Submission to the Productivity Commission on the Market Mechanisms for recovering water in the Murray-Darling Basin- Issues Paper

By

Victorian Farmers Federation

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Foreword

The Victorian Farmers Federation is Australia's largest state farmer organisation, and the only recognised, consistent voice on issues affecting rural Victoria.

The VFF consists of an elected Board of Directors, a member representative Policy Council to set policy and eight commodity groups representing dairy, grains, livestock, horticulture, chicken meat, pigs, flowers and egg industries.

Farmers are elected by their peers to direct each of the commodity groups and are supported by Melbourne-based staff.

Each VFF member is represented locally by one of the 230 VFF branches across the state and through their commodity representatives at local, district, state and national levels. The VFF also represents farmers' views on hundreds of industry and government forums.

Andrew Broad

President

I. Introduction

The Victorian Farmers Federation (VFF) welcomes the opportunity to comment on the Productivity Commission's Issues Paper on the Market Mechanisms for recovering water in the Murray-Darling Basin (MDB).

The VFF understands outcomes and recommendations developed from this issue paper will be utilized to report to the Australian Government into alternative market-based mechanisms that could be used to diversify the Commonwealth's water purchase program and secure access to the suite of entitlements necessary for the Commonwealth's Restoring the Balance program[1]. The VFF recognises the importance of a wide discussion on current and potential practices as to alter the allocation of water within the MDB that reflects the significance of this precious resource, and the industries and communities of which it supports.

The VFF does not support Government entering the water market to secure additional water for the environment. The VFF maintains that Governments should firstly explore investment opportunities in irrigation infrastructure. When Governments invest in infrastructure, the community maintains the economic benefits and the environment receives the water savings without damaging the important economic contribution of agriculture. If, as a last resort, Governments need to enter the market on behalf of the environment, then the process of Government buyback requires a thoroughly planned approach. A "targeted-buyback" plan, based on a strategic view of the irrigation systems across the basin must be developed and is essential to the success of the reforms. There also needs to be an overall environmental watering plan which would be a plan of how much water the environmental water holder need to purchase out of what catchments and tributaries and where the environmental water holder intends to use that water.

It is important to note that while water trading and water markets enhance water use efficiency and provide a mechanism for water users to manage their businesses and survive extreme conditions, trading rules must also take into account social and economic impacts of water transfers. Water is vital to the ongoing viability of agriculture and regional communities. The VFF strongly supports mechanisms like the 4% limit on permanent trade out of an irrigation district and termination fees, not only to ensure that rural adjustment resulting from movements of water occurs at a manageable pace, but to also guarantee that farmers not selling their water and wanting to continue farming are not faced with stranded assets and increased costs.

Governments' objective of a water market is to see it move to the higher value uses. However, the movement of water is a movement of economic activity. Dealing with movements in the water market due to inflow and demand variability is a difficult issue for farmers to plan for. Trading and market rules must not allow distortion in the market,

[1] Productivity Commission's Issues Paper on the Market Mechanisms for recovering water in the Murray-Darling Basin, Pg III

including those that may arise from Governments entering the market to secure additional water for the environment and/or funding an over-allocation buy-back.

It is integral that water market rules provide sensible mechanisms and tools, on a level playing field, to allow individuals to be responsible for decisions about their water supplies, manage climate variation and change and provide farmers with the essential level of certainty. It is also important that the development of water trade and market rules, in situations where there is likely to be a change in current state arrangements/ trade practices, is mindful of adverse impacts on existing users and water holders.

II. What are the objectives of the Restoring the Balance program?

Is the focus on acquiring entitlements the best way of achieving the environment's needs?

Is a 'no regrets' presumption a reasonable basis for purchasing entitlements, and at what point does this cease to be the case?

What are the arguments for continuing the buyback after the new Basin Plan is implemented in 2011, and associated state water sharing plans start to be implemented in 2014?

