

# Chapter 4

## Issues to do with water trading

4.1 The purpose of water trading is to allow water, through market forces, to move to more profitable uses. Trade has occurred to some extent for many years, but to date it has been mostly small scale temporary trade (that is, trade of annual allocations, not the underlying entitlement). There are still impediments to interstate trade.

4.2 The Intergovernmental Agreement on a National Water Initiative (IGA) aims to remove impediments to trade. However all trade will still be subject to environmental constraints. For example, if water is sold upstream, the river flow between the selling and buying points will be reduced, with possible environmental consequences. Exchange rates are needed to allow for seepage and evaporation between selling and buying points. Trading rules will be needed to control these and other situations. The IGA lists 11 principles for trading rules (Schedule G).

4.3 Interstate trade will require the categories of entitlement in different states to be redefined so they correspond.

4.4 Most submitters to this inquiry supported water trading. Some are quite used to buying water as needed like any other business input, whether to top up an allocation or because they have no entitlement. Some are looking forward to the greater flexibility, in a more mature market, to sell their entitlement. However most stressed the need for some controls on the market to prevent entitlements accumulating in the hands of large investors who might gain market power.

4.5 The main concerns about water trading are discussed below.

### **Who should be allowed to buy water?**

4.6 This question summarises two somewhat different concerns:

- concerns about possible contraction of rural economies in areas where water is sold away;
- concerns that water entitlements may accumulate in the hands of investors or speculators who may gain market power, to the detriment of farmers who then need to buy the water.

4.7 These concerns overlap but conceptually they should be distinguished. The first concern arises even if water is sold only to other water users. The second concern is additional.

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***Possible contraction of local economies where water is sold away***

4.8 Many witnesses, though they support water trading in principle, were concerned that the economic benefits of water use should remain in the local area. They were concerned that if water is sold away the community loses the economic activity that the water created. For example:

It [trading] does need to have some parameters to govern it .... we cannot allow free trading to suddenly take all the water out of the Namoi Valley and place it down in the Darling somewhere and leave Gunnedah, Narrabri and Wee Waa as desert towns.<sup>1</sup>

4.9 Such comments imply that water should only be bought by people who will use it in the same area (somehow defined) as the seller; or, if there is a middleman, that the water is tagged in some way so that it can only be resold to someone who will use it in the same area.

4.10 In such comments it seemed to be often implied that ‘the local area’ means ‘the catchment’. However in a large catchment the concern could equally apply if water is sold from one region to another within a catchment.

4.11 The Committee is sympathetic to these concerns. However it must be said that to limit trade in this way would run fundamentally counter to the IGA’s policy of allowing the freest possible trade (subject to environmental needs) so that water can move to more profitable uses. If water moves to areas where different natural endowments allow it to be used more profitably, this necessarily implies that the relatively less endowed source area will lose out.

4.12 The IGA does not propose any restrictions on trade based on socio-economic considerations. By negative implication it forbids them, since nothing of the sort is contemplated in the principles for water trading rules, which deal with limits on trade because of environmental requirements or delivery constraints (Schedule G). As well, it says:

The States and Territories agree to establish by 2007 compatible institutional and regulatory arrangements that facilitate intra and interstate trade.... including:

v)... no imposition of new barriers to trade... (s60)

4.13 In the case of irrigation areas with shared infrastructure, where there are concerns that trading out may leave stranded assets, the IGA allows permanent trade out to be limited to 4 per cent of the total entitlement ‘subject to review by 2009 with

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1 Mr J. Kahl (Lower Namoi Cotton Growers Association), *Committee Hansard* 26 August 2003, p.140. Similarly for example, Mayor J. Stone (Balonne Shire Council), *Committee Hansard* 25 August 2003, p.47. Mr P. Weller (Victorian Farmers Federation), *Committee Hansard* 21 April 2004, p.593.

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a move to full and open trade by 2014 at the latest' (with certain other conditions for the southern Murray Darling Basin - s60(iv)(b)).

### ***Comment***

4.14 The Committee accepts that the regional adjustment problems caused by trade out could be serious matter in some areas. The Committee suggests that trading rules should take into account socio-economic impacts of trade.

4.15 Investment in water use efficiency measures may help incidentally, by putting a less naturally endowed area in a better position to use water with adequate profitability. However it is important that any public investment in efficiencies is economically disciplined and directed with priority to the highest returns. It should not be allowed to become a backdoor form of structural adjustment assistance.

