
7. Market regulation and trading mechanisms

Key findings for market regulation and trading mechanisms

- Specific additional regulation of the water sector would not seem warranted at this time. The need for and format of any future market regulation, including options such as licensing of market intermediaries, should be monitored and retested as the market develops.
- For the water sector a mix of trading mechanisms, as is currently employed, is likely to be appropriate. This suits the different dimensions of the market (temporary versus permanent exchange, especially) and also provides options for market participants.
- Governments should not mandate a particular form or mechanism through which water trading must occur and equally should leave open the prospect for new and different forms of market exchange to develop.
- The market has benefited from the (somewhat limited) price exposure provided by existing exchanges.
- It would be desirable for one or more exchanges to develop the capability to accommodate permanent interstate trade, as the trading rules and boundaries for cross-jurisdictional trade are revised.
- Governments should monitor whether this development appears likely and, if not, consideration should be given as to how it might be facilitated.
- If the impediment is a financial one, then there would be merit in governments contributing towards the costs of developing the necessary exchange, probably on the platform of an existing exchange, given the value to the market of the price transparency this would create.

7.1. Market regulation and oversight

Australia's water markets have expanded rapidly over the past decade. Water markets are currently characterised by a large number of temporary trades, mainly in key agricultural production areas of Australia, and a smaller but increasing number of permanent transfers of water access entitlements.

Market expansion is often also characterised by an increase in intermediary activity (such as broking services), where these fulfil a useful market role and profitable opportunities exist to structure and deliver services to market participants. The question is whether some form of regulation may be warranted to monitor these activities or market conduct more generally.

Existing market regulation includes the:

- primary resource management and related regulatory roles (eg, regulation of land and water use) fulfilled by State resource management agencies;
- administering water entitlements registries, and the related controls and assurance processes associated with these (eg, recording and discharging details of mortgages and encumbrances);
- administering water allocation accounting systems, and the related assurance procedures associated with these (eg, reconciling to announced allocation notifications and records of trade and use);
- various State/Territory level fair trading and consumer protection legislation and institutions;
- the trade practices and consumer protection powers of the Australian Competition and Consumer Commission; and
- potentially, the financial services regulatory powers of the Australian Securities and Investment Commission (ASIC).

Any form of regulation imposes costs. This includes the direct costs of designing, administering and enforcing the regulatory framework, and costs through curtailed competition should the regulatory mechanism limit the number of market participants or transactions in some way. Sufficient assurance is therefore required that the net benefits of any further regulation of the water sector are positive.

At present there are no specific arrangements in place for the licensing of water brokers. The general market frameworks created through the *Trade Practices Act*, various State legislation, company and financial services laws and managed via regulatory bodies such as the ACCC and ASIC

mission are relied upon to regulate any illegal or undesirable activities in water markets.

Options for regulating market participants are varied, ranging from:

- no specific licensing or regulation, other than the usual regulatory controls on commerce and fair trading;
- some form of licensing or registration for brokers and other market intermediaries, which may involve some minimum eligibility standards or other industry-specific consumer protections; and
- industry self-regulation, such as where an industry association undertakes to accredit its members and ensure they comply with certain requirements as to conduct, prudential systems or otherwise, but where attaining such accreditation is voluntary.

In those markets where some form of regulation or licensing has been adopted, usually the primary motivation is the protection of consumers. Regulation of real estate agents and motor vehicle traders, for instance, is intended to protect consumers against fraud and ensure that some minimum requirements are met as to disclosure.

During our consultations, there was little support expressed, and no obvious need identified, for specific market regulation of the water sector. The market has evolved over the past few decades, and is generally regarded to be operating reasonably well, with few cited instances of overt market manipulation, fraud or impropriety.

However, while instances of fraud or inappropriate market conduct are uncommon, it remains that there are growing number of intermediaries coordinating transactions of significant value, with no specific regulatory oversight or associated requirements.

The question is whether there is merit in ensuring that brokers and others operating within the market (excluding buyers and sellers) comply with some minimum requirements, and if so what these requirements are. Given the market is still maturing, establishing some code of conduct may have some benefit in underwriting the confidence of market participants, which once lost may be difficult to regain.

However to date it is evident that trade has not been restrained by the absence of any regulatory or licensing requirements for market makers, and the existence of competing avenues for trade to occur (see below) provides a discipline on trading mechanisms. A loss of confidence in any one form of exchange (eg, concerns about unlicensed brokers) can be remedied by channelling trade towards other trading mechanisms.

Should market participants perceive there is merit in brokers and other intermediaries complying with some minimum standards of conduct then the industry may gravitate towards some form of self-regulation. Brokers and others may seek to differentiate themselves on these 'non-price' factors, voluntarily adopting the conduct and insurance requirements of other markets (such as those for real estate agents).

A further driver, which we expect will emerge in the very near term, is the application of financial services law. As the market develops from a primary market in exchanging water access entitlements and allocations between users, to a more sophisticated market involving more derivative-type products, it is probable that some of the derivative products that may evolve will fall within ASIC's jurisdiction as financial services.