What implications do environmental demands across the Basin have on the targeting of purchases and the mechanisms and instruments that should ideally be used?

How should environmental water be allocated across competing projects and sites?

The VFF has long opposed governments taking the convenient option to buy water from irrigators in the MDB to provide water to the environment. Our opposition has always been based on ensuring food security, social stability and the dependence of rural communities on the economic activity and food production that is generated by irrigation. Governments should firstly explore investment opportunities in irrigation infrastructure. When Governments invest in infrastructure, the community maintains the economic benefits and the environment receives the water savings without damaging the important economic contribution of agriculture. If, as a last resort, Governments need to enter the market on behalf of the environment, the VFF supports the development of rules for Governments' buying water; these include transparency, accountability, targeted purchase, mature market and an integrated approach that considers alliance of infrastructure upgrade and buyback.

The VFF is unclear on the outcomes that are expected by any increase in environmental flows. While an objective target on increase in flows is easy to stipulate, the real question is what needs to be achieved and how much water is needed to achieve it?

The primary goal of the Commonwealth's Restoring the Balance program is to balance water for consumptive use and water to the environment. The Government must specify how water for the environment will be utilised, how the additional flows will be accounted for, the river health benefits that can be expected and how these benefits will be measured. An assessment must be made of the current environmental status of rivers to provide base data and a procedure put in place to monitor and publicly report environmental benefits arising from additional flows.

New environmental water should be introduced through a phased process with community involvement and continual independent monitoring of outcomes. If the environmental monitoring does not indicate there are clear and measurable improvements in river health as a result of increased flows, further research will be required before any additional water is returned to the rivers. If there is no evidence to indicate additional water is having a positive impact on river health that water should be returned for consumptive use.

There is no information regarding the socio-economic impact of diverting additional water to environmental flows. As national water reforms are rolled out, the socio-economic impact on communities must be measured and publicly reported. With good information on the environmental benefits gained from additional water for environmental flows and the socio-economic impact, governments and the community will be in a better position to make sound policy decisions in relation to any further commitments to return water to the environment.

The VFF supports an integrated and coordinated approach towards the use of environmental water among all holders of environmental water entitlements to achieve defined environmental objectives in such a way that:

- Makes the most efficient and effective use
- Addresses the social and economic impacts
- Engages the irrigators in the Basin through full consultation processes.

The construction of environmental asset works should be a tool implemented to increase the efficacy of environmental water delivery. Investing in infrastructure to deliver environmental water, just as in the case of water for other uses, minimises losses thereby reducing the volume of water needed to achieve any particular outcome. This could involve upgrading channels and piping water to supply wet lands and other environmental assets.

There needs to be a transparent and rigorous assessment in developing environmental objectives, and setting a water flow target. An ongoing rigorous and transparent review of the outcomes to measure the actual against the expected targets is needed.

Should the buybacks be designed so as to reduce structural adjustment costs or should adjustment be addressed separately? If the former, are there particular buyback mechanisms that should be used to do this? If the latter, what approach should be used?

Buybacks should be designed so as to reduce structural adjustment costs. The VFF have always supported a planned approach to buyback (targeted buyback) as opposed to a 'shotgun' method of simply buying individual water entitlements with no overall vision for the future of irrigation and regional communities.

Upon completion of Government buybacks and exit packages, like any other area that experiences loss of industry, rural Victoria will need a comprehensive program of rural regional adjustment due to likely reductions in irrigated agriculture. A policy involving such programs as regional development, re-education and re-training are essential is ensuring the long-term viability of many areas in rural Victoria that will be affected by the Government water buyback process. Accordingly, a strategic plan for the buyback process should aim at aligning purchase program with both off-farm and on-farm modernisation programs, to reduce the costs associated with structural adjustments.

Does the exit grant package for small block irrigators play a useful role in the overall buyback scheme? Should it be offered again?

Farmers showed considerable interest in this program. VFF believe that this program should be offered again.

