

Response to the ACCC Water Markets Inquiry Interim Report

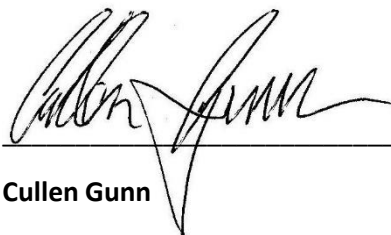
By

Kilter Rural

Date Submitted: 30 October 2020

Kilter Rural Approval of Submission

To the best of my knowledge and belief, this submission, as it appears, is true and accurate. Nothing has come to my attention that causes me to believe that providing this public submission may involve conduct by any person that is false, misleading or deceptive or that may mislead or deceive. Similarly, I confirm that I will bring to the attention of the Chair of the ACCC any matters which arise or otherwise come to my knowledge, during the period between signing this public submission and the conclusion of the Inquiry, which may render this submission as false, misleading or deceptive



Cullen Gunn

Chief Executive Officer & Director

Response to ACCC Water Markets Inquiry Interim Report

Introduction

Kilter Rural has been managing water investments in the southern Murray-Darling Basin (sMDB) on behalf of investors since 2008 and is proud of the role it has played in the market. Kilter Rural has engaged proactively with the Australian Competition and Consumer (ACCC) in relation to its inquiry into the Australian water markets. Our contribution to date has consisted of two voluntary submissions as well as the provision of comprehensive records of trading activities as requested.

As both an irrigator and water fund manager, Kilter Rural is well positioned to respond to the request for stakeholder feedback in the ACCC Interim Report released in July 2020. Kilter Rural has been a long-term member of the National Irrigators Council (NIC) and has also provided input into the NIC response.

Background on Kilter Rural

Founded in 2004, Kilter Pty Ltd (trading as Kilter Rural) is an innovative, forward-thinking Australian based provider of rural asset investment and management services. Collectively, the Kilter Executive Team has over fifty years' experience in direct farmland and water management.

Kilter was formed in response to institutional demand for investment in sustainable management of farmlands, water and ecosystems. In 2006 Kilter attracted its first \$50m commitment to invest through its proprietary operational model in the renewal of rural landscapes. By October 2020 funds under management have grown to over \$500m in land, water and ecosystem assets. Kilter is based in Bendigo in Victoria with a staff of 40 engaged across farmland, investment and administrative activities.

Kilter is engaged as investment manager by investment funds that own farmland in Victoria and own water entitlement in the Goulburn, Murray and Murrumbidgee river systems. Kilter regularly participates in water markets to acquire water to support these farming operations and is Goulburn-Murray Water's largest water-using customer.

Kilter also actively participates in water markets as the manager of water investments. In this capacity it acquires water entitlements and generates investment returns through the development and distribution of water products to a client base of irrigation farmers. These products include water entitlement leases, forward contracts for water allocation, water carryover solutions and spot sales of water allocation. In so doing it supports the wider irrigated agriculture sector in the southern Murray-Darling Basin.

General comments on the Interim Report

Overall, Kilter Rural commends the ACCC on its Interim Report. It provides a detailed and balanced examination of the current state of water markets in the Murray-Darling Basin, particularly in relation to the sMDB.

A minor criticism is that it lacks a concise summary of findings and recommendations. At 544 pages, many in the market who have raised concerns as to its operation may find the document impenetrable. Hopefully, this will be addressed in the final report so that the good work done can be shared with, and consumed by, the broadest possible audience. That said, the size of the report also reflects the scale and complexity of the topic.

It is also worth noting that the Interim Report details the ACCC's preliminary findings that water allocation price movements are strongly driven by relative scarcity. This inquiry was commissioned at a time when water allocation prices in the sMDB were relatively high and amid accusations of anti-competitive behavior or market manipulation occurring. The report acknowledges that further work is to be undertaken in order to confirm if

such market behavior has occurred, particularly during 2019. It is important for the ACCC to complete this work so that the market can be accurately informed as to the extent of any such activity.

Response to Interim Report – Options for Market Reform

Conduct of market participants

1. There is insufficient regulatory oversight, and enforcement and compliance activity, in relation to some practices of some market participants

The ACCC's preliminary view is that market integrity regulation needs to be improved for water rights trading. The ACCC has identified the following three options for improving market regulation and seeks feedback about which option would best improve market integrity. These options are:

a) Government-initiated licensing scheme for intermediaries.

