ASIC

Australian Securities & Investments Commission

**REPORT 320**

# Response to submissions on CP 177 Electricity derivative market participants: Financial requirements

December 2012

## About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 177 *Electricity derivative market participants: Financial requirements* (CP 177) and details our responses to those issues.

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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.

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- 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).

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## Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).

# Contents

# A Overview

1 In Consultation Paper 177 *Electricity derivative market participants: Financial requirements* (CP 177), we consulted on revised financial requirements for over-the-counter (OTC) electricity derivative market participants.

2 This report highlights the key issues arising from the submissions received to CP 177 and our responses to those issues.

3 This report is not a comprehensive compilation of all responses we received, nor does it detail every question from CP 177. This report is limited to the key issues. For a list of the non-confidential respondents to CP 177, see the appendix. Copies of the submissions are on our website at www.asic.gov.au/cp under CP 177.

## ASIC's role in the OTC electricity derivative market

4 In most Australian states and territories, electricity is bought and sold through wholesale markets. Many of the participants in these physical 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 Australian financial services (AFS) licence with appropriate authorisations. For many participants in the physical electricity market, derivative 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'.

5 ASIC is therefore responsible for licensing and monitoring the financial services activities of electricity businesses. However, we have no role in regulating the physical electricity business of electricity derivative market participants.

6 Other regulators with responsibility for various aspects of the electricity sector include the Australian Energy Market Commission (AEMC), the Australian Energy Market Operator (AEMO) and the Australian Energy Regulator (AER). In particular, the AEMC is currently consulting on the resilience of the financial relationships and markets that underpin the operation of the National Electricity Market (NEM).

## Our financial requirements for AFS licensees

7 All AFS licensees must comply with certain general conduct obligations under the *Corporations Act 2001* (Corporations Act). Among other obligations, AFS licensees must maintain:

(a) adequate resources to provide the financial services covered by their licence and to carry out supervisory arrangements (s912A(1)(d)); and

(b) adequate risk management systems (s912A(1)(h)).

8 We have set financial requirements that AFS licensees must meet, according to the types of financial services they provide. These are explained in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). We generally apply our financial requirements by using our statutory power to modify Pt 7.6, or by AFS licence conditions.

9 We set minimum financial requirements to promote appropriate financial risk management, taking into account the nature, scale and complexity of an AFS licensee's business. While our requirements are not aimed at preventing licensee failure, they are intended to help ensure that cash shortfalls do not put compliance with the licensee's obligations at risk.

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

(a) the base level financial 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 D of RG 166 for more details on how ASLF is calculated.

## Consultation Paper 177

11 We initiated our review in CP 177 to investigate whether the current financial requirements are promoting the orderly operation of the OTC electricity derivative market, and adequate risk management by participants.

12 As with all AFS licensees, we are concerned to ensure that electricity derivative market participants have sufficient financial resources to ensure they can meet their obligations under the Corporations Act. This includes making adequate provision for the types of risks that are characteristic of OTC derivative markets, particularly counterparty risk and operational risk.

Note: By 'counterparty risk' we mean the potential for one party to a contract to be unable to fulfil its obligations, resulting in loss for the other party. By 'operational risk' we mean the failure of people, processes and systems, resulting in financial loss.

13 In CP 177, we proposed revising the financial requirements applicable to electricity derivative market participants so that these participants would be required to:

(a) prepare rolling cash flow projections with anticipated revenue and expenses, have those projections approved by the board of directors, and make them available to ASIC on request;

(b) hold net tangible assets (NTA) equal to the greater of:

(i) $150,000; or

(ii) 10% of average revenue; and

(c) ensure at least 50% of the required NTA is held in cash or cash equivalents, with the remainder held in liquid assets.

## Responses to consultation

14 We received 10 written responses to CP 177, including three confidential submissions. We are grateful to respondents for taking the time to provide us with their comments.

15 Key issues raised in submissions related to:

(a) the rationale for changing the current requirements, with many respondents arguing that electricity derivative market participants are adequately managing their exposure to financial risk under the current requirements;

(b) whether revenue is an appropriate measure to set financial requirements for electricity businesses;

(c) concern that implementing the proposed liquidity requirements could require significant expense; and

(d) the timing of the review and the implementation of any new requirements, given that the electricity sector is currently adapting to various regulatory changes, including the introduction of the carbon pricing mechanism on 1 July 2012.

16 After considering the feedback we received in submissions, we do not believe that the approach proposed in CP 177 is the best way to ensure electricity derivative market participants address the risks on which our financial requirements for AFS licensees are focused. Therefore, we do not intend to implement the proposed revenue-based NTA and liquidity requirements. Section B provides more details on the issues raised in submissions, our responses to those specific issues, and our rationale for not implementing the proposed requirements.

