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Submission to Productivity Commission

Market Mechanisms for Recovering Water in the Murray-Darling Basin

Draft Research Report

100119

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Introduction

NSW Irrigators' Council (NSWIC) represents more than 12,000 irrigation farmers across NSW. These irrigators access regulated, unregulated and groundwater systems. Our members include valley water user associations, food and fibre groups, irrigation corporations and commodity groups from the rice, cotton, dairy and horticultural industries.

This document represents the views of the members of NSWIC. However each member reserves the right to independent policy on issues that directly relate to their areas of operation, or expertise, or any other issues that they may deem relevant.

General Comments

NSWIC welcomes the draft report of the Productivity Commission with which, in the main, we concur.

In particular, we congratulate the Commission on its engagement process. It is a model that ought be noted by other entities as one which has embraced and accepted the views of stakeholders.

This further submission is in respect of specific matters only. Where a finding or recommendation of the Commission is not addressed, an assumption may be made that NSWIC *does not disagree*.

Draft Finding 3.1

NSWIC submits that, in respect of NSW, it is incorrect to state that "northern Basin ... markets are not well developed."[1] Whilst this may be the case in parts of southern Queensland due to the delay in the commencement of trade, it is not the case in NSW. Instead the situation is brought about by the lack of the depth and volume in the market seen in the southern connected system. This is merely a symptom of the overall lower license volume.

The effect that the Commission points out – that there are implications for the buyback – are not mitigated, however, and to that extent we suggest a rewording of the Draft Finding rather than an alteration of intent.

Draft Finding 3.2

NSWIC acknowledges that market intermediaries have developed alongside the market to facilitate trade. We are greatly concerned – as we have pointed out in a range of submissions – that the regulatory environment surrounding these intermediaries has most certainly not kept pace with that development.

It remains the case that there is absolutely *no regulation* of water market intermediaries. NSWIC has repeatedly submitted that water brokers must be licensed and subject to, at very least, training requirements, the use of trust accounts and the retention of professional indemnity insurance.

The response from investigating authorities – including the Commission – to our concerns has essentially been that no problem has yet occurred. In the Draft Report, the Commission points to what it considers a low number of complaints to the ACCC in respect of the behaviour of intermediaries.

With respect, the Sydney Harbour Bridge has yet to fall down; this fact has not prevented ongoing maintenance occurring. It is foolhardy to wait for a problem to occur prior to taking action to prevent it. NSWIC submits that the Commission must examine the likelihood of an intermediary acting improperly[2], the extent of the results of such action and the capacity of regulation to prevent it. We submit that such investigation would result in a finding that regulation of intermediaries is not only necessary but likely to be beneficial to the market and all users of it.

Section 4.2 – Deciding on Environmental Priorities

NSWIC notes the statement of the Commission:

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[1] At page 49.
[2] NSWIC is content to provide examples in a meeting with the PC.

> *There is currently no volumetric recovery target set as part of the RTB program to purchase water entitlements.*[3]

This simple statement of fact goes to the heart of our initial submission, which highlighted to lack of defined outcome in the RTB program:

> *Buying water without an understanding of how much is required, where it is required and when it is required is foolhardy.*[4]

In light of our position and the factual statement of the Commission, we are disappointed that a finding has not been made in respect of this issue. Moreover, a recommendation from the Commission ought be made that the Commonwealth develop and publish a clear strategy that provides desired outcomes and how they will be achieved prior to continuing the RTB program.

Draft Finding 4.1

Whilst NSWIC concurs with the finding, we do not believe it is complete without the addition of a statement that this finding has not been taken into considering in designing the current RTB program.

Draft Finding 4.2

NSWIC strongly concurs with this finding and submits that a recommendation ought be based on it.

In particular, NSWIC submits that a recommendation that description of social and economic impacts as part of a Basin Plan driven by environmental requirements is not in any sense a consideration of tradeoff and is most certainly not one that considers community preference.

Draft Finding 6.1

Pursuant to our submission above, NSWIC strongly concurs with the draft finding that a Basin Plan based solely on environmental requirements is sub-optimal. Whilst we recognise that the finding is made in the context of the RTB program, we believe that the commentary surrounding the finding ought lead to a more general finding that the Basin Planning process is flawed.