- ▶ Kilter Rural is appreciative and supportive of the role water intermediaries such as water brokers play in the market. They help facilitate market liquidity and play a key role in building market literacy. However currently there is limited oversight of operational standards within this industry which has the potential to lead to unfair trading outcomes. Hence Kilter Rural is in favour of implementing a licensing scheme for market intermediaries following appropriate stakeholder consultation.
- ▶ An independent stakeholder workshop/review of the service standards for the water broker industry is recommended to:
 - i) Facilitate drafting industry service standard guidelines and/or regulations
 - ii) Determine industry training and competence assessment protocols
 - iii) Evaluate professional indemnity insurance thresholds
 - iv) Agree audit regimes and penalty structures for non-compliance
 - v) Make cost estimates and options for cost recovery, and
 - vi) Identify implementation timelines
- ▶ Kilter Rural has some concerns with the current operating environment for water brokers in relation to:
 - i) The lack of statutory requirements for water brokers to maintain and operate audited trust account facilities in a similar way to licensed real estate agents. The transaction deposit amounts held by brokers often involve large sums of money. In addition, for some transactions, brokers may hold deposit monies for up to 5 years. In the absence of proper trust account facilities, the ultimate recipient of these deposits is likely to be treated as an unsecured creditor in the event of broker insolvency. We are of the view that this is an unacceptable situation. Other industries including the legal and real estate professions have been able to establish statutory trust account standards to address these issues. We recommend that the same approach be taken to water brokers.
 - ii) The difficulty in undertaking due diligence on the professional indemnity insurance status and the financial position of water brokers holding security deposits on behalf of counterparties.
- ▶ Kilter Rural is of the understanding that the Australian Water Brokers Association (AWBA) has endeavored to lift professional standards within the industry. However, to date demonstrable progress has been limited and indicates that self-regulation is a relatively ineffective option. It would be expected that the AWBA would be a key participant in drafting any proposed industry guidelines and regulations.
- ▶ Given the increasing reliance upon water brokers for market liquidity, Kilter Rural regards this reform as a high priority.

b) *Applying the financial regulation framework to all water products.*

▶ Kilter Rural does not have strong views in relation to the merits of applying the financial regulation frameworks to all water products. However it would be concerned to ensure that any such reform only occurred following a comprehensive assessment of costs and benefits.

c) *Independent market-focused government regulator.*

▶ Kilter Rural is not opposed to this approach. However, it is neither in strong support for the following reasons:

i) The operation of water market participants is already monitored by both state and federal government agencies. For example, it is expected that the ACCC will continue its oversight of competitive behavior within the water markets and undertake periodic reviews and the Victorian government is committed to publishing the trading activities of identified large-holding participants.

ii) Costs to support such a regulator would likely be significant and would need to be borne by what is comparatively a small market. Accordingly any such proposal would need to be subject to a thorough cost-benefit analysis.

▶ If a lack of cooperation between the States significantly stifles water market reform then the case for appointing an independent regulator becomes stronger.

Improving trade processes and market transparency

2. Practical changes to trade processing are needed to improve the quality and timeliness of core market data

Market participants face difficulties in accessing reliable and representative market data. Trade processes are outdated and fragmented across many public and private service providers. The ACCC has identified several practical improvements that, in its preliminary view, should be made as soon as practicable:

a) *Basin States to improve trade data validation and quality checking processes before providing data to the Bureau of Meteorology as required under the Water Regulations 2008 (Cth).*

b) *Update trade application forms to capture the reason for trade or trade type, struck date, lodging party and matching pathway.*

c) *Remove the ability for zero dollar trades to be approved or recorded unless certain conditions are met (as exception, and with explanation provided) and continue progress to move trade forms online.*

d) *Increase harmonisation across the Basin States' registers through consistent terminology and data structures.*

▶ Kilter Rural is in support of all of the recommendations listed above as they would result in improved market transparency. It is encouraging to note that some States have already implemented a number of these recommendations as mandatory data fields in their trade processes.

▶ Trading efficiency would also be improved if state trade application forms and processes were more aligned.

▶ The process around inter-valley trade transfers should be reviewed so that all market participants have equal opportunity for successful trade outcomes. For example, currently water brokers registered with the Victorian Water Register have access to trade features not available to irrigators ('My Water' users) leaving irrigators at a trading disadvantage.

3. Practical changes need to be underpinned by clear and comprehensive mandates to provide efficient trade services and high quality information to market participants

There is a need to establish a clear and comprehensive trade processing and market reporting framework governing all entities who process trades—including brokers who provide matching services, exchanges, IIOs and Basin State approval authorities. The ACCC’s preliminary view is that the following suite of changes could be implemented over the medium term to achieve such a consistent and comprehensive framework.

