THE LAW SOCIETY
OF NEW SOUTH WALES

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Director, Murray-Darling Basin Inquiry
Australian Competition and Consumer Commission
GPO Box 3131
Canberra ACT 2601

By email: waterinquiry@accc.gov.au

Dear Director,

Murray-Darling Basin water markets inquiry – interim report

The Law Society of NSW appreciates the opportunity to make a submission in response to the Murray-Darling Basin water markets inquiry Interim Report ("Interim Report"). The Law Society's Rural Issues Committee contributed to this submission.

General comments

With the rapid maturity of the water market in the last few years, in our view there is an urgent need for regulatory reform in this area. The soaring value of water rights from just under $16 billion to $22.7 billion in the 12 months to June 2019[1] reflects this need, together with the emergence of more complex trading products and strategies. The number of participants in the market has also risen dramatically, with increased involvement from sophisticated non-primary production participants such as superannuation companies, financial investors and environmental water holders.

Different water ownership and trading strategies have increased trade but have not resulted in any major reform to ensure the integrity of the market or to enable users to maintain trust and confidence in the intermediaries they interact with. In our view, these unregulated environments may foster conflicts of interest and lead to inaccurate reporting. The current system under the various State legislative regimes is designed primarily for water management with water trading an ancillary aim. The *Water Act 2007* (Cth) and subordinate rules have responded to some of the challenges that initially faced the industry, but do not adequately deal with the challenges that arise in a complex market with multiple participants ranging from sophisticated corporate investors focused on income return and capital growth to "mum and dad" primary producers focused on farm productivity and family and community wellbeing.

[1] "Water prices in southern Murray-Darling skyrocket as increased water demand 'collides' with dry conditions", ABC News 23 August 2019, https://www.abc.net.au/news/rural/2019-08-23/water-prices-in-the-southern-murray-darling-basin-skyrocket/11440978.

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CONSTITUENT BODY

We support the improvement of the quality and availability of water trade information and see merit in the development of a central exchange and clearing house in the temporary market. In the permanent market we support a regime that provides participants with a similar level of protection as those buying or selling land. A permanent water rights transaction is one of the most significant investment decisions that a farmer can make and it ought to have similar regulatory protections as those that apply to land transactions.

In relation to regulatory reform, we support increased regulation of water market intermediaries by way of licensing and/or a mandatory code of conduct, appropriately resourced and enforced. To ensure brokers' interests do not diverge from those of their clients, we suggest that industry specific regulation is required. Currently there are few rules to prevent market manipulation, and no regulator appointed to monitor trading behaviour.

In our view, the current governance arrangements have contributed to a loss of trust in the market amongst users. Presently, various different bodies oversee water markets in the Murray-Darling Basin area under different legal frameworks. Roles and responsibilities overlap in some areas, whilst there are significant gaps in others, leaving the water market to operate in a complex, fragmented and inconsistent way.

The findings and recommendation of this Inquiry are critical in providing a path forward for much needed reform of the water market.

Specific questions

We set out our responses to some of the questions listed in the Interim Report, as appropriate, in **Attachment A**.

The Law Society thanks you for the opportunity to provide a submission to this inquiry. If you have any questions, please contact Stephanie Lee, Policy Lawyer, on (02) 9926 0275 or stephanie.lee@lawsociety.com.au.

Yours sincerely,

Richard Harvey
President

Encl.

Attachment A

Chapter 4—Buyers and sellers: Who trades, where and why?

- **What barriers, if any, prevent an irrigator from buying or selling allocations or entitlements, or using leases, carry over parking or forward contracts? Please describe any barriers and give specific examples where possible.**

There may be a lack of knowledge on behalf of some irrigators and their advisors that more sophisticated contractual arrangements are possible.

The *Water Management Act 2000* (NSW) ("WMA") and associated regulations in New South Wales do not provide for some of the more sophisticated contractual arrangements that have developed over time. The WMA contemplates a transfer of a licence, a transfer of part of the shares of the licence, a transfer of the allocation and a "term transfer" which is not the same, and was not at the time intended to be the same, as a lease. As the legislation and the regulator have not contemplated more sophisticated arrangements, it is not surprising that some participants in the market are not aware of them.

There may also be a lack of professionals who can advise irrigators on the risks and benefits associated with contractual arrangements. The market has developed in such a way that brokers, intermediaries and larger participants are conducting transactions without recommending to parties that they seek advice from lawyers or other professionals. Participants may be receiving advice from intermediaries who are primarily paid on a commission basis, or some other form of success-based fee, which may compromise the independence of the advice.

