



24 August 2004

Ms Loretta Boman
Acting Executive Director
Ministerial Council of Energy
Office of Energy
Department of Natural Resources, Mines and Energy
GPO Box 2454
Brisbane QLD 4001

Initially by email: loretta.bowman@treasury.qld.gov.au

Dear Ms Boman

It has recently been brought to the attention of the Australian Financial Market Association [AFMA] that Charles River Associates (Asia Pacific) Pty Ltd [CRA] has compiled a draft report on the Criteria for a Review of Regional Boundaries, on behalf of the Ministerial Council of Energy [MCE]. It is our understanding that following input from the MCE, this report will be subject to a consultation process prior to finalisation. AFMA would appreciate the opportunity to be involved in this consultation process.

AFMA is the peak body in Australian Over-the-Counter financial markets and has been involved extensively in the development of the electricity financial market. The majority of physical electricity industry participants are members of AFMA. Whilst some of our members have made individual submissions, it is worth noting that AFMA's advantage is that it is able to present a unified view, focused on the impact of the reviews' findings on the financial market, independent of individual organisational issues.

Organisations active in the electricity financial market are not necessarily participants in the physical industry. However, the majority of the former organisations are members of AFMA.

The financial market is a key component to be considered in this review, as it is the mechanism by which price risk is managed and price signals are projected into the future. Too often, issues that impact the financial market's efficiency are either ignored or merely noted as subjective issues with only passing reference to their materiality relative to other issues or benefits.

Indeed, this was noted as one of the findings in the Ministerial Council on Energy Report (The Parer Report), "Towards a Truly National and Efficient Energy Market" (2002). Finding 5.2 recommended that "The National Electricity Code should reflect the principle that the impact of any changes to the Code must assess and take into account the likely impact on financial market activity." It is in the spirit of this

Australian Financial Markets Association
ABN 69 793 968 987

Level 6, 15 Castlereagh Street Sydney GPO Box 3655 Sydney NSW 1044 Tel: (61 2) 9776 4411 Facsimile: (61 2) 9776 4488

recommendation that AFMA makes this submission on behalf of the electricity financial market.

It is our understanding that one possible outcome of the Regional Boundary Review could be a move to Nodal Pricing.

The issues for the financial market associated with Nodal Pricing can be summarised as follows:

- **Market Disruption Events** – The majority of electricity financial instruments are executed under the International Swaps and Derivatives Association Master Agreement [ISDA MA] and an electricity specific Schedule to it. Such transactions will therefore define a change in boundaries of the region as a Market Disruption Event. This will trigger an initial fallback of price renegotiation for an estimated \$8bn of hedge transactions. If the parties cannot agree an outcome by successful negotiation, a determination by a Calculation Agent is required. Given the experiences associated with the default of Enron Australia, this would almost certainly result in protracted disputes, substantial (and unnecessary) legal costs and major disruptions to market liquidity and a lack of focus on genuine risk management issues;
- **Re-draft of Schedules to, and renegotiation of, the ISDA MA** – The impact of a Market Disruption Event, based on the Enron experience, is likely to give rise to a redraft of ISDA Schedules and renegotiation of ISDA documentation among the majority of parties. This process could take a number of years and would significantly reduce market liquidity, thereby constraining the ability of market participants to effectively manage risk in the interim; and
- **Dilution of the derivatives market** – The volume of transactions executed against any given node will be diluted through the introduction of many more pricing nodes. This would manifest itself as increased costs, either in the form of wider bid/offer spreads on more but less active nodes or through increases in the level of basis risk which organisations are forced to carry due to the inevitable emergence of a large number of inactive and rarely traded nodes.

Members of the AFMA Electricity/Energy Committee would welcome the opportunity to work with the MCE and/or CRA as appropriate, in expanding on the issues raised in this letter and in developing some quantitative analysis on these issues.

Yours sincerely



Kenton G Farrow
Chief Executive
AFMA



Andy Young
Chairman
AFMA Electricity/Energy Committee

Australian Financial Markets Association
ABN 69 793 968 987

Level 6, 15 Castlereagh Street Sydney GPO Box 3655 Sydney NSW 1044 Tel: (61 2) 9776 4411 Facsimile: (61 2) 9776 4488