The current small block irrigator grants provide an exit grants of up to $150 000, $20 000 for the removal of irrigations infrastructure and an additional $10 000 for training. The eligibility for the program excludes farms greater in size that 40 hectares. This program should be opened up to farms greater than 40 ha in size to ensure all irrigators are treated equitably.

The grant for removal of irrigation infrastructure would need to be changed to a per ha basis for larger scale properties. The current grant provides a maximum of $500 per ha which should be used as the grant amount.

III. The market for water

What impact has the Restoring the Balance program had on the price of water entitlements to date? What, if any, impact has this had on the market for seasonal allocations?

DEWHA is now publishing average prices paid for entitlements. What impact is this likely to have on bids in subsequent tenders or one-off purchases?

How much influence would the choice of market mechanism used to purchase entitlements for environmental purposes have on the market for water?

What impact has the entrance of the Commonwealth (and other governments) into the market for water had on background trade in water between third parties?

How would speeding up or slowing down the Australian Government's water purchases influence the effects on trade between irrigators?

The water market works best when there are many buyers and sellers. Market can be distorted if a single large trader like the Governments enters the market, unless appropriate rules and regulations are carefully developed to reduce such distortions. Government purchase could lead to large amounts of water from one district removed in one year; which may not provide the best community outcome; inflate the price and prevent appropriate allocation; and reduce certainty in agriculture which will ultimately lead to lower investment.

IV. What market mechanisms should be considered?

What are the advantages and disadvantages of the different market mechanisms that could be used to obtain water for the environment? In particular, how do they compare in terms of compliance and transactions costs and the ability to meet the different watering needs of environmental assets?

Are there other market mechanisms, not listed above, that the Commission should be considering?

With the benefit of the experience gained from three tenders under the RTB program:

- ***What are the advantages and disadvantages of the chosen rolling tender process?***
- ***How could the tender process be improved?***
- ***How do you think an open market process would have fared instead?***

What mix of market mechanisms should the Australian Government be using to achieve its environmental objectives?

As stated in the issues paper, there are advantages and disadvantages of each of these market mechanisms, with some more suitable to certain circumstances than others. The Commission will use the effectiveness, efficiency and appropriateness criteria discussed earlier to assess these options[2]. The VFF believes these criteria do not adequately address the concerns of rural water users. The socio-economic impact of water in production should be recognized and addressed through market mechanisms to achieve the Basin Plan's

[2] Productivity Commission's Issues Paper on the Market Mechanisms for recovering water in the Murray-Darling Basin, Pg 19

objectives. While the listed criteria mention the need to recognize the environmental and social impacts[3], it does not seem to adequately reflect the importance of social and economic impacts on the transfer of water.

The VFF believe water market will lead to structural adjustments such as contraction in the demand for complementary agricultural services and output from districts. This may result in significant and rapid changes to the demographics population and sustainability of communities.

The VFF believes that the impact on 'third parties' in terms of regional effects must be accorded sufficient consideration when assessing water market mechanisms.

Rules around Governments buying water for the environment should be developed in such a way that facilitates:

- Transparency
- Alliance of infrastructure upgrade and buyback
- Targeted purchase in accordance with reconfiguration and modernization processes. The option of offering additional incentives to encourage farmers taking cooperative initiatives within certain systems to maximize benefits, needs to be further considered.
- Accountability
- Mature market – a level playing field on both state and national levels.

The VFF supported the consultative process to guide the $3billion purchase of water for the environment through establishing formal transparency rules around how those purchases will be managed.

V. Do we need a portfolio of mechanisms and water products?

What mix of water products should the Australian Government be using to achieve its environmental objectives?

VFF has recently reviewed its position on the **"four percent cap on Low Reliability water shares**". VFF believe that allowing 100 percent of Low Reliability water to be exempt from the 4 percent cap would provide a water product that is beneficial to the environment, since low reliability allocated when water available which is generally when the environment receives its water supply, at reasonable prices and lower costs to the Commonwealth. Exempting low reliability water from the cap will provide an alternative that will minimise the negative impacts of loss of water from irrigation districts and thus increases affordability of irrigation into the future and protects investments in irrigation infrastructure, giving all irrigators more certainty into the future.