- **How do these barriers prevent irrigators from using a given water product?**

A lack of objective independent advice may see irrigators offered products that are in the interests of larger participants and earn commission for a broker, as opposed to other products that may better manage risk for the irrigator.

Chapter 5—Investor roles, strategies and conduct

- **What types of other water investors participate in the MDB water markets?**

There is an emergence of investors who buy land and water for the purpose of leasing them both together to third parties who are irrigators/farmers. Water investors who are non-land holders include pure traders, superannuation companies and environmental water holders.

- **What are the investment objectives and strategies of small water investors?**

In the experience of some of our members who act for smaller water investors, the investment objectives and strategies are the same as those of most small investors in any property asset class: reasonable income, capital gain and stability.

Similarly, small water investors are generally those who are involved in agriculture but not necessarily farming themselves. For example, associated professionals such as finance professionals, with an understanding of water entitlements as an asset class.

- **What are the investment objectives and strategies of water investors that participate in the water market by buying and selling water allocations but do not own entitlements?**

In the experience of our members, the primary investment objective of those who do not own water entitlements is short term profit.

- **What are the investment objectives and strategies of irrigators that buy and sell water allocations for profit, alongside their farming operations?**

In the experience of our members, the objective is to obtain an income from a capital asset in circumstances where the allocation is not required in that season.

- **What are the investment strategies adopted by retired irrigators who have retained their water access entitlements?**

For retired irrigators, water access entitlements represent an asset class with which they are familiar and understand the risks, and this may not be the case for alternative asset classes. Retired irrigators may retain their entitlements for longer term succession planning, especially if related parties have purchased the balance of the farm assets.

For smaller investors, water entitlements over the longer term are stable, provide an income and have the potential for capital gain.

Chapter 6—Water broker roles, practices and conduct

- **Should a broker or brokerage firm be permitted to provide brokerage services to both parties to a trade?**

Yes, but only if fully disclosed to both parties. The potential for conflict arises where the broker charges a commission to both the vendor and the purchaser. For example, if a broker has a small one-off client on one side, and a large client who conducts multiple transactions, there may be a perception that the broker will act in the best interests of the client who undertakes multiple transactions.

We consider that the role and obligations of a broker should form part of the broker's contract with the client. There is no standard form contract or cost disclosure requirement, and in our view, a government regulated licensing scheme should make this a requirement.

There should be a positive obligation on a broker to disclose conflict and outline the steps the broker will take if a dispute arises, or if one party does not agree to the broker acting for both parties. We suggest consideration be given to the recommendations made in the *Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry* in relation to mortgage brokers. The Royal Commission recommended compelling mortgage brokers to act in the best interests of the intending borrower, enforceable by civil penalty.[2]

- **Should a broker that is providing intermediary services in a trade, be permitted to have an interest as a principal in that trade?**

Yes, but only if the interest is fully disclosed. The counterparty in all trades should be disclosed.

[2] Recommendation 1.2, *Final report of the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry*, https://financialservices.royalcommission.gov.au/Pages/reports.html#final.

Further consideration should also be given to the circumstances where the intermediary is also a stakeholder: for example, where a broker is either the vendor or purchaser, or where they hold a deposit.

A fiduciary cannot enter an engagement which has or could have a personal interest conflicting with that of their principal or make a fiduciary gain or a profit personally or for a third person without the informed consent of the principal.

Some brokers disclose their approach to managing such issues. For example, disclosure may be made pursuant to their obligations under the Australian Water Brokers Association's Code of Conduct to disclose conflicts, or pursuant to their firm's conflict of interest policy.

- **In what circumstances should individual brokers or brokerage firms be permitted to have water accounts?**

The water accounts should be kept separate from their broking business and not used for trades.

- **Should individual brokers be permitted to only trade in water markets for personal irrigation purposes and in that case, always through an unrelated broker (in an unrelated firm)?**

This could be permitted on the provision of full disclosure. See also our comments above in relation to brokers having an interest as a principal in a trade.

- **What is your experience of brokers holding client funds? Should a broker or brokerage firm have statutory obligations in respect of holding client funds?**

In our view, brokers holding client funds should be subject to the same obligations as property, stock and station agents. Brokers can at any one time hold a significant percentage of the total value of the trade until settlement. The introduction of statutory trust accounts and professional indemnity insurance would foster greater trust and confidence between the parties, increase transparency and reduce opportunities for fraud or misuse of funds.

Clients may not be aware that many water brokers and intermediaries do not operate a trust fund for handling client monies. Only members of the Australian Water Brokers Association are required to establish and operate a trust fund, and membership is not mandatory.