The potential application of financial services regulation does not imply any particular changes to the market design parameters developed in this report. It is up to market participants/brokers to ensure that they comply with their relevant regulatory obligations. It may also provide an avenue for water brokers to differentiate their services by demonstrating that they comply with these requirements, even though they may not technically be applicable to all of the services they provide.

Having regard to these factors, our view on this is that a specific form of regulation or licensing for water market intermediaries is not required at present. However, this position should be retested periodically as the market develops having regard especially to:

- the volume and value of trade in both water access entitlements and water allocations, including both the aggregate size of the market and the average transaction size - as the market and average transaction value grows, the benefits of preventing inappropriate or illegal market conduct also increase, as does the cost effectiveness of any regulatory response (measured as regulatory costs as a proportion of industry size);
- performance of brokers and other market intermediaries – if instances of fraud, market manipulation or other improper market conduct were to occur, then this obviously would strengthen the arguments for further regulation; and
- convergence with other markets – many water brokers already are licensed real estate/stock agents, and apply similar internal processes to water trades as for real property transactions. This arguably provides a degree of implicit assurance to market participants as to the propriety of brokers' actions. Should this trend continue (perhaps with brokers also becoming accredited financial services advisors), then this diminishes the need for specific additional regulation for the water market.

If any licensing requirements are to be adopted in the future, then logically these should be applied consistently across the different jurisdictions – a licence to act in the market in one State should be recognised in all others.

Market supervision and enforcement of trading rules

There are two specific types of rules associated with trade that need to be enforced. These are:

- specific rules and restrictions on water trade designed to achieve various social, environmental and operational issues. Where such rules exist, their effectiveness relies upon adequate compliance and enforcement processes; and
- rules and other arrangements associated with processing trades and operating various centralised exchanges.

Generally, the relevant government department or water authority (or both) are responsible for enforcing rules and restrictions on water trading.

In Victoria responsibility for approving of trades (and for ensuring that trades comply with the relevant trading rules) resides with the relevant Rural Water Authority. In comparison, in South Australia, Queensland, the Northern Territory, New South Wales, Tasmania and the ACT, responsibility generally sits with the relevant Government authority. However temporary trades within irrigation districts in these jurisdictions are usually approved by the infrastructure supplier (eg, Murray Irrigation Limited and SunWater).

Rules associated with the operation of centralised exchanges such as Watermove and Waterexchange are developed and applied by the exchange operators themselves – although it is emphasised that these rules are trading rules, not water resource management rules. The nature of these rules lends themselves to the standard application of internal and external assurance processes.

In relation to rules associated with processing trades and operating centralised exchanges, again we see no real need for specific enforcement arrangements that could not be dealt with by adopting standard internal controls and auditing procedures.

For example, controls should prevent persons responsible for processing trades or operating exchanges to use their ‘insider’ knowledge of the market (for example, knowledge of sell and bid offers, or knowledge of any intention by water authorities to increase or decrease allocations). This suggests that where an entity is responsible for both making decisions on water allocations and processing trades, that sufficient separation of these functions should be in place to remove the possibility of conflicts of interest arising.

The extent to which trading rules and entitlements are effectively managed determines may in part determine the extent of improper conduct - the greater the integrity of transaction and recording systems, the lower the opportunity for illegal or undesirable activity.

Recommended actions

- Processes for managing trades and the entitlement registers should be subject to a regular audit program to ensure the internal controls around these processes are adequate to compliance with trading and entitlement rules.

For example, arrangements should be introduced to ensure the operational staff who manage trade are appropriately 'ring-fenced' from decisions that are likely to impact market prices and are unable to use any 'inside information' for personal gain. This action should be implemented by those responsible for managing trades and entitlements immediately.

- Tools that govern the conduct of market intermediaries, such as codes of conduct, accreditation or licensing in the sector, are not required at the present time. However their need should be reviewed periodically.

7.2. Alternative forms of trading mechanisms

A design choice in the architecture of the market is whether the market is centralised or decentralised.

A centralised market generally involves a common point of exchange, such as electricity and equity capital markets. For instance, Australia's National Electricity Market (NEM) operates as a mandatory gross-pool basis, with tightly-controlled rules around bidding, dispatch, settlements and prudential requirements for market participants. For equity share transactions, though the Australian Stock Exchange is the primary market, there is no obligation to use this exchange and off-market transactions are not uncommon.

By contrast, a decentralised market might feature bilateral contracting between parties, transactions characterised by unique prices and other terms, and involve widely-divergent contractual forms to facilitate exchange. Such decentralised markets may be supported by market infrastructure such as voluntary bulletin boards, which provide some level of price disclosure.

The choice between the forms of market exchange is essentially a trade-off between the transactions and administrative costs of a complex and sophisticated market form, against the arguably more efficient price signalling these markets provide.

Centralised exchanges work well where there are a very large number of similar transactions, involving homogenous commodities and where the transaction can be both standardised and isolated from other interdependent markets. Trades in financial securities, for instance, proceed on the basis that the security is unencumbered and the purchaser buys shares on this basis. One person's trade imposes no costs on any third parties.