[3] Productivity Commission's Issues Paper on the Market Mechanisms for recovering water in the Murray-Darling Basin, Pg 6

VI. Upgrading infrastructure

Should water purchasing and infrastructure upgrades be coordinated and, if so, how?

As discussed earlier, Water buyback should be aligned with infrastructure upgrades. A good example is the recent Commonwealth – Victorian agreement on the 4 percent cap on water trading. The VFF acknowledged the agreement which will introduce a more strategic approach to obtaining water for the environment. The agreement specified that environmental water, derived through such programs such as Northern Victorian Irrigation Modernisation Program (NVIRP) and the recently announced On-Farm Irrigation Efficacy Program, will be exempt of the 4 percent trading rule. Other key aspects of the agreement stated that Water trades associated with the Commonwealth's Small Block Irrigator Exit Grant Package in Victoria will be allowed to proceed immediately, regardless of the four per cent cap.

What potential is there for a more cost-reflective approach to pricing of water delivery to obviate the need for targeting purchases of water?

The VFF supports equality of pricing of water to all northern gravity irrigators. Currently Goulburn-Murray Water (G-MW) pools together its share of the costs for operating storages in the Goulburn, Loddon, Campaspe, Broken and Bullarook basins to produce one average bulk water price called the Goulburn system price. A similar process is used to pool and average costs for storages on the Murray, Ovens and King basins to create a Murray system price. The VFF notes that in March 2007, (G-MW) has made in-principle decision to introduce basin pricing with its implementation to be effected in conjunction with major capital works on a basin by basin basis. The VFF oppose this decision as it will result in smaller basins experiencing dramatic price increases. As many of the basins are interconnected it is very difficult to draw such distinctions. However, VFF is not uncomfortable with the current interstate trade policy in regards to charging the full basin price when water is traded out of the G-MW areas. Farmers in the smaller systems have invested on the assumption of continuation of averaging of bulk water prices across the Goulburn and Murray systems. It would be unfair to wind back this arrangement for small basins over a short period of time, and would have a substantial impact on affected farm businesses. VFF believe much greater consideration and consultation is required to examine the costs included in bulk water charges for these small systems prior to any change. The VFF strongly recommends engaging the Water Services Committee (WSC) in such a process.

How well has the irrigator-led group proposal component of Restoring the Balance addressed the possibilities for taking group action that coordinates infrastructure upgrades and water sales? How could it be improved?

The Federal Government should aim to purchase entitlements held by farmers on a strategic basis and in particular work with groups of willing sellers where water savings can be

achieved as part of the buyback process. For example a group of farmers on the same reach of an irrigation system willing to sell their water entitlements has the potential to obtain significant water savings as the 'system losses' would also be recovered.

In situations such as this, the payment for entitlement should adequately reflect the farmers 'lost opportunity' as this farmer's land will be permanently closed to irrigation as well as incorporating the value of the additional water saved. The cost of water would need to include:

- Market value of water being sold to the Government
- Market value of the individuals share of the savings occurring due to closure of system
- Share of avoided cost of any infrastructure upgrade
- Drought Assistance Package

On-Farm Irrigation Efficiency Program

VFF strongly supported the Commonwealth's $300 million On-Farm Irrigation Efficacy Program, targeted in the Southern Basin. This funding, forming part of the Federal Government's $12.9 billion *Water for the Future* plan, will be used to upgrade on-farm irrigation infrastructure. This program aims to recover 115GL of water, 50% of which will be transferred to the Commonwealth Environmental Water Holder.