- a) *Each Basin State should be given a clear legislative mandate to keep a register to record all entitlement trades and all allocation trades.*
 - b) *Each Basin State water register should be given a clear legislative mandate to provide information services based on registry data, and clear publication requirements should be specified.*
 - c) *IIOs should be required to establish and maintain comparable registers for both temporary and permanent trades, within, out and into their networks. This might occur in partnerships with state agencies.*
 - d) *Update Water Regulations 2008 (Cth) to more clearly specify data reporting requirements for trades of irrigation rights.*
 - e) *Create the ability to register contracts with water registers, and/or annotate allocation trades conducted under a contract, with an identifier such that all allocation trades arising under one contract can be identified together.*
 - f) *Introduce standardised single party identifiers across the Basin, for example using ABNs.*
 - g) *Standards and agreed processes for processing trade applications and recording and disseminating trade data should be mandated and consistent across jurisdictions. These should apply to all IIOs and Basin State approval authorities. Further, there should be standardised record-keeping and continuous disclosure rules placed on exchanges and brokers.*
 - h) *Basin States should work towards harmonising trade application fees for allocation trade in the Southern Connected Basin, while also recognising the NWI principles for cost recovery.*
 - i) *Basin Plan trading rule 12.48 should be revised to require prices to be reported for all tradeable water rights; that is, including irrigation rights and water delivery rights, not only water access rights.*
- ▶ *In the main Kilter Rural supports most of these specific measures as means to improve both efficiency and transparency of the market. The overriding objective should be to agree a standard format records for water allocation and water entitlement trade that is used for by all authorities and IIO’s so as to support interoperability.*
 - ▶ *We do question the merits of also including the capability to identify trades to specific contracts. Mainly because it would appear to add significant complexity for little additional benefit if the following information is already being recorded:*
 - i) Reason for Trade
 - ii) Date of original deal
 - iii) Reasons for zero dollar trades.

4. Digital technologies offer the opportunity to streamline trade services, at the same time as improving information quality and availability

The practical changes identified above could go a long way towards improving the quality and timeliness of providing information to market participants and streamlining trade processes. However, digital technologies offer the opportunity to make more substantial improvements, and at the same time enable increased market oversight to improve the integrity of Basin water markets. Options for using technological change to bring about these improvements include:

- a) *A comprehensive and open digital protocol to enhance interoperability between Basin State approval authorities and registers, IIOs and exchanges, with the ability to securely transmit data, seamlessly interface between private exchanges, IIOs, trade approval authorities and registers, execute instructions, and automate collection, cleaning and publishing of water market information.*
- b) *A single information portal for publishing water availability and trade information, which collates data from multiple sources, but does not facilitate trade.*
- c) *A spot market and real-time automated matching of buyer and seller offers, similar to the National Electricity Market.*
- d) *A single exchange platform for posting and matching trade offers by creating a single mandatory online platform for matching buyers and sellers.*
- e) *An ASX-like approach of a single clearinghouse for administering trading (but connecting via interoperability protocols to trading platforms as overlays and different Basin State registers underneath).*
- f) *Distributed Ledger Technology which administers trade through smart contracts and also records all registry information.*
- g) *A single common register in which all water accounting for both trade and delivery (use) would be accounted for in the same, single system.*

The ACCC's preliminary view is that, while governance remains distributed between Basin States and other actors, options which deliver harmonisation and co-ordination are more suitable than options which deliver centralisation. In line with this, the ACCC's preliminary view is that the digital protocol option combined with a water market information platform, which brings together (but does not replace) diverse information sources, is the most appropriate pathway. If there were to be a more centralised approach to governance, this would open up options to centralise trade administration and technological solutions.

- ▶ Kilter Rural supports continued implementation of technology solutions to increase market integrity through improved transparency and efficiency. Accurate and timely information providing visibility of market depth and price discovery should be readily available to all market participants. Also the development of secure transaction clearing services is important to manage counterparty risks.
- ▶ In Kilter Rural's view the focus for improvements should start with achieving common data structures across all State jurisdictions as this will support interoperability and the potential for future centralised reform.
- ▶ Standardising data structures will also support the objective of improved transparency through a single portal for water information. Historically we believe there have been issues as to which organization should 'own' such a data platform. Currently the Bureau of Meteorology (BoM) has assumed this role but this is not their core business. In addition it appears to lack authority to compel market participants to provide data. This would need to change. Determining who should own this function will require adequate consultation. Ultimately whoever assumes this role needs to be provided with sufficient authority to secure access to timely information by market participants.
- ▶ Kilter Rural is of the view that although the concept of a single market exchange may appear attractive it would likely face very significant practical impediments to its implementation. Accordingly Kilter Rural is at this stage not supportive of this approach. If the development of common data structures produced significant improvements in interoperability this view could change. However if such changes produced material improvements in efficiency and transparency then the need for one centralized exchange platform may be obviated.
- ▶ Commercial investment in information services should be encouraged, including the use of open data protocols, as the benefits of such services can be observed in other mature trading markets.