Central exchanges typically operate around a uniform market clearing price, which provides for transparency for regulatory agencies and public scrutiny over the market's performance.

However, centralised markets have a number of limitations, including a necessary reliance on restrictive contract forms and complex procedural rules. They can be costly to set up and administer, and hence rely on substantial trading volumes to make them cost effective. In electricity, the value of energy traded through the NEM is around \$500 million each week. Costs to administer the NEM exchange platform, measured as a proportion of this value of turnover, are therefore relatively low. In comparison, water markets are significantly smaller, probably representing less than two per cent of this amount.

Even for commodities such as electricity, the centralised market relies on separate bilateral markets for auxiliary services and for financial risk management (hedge contracts). These markets typically do not have the depth and liquidity to support a fully-functioning exchange-type market. All generation is channelled through the spot market in electricity, mostly to provide for efficient, real time dispatch.

Another example is the international base metals markets, where only a small volume of trades actually pass through the centralised metals exchange (commonly around five per cent), yet almost all bilateral trades involve contracted prices set with direct reference to exchange spot prices.

What this shows is that choice around the form of market exchange need not be mutually exclusive. It is entirely possible, and in the case of water appropriate, that different forms of exchange co-exist.

Pool-type markets, for instance, work best for more standardised, physical transactions, which in the case of water describes the temporary market in water allocations. Here market rules and other procedures can be more readily codified *ex ante*, and where the transaction volume is sufficient for market liquidity and to allow for recovery of the fixed costs of administering the exchange platform.

For permanent exchange in water access entitlements, where approvals processes are more complex and transaction-specific, then a less centralised and a more flexible form of transaction is probably more suitable. These types of transfers may be facilitated by brokers or portal-type exchanges, but the specifics of each transaction may make them less amenable to standardised settlement processes.

Currently, the water sector is characterised by a mix of decentralised, bilateral trades, some of which are facilitated by brokers and other intermediaries, and a number of exchanges which operate in different (though sometimes overlapping) geographic areas and employ slightly different forms of market processes. In Victoria, for instance, around one-third of temporary trades were through brokers in 2003-04 - a quarter through WaterMove, and the balance directly between entitlement holders.

Some of the existing exchanges include:

- Watermove - Watermove is a Victorian water exchange that operates regional trading zones, which provide permanent and temporary trading throughout Victoria and temporary trading only in Southern New South Wales. Offers are able to be lodged by mail, fax or online.

In the exchange pool, prices for each trading zone are determined from the buy and sell offers provided. Exchange (or trade) is carried out weekly on each Thursday.

The exchange provides confidentiality for traders through an anonymous bidding scheme and provides transparent operation through independent auditing and independent supervision of the exchange.

- SunWater – Sunwater’s exchange operates in Queensland. The exchange is a scheme-based water exchange providing for temporary water trading in each of SunWater’s irrigation schemes (where the necessary Resources Operations Plan is in place). Offers are able to be lodged by fax or online.

Pool prices for each scheme are determined from the buy and sell offers provided. Exchanges (or trade) usually occur fortnightly.

In some schemes, specific delivery constraints or license conditions may limit the number of trades that may occur – these rules are embedded within the exchange and customers are notified when placing the trade if restrictions apply.

- waterexchange.com.au - provides markets for regulated, unregulated and groundwater in New South Wales, Victoria, South Australia and Queensland. The exchange divides water allocations into regional areas, each with an individual exchange. The exchanges provide a transparent ‘bulletin board’ style exchange where offers are able to be lodged by mail, fax or online.

No one exchange has universal support amongst all market participants, nor is there any evidence of widespread market support for a mandated, centralised exchange mechanism. Should one be required, then it is likely that the market could and will sort this out without any form of intervention from the Australian Government or States.

For the immediate future it is likely that the market will continue to operate using a mix of bilateral trades, some of which are organised through brokers and other parties, and a number of existing and possibly prospective exchanges. Future development may include greater convergence between these markets. This might involve brokers arranging for transactions which settle at certain dates in the future at prices determined by the market price from one of the organised exchanges on this day.

It would be desirable for one or more exchanges to develop the capability to accommodate permanent interstate trade, as the trading rules and boundaries for cross-jurisdictional trade are revised. Governments should monitor whether this development appears likely and, if not, consideration should be given as to how it might be facilitated.

Recommended actions

- The existing mix of exchanges, brokers and other trading mechanisms has served the market well, and likely will continue to do so in the future.
- Governments should not mandate that trade must occur through a particular trading platform, as competitive rivalry between alternative forms of exchange is an important market discipline.

- Government has a role in monitoring the development of the market and therefore should examine periodically whether exchanges that develop to facilitate trade provide sufficient market information and an efficient mechanism for trade.
- It would be desirable for one or more exchanges to develop the capability to accommodate permanent interstate trade, as the trading rules and boundaries for cross-jurisdictional trade are revised. Governments should monitor whether this development appears likely and, if not, consideration should be given as to how this may be facilitated.