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PUBLIC SUBMISSION TO

MARKET MECHANISMS FOR RECOVERING WATER IN THE MURRAY DARLING BASIN

AUSTRALIAN PRODUCTIVITY COMMISSION ISSUES PAPER

BY

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Productivity Commission Study into Market Mechanisms for Recovering Water in the Murray Darling Basin

Introduction

Western Murray Irrigation Limited (WMI) is an infrastructure operator that services the irrigation districts of Buronga, Coomealla and Curlwaa in Southern New South Wales. WMI is a privatised corporation where its irrigator members are its shareholders. WMI irrigators have been active in the permanent water entitlement market for many years. As part of the NSW water-sharing plan, WMI irrigators provide 3% of their allocation to the environment each year and as a result water allocation to their entitlement can never exceed 97%.

As a general comment, WMI supports Government purchases in the market for the environment. The current buyback program has clearly recognised the water entitlement as equivalent to a property entitlement and makes purchases from willing sellers. The Government's commitment to retaining the characteristics of the water purchased also provided reassurance that this water cannot take priority in any allocation process.

Of concern to WMI is how the buyback is managed. The fact the tender is discriminatory and not an open tender process leads to inefficiencies and application of significant administrative resources to process the many tenders offered by irrigators, many which will be rejected because the asking price is too high.

WMI's preference would be for an open tender with a clear price at a slight premium to the market to secure the water quickly. The rolling tender should be replaced with short tender processes in each year to prevent the Government constantly being in the market. Clear performance targets should be set for the timeframe for due diligence, approval and payment of funds to the irrigators who have signed contracts for sale.

The ten-year timeframe for Government purchasing will need to be reassessed once the Basin Plan is adopted and environmental watering needs clearly defined.

Responses to specific questions

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

In the longer-term yes but in the short term no. Much of the water entitlement purchased does not convert to real water allocation in dry years and of the buybacks to date only a small volume of water has been provided for environmental assets.

There is an active and significant temporary trade market and in years of drought if enough importance is placed on the environmental assets some "real" water should be purchased by the Government using the standard method of brokers and exchanges. The environment has a dollar value as does agricultural production and the key driver for the water market is diverting the water to its most productive use in any one season. The annual croppers have a dollar figure where it is more viable to trade water on the seasonal market rather then grow a crop. This figure is generally in the vicinity of $300-$400 per ML.
The focus on value for money has stopped the purchase of "high security" water entitlement where there is an actual water allocation each year that can then be reliably applied to the environment. In the case of WMI customers the market price has consistently been above

what the buyback has been prepared to accept. As a result there has been a minimal amount of NSW high security purchased in the buyback to date.

The long-term strategy must be the ownership of a mix of permanent water entitlements (across valley and security type) and the use of the annual water market when needed to top up the environmental water needs.

The infrastructure expenditure is also required to balance the book in basin communities and allow more to be done with less water over time.

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

The willing seller principal must be upheld and the Government has an overall dollar target in place. There however must be a "stop" point where the scale has tipped too far and basin communities will be damaged beyond adjustment and repair. The irrigation community has been requesting a purchase target by valley and security type and this would provide transparency and a greater certainty for future investment.

The purchases must eventually tie into the environmental assets watering framework and actual needs which should form part of the Basin Plan.

The living Murray program, wetland management groups and state environmental programs have all secured permanent water entitlement and the risk is of duplication. Eventually there will need to be a full audit of all Government and private water entitlement held for the environment.

If environmental water allocation is to be placed on the temporary market in the future, clear triggers must be in place to allow this to occur.

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?

Any irrigator would prefer the buyback rather than the proposed adjustment that may take place under the Basin Plan where a percentage will be taken from each irrigator under the new sustainable diversion limits. There is no guarantee any reduction will be supported by compensation despite the fact the value of the property right will be eroded.

As an infrastructure operator, WMI is attempting to plan for its future with less water. If an irrigator wishes to get out of the industry, it is better if it happens sooner rather than later to provide clear signals for infrastructure investment or downsizing. Many external forces including low commodity prices and the ageing population of the farmers are driving adjustment and water is only one factor in the decision making in our region.

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?

There needs to be a recognition that not all environmental assets can or should be saved and nature will take its course in some instances. This is consistent with the knowledge not all irrigation assets can or should be saved.

Science and protection of species must drive allocation on water to environmental sites.

Environmental demands will change from year to year. Buybacks should be targeted where water can realistically be moved between systems.

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?

Paying a premium for the water where there are co-ordinated offers from irrigators will assist with structural adjustment as it allows for system retirement and an exit with dignity.

Paying the termination fee over and above the market price to the infrastructure operators to allow "in district" irrigators to be on a level playing field with private diverters would improve capital retention in basin communities.

The buyback is one part of adjusting Basin usage and should be co-ordinated with the on farm and infrastructure investment programs. WMI supports the other "strengthening basin communities programs" aimed at local government.