### ***Concerns about possible manipulation of the market***

4.16 There are concerns that water entitlements might accumulate in the hands of major investors who might then exercise market power at the expense of water users. For example:

Water is for the benefit of the entire region, not just for someone who happens to be in Sydney and is shoving a piece of paper in a drawer to constrict the market and then leasing things out to the highest bidder under desperate circumstances.<sup>2</sup>

4.17 Similar concerns arise at the prospect of entitlements being owned by non-users, whether or not there is market power:

The Victorian Farmers Federation sees no advantage in someone in Collins Street owning water and trading it. There is no advantage for the environment, and there are no advantages for farmers. All that it will do is put another cost in there.<sup>3</sup>

4.18 A contrary view is that, assuming there are enough buyers and sellers, the discipline of the market will prevent profiteering:

At the end of the day the water market is a bit like any other market: it is a supply and demand situation, and you can be the biggest water holder in the country but that water is not worth anything to you unless somebody wants to take it up and use it.<sup>4</sup>

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2 Miss J. Hamparsum (Upper Namoi Water Users Association), *Committee Hansard* 26 August 2003, p.178.

3 Mr P. Weller (Victorian Farmers Federation), *Committee Hansard* 21 April 2004, p.593.

4 Mr N. Shillabeer (South Australian Murray Irrigators Inc.), *Committee Hansard* 20 April 2004, p.527.

4.19 The Committee suggests that while this may be true in the spot market for allocated water, it would be unwise to assume it in relation to the relatively untried market for water access entitlements. There is risk of speculation in hope of growth in the capital value of the limited resource, not merely in relation to the current use value of the water.

4.20 Most witnesses agreed that the possibility of profiteering is a concern, and that the market needs to be regulated. Prof. Cullen said: ‘I agree with you that you would not want an unregulated market. I would be very concerned if I thought one or two people were going to own all the water and we were going to have peasant farmers. I hope that we can design a market that will stop that happening.’<sup>5</sup>

4.21 Mr Creighton of CSIRO argued, ‘I do not believe we are about a free-form economic open market here, because we are about public good as well... We are not about a willy-nilly open market; we are about some managed trade.’<sup>6</sup>

4.22 Prof. Young suggested, ‘If you wanted to stop it, you can simply require that somebody who owns a water right has to own some land as well.’<sup>7</sup>

4.23 Mr Dalton of the Department of Agriculture, Fisheries and Forestry said, ‘I think that is an area where we would seek to have further serious analysis and investigation done.’ Mr Sutherland of the NSW Department of Infrastructure, Planning and Natural Resources noted that ‘There are provisions in the New South Wales legislation whereby the minister must approve the trading regime and can take into account any impacts that trading might have, any concerns about monopolies et cetera. However the basic reliance would normally be on the ACCC and the normal trading regulatory regimes.’<sup>8</sup>

4.24 The IGA has nothing to say about this matter, beyond the possible relevance of the following sections:

- trading arrangements should ‘provide adequate protection to third-party interests.’ (s58(v));
- in regard to the southern Murray-Darling Basin, the relevant parties agree to ‘the National Water Commission monitoring the impacts of interstate trade and advising the relevant parties on any issues arising’ (s63(vi)).

4.25 The Committee notes the policy in the recent Victorian White Paper on water, that ‘a limit will be placed on the total volume of water than can be held by non-water

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5 Prof. P. Cullen, *Committee Hansard* 11 December 2002, p.12.

6 Mr C. Creighton (CSIRO), *Committee Hansard* 14 July 2004, p.677.

7 Prof. M. Young, *Committee Hansard* 11 December 2002, p.13.

8 Mr R. Dalton (DAFF), *Committee Hansard* 14 July 2004, p.710. Mr P. Sutherland (NSW DIPNR), *Committee Hansard* 15 July 2004, p.799.

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users in each supply system equal to 10 per cent of the system's entitlement'. The White Paper comments:

It is unlikely that this limit will be reached in the near future. All the permanent trade that has ever taken place in the 12 years since it began has not yet amounted to 10 per cent of entitlement. Moreover, much of the permanent trade will continue to be from one irrigation business to another.<sup>9</sup>

### ***Comment***

4.26 The behaviour of a freer water market is hard to predict. The question is whether it will indeed become an efficient market with many buyers and sellers, none of whom can influence the general price level. The probability of a bad outcome is hard to estimate, and possibly low; but the consequences if it happens could be severe. The risk should be taken seriously. The Committee doubts that relying on the competition provisions of the Trade Practices Act would be an adequate remedy in practice.