In particular, we would like to see statements such as *"more water for the environment means less water for consumptive use and decisions about this tradeoff*

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[3] At page 65

[4] NSWIC initial submission to PC at page 3.

should take into account community preferences"[5] and *"not considering (additional issues) may result in a substantial waste of public funds and unwarranted disruption to rural communities for little (if any) environmental benefit"*[6] incorporated into a finding in respect of the Basin Planning process.

Draft Recommendation 6.1

NSWIC submits that this finding must be delivered to the Commonwealth as a matter of urgency.

It is very clear that risk assignment provisions are little understood at an administrative level.

The draft Basin Plan will be released in the middle of this year. It is reasonable to assume that work on implementation of risk assignment is currently underway.

Given that the Commission's report is due in March of 2010, NSWIC strongly encourages the Commission to provide an interim finding in respect of this matter to the Commonwealth immediately.

Section 6.2 – Infrastructure Upgrades

Price Increases Due to Productive Value Increase

The Commission rightly notes that reducing water available for consumptive use will result in upward pressure on prices. The conclusion reached by the Commission based on the submission of Crase and O'Keefe[7] that this pressure will be greater when water is obtained by infrastructure investment[8] is, however, disputed by NSWIC.

The assumption underlying the conclusion is that value increases in respect of both *scarcity* (which we do not dispute) and *productive value* (which we dispute).

The assumption is only correct in the instance that productive capacity can increase, which, at a practical level is not sustainable. In theoretical terms, whilst there was a downward shift on the supply curve (as water is removed from the consumptive pool), there is a corresponding downward shift on the demand curve as water use efficiency improves.

In the parlance of the current discussion over infrastructure efficiency, the potential of the investment is to allow an irrigator to maintain their existing level of production

[5] At page 108.
[6] At page 109.
[7] Submission 1.
[8] At page 120.

whilst utilising less input; it is not about increasing levels of production with the same input.

Price Increases Due to Coexistence With Purchasing

In this same section, the Commission concludes that “the SRWUI program may increase the price that needs to be paid for water under the RTB program, thus reducing the cost effectiveness of water purchasing.”[9]

NSWIC submits that, in the absence of the productive value increase rejected above, any increase in the price paid in the RTB program is merely reflective of a scarcity based price increase through a shift along the supply curve. That is, water obtained under either RTB or SRWUI will have an equivalent effect on relative scarcity and hence have an inflationary impact on prices. NSWIC submits that the impact will be similar between programs.

Economic Rationalism

Further in the same section, the Commission concludes that “in the absence of a government program to recover water through irrigation infrastructure upgrades, market incentives would be expected to effectively coordinate the mix of water recovery activities.”[10] In short, the Commission suggests that similar outcomes to a combination of SRWUI and RTB would be achieved though merely directing funding solely to RTB.

The assumption underlying this is that irrigators would sell entitlement to release capital funding to, in turn, undertake works. Whilst this is clearly feasible at a theoretical level, reality is such that projects that will be undertaken under SRWUI *would not* be undertaken in the absence of it. When external factors including cash flow, the acceptance of projects by mortgage holders and certainty in respect of future policy directions are taken into account, economic theory does not bear out in practice.

The Question of Efficiency

The Commission has assumed that a premium – or subsidy – will likely be paid under the SRWUI when compared with RTB[11]. NSWIC makes no submission as to the likely veracity of such assumption.

That said, NSWIC contends that whilst “in most cases (the cost) exceeds the cost for recovery through purchasing”[12], the benefits will also significantly exceed those of purchase. This is in direct contradiction of the Commission’s view that “there is a

[9] At page 120.
[10] At page 121.
[11] See page 121 and 122.
[12] At page 122.

general tendency for infrastructure works to product external *costs* rather than benefits."[13]

Whilst we are prepared to concede that "lower return flows" are often the results of increased efficiency[14], we submit that no thorough analysis of the positive benefits has been undertaken prior to reaching this conclusion. We submit that a full and complete analysis of the matter must be undertaken prior to a conclusion – and recommendation – being reached. In particular, we submit that an understanding of the value of the retention of rural productivity, employment and social benefits associated therewith be obtained forthwith.