Improving market architecture

5. The design of the southern connected Basin market architecture has not kept pace with increasing trade activity, and the ACCC is seeking to identify options for reform

Reform of the market architecture can build more robust frameworks for trade, and improve arrangements for addressing impacts on other water users and the environment. Market architecture that better integrates trade, operational requirements and the physical characteristics of the system, will improve the operation of water markets. This will help achieve a range of benefits, including properly pricing the costs of trade and protecting other water users and the environment. The ACCC is seeking to identify appropriate market architecture reform options. Options might include:

a) Improvements to policy transparency and consultation processes

▶ Two areas where improvements in transparency would benefit market participants by reducing uncertainty include:

- i) Improved continuous disclosure from water authorities as likely future water allocation determinations based on up to date information on volumes in storage and inflows. Essentially to lower the probability determinations being significantly different from what the market is expecting.
- ii) Providing greater visibility in relation to potential inter-valley trading opportunities. This could include information relating to estimated Upper to Lower Murray trading opportunities for the start of the water year and planned timing of environmental water trading and deliveries which lead to inter-valley trading opportunities.

b) Alternative approaches for allocation and carryover policies, such as continuous accounting and capacity sharing

▶ Kilter Rural is not supportive of any changes to current carryover policies. Change would only be warranted if there is a demonstrated market failure in relation to carryover. Kilter Rural does not believe there has been such a market failure. Further, carryover is an important risk management tool. It is also widely accessed by market participants with an active market in carryover space being intermediated by water brokers every year. In addition, the carryover rights associated with classes of water entitlement on issue are intrinsic to their market value. Changing these rights would represent an interference with the private property rights of the owners of these assets and would almost certainly impact on their value.

c) The creation of formal markets for storage and delivery capacity

▶ As mentioned above, Kilter Rural is of the view that there is already an active market in storage capacity and accordingly change is not required.

▶ Delivery capacity (including annual use limits) is becoming an increasingly important issue to manage due to the substantial increase in perennial horticulture in the Lower Murray region. It seems likely that reform will be required to ensure that existing investments in this region are not put at risk as a result of new developments. This should be considered as a high priority so that any reform in this area can be confirmed and then communicated to the market as quickly as possible to enable investment decisions to be as informed as possible. Ultimately a market for delivery capacity may be the solution.

d) Application of transmission loss factors to water deliveries in the southern connected Basin

▶ It is understandable that some irrigators are in favor of this proposal. Practical implementation is difficult to envisage. Perhaps a high-level mechanism that took into account transmission losses when water allocation was moved between trading zones could be implemented. It is hard to see how a more granular approach could be developed. Implementation of such a policy would add complexity and cost and for these reasons Kilter Rural does not currently see this as a high priority issue.

- e) *Removal of the exemption for grandfathered tags or removing entitlement tagging altogether*
 - ▶ For the sake of market simplicity this proposal makes sense. However, it also needs to be recognized that these features are part of the private property rights associated with these entitlements. Consideration may need to be given to compensation if these rights are removed.
- f) *Alternative and more dynamic mechanisms to manage inter-valley trades*
 - ▶ For inter-valley trading, Kilter Rural supports both the principles of using:
 - i) Dynamic mechanisms to adjust rules thresholds to cater for changes in seasonal conditions
 - ii) Alternative mechanisms for setting IVT trade rules which enable river flows to better match the natural seasonal flow of the rivers. For example enabling trade from the Goulburn to the Murray with a delivery window that expires at the end of Spring.
- g) *Changing all allocation trade to tagged allocation trade*
 - ▶ Kilter Rural recognises this option has conceptual merit and is worthy of future consideration.
- h) *Improving consistency across Basin States' accounting and metering requirements.*
 - ▶ Kilter Rural supports all options which lead to improved consistency of operation across state jurisdictions. Confidence in the accuracy of metering is vital for market integrity and upgrading all metering to real-time SCADA monitoring should be considered a high priority.

Changes to market governance

6. There is a need to reconsider governance frameworks to enable independent and clear decisions on the development of market settings

The ACCC considers that improved governance will help to effectively resolve many of the issues identified throughout the inquiry, as well as strengthening the system so fewer problems emerge in the future. The ACCC is considering options to improve market governance. Broadly speaking, options may seek to:

- a) *Establish clear, independent decision-making structures*
- b) *Separate market governance roles from broader water management governance*
- c) *Consolidate or harmonise fragmented roles*
- d) *Reduce regulatory gaps by creating and assigning new roles or functions.*
- e) *Address conflicting roles.*
 - ▶ Kilter Rural supports reform which leads to improved governance. Kilter Rural recognises the challenges faced when the market operates across multiple State jurisdictions. The recent change announced by Water Minister Keith Pitt to transfer compliance powers from the Murray-Darling Basin Authority to a new independent authority seems a sensible first step.
 - ▶ Given the significant due diligence the ACCC has undertaken in producing this Interim Report and their ongoing work to publish the Final Report, it seems sensible to build on this capacity and allow the ACCC to continue in this oversight role of the water markets for the foreseeable future.