Increasing on-farm irrigation efficiencies will assist irrigated agriculture confront a future with less water without compromising productivity whilst simultaneously assisting the Federal Government to achieve its environmental water acquisition volume. On-farm irrigation upgrades would complement the off-farm irrigation modernisation and a key aspect missing from *Water for the Future*.

VII. Impediments to the use of particular market mechanisms

Four per cent limit on trade in entitlements

What impact is the 4 per cent limit having on the market for water entitlements?

What impact is it having on the effectiveness and efficiency of the Australian Government's purchasing programs (both under the RTB program and under The Living Murray)?

To what extent are irrigators who wish to sell their entitlement being disadvantaged by the limit?

Is a limit on outwards trade the best way to address concerns over possible socio-economic impacts on particular irrigation areas?

Is the Commonwealth–Victorian agreement on the 4 per cent limit a satisfactory way to allow a greater quantity of entitlements to be purchased in Victoria?

The VFF has a long-held position strongly supporting mechanisms like the four per cent limit on permanent trade out of an irrigation district, not only to ensure that rural adjustment resulting from movements of water occurs at a manageable pace, but to also guarantee that farmers not selling their water and wanting to continue farming are not faced with stranded assets and increased costs.

Allowing unfettered transfer of irrigation water, particularly in an market that is impacted by water shortages due to low inflows, and has major players not driven by commercial considerations, will cause significant hardships onto rural communities. The 4 per cent rule is essential in ensuring that rural adjustment resulting from movements of irrigation water occurs at a manageable pace and allows communities to adapt to the change. The movement of water out of an area has a number of direct impacts that must be managed.

These impacts include;

- Loss of economic activity leading to structural adjustment
- Reducing the efficiency and viability of a delivery system
- Increasing costs on remaining system users

The movement of water is a movement of economic activity. The loss of substantial amounts of water in a short time period from a community, which would be likely if the cap was removed, will cause significant disruption of local economies, employment opportunities and social structures of the many local communities reliant on irrigated agriculture.

The VFF believe that the review of this rule should be carefully planned and informed through an integrated approach that considers three major components; Commonwealth's purchase of entitlements, investment in infrastructure upgrade, and the new diversion limits resulting from the Basin Plan due in 2011. Subsequently, if any change is to be made, it should be planned carefully and gradually and adjusted over a reasonable timeframe.

Any early and unplanned review of the rule will only exacerbate the stress in some areas and may also result in considerable loss of investments. The intent of this rule has always been an insurance to help manage concerns about the adjustment of regions to water trade, and to monitor the socio-economic impacts of water trade.

It could further threaten irrigators' supply of water, and provoke detrimental rates of social and economic change in irrigation districts. There is already a high level of stress and uncertainty surrounding water supplies for farms due to the risks associated with climate change.

It is accepted that will be some positive benefits from the removal of the cap through a faster transfer of water to higher value uses. This benefit will still be realized, only over a longer time frame with the 4 per cent cap remaining in place. The will allow communities time to adjust to a change in the production mix in their respective farming regions, without preventing the achievement of the long term economic benefits.

The discussion above has been in relation to transfers between commercial users of water. The entry into the market of the Government or agencies of the Government with a $3 billion bank roll will complicate the market impacts. With farmer to farmer trade the economic activity moves from one location to another and the problems are managing the adjustment process; when water is bought in order to increase environmental flows, the economic activity is lost entirely from rural communities.

Environmental purchases are not driven by commercial principles and it is difficult to envisage the expenditure of $3 billion, even over a number of years, not causing significant distortions in the water market. Rules on Government trading in the marketplace will be necessary to ensure that impacts are minimized. The existing 4% trade cap is one of these.

The VFF acknowledged the Commonwealth – Victorian agreement which will retain the 4 per cent cap on water trading until at least 2011. Under the agreement, and subject to a review of progress on the modernisation project, Victoria will begin to phase out the four per cent cap on permanent water trades from irrigation districts from July 2011, with a view to removing the cap entirely by 2014. It is recognised that this agreement will introduce a more strategic approach to obtaining water for the environment.