As an aside, we are extremely concerned that a politically motivated project – the Northern Victorian Irrigation Renewal Project Stage 2 – is provided as the example of premium payment. [15] Without providing express commentary on the veracity or otherwise of this project, we note that it has not yet completed due diligence and hence funding has not been provided to it. We submit that the Commission provide a more relevant example of infrastructure investment and the benefits that it provides. There are a wide range of such examples available across the Basin. An analysis of a much wider range would prove beneficial in this report.

Full Cost Recovery

The Commission contends that principles of full cost recovery will be breached by Government-funded infrastructure investment in the event that a premium over purchase price only is paid.[16]

In the first instance, NSWIC is concerned at the growing number of instances in which provisions of the NWI are conveniently relied upon when they suit an argument by a government entity and entirely ignored when the situation is reversed. In respect of full cost recovery, NSWIC points to the relative performance of State's in this respect and the very high level of recovery in NSW when compared to others. In particular we note recovery in respect of Water Planning and Management Charges.

Nevertheless, NSWIC acknowledges that infrastructure investment may result in a price premium which may be seen as yet another breach of the NWI. In this instance, we encourage the Commission to adopt a broader perspective and to consider that publicly funded expense against the backdrop of economic and social benefit to the wider community of retaining irrigation businesses, which has been discussed in depth previously.

Our submission must be considered in light of NSW having been more significantly affected by the unfair situation described by the Commission where private funds have been directed to infrastructure upgrades.[17] Irrigators within infrastructure

[13] At page 123.
[14] Box 6.3 as referred to at page 123.
[15] At page 122.
[16] At page 125.
[17] At page 125.

operator areas have made significant contributions to upgrades and installation of infrastructure over a period in excess of a decade since privatisation. These same irrigators do not begrudge similar upgrades now being performed interstate without private investment, but expect similar quantum of support in their own districts.

Impact of Reductions on Regional and National GDP

NSWIC has been perplexed for some time at the acceptance of academic economic modelling showing that reductions in the availability of water for irrigated agriculture could have limited or, in some cases, *positive* impacts on regional (and national) gross domestic product. We are now extremely concerned to see acceptance of such theory by the Commission.[18]

In the first instance, the theoretical conclusion simply does not pass the common sense hurdle. We have little doubt that an ironically termed dry economist is able to mount impressive academic argument in favour of the positive conclusion, but at a common sense level it is clearly irrational to suggest that removal of a crucial input could result in increased output, particularly in the absence of productivity increase at a higher rate.

Ask a farmer what happens to production in a region when water is removed from it.

NSWIC points out that of the four theories advanced in the draft report[19], only one actually predicts an increase – and then only in a limited range of valleys (notably in Victoria, where there is a limitation on the level of buyback in any event!). The other three reports not varying decreases in production and GDP. NSWIC submits that the Commission has therefore drawn an unsubstantiated conclusion that impacts may be positive.

Further, the report from the Centre of Policy Studies at Monash University[20] is, in the opinion of NSWIC, theoretically flawed in any event. Our analysis of the paper suggests that the price elasticity of demand for irrigated agriculture production has been ignored. We believe that the paper assumes and increased value of allocated water, that the allocation is traded (and hence revenue is derived from it) and the resultant production is sold at a higher price given the higher input cost.

In the first instance, this has resulted in a GDP boost given the assumed trade of water prior to consumption. As the Commission would understand, this assumption is incorrect as the vast majority of allocated water is owned by the consumer in the first instance. It is therefore not traded and that artificial boost to GDP does not occur in any event.

In the second instance, the theory assumes (we believe) a higher price on the basis of higher input costs (assuming trade in water prior to consumption). This entirely ignores the fact that Australian agriculture must compete in a global commodities

[18] At page 126 – "The more robust modeling available estimates that the buyback will result in a small *increase* in real consumption in most southern Basin regions". See modeling summary at Appendix D.
[19] Appendix D.
[20] Referred to in the draft report as "Dixon".

market place. Even aside from the price sensitivity of Australian consumer (the price elasticity of demand mentioned earlier), some 80% of Australian agricultural production is exported. Whilst that is significant in terms of our economy, we are not a producer of such significance in global commodity markets to materially affect price. That is, we are price takers and will continue to be regardless of the costs of inputs.