17 Nevertheless, we remain concerned about how electricity derivative market participants are managing risk. Section C sets out our approach for the next phase of our review, including an indication of alternative requirements that we may consult on in the future. Our intended approach takes into account Australia's implementation of the G20 reforms to OTC derivative markets.

Note: The Group of 20, or G20, includes 19 member countries and the European Union. Its mandate is to foster discussion on means to promote international financial stability. The G20 directives for reforming OTC derivative markets are described in more detail in Section C.

# B Response to submissions on CP 177

**Key points**

This section outlines the key issues covered in submissions to CP 177 and our responses to these issues.

It covers our proposals for:

- requiring rolling 12-month cash flow projections;
- implementing a net tangible assets (NTA) requirement; and
- requiring at least 50% of the required NTA to be held in cash or cash equivalents, and the remainder in liquid assets.

It also discusses our findings on risk management practices of electricity derivative market participants.

## The proposed new financial requirements

18 Many respondents to CP 177 argued strongly against making any change to the current requirements. They raised the specific issues detailed below.

### Requiring rolling 12-month cash flow projections

19 Many respondents were supportive of the role that longer term cash flow projections could play in a business. However, there was concern that requiring projections to be approved by directors would add an additional and unnecessary level of complexity to current compliance arrangements. Some submissions noted that directors already frequently review cash flow projections, but stated that crystallising this practice into a formal requirement would increase the pressure on directors' time.

### Implementing a revenue-based NTA measure

20 There was broad concern with the implementation of a revenue-based financial measure. Submissions argued strongly that there is insufficient connection between OTC derivative exposure and total revenue for many electricity derivative market participants to justify this approach. They noted that revenue may be driven by a range of factors unrelated to derivative trading, including energy consumption patterns and demand, and, in the case of electricity retailers, a component that is passed through to third parties such as distributors. Some respondents suggested any revenue-based NTA measure should be capped.

## Applying liquidity requirements

21 Respondents were concerned that maintaining the required NTA in liquid assets (including 50% in cash or cash equivalents) would be onerous, and could require the expense of borrowing extra liquid assets in some cases, or restrict the use of working capital.

> *ASIC's response*
>
> We do not intend to implement the revenue-based NTA and liquidity requirements proposed in CP 177. From the feedback we received, we no longer believe that these requirements are the best way to address the risks on which our financial requirements are intended to focus. Additionally, as outlined in Section C, since releasing CP 177, we have gained additional understanding of participants' current risk management practices, and this has informed our views.
>
> Revenue provides a pertinent indicator of risk exposure for many AFS licensees. It ensures that the level of financial resources held corresponds with the size of a licensee's business, and therefore increases in proportion with the size of its operational risk exposure.
>
> However, we recognise that, for many electricity derivative market participants, derivative trading is only one component of a diverse business, which generally includes the production or sale of electricity, and often other sources of energy. Therefore, using revenue as a measure may result in financial requirements that are not appropriately targeted to match the risks associated with the financial services component of the business.
>
> In recent reviews of financial requirements applying to AFS licensees in other industry sectors, we have mandated that the required financial resources should be held in a highly liquid form. This ensures that they will actually be available to assist licensees to meet unexpected financial losses or expenses if required: see Report 259 *Response to submissions on CP 140 Responsible entities: Financial requirements* (REP 259) and Report 293 *Response to submissions on CP 156 Retail OTC derivative issuers: Financial requirements* (REP 293). Such liquidity requirements augment the base level financial requirements applying to all licensees to ensure that they have sufficient resources to meet anticipated cash flow expenses: see Section B of RG 166.
>
> While we do not intend to implement the proposed liquidity requirements, any future changes we propose for this sector will take into account the need to ensure that the financial requirements ASIC mandates prepare AFS licensees to meet unexpected financial losses or expenses.
>
> We acknowledge concerns that requiring directors to approve cash flow projections could increase AFS licensees' compliance burden. However, we consider that it is critical that there is a

rigorous level of governance around the process of anticipating future expenses and risks to a business. We are gradually applying the requirement to prepare cash flow projections and have them approved by directors to all AFS licensees, as appropriate, and may apply this requirement to electricity derivative market participants after future consultation.

## Rationale for the review

22 Many respondents to CP 177 queried the rationale for reviewing the financial requirements applying to electricity derivative market participants.

23 They noted that, for most participants in the wholesale electricity market, derivative trading is an essential part of minimising their exposure to electricity spot prices, and is part of a comprehensive risk management strategy. These respondents argued that, because risk management is already embedded in the business practices of most electricity derivative market participants, there is no reason to change the financial requirements applying to them, particularly if those new requirements are more onerous than those currently applied.

*ASIC's response*

We understand that using derivative trading to hedge against the volatile nature of the electricity spot price is an essential part of risk management for many electricity derivative market participants.