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

No, the small block irrigators' grant is detrimental to economic adjustment in irrigation districts. The small farms targeted in this program have generally been unviable for some time and are close to urban areas.

Locking up land for five years in smaller irrigation districts is a poor strategy where there is opportunity for cash cropping under highly efficient water use systems. The land values are also impacted by the package.

These small block irrigators have had the opportunity to participate in the buyback on equal terms with other irrigators and can retain land and housing.

It would be of interest to know how much water has been secured through the exit grant, in what valleys and how much irrigation land has been locked up for five years. The cost of the program versus the actual benefit should be reviewed. Benefits to individuals could be proven but on a broader scale would be harder to substantiate.

The concept of exit grants should be tied into the review of drought and exceptional circumstances relief.

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?

There has been strong growth in the price of NSW high security water that is due to the prospects of consistently high allocations. Currently the Government is out of the market and the price for high security continues to increase. When the Government was in the market they were consistently below the market price being paid for high security water.

Currently in the WMI districts, demand is being generated from Victorian and South Australian irrigators who are buying properties with water, turning the water off and transferring the water on a temporary basis. In some instances Victorian irrigators have sold their Victorian water entitlement to the Government in the buyback to generate cash flow to purchase NSW high security water entitlement.

The scarce resource and ongoing drought has had an impact on water prices. The Government buyback may have had an impact of the price of general security water entitlement, as the Government would remain the major buyer in this market.

The market expectation is the Government will remain in the market for some time due to the billions which must be spent and a floor price over and above what may be there otherwise will be maintained until the Government money is spent.

There would be minimal impact on the temporary water market as once water is allocated regardless of which type of security it is from, it is equivalent in terms of volume offered and market price. The key driver for the temporary water market is allocation, higher prices if there is a lack of allocation, lower prices if there is plenty of allocation.

The Government buyback has purchased a considerable amount of water where there has been little allocation since its purchase.

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?

This is one source of information and is useful but as the list of willing sellers in the preferred water entitlement products dwindles past data is not necessarily an indicator of future market price or wider demand. An open tender price would be more transparent and fair to the irrigator community.

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

The productivity commission should assess each type of market mechanism available. As noted in the issues paper, the Government's plan is to purchase entitlement well in excess of the pre-buyback size of the market. The timeframe of the buyback could have a greater impact. At the moment the perfect storm has been created "drought, low allocations, poor commodity prices and an increase in the capital value of the water asset" is increasing the number of willing sellers. The Government may wish to optimise on the increased supply of water to the market while it is available.

The SA Government has recently announced it plans to buy permanent water entitlement indicating the Federal Government is not the only competitive player.

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?

There has been significant trade including water with land between irrigators despite the Government's presence in the market. This is due to the scarcity of the NSW high security product.

The Productivity Commission needs to consider that not all deals are just for water and property sales with water also make up a percentage of water transactions.

The Government being in the market may have increased the rate at which water is being sold without land and the land is effectively being dewatered. This information would also be of relevance to the study as once water leaves the land it is generally not returned in a permanent capacity.

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

WMI's preference is for the Government to be out of the market as soon as possible or at the very least run short and sharp open tenders each year. If the Government is only there for two months of each year the rest of the year can be set aside for normal trading activity.

Slowing down or reducing the money to be spent each year would lessen the potential price impact but also reduces the adjustment that needs to be undertaken.

Speeding up the buyback will force adjustment or fast track decisions for non-viable irrigators which may be in the best interests of the Basin longer term.

The Basin Plan is expected to provide a greater level of certainty to the investment decisions being made by irrigators including the need to purchase water for productive use. Until the Basin Plan is in place caution should be taken with speeding up the buyback.

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?

WMI believes Government should use a limited number of market mechanisms to ensure its efficient use of administrative resources and above all to be seen to be transparent.

Purchasing entitlements in the general marketplace will lead to discriminatory pricing and incurring commissions from brokers (between 1.5% - 3% of the deal).

The tender process would be cheaper and all "willing seller" irrigators (without using brokers) and brokers can access this in an easy manner.

WMI supports an open tender process with a binding bid provided certain timeframes are met by both parties and due diligence is successful.

WMI does not support purchasing land and entitlements unless there are significant environmental benefits and a clear strategy for the use of the land e.g. National Park.

WMI supports Government purchasing seasonal allocation to save critical environmental assets. This is not dissimilar to towns and cities purchasing temporary water for use on public spaces. This could include long-term lease arrangements.

The Water Trading Rules being developed by the ACCC should be considered in the Productivity Commissions approach to different market mechanisms.

The more complicated mechanisms should be avoided unless they are well understood by the sellers and presently there is not general acceptance of options contracts.

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

WMI would be interested in the Productivity Commission assessing the exchange of capital grant funds for water savings generated, which could be deemed to be a market mechanism.

