteristics specific to the electricity sector that we should consider in setting requirements relating to liquidity—for example, particular ways in which cash flows are managed?</p> <p>C3Q4 Would complying with this proposal require you to restructure your business in any way?</p> <p>C3Q5 What impact will this proposal have on your business costs? How will you manage these changes?</p> <p>C3Q6 Are there any practical problems with the implementation of this proposal?</p> <p>C3Q7 Will this proposal have any impact on competition?</p>

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<p>D1 We propose a staged implementation as follows:</p> <ul style="list-style-type: none"> (a) after 12 months, electricity derivative market participants would need to hold NTA equal to the greater of: <ul style="list-style-type: none"> (i) \$150,000; or (ii) 5% of average revenue (as defined in the key terms); (b) after 24 months, electricity derivative market participants would need to hold NTA equal to the greater of: <ul style="list-style-type: none"> (i) \$150,000; or (ii) 7% of average revenue (as defined in the key terms); and (c) after 36 months, electricity derivative market participants would need to meet the proposed requirements in full. <p>We propose that the cash flow requirements (see proposal C1), and the liquidity requirements (see proposal C3), would apply from the commencement of the staged implementation process.</p>	<p>D1Q1 Do you agree with the proposed timeframe for the implementation of the proposals in this paper?</p> <p>D1Q2 When do you think you could be ready to meet the proposals in this paper? Do you require a staged implementation to ensure that you have adequate arrangements in place to meet the proposed requirements?</p> <p>D1Q3 Are there any specific implications arising out of the introduction of the carbon pricing mechanism for meeting our proposed financial requirements, including the timing of implementation?</p>