However, we are concerned that, in some cases, risk management practices in the OTC electricity derivative market differ from the kinds of risk management practices that are now typical in the broader OTC derivative market. We think that the OTC electricity derivative market would benefit from participants adopting risk management practices that are more consistent with those used by participants in the broader market: see Section C.

While ASIC regulates the financial services activities of electricity businesses, we have no role in regulating the physical electricity business of electricity derivative market participants.

We are concerned that there is no single regulator of the physical and electricity derivative markets. There are strong connections between both aspects of an electricity business. Any interruptions to the physical electricity business may risk obligations under derivative contracts not being met, and vice versa.

The electricity sector is systemically important, and any disruption to it could affect both the real and possibly potentially the financial economies. This suggests to us that a regulator with a more prudential focus which, unlike ASIC, had power to monitor both the physical and financial aspects of electricity businesses could address the broader systemic risks in the electricity sector.

# C Our strategy for future work

**Key points**

While we have decided not to implement the changes to financial requirements for electricity derivative market participants proposed in CP 177, we remain concerned about the quality of participants' risk management practices.

The OTC electricity derivative market may benefit from participants being required to meet some of the reforms to OTC derivative markets proposed by the G20.

However, if these reforms are ultimately not applied to electricity derivatives, we will consult further on applying similar requirements through our AFS licensee financial requirements.

24 While we have decided not to proceed to implement the financial requirements for electricity derivative market participants proposed in CP 177, we nevertheless remain concerned about risk management practices in this sector.

25 We think new requirements specifically aimed at improving risk management practices for electricity derivative transactions would greatly benefit the OTC electricity derivative market. Some of these new requirements may be applied through the implementation in Australia of reforms to OTC derivative markets proposed by the G20. If electricity derivatives are ultimately not included in these reforms, we will consult on adapting components of these new requirements that we consider address specific issues in the OTC electricity derivative markets through the AFS licensee financial requirements.

## G20 reforms and electricity derivatives

26 Following recent times of financial crisis, there has been significant international discussion on reforms to OTC derivative markets to better promote their ongoing stability.

27 International consensus has now developed around four key reforms to OTC derivative markets, which have been most notably articulated and recommended by the G20. These are:

(a) OTC derivative contracts should generally be reported to trade repositories.

(b) All standardised OTC derivatives should be cleared through central counterparties.

(c) Where possible and appropriate, OTC trading of standardised derivatives should transition to trading on exchanges or electronic platforms.

(d) Non-centrally cleared derivative contracts should be subject to some additional financial requirements. These could include margining requirements.

28 Many jurisdictions are now in the process of implementing regulatory reforms to give effect to these commitments.

29 In Australia too, work is progressing to implement these reforms. The Australian Parliament recently passed legislation to establish a framework to implement Australia's G20 commitments: *Corporations Legislation Amendment (Derivative Transactions) Act 2012*. Rules made under this framework could mandate trade reporting, central clearing, transitioning of some OTC markets to platforms, and ultimately margining requirements for non-centrally cleared derivatives.

30 At this stage, it is unclear which, if any, are likely to apply to electricity derivatives. In particular, we recognise that it may be difficult to apply rules concerning central clearing and transitioning to exchanges or platforms to electricity derivatives, as they may be traded via instruments with non-standard features. Additionally, further consideration is required to determine whether reporting rules can be applied to electricity derivatives to ensure that any data collected by this process will provide useful information.

31 However, we consider that the fourth element of the G20 reforms, concerning additional financial requirements for non-centrally cleared derivatives (described in paragraph 27(d)), may be particularly appropriate for electricity derivative markets.

32 Applying additional financial requirements to non-centrally cleared derivatives is aimed at addressing the counterparty risk associated with OTC markets, which do not involve the procedures and guarantees of a trading platform or exchange. In particular, requirements involving the exchange of collateral address the risk of default by a counterparty, by better equipping the surviving counterparty to re-enter the market and obtain a replacement trade.

## Managing risk in the OTC electricity derivative market

33 While operational and market risks are also significant, counterparty risk is a key risk in OTC electricity derivative markets. If a counterparty to a derivative trade defaults, the surviving counterparty will be exposed to prices in the physical market. The surviving counterparty will then be under pressure to obtain a replacement trade as quickly as possible. Often, a default to a trade will have been caused by an operational fault in electricity generation or supply. This interruption may result in volatility in physical market prices, and in these conditions it may be more difficult for the surviving counterparty to put in place a replacement trade.

