



8 October 2014

Settlements Team
Australian Energy Markets Operator

By email: settlements@aemo.com.au

Dear Settlements Team

CDEII Index Procedures Review

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the Carbon Dioxide Equivalent Intensity Index Procedures Review. AFMA represents the interests of participants in Australia's wholesale banking, financial and energy markets. Our members include Australia's major energy companies and other users of over-the-counter electricity derivatives.

As the national association for participants in the wholesale financial markets, AFMA has established trading protocols and developed standard contract documentation, as well as providing data services, dealer accreditation, training and other services to facilitate the efficient operation and development of the markets.

Our response relates primarily to your section entitled **Significance of the CDEII** and the questions posed within:

Given the carbon tax repeal, do stakeholders still see value in the CDEII? How does it benefit the market as a whole? Is there still a need to have it calculated and published in its current form? For a limited time or indefinitely?

Importance to the electricity derivatives market

Standard AFMA documentation is commonly used as the default for the brokered market in OTC electricity contracts. The most commonly used documentation for electricity market participants is known as the Australian Carbon Benchmark Addendum. (the "Addendum").

The Addendum was developed by members of AFMA in the latter part of the last decade to deal with the uncertainty as to the impact of potential Carbon Scheme(s) on the National Electricity Market pool price. AFMA members acknowledged that a Carbon Scheme was likely to have a material effect on electricity derivative pricing, dependent on the future price of carbon. Trading forward contracts for electricity therefore required a mechanism to allow parties to agree on the impact of the future price of carbon in their negotiations despite regulatory uncertainty, and the mechanism developed through AFMA is one means of doing so. The Addendum was therefore designed to facilitate financial markets trading by managing the legislative risk associated with the cost of carbon.

The risk reduction benefits provided by the Addendum are significant, as it allows for the risks of a failure of the scheme to commence (or the risk of scheme termination) to be dealt with in a transparent and efficient manner, and thereby enhances liquidity.

Derivative contracts comprise an agreement to pay (receive) a fixed price and receive (pay) a floating price. In the case of electricity derivatives the floating price is determined by AEMO publishing a spot price for each of 5 NEM regions in real time. The Addendum provides for an adjustment to the Fixed Price (or, optionally, the Floating Price) in an electricity transaction (in \$/MWh) derived from the Average Carbon Intensity (ACI) and the Carbon Reference Price (CRP). This carbon price adjustment is intended to reflect the broad impact of a Carbon Scheme on NEM spot prices and is taken into account when determining the amount to be paid on each Settlement Date.

The ACI is sourced from AEMO's NEM-wide Carbon Dioxide Equivalent Intensity Index (CDEII). Consequently the CDEII is a critical component for the carbon price adjustment in these widely-used contracts, and consequently it benefits the market as a whole.

Carbon tax repeal

Following the recent repeal of the clean energy legislation, including the carbon price, it is prudent to review the CDEII in this context.

Reducing carbon emissions remains a key priority on a global scale, and will continue to be for the foreseeable future. As the recent United Nations Climate Summit illustrated, carbon pricing is growing in importance as a key method for reducing emissions. In Australia, despite the recent removal of the carbon price, the probability of a reintroduction of a carbon pricing mechanism at some stage in the future is considerable. A measure of emissions intensity such as the CDEII will continue to remain important indefinitely for this and other policy reasons.

The initial driver for the development of the Addendum, i.e., legislative uncertainty, remains, and derivative contracts utilising the AFMA Carbon Addendum are still the primary form of over-the-counter transactions in Australia. Despite the recent repeal of the carbon tax, the CDEII remains an important price component of the documentation, and will continue to do so. Given the documentation's reliance on the CDEII, there is the possibility that cessation of publication of the CDEII would represent a price source disruption trigger under International Swaps and Derivatives Association (ISDA)

documentation. This would be an undesirable outcome for market participants with potentially widespread unintended adverse effects on the functioning of the electricity derivatives market in Australia.

Finally, from a data completeness perspective, it is important for data such as the CDEII to meet requirements of current as well as future demand for information. It would be a disappointment for the CDEII to cease publication for a period of time, only to be required again in the future as circumstances change.

Conclusion

In summary, the CDEII is an important component of the most common form of over-the-counter electricity derivatives documentation, the AFMA Carbon Addendum, and hence it is of significant importance for the electricity market as a whole, and will continue to be so in the future, regardless of the recent carbon tax repeal. Given that emissions reduction will remain an issue for Australia for the foreseeable future, and legislative uncertainty remains with respect to carbon pricing in particular, AFMA recommends the publication of this index indefinitely.

Please contact myself at mchadwick@afma.com.au if you have any queries regarding our comments.

Yours sincerely

A handwritten signature in black ink, appearing to read "M. Chadwick". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mike Chadwick
Director - Markets