The use of trust accounts can assist in separating and identifying funds held on trust from an intermediary's assets, which reduces the risk of client funds being distributed to creditors in the case of insolvency or bankruptcy. Annual audits would further improve the robust nature of trust accounting schemes.

By comparison, there are specific administrative standards under state and territory legislation for the management of trust accounts by solicitors and real estate agents which are not onerous. For example, under the *Property and Stock Agents Act 2002* (NSW), licensees must hold client funds in a trust account kept at an authorised deposit-taking institution. The institution must be informed that the account is a trust account and the words 'trust account' must appear in the account name. The trust account must be audited each financial year.

- **If statutory trust accounts were mandatory for brokers, should any interest on client funds be directed to an assurance or fidelity fund?**

In our view, brokers should be subject to the same rules as property stock and station agents. The compensation fund that is in place for real estate agents could be used as a model. Interest on client funds should be directed to an assurance or fidelity fund, however, given historically low interest rates any assurance or fidelity fund may not be sustainable in the long term without a substantial corpus.

- **Should brokers be required to hold professional indemnity insurance?**

Yes, brokers should be required to hold professional indemnity insurance as they are providing professional advice. It is noted that a requirement for membership of the Australian Water Brokers Association is holding professional indemnity insurance. Mortgage brokers, solicitors and real estate agents are all required to hold professional indemnity insurance. In our view, requirements in relation to professional indemnity insurance, fidelity fund and trust accounts should all form part of a licensing scheme uniformly administered by the states.

- **If clear, reliable and timely information about the market was more easily available, would this prevent brokers from providing misinformation to clients?**

We consider this would reduce the opportunity for brokers to provide misinformation to clients.

In relation to temporary trades, a single trading platform with Commonwealth Government oversight and transparency laws would give users confidence that market prices are moving with supply and demand and not under the influence of brokers. Presently, many different companies operate their own water trading platforms and finding an agreed market price for water can be difficult.

A single trading platform with real-time data and sharing capability would enhance transparency, eradicate overlapping exchange platforms and reducing the risk of misconduct or criminal behaviour.

The introduction of a national platform provides an open market for access to cumulative data of previous and existing water use, trading history and proprietary holdings. The platform should be easily accessible to all parties, including smaller parties who have previously been reliant on third party broker information. At present, the system is fragmented and outdated and only accessible to brokers, giving rise to the potential for manipulation of information. A national platform should also eliminate the ability to record zero trades where they are not appropriate.

- **Should brokers be required to give reasons for zero-dollar trades?**

Yes, but the requirement should not be unduly complicated; most zero-dollar trades occur between related entities or because there are longer term underlying contracts.

- **Do you consider you are able to effectively access inter-valley trade opportunities when they arise? Why/why not?**

There are inter-valley trades that are conducted on a “first in, first served” basis and the difference in access can be a matter of seconds. This seems unfair, and we suggest the regulator consider other ways of managing the trades, for example, access by ballot or spread across those who apply within a specific timeframe.

- **For holders of water rights who have traded water into another valley during an intervalley trade opening, did you use a broker to facilitate the trade? Why/why not? If yes, Does the broker aggregate your water rights on to their water account before an opening? How far in advance of the anticipated inter-valley trade opening do you transfer your water rights on to the broker's water account?**

Our members are aware that this practice occurs. Though it is not illegal, in our view the regulators ought to be reviewing these types of contracts and considering whether they are inconsistent with the intent of the relevant Water Sharing Plans.

- **When is the price for the water rights agreed on? When do you receive payment for the transfer of your water rights? (Before or after the inter-valley trade is approved?)**

In the experience of our members, payment or at least part payment generally occurs before approval.

- **Are you aware/are you able to see the price the buyer pays to the broker for the purchase of your water rights?**

In relation to permanent water entitlements, in our view both parties should know the price and the name of the counter-party. An undisclosed counter-party represents an unacceptable risk to both parties.

In relation to temporary trades, if the trade is a direct trade between the seller and the buyer, the price should be disclosed. If the trade is between the seller and a broker, who is acting as a water trader, who then on-sells the water, there is less of a need to disclose the price. However, the documentation must be clear on the capacity of the broker/trader and if the intermediary is acting as a trader and taking a profit on a resale, they should not be permitted also to take a commission.

In relation to permanent water entitlements, ideally these should only be transferred after receiving advice from a solicitor. Brokers, similar to real estate agents, are in a position to facilitate a deal, however they are not in a position to act in the client's best interest or provide the required advice, particularly where the transaction also involves the sale/purchase of land. Brokers are neither qualified nor insured to provide essential advice on tax concessions, for example, and clients should have the opportunity to benefit from such advice.