4.27 The Committee regrets that the IGA does not deal with this matter. The Committee regrets that the IGA has not taken up the suggestion that entitlements should only be bought by people who also own land on which they could be used. This would solve the problem simply. It would not prevent brokers from facilitating trade, and it would not prevent the operation of a water exchange. It would have some administrative cost, but it should not significantly affect the economic efficiency outcomes of trade, since traded water only participates in economic production when it is eventually put on land by a buyer who has land. It would only prevent middlemen from *owning* the entitlement along the way.

4.28 The Committee has a concern that leaving this matter for state level control of trading regimes may lead to divergent policies in different states. In the Committee's view the policy on this matter should be national. The Committee recommends that COAG should develop a policy on rules to control the water market to prevent profiteering. This should be considered separately from the principles for trading rules already agreed in schedule G of the IGA, as the latter are focussed on the different matter of controlling trade to respect environmental requirements.

### **Recommendation 3**

**4.29 COAG should develop a policy on rules to control the water market to prevent profiteering or speculation by non-users, including foreign interests, to the detriment of water users or the environment.**

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9 *Securing Our Water Future Together*, Victorian Government White Paper, June 2004, p.69

## Need for structural adjustment assistance

4.30 Most comment in evidence about structural adjustment assistance referred to the need arising from recovery of water for the environment. The concern is that while individual farmers might be paid for recovered water (subject to the risk sharing rules), this would not compensate for the knock-on effects of reduced economic activity on rural communities. The logic is that environmental goals should be paid for by the whole community, not only by farming communities:

We are advocating the need for major structural adjustment reform in the way we manage the landscape. We are saying that you cannot ask farmers to bear that cost.<sup>10</sup>

4.31 Where a local economy contracts because of water trading out, the moral case for assistance is not the same. It could be argued that economies are not immutable; the chance of economic downturn is one of the risks of life; the community has effectively benefited from a restrictive trade practice in the past and need not be compensated for losing it.

4.32 On balance the Committee is *not* inclined to argue on these lines. In the Committee's view communities affected by water trading out have a fair claim to structural adjustment assistance, since:

- many of the communities concerned are longstanding, and have developed a social infrastructure in reasonable expectation of a stable future;
- the need arises not from the normal evolution of the economy, but from a deliberate, one-off government decision;
- the economic effects of water trading and recovering water for the environment may be hard to separate;
- both activities serve the overarching community goal of improving the health of rivers.

4.33 The IGA commits the parties to 'address adjustment issues' (s94) and the Commonwealth commits to 'discussing with signatories to this Agreement assistance to affected regions on a case by case basis...' (s97). There are no specific proposals.

4.34 It will take time to see the extent of the need, as the water market matures. However the need should not be overlooked simply because the effects may develop gradually. The Committee notes that the Murray Darling Basin Commission is studying the socio-economic effects of the First Step project to recover 500 gegalitres

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10 Mr P. Cosier (Wentworth Group), *Committee Hansard* 11 December 2002, p.10.

of environmental water.<sup>11</sup> This could usefully be broadened to cover the effects of water movement generally.

4.35 The Committee suggests that COAG should commit early to a program of jointly funded structural adjustment assistance for affected communities, of similar profile to the Intergovernmental Agreement on addressing overallocation in the Murray Darling Basin. The Committee suggests that this would improve public acceptance of water reform. The exact money involved would not need to be decided early. It would depend on how trade develops. However it is important to set up the framework and to start the necessary research early so there is a baseline for comparison later.

#### **Recommendation 4**

**4.36 COAG should commit to a jointly funded program of structural adjustment assistance to communities whose economies are contracting because of water trading, and agree to provide adequate financial support for projects to promote environmental recovery in degraded areas.**

#### **Problem of stranded assets**

4.37 Adjustment problems will probably be most serious in some irrigation areas. This raises the problem of ‘stranded assets’: if some farmers sell out, the burden on those remaining to pay the maintenance costs of shared infrastructure increases.

4.38 Some irrigation area bulk suppliers have restricted trade out of the area for this reason. For example, in the Central Irrigation Trust (South Australia), ‘You can trade your water, but you are allowed to trade only two per cent out of the system at any one time....’