34 Counterparty risk in the OTC electricity derivative market may be intensified by some distinctive characteristics of this market. These include:

(a) the concentration of the market, and interdependency of key players—just over 90% of OTC market trading in electricity derivatives is engaged in by eight entities, and over 70% of trading by the three most significant entities;[1] and

(b) the lack of bank intermediation in the OTC derivative market—data gathered in a recent survey of electricity derivative market participants indicated about 25% of electricity derivatives were traded with banks and financial institutions, while the bulk were traded among generators and retailers (74%).[2]

35 ASIC, the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) have recently released a report (joint report) on the Australian OTC derivative market, based on a voluntary survey of around 60 market participants.[3] The results of this survey will provide an empirical foundation for considering how best to implement the G20 reforms in Australia.

Note: We have been working with APRA, the RBA and Treasury for some time to assess the need for reform to the Australian OTC derivative market, through our participation in the Council of Financial Regulators. In March 2012, the Council of Financial Regulators published a report recommending the creation of a legislative framework for the implementation of the reforms: see Council of Financial Regulators, *OTC derivatives market reform considerations*, March 2012.

36 This joint report covered electricity derivatives as part of the OTC market and noted that the interdependency of electricity derivative market participants makes it particularly vital that they have in place appropriate risk management practices. However, the report highlighted some significant differences in the risk management practices deployed by electricity

[1] Australian Financial Markets Association (AFMA), *2012 Australian financial markets report*, AFMA, 2012.
[2] APRA, ASIC and RBA, *Report on the Australian OTC derivatives market*, Council of Financial Regulators, October 2012.
[3] ibid.

derivative market participants relative to participants in other OTC derivative markets. In particular, the report found:

(a) Most electricity derivative market participants do not use credit support agreements to accompany derivative trades, which are common in other markets. Instead, they tend to use alternative arrangements such as letters of credit or parent guarantees.

Note: Credit support agreements are typically incorporated into a derivative contract, and involve an agreement between counterparties as to the level of exposure to one another they will permit before certain additional requirements are triggered. These generally consist of margining requirements, including the initial exchange of collateral, and sometimes the provision of ongoing variation margins.

(b) Additionally, in many cases, trades are not accompanied by any exchange of cash or other forms of collateral between counterparties, particularly where counterparties assess one another as being of high creditworthiness.

37 The joint report found that these factors may lead to large uncollateralised exposures among participants, and noted that this could make them particularly vulnerable if a counterparty were to default, with the potential to impact the resilience and stability of this market. The report recommended that it may be appropriate to strengthen risk management practices—for example, by requiring participants to establish, over an appropriate period of time, credit support agreements (or equivalent arrangements).

38 The survey results in the joint report confirm some findings from our own regulatory experience. We have generally found that risk management practices in the OTC electricity derivative market diverge from practices that are common in the broader OTC derivative market. In addition to the areas outlined in paragraph 36, we have also found that some electricity derivative market participants do not assess their risk exposure on a sufficiently regular basis—for example, by only undertaking a mark-to-market valuation of their net derivative position on a monthly or quarterly basis, rather than daily as is undertaken by many OTC derivative market participants.

## Our proposed approach

39 The details of whether and how the G20 reforms are to be applied to electricity derivatives in Australia are yet to be determined, and some elements of the reforms may be more appropriate for electricity derivatives than others. However, at this stage, we propose to wait until the implementation of the G20 reforms in Australia is more settled before completing our review of financial requirements for electricity derivative market participants.

40 If the G20 reforms are ultimately not applied to electricity derivatives, we think that some aspects of the reforms may be appropriate for the OTC electricity derivative market. In this case, we would consult further on new financial requirements that have a similar focus on risk management practices to some of the measures proposed by the G20.

41 Now that we have further specific information about the OTC electricity derivative market from the recent survey, we no longer consider that the best approach to financial requirements for participants is to implement enhanced liquid capital requirements of the kind proposed in CP 177. Rather we would consult on proposals that could involve the following:

(a) putting in place credit support agreements (or equivalent arrangements) for all trades, including requiring margining requirements above specified trading thresholds based on the scale of the participant's trading activities; and

(b) having a comprehensive risk management policy, approved by directors.

These new requirements would likely replace the current AFS licence requirements.

42 Depending on the progress of the international discussion on OTC derivative market reforms, we would look to this for guidance on the specific matters that we think are appropriate for OTC electricity derivative markets, such as setting requirements relating to margining. By waiting until the G20 reforms are more settled, we will not risk pre-empting international developments in this area.

43 Finally, we note that, once the G20 reforms are more settled, we are likely to undertake a general review of financial requirements for all AFS licensees that deal or make a market in OTC wholesale derivatives. We will do this to ensure that the relevant financial requirements are still appropriate and not duplicative in light of the G20 reforms, and will make amendments where necessary.

# Appendix: List of non-confidential respondents

- Australian Financial Markets Association
- AGL Energy
- Alinta Energy
- Clayton Utz
- National Generators Forum
- Energy Supply Association of Australia, Energy Retailers Association of Australia, National Generators Forum and the Private Generators Group (joint submission)
- TRUenergy