In considering the Monash report, the Commission ought consider the statement that "the payment to irrigators for buyback water was added to regional income".[21] As the Commission would be well aware, buyback income is a once-off capital transaction. As a result, it is simply flawed logic to assume that it adds to regional GDP in the longer term.

In particular, the Monash report assumed that buyback participants would continue in agricultural operations. The author attempted to substantiate the assumption on the basis that buyback payments are generally small relative to the size of regional economies. Aside from the fact that in excess of $3b in buybacks and $5b in infrastructure investment (which will remove water entitlements) most certainly is not relatively small, the overall assumption is likely not substantiated by the fact. The Commission is in a position to review action subsequent to initial phases of RTB prior to accepting the Monash report. Did participants continue to farm? If so, was production from that farming enterprise commensurate with pre-RTB involvement? Anecdotal evidence most certainly suggests otherwise.

NSWIC submits that the conclusion that buyback will not have a significant effect on regional productivity is entirely flawed and must be excised from the report.

Draft Recommendation 6.2

NSWIC concurs that all projects under SRWUI ought be subject to "rigorous approval process"[22].

We do not accept, however, that the cost per megalitre ought be "similar to the market price." We submit that the analysis ought be "similar to the market price plus the value of external benefits when considered against external costs of purchase only."

Acceptance of this submission would allow a more detailed debate as to the costs and benefits of RTB when viewed against SRWUI and would allow implementation of the informed outcome of that debate.

Draft Recommendation 7.1

Whilst NSWIC concurs with the recommendation that the Government ought "adopt a portfolio approach to purchasing water products, and not focus solely on water

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[21] At page 292.
[22] At page 129.

entitlements"[23], we do not support the involvement of the Commonwealth in the temporary market as a buyer. We submit that the temporary market, particularly in dry periods, is vital to the operation of irrigated agriculture and the entry of a participant of the size of the Commonwealth will devastate both the market and the businesses that rely on it.

We do note, however, support for the market entry of the Commonwealth Environmental Water Holder in the longer term to manage Commonwealth water holdings and environmental requirements.

We submit that the Water for the Future program is focused on the medium to long term. Engagement in the temporary market is a short term solution which we submit is neither necessary nor warranted.

Draft Finding 8.5

Whilst NSWIC concurs that the RTB program ought not be a primary method for addressing indirect objectives[24], we submit that considering such objectives as part of the overall assessment of the value of a purchase (or bundle of purchases) is a legitimate process.

Acceleration of Buyback

NSWIC notes – and concurs with – the comments of the Commission that:

> *"Accelerating the buyback will increase its cost."*[25]
>
> *"...accelerating acquisitions before environmental needs are clearly identified increases the risk of purchasing entitlements in less than ideal locations or acquiring more water than is ultimately needed..."*[26]
>
> *"The pace of the buyback should reflect the tradeoffs between the increasing costs of shifting water out of agriculture (and in particular, asset fixity in agriculture) and the accelerated achievement of environmental outcomes."*[27]

In light of the importance of this issue and the unequivocal comments of the Commission, NSWIC is perplexed that no draft finding or recommendation has been made in the draft report.

NSWIC submits that a draft finding ought be made and that a draft recommendation ought suggest that the timeframe for buyback be examined.

[23] At page 165.
[24] At page 183.
[25] At page 185.
[26] At page 185.
[27] At page 187.

Comment on Institutional and Governance Issues

The Commission poses two questions.

1. *Based on good governance principles, what do you think are the appropriate institutional structures for:*

    - *conducting the purchase of entitlements under the Restoring the Balance program*
    - *purchasing the suite of water products that the CEWH will need, to meet varying environmental demands in the interim before the Basin Plan takes effect*
    - *purchasing environmental outcomes through new programs aimed separately at private providers and public environmental managers?*

    NSWIC is dismayed by the question.

    Our principal submission – made in an opening statement – to the Productivity Commission in the first instance was:

    The issue is surely not how to buy, but what to buy. The how must come after the what![28]

    Until such time as there is clear identification of what is to be purchased – including a thorough understanding of volume, type, location and proposed use – it is premature to comment on how this process ought be undertaken.

2. *What do you think the role of the CEWH should be in holding and trading in water products once the Basin Plan has been fully implemented?*

    NSWIC and others lobbied strongly for the capacity of the CEWH to be able to trade entitlements that it held. We were successful in that campaign and remain committed to that principle.