The reason behind that is that, if you have a massive irrigation infrastructure, you do not want everyone trading their water at the same time.<sup>12</sup>

4.39 The Committee notes the argument that shareholders of a company have every right, by majority vote, to manage the company this way:

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11 Mr K. Goss (MDBC), *Committee Hansard* 30 October 2004, p.312. Murray-Darling Basin Commission, *Scoping of economic issues in the Living Murray, with an emphasis on the irrigation sector*, 2003. Hassall & Associates et al, *Scoping Study: Social Impact Assessment of Possible Increased Environmental Flow Allocations to the River Murray System, Stage 1*, 2003. Hassall & Associates et al, *Profiling - Social and Economic Context: Social Impact Assessment of Possible Increased Environmental Flow Allocations to the River Murray System, Stage 1, Volume 2*, 2003. EBC, *Development of a Framework for Social Impact Assessment in the Living Murray: Water Recovery in the Murray Irrigation Area of NSW*, 2003.

12 Mr T. Mader (Riverland Development Corporation Inc.), *Committee Hansard* 20 April 2004, p.541.

As a corporation, we went along to the shareholders and said: ‘These are the assets you own. How are we going to manage them?’ One of the things they said... was that as a group of shareholders and a community they do not want to see water traded out of the area. We take that not as a barrier to trade; it is just the shareholders who own the assets saying that they do not want to sell them.<sup>13</sup>

4.40 The IGA aims to override this behaviour to ensure the freedom of individual end users to trade. As a concession, trade out of irrigation areas may be limited to 4 per cent of entitlement per year for the time being, with the aim of a move to full and open trade by 2014 (s60,63).

4.41 Exit fees have been proposed as a way of maintaining the viability of an irrigation area when water is sold out. These could be calculated as the net present value of the stream of future levies which the seller would have paid for maintenance of shared infrastructure.<sup>14</sup> The IGA has provisions which imply a concern that exit fees could be used as a disguised barrier to trade.<sup>15</sup>

4.42 The Committee draws attention to the need to monitor this matter. The Committee notes that imposing exit fees may have economic efficiency implications in the longer term. At the limit it raises the possibility that many farmers who have sold out are paying to maintain expensive infrastructure indefinitely for a few who remain.<sup>16</sup> This may be regarded as fair to those who remain, but it might not be an efficient use of resources.

### **Unintended effects of trade: activating sleepers**

4.43 The Committee heard that more trade has had the effect of activating ‘sleeper’ (unused) licences, when the owner of a sleeper sells it to someone who does want to use it. This has increased water use.<sup>17</sup> The implication may be that this is a reason to limit or postpone freer trade.

4.44 Where water needs to be recovered from overallocated systems, it is a vexed question whether sleepers should be given the same treatment as active users, or whether sleepers should be confiscated first, by a ‘use it or lose it’ policy, on the

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13 Mr M. Bramston (Coleambally Irrigation Cooperative Ltd), *Committee Hansard* 27 August 2003, p.235-6.

14 [COAG], *National Water Initiative Discussion Paper*, [April 2004], p.16.

15 s60(vi): ‘...no imposition of new barriers to trade, including in the form of arrangements for addressing stranded assets.’ s62: ‘...the Parties agree to ensure that support mechanisms... such as access and exit fees and retail tagging, do not become an institutional barrier to trade.’

16 ‘Indefinitely’: this is the case where an exit fee is set at the net present value of the stream of future maintenance levies which the departed farmer would have paid.

17 For example, Mr R. Browne (Gwydir Valley Irrigators Association) *Committee Hansard* 26 August 2003, p.134. Similarly House of Representatives Standing Committee on Agriculture, Fisheries and Forestry, *Getting Water Right(s) - the future of rural Australia*, 2004, p.84.

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grounds that this minimises economic dislocation. The arguments are considered further from paragraph 5.25.

4.45 The Committee suggests that this problem should not be a reason to limit trade. To do so for this reason would effectively be saying: ‘You may activate your sleeper, but you may not trade it, because we know that in practice this makes it less likely that it will be activated.’ This seems a rather ad hoc and possibly unfair approach.

4.46 The sleeper problem will need to be worked out by catchment communities and government on a case by case basis. If the answer is to give sleepers equal rights with active licences, increased water use caused by trading sleepers will need to be addressed by the general procedures for recovering overallocated water.

### **Need for nationally consistent regulation of trade**

4.47 Schedule F of the IGA lists guidelines for water registers, and schedule G lists 11 principles which the parties are to follow in setting water trading rules.

4.48 If such rules are not nationally identical, they should at least be nationally equivalent in effect. The Committee sees a risk that without deliberate continuing oversight the rules may diverge in different states, due to the normal vagaries of state politics subject to differing local political pressures. As well, there is a risk that the ongoing interpretation and application of the rules in detailed management of trade could differ.

4.49 The Committee sees a need for ongoing oversight of the water market to ensure national consistency. This could presumably be a role for the National Water Commission.