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?

Improvements required:

- Set purchase targets by valley and product type.
- Have a definitive end date for each tender.
- Only open the tender for a short time.
- Offer a firm price similar to a share buyback to prevent a number of rejected or "silly" bids. Don't be afraid to offer a premium to secure the water needed (the higher price paid is a short term perceived value for money issue against the longer term benefits to the Basin and the cost of administrative resources to undertake discriminatory tenders and to be constantly evaluating a market price).
- Speed up the paperwork and the payment to irrigators.

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

Government provided they are open and transparent and the environmental objective is clearly linked to the option and communicated should use a mix of permanent and temporary trading options.

Upgrading infrastructure

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

The Government should recognise significant private investment will continue to take place to improve water use efficiency.

Government should not support infrastructure upgrades if there will not be the irrigators to use it in the future or the irrigators are not prepared to pay for any component of the upgrade.

Infrastructure operators must be at full cost recovery and irrigators should recognise their commitment to the future of the system if significant investment is made. Business cases must be sound. Provided they are, then a fair value offset for water savings offered against the capital grant makes sense.

The time lag in getting an infrastructure project to fruition is an obvious challenge when compared to a straightforward buyback. This lag provides an argument to slow down the buyback to allow the infrastructure projects some time to catch up.

While focus is on the environment at the end of the day Government must also encourage those viable irrigators who want to stay farming and are productively providing food and using water wisely.

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

NSW irrigators operate in a full cost recovery environment and have not received rebates for fixed charges. The ACCC water charge rules is the first step in moving towards fairer water pricing but as these will not be compulsory, inequities and political forces will continue to influence whether water is kept or sold.

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?
What impact is the NSW Government's ban on sales of NSW entitlements to the Commonwealth for environmental purposes likely to have on the ability of the buyback to obtain water efficiently and effectively?

Under the Water Market Rules all NSW and SA operators will be prevented from applying a 4% cap effective 1 January 2010.

WMI has never reached the 4%. WMI supports the full removal of the cap for all operators within all States and until that point is reached supports an equal playing field. If this requires a limit from how much can be removed from each State WMI remains supportive of this approach.

WMI supports an individual's right to deal with their water asset when and how they see fit. Irrigators have been disadvantaged by the 4% rule in Victoria and the embargo in NSW however the detrimental economic impacts of the buyback should not be targeted at one State or valley.

The socio economic impacts of the drought are being felt in each irrigation area. These are short-term impacts. The water buyback and the removal of wealth from an area permanently will have a much greater impact in the longer term. A limit on outward trade is only delaying the inevitable if water is going to move anyway.

As an infrastructure operator there will come a point where only so much water can be removed before the system will no longer be viable to operate. The irrigator who remains in the system will be disadvantaged not the one who has left or who wants to leave.

Termination fees

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

Termination fees have been set at a 10 times multiple. The ACCC has supported termination fees in the short term recognising there must be a sharing of risk between those who wish to leave and those that wish to stay. The productivity commission must remembers many of the districts were established as a group scheme with a non tradeable and defined water entitlement and investment decisions were based on the water entitlement remaining in the system.

WMI would remove termination fees if Government provided the equivalent value to the sinking fund of the company to deal with asset retirement, downsizing and refurbishment.

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?

Yes, stranded assets are a valid concern. WMI is an efficient operator located close to the river and processing facilities but faces massive loss of water entitlement due to the value of the high security water entitlement owned by its customers.

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

There will be no impact on operator's decision apart from the fact there is some protection for past commitments. For example WMI continues to pay the NSW Government for modernisation works undertaken upon privatisation. This was a 25-year commitment made with all irrigators at that time and the commitment must be honoured.

The availability of capital grants from Government will be a key driver for investment in irrigation infrastructure.

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

The key incentive has to be significantly improved water use efficiency coupled with the ability to manage and pay for the ongoing maintenance of the system into the future. If termination fees are seen to be a barrier to trade the amount provided for irrigation modernisation infrastructure funding could be bulked up by the termination fee and the termination fee removed.

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

They would have no impact if the Government recognised the difference between the private diverter irrigator and the irrigator within an irrigation scheme and paid the termination fee direct to the operator. The termination fee is over and above the market price achieved by the private diverter.

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 Productivity Commission should work with the National Water Commission and the ACCC on the costs of water trading. The transaction costs from an operator are an insignificant component of a permanent water trade and the NSW State related fees are not substantial. Timeframes are improving and the Water Market rules have set down approval guidelines.

If brokers are not required in a permanent water trade the commission will be saved. The tender forms for the buyback have been simple to complete.

WMI has found in the past delays are due to inaccurate documentation being provided from solicitors, brokers, third party interests or the irrigators themselves.

The water asset is not dissimilar to the transfer of land and takes time and a processing timeframe for the transaction of less than two months would be deemed to be a good result.