The agreement specified that environmental water, derived through such programs such as Northern Victorian Irrigation Modernisation Program (NVIRP) and the recently announced On-Farm Irrigation Efficacy Program, will be exempt of the 4 percent trading rule.

VFF has recently reviewed its position on the **"four percent cap on Low Reliability water shares**". VFF called for f Low Reliability water to be exempt from the 4% cap.

Termination fees

How substantial are the impediments to trade in entitlements created by the imposition of termination fees?

Is the potential for irrigation assets to be stranded a relevant concern? Should some buyback mechanisms be preferred over others because they have a lower propensity to lead to stranded assets?

Are termination fees likely to help or hinder the efficient use of, and investment in, irrigation infrastructure during the buybacks?

How can the right incentives for investment in irrigation infrastructure be achieved during the buyback program?

What impact are termination fees likely to have on an irrigator's willingness to sell and the cost of the buyback?

The VFF supports water market rules should prohibit any compulsory termination upon transformation (exit fees) and exclude them from being part of terms and conditions for

transformation and/or trade. VFF maintained that appropriate and consistent termination fees across state boundaries are vital for fair trade in water and to ensure irrigators do not suffer from rising prices when water is traded out of an area. VFF recommended that collected termination fees within a district should be quarantined within that district, accounted for separately and should be used to cover any increase in charges to irrigators remaining on the system.

VFF supports the factor used for the calculation of termination fees should be set to ensure sufficient funds to maintain water supply infrastructure over a suitable period and for structural readjustment so that remaining users are not required to absorb these costs. VFF supported a factor used for the calculation of termination fees to be set at a maximum multiplier of 15 times the access fee. This ensures sufficient funds to maintain water supply infrastructure over a suitable period and for structural readjustment so that remaining users are not required to absorb these costs.

However, and as stated in the issues paper, from 1 September 2009 termination fees will need to comply with new rules recommended by the ACCC and adopted by the Minister for Climate Change and Water in February 2009. The rules cap termination fees at 10 times the annual infrastructure access charge. But termination fees may be waived, in whole or in part, depending on the degree to which the operator can avoid costs by reconfiguring or rationalising the remaining infrastructure. This may, for example, occur where a group of irrigators served by a particular spur channel collectively agree to terminate their delivery rights[4]. The VFF expressed concerns if ACCC did not allow higher termination fees than a multiple of 10 times access fees, for those existing projects with outstanding debts and with no existing contract. VFF believes that without such flexibility in higher termination fees, operators may not be able to recover their committed fixed costs compromising the viability of operators and/or those irrigators remaining on the system.

Transaction costs

Are the costs associated with trading water entitlements (including those associated with delays and lack of market information) higher than they should be?

Are these costs a significant impediment to the efficient operation of government water buybacks and the water market more generally?

How might these costs be reduced?

The VFF support an alternative measure used by the commercial sector when, for example, buying shares. This is a systematic process where applications logged either by the buyer/seller, shares are placed in a queue, to allow for orderly progression and to derive a

[4] Productivity Commission's Issues Paper on the Market Mechanisms for recovering water in the Murray-Darling Basin, Pg 25

rough time frames for customers. The VFF supports a systematic application process, as opposed to the 'ballot' system for permanent water trade.

A National register, not unlike how information is presented on the Stock Exchange, may be an effective approach that could address all transparency issues surrounding water trading. A national register may consist of information regarding current price of High and Low Reliability water, permanent and temporary trade in respect to different systems around Australia, and could also incorporate information regarding individual irrigation system's seasonal allocations. This would allow all willing buyers and sellers to have access to comprehensive information regarding all water trade within Australia, Murray-Darling Basin.

All water brokers would then be brokers to the exchange, with similar regulation as a stock exchange broker.

This also ties in well with the key principles underpinning an efficient free market which is 'well informed decision making in the part of the market participants'.