- **Are you aware of brokers taking a personal position in inter-valley trades? Is this disclosed to the other party to the trade?**

Yes, but we are unable to comment on the extent of disclosure in such cases.

Chapter 7—Regulatory settings and solutions

- **Do you consider that there is a place for bona fide water options and futures in the MDB water market?**

Yes, but there is an issue in relation to the disclosure and the advice given to non-sophisticated parties. If the options/futures are derivative contracts, they ought to be regulated under the financial markets regime.

- **Do you think that brokers and intermediaries in MDB water markets should be licensed?**

Yes, our preferred approach is a single national exchange that is a centralised water market platform providing a licensing and regulatory framework for market participants. A "one stop shop" for participants which encompasses licensing, regulation, exchange, trading, real time data, and enforcement would ensure information is clear, reliable and current. We suggest a licensing scheme, which encompasses a mandatory code of conduct, professional indemnity insurance, statutory trust accounts and fidelity fund requirements, which is uniformly administered by the states.

- **Should a licensing scheme be enforced at the Basin State or federal level?**

Our preferred approach is a uniform national scheme, with the licensing portion administered individually by the states. The licensing regime could be enforced at the state level, but other issues of regulatory compliance could be enforced at a federal level. Although a federal approach may appear to be the more costly option,[3] it may be a preferable option, especially given the existing role of the ACCC in respect of the Water Market Rules.

- **Should the licensing scheme be entrusted to an already established body or an independent new body specific to the MDB water market?**

The licensing scheme should be entrusted to the state bodies that oversee the regulation of property and stock agents. The rules governing real estate agents are broadly appropriate for water brokers given the similar risks involved. Many water brokers come from a real estate background, so the transition would not be difficult. The current legislation could be amended to include water brokers and include an additional schedule with a code of conduct.

That code of conduct could provide for different rules for the trading of permanent and temporary water entitlements.

- **Should the financial regulation framework be applied to basic tradeable water rights and arrangements to buy and sell them, noting that it is a ready-made market regulation framework?**

No, the financial regulation framework has been designed for financial products which are too dissimilar to water rights. To the extent that parties design derivative products they will be governed by the financial regulation framework and that is appropriate.

The financial regulation framework would be overly complicated and not well understood by brokers; the rules governing real property are more appropriate given that, as an asset class, real property is similar to water rights.

The present legislative regime adequately regulates water trading which is truly derivative. Whilst there is a legitimate and economic right to trade water, ultimately it is a natural resource and should be treated as such.

[3] Regulation of Water Market Intermediaries - Draft COAG Regulation Impact Statement For Consultation April 2013, https://ris.pmc.gov.au/sites/default/files/posts/2013/04/03-Water-Market-Intermediaries.pdf

- **Should a market focused independent regulator be established for the MDB water market?**

No, but the Water Market Rules could be broadened to regulate and limit market manipulation. The ACCC should oversee the Water Market Rules.

Our members report that there are parties who are buying up temporary water at the start of the season to resell at critical times later in the season at high demand with a view to making a "super profit". Consideration should be given as to whether this is a type of market manipulation that should be disallowed.

- **Should the regulation of the water market be entrusted to an already established independent regulator or a new body?**

The water market should be regulated by the ACCC as, in our view, it has the appropriate expertise in overseeing markets.

Chapter 8—Trade Processes—advising, matching, clearing, settlement, registration and information

- **Do you consider that entitlement trades should also be standardised across the states?**

There would be some benefit to standardising entitlement contracts as much as possible, noting that unsophisticated investors should be encouraged to obtain legal and accounting advice in relation to the sale of permanent entitlements.

The sale and purchase of permanent entitlements often occurs as part of a real property transaction.

We suggest the verification of identity requirements that apply to real property transactions should also apply to entitlement transactions.

- **Would you like to see one trade form with standardised language be used across the states?**

In our view, it would be advantageous to see the states adopt, so far as is possible, standard language. If a standard form contract is used, in our view, it should include a recommendation to obtain legal advice specific to the transaction. There are tax, structuring and other considerations that mean that transactions involving permanent entitlements should be subject to legal advice.

- **Would you like to see the trade type and party type (investor, irrigator, other) recorded publicly?**

In relation to trades of entitlement, we would not, as the capacity in which a party holds water may change over time.

In relation to allocation trades, there may be some advantage to obtaining this information, but consideration would have to be given to defining these capacities. Whilst the capacity will be clear in most circumstances, many irrigators, small and large, hold water entitlements in an entity that is not the same as their operating entity. There are also a number of landholders who lease their land and their water to the same (or related) parties; the issue would need to be resolved as to whether they would be classed as investors.