    The Basin Plan must clearly take into account the holdings of the CEWH, not only in volume but in location, reliability and capacity for movement. NSWIC also expects that the CEWH will be provided with environmental watering priorities by the Basin Plan which will allow the development of a purchasing strategy.

    We submit that the capacity for trade granted to the CEWH is designed to meet a wide variety of requirements, all of which we submit are legitimate;

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[28] NSWIC Submission at page 3.

- Offsetting the cost of CEWH operations to minimise the cost-impact on taxpayers or, more particularly, irrigators. There is no reason that a well managed CEWH strategy ought not result in a cost-neutral operation;

- Providing a counter-cyclical supply of temporary water. Our understanding of environmental requirements – at a greatly generalised level – is the provision of further water in medium to wet years. The CEWH ought then be able to provide temporary water to the market in dry years where, under natural conditions, environmental sites ought expect to be dry in any event;

- Movement of water from one location to another via market interaction rather than physical transfer with associated losses. That is, the sale of water held in one part of the Basin in return for the purchase of water in another to meet cyclical environmental priorities; and

- Longer term market interaction to fine-tune the mix of products held – including obtaining new products if suitable – to best suit environmental needs.

Restrictions on Trade

The Commission states that the "exemptions agreed by Victoria mean that the (4% limit with volumetric variance) will be less of an impediment to the buyback."[29]

Moreover, the Commission states that the agreement with Victoria to leave a 4% rule in place with certain volumetric extensions, coupled with a medium-term gradual lift (outside the National Water Initiative timeframe) "effectively deal with the NSW Irrigators' Council's concern that the limit forces a disproportionate share of entitlements to be purchased from New South Wales."[30]

We can advise the Commission unambiguously that the agreement with Victoria most certainly **does not** deal with our concern in any way, shape or form. Had the Commission sought our opinion on that matter prior to printing the draft report and effectively committed us to a position with which we do not agree, we would have provided that advice directly.

The agreement with Victoria merely replaces a percentage based trade restriction with a volumetric restriction and overrides the timeframe for removal agreed in the National Water Initiative.

What has forestalled the prospect of NSW providing a far greater source of entitlements is the bilateral agreement between the NSW and Commonwealth Governments to limit on a volumetric basis the purchases to be made in this state

[29] At page 209.
[30] At page 209.

under the RTB program. It is nonsense to suggest that any protection is afforded by the agreement with Victoria.

Moreover, NSWIC notes its opposition to trade limits in both NSW and Victoria. We have openly advocated a free market and continue to do so. We reiterate, however, the necessity for a level playing field. If restrictions are acceptable in one jurisdiction, then they must be seen as acceptable in others. Our preference is for the removal of all restrictions.

NSWIC concurs with Draft Finding 10.1 and Draft Recommendation 10.1.

Improving Pricing

NSWIC has provided advice to the ACCC in respect of the Water Market Rules and the Water Charging Rules. Some of that advice was heeded. Rules have been created that cover both termination fees and charging rules for infrastructure operators. Whilst those Rules are not universally supported by NSWIC or infrastructure operators, further change would lead to further uncertainty and cost without demonstrable benefit.

NSWIC submits that this section is not useful and ought be removed from the report.

Improving Intertemporal Water-Use Choices

Draft recommendation 10.2 would have the MDBA "commission an independent study into ways of expanding the ability of water users to carry over water, while adequately managing third-party impacts."[31]

NSWIC notes that a large portion of the costs of the MDBA are passed on to water users in some states. A higher proportion of passed-through costs are charged to irrigators in NSW.

We submit that it is entirely inappropriate that a study to determine the benefits of altering the current system of carry over for the sole benefit of environmental water holders and users be funded by irrigators. We therefore submit that any such study ought be carried out and funded by Government directly, either via the CEWH or DEWHA.

Further, we note the recommendation that the study "should consider options that treat environmental entitlements and consumptive use entitlements the same and options that treat them differently."

NSWIC and others have maintained the strong position that purchased entitlements must not have their characteristics altered. This position has been agreed by governments. Irrigators will not accept – and governments ought not suggest – that such changes ought now be contemplated. NSWIC rejects this recommendation.

[31] At page 223.