- **Would you like to see all state water register websites to provide the same information, presented consistently? If no, why not?**

To the extent that the information being compared is the same, we would.

- **Do you think that the consolidation of trading rules into one document per state/per Basin would assist users in undertaking trades?**

There may be a risk in consolidating trading rules such that the one document becomes too complicated for users. To the extent it is possible, having a consistent layout may assist users.

- **Do you think there would be benefit in standardising and making it clear that each state should have the following separate and distinct registers and information should be published on each:**

    - **Ownership register (water entitlement)**
      In relation to these existing registers in New South Wales, Queensland and Victoria, for registrable entitlements the information currently listed is generally appropriate and no significant changes are necessary.

      To the extent that entitlements are held by an Irrigation Infrastructure Operator ("IIO"), consideration should be given to establishing a register that can similarly capture the entitlements held by them. Some of the IIOs are smaller corporations so it is important that this does not impose a costly burden on their business.

    - **Water entitlement trade/transfer register**
      Yes: for transparency, a register capturing date, volume and price may assist the market. There may be a need to identify related party transfers and transfers that happen contemporaneously with a land transfer as these can have an impact on the price.

    - **Water allocation trade/transfer register—including identifying product type**
      Yes, we support a public register showing volume, price and date.

- **Do you consider that the roles of approval authorities and registers are clearly understood? Are trade processes, what is actually assessed when a trade form is submitted, well known to participants? Do you consider that the assessment of applications and how it differs across states and across trade types is well understood? How could this be improved?**

No, we do not consider the roles of approval authorities and registers are clearly understood, and as a result, many participants use brokers.

Chapter 11—Solutions to improve trade processes, transaction costs and information

- **Do you consider that the markets for permanent trade, derivatives and temporary transfers can all be dealt with under one technological solution? Do you consider permanent trades less reliant on real-time data and would be better suited to a different solution?**

Permanent trade would be better suited to a different solution; there can be more complicated legal issues surrounding permanent trade. We consider that, as there are still numerous permanent trade transactions that happen contemporaneously with land trade transactions, it would be ideal to have electronic conveyancing platforms used for water

trades. There could also be advantages if participants were required to meet the standards that generally apply to these platforms, such as the requirements in relation to the verification of identity and minimum systems security requirements.

- **Do you agree that it is important to preserve the ability for buyers and sellers to strike 'off-market' deals, provided that all approved trades are registered and captured in historical trade data? Why or why not?**

Yes; in the experience of our members there are many market participants that deal with each other directly.

- **Do you consider the identification of water right holder types (land-owner, brokers, agribusinesses, environmental water holders) in ownership, permanent and temporary trade registers would change your approach to engaging in water markets? How do you consider such a classification would be made—by account or by individual (for example, a farmer may own an ABA that is not connected to a use licence and then own another that is, in the first option that same farmer would have two classifications, in the second option he would be classified as a land-owner for both accounts).**

This may be unnecessarily complicated.

- **Do you support disclosing some ownership information for those who own more than a certain amount of entitlement in a system? If yes, what proportion should this be and how will this change your approach to engaging in the water market? If no, why?**

Yes, provided there is a central and regularly updated platform for disclosure.

Chapter 14—Market architecture reform options

- **The ACCC seeks stakeholder feedback on the merits and drawbacks of, and the potential to adopt, the options outlined below:**

    - **making carryover parking markets more formal**
      We suggest there should be a review of these arrangements by the relevant water regulators initially to ensure that these arrangements are not undermining the integrity of the water sharing plans and the carryover rules.

    - **unbundling storage access/carryover eligibility from water access entitlements and creating formal, separate markets for carryover storage**
      We suggest there should be a review of these arrangements by the relevant water regulators initially to ensure that these arrangements are not undermining the integrity of the water sharing plans and the carryover rules (subject to the rules in the MDB Plan).

    - **introducing continuous accounting in the southern Basin**
      In our view, continuous accounting is better suited to systems with high variability; however given its complexity, it will not necessarily address the issues happening in the Southern Basin.

- **harmonising or increasing the frequency of water account reconciliation and reducing the ability to reconcile accounts by entering water markets (this would require upgrades to metering technology, the cost of which would vary by location)**

  Better water account reconciliation and better metering would assist in the integrity of the water accounting regime; however, we consider there should not be a restriction on entering the water markets to reconcile accounts for true primary production reasons. Irrigators can overrun their budgets due to unexpected seasonal conditions and in our view, it would be unfair to penalise them for this.