Australian Government
National Water Commission

95 Northbourne Avenue CANBERRA ACT 2600
Phone: 02 6102 6000 Fax: 02 6102 6006
www.nwc.gov.au
enquiries@nwc.gov.au

General Manager
Water Reform Water

Dr Deborah Peterson
Assistant Commissioner
Productivity Commission
LB2 Collins St
East Melbourne VIC 8003

Dear Deborah

Re. Submission to the Australian Government Productivity Commission Study: Rural Water Use and the Environment: The Role of Market Mechanisms

The National Water Commission appreciates the opportunity to provide the following comment on the Productivity Commission study into Rural Water Use and the Environment: The Role of Market Mechanisms (the study).

Background

The continued emergence of more mature market conditions has created a number of opportunities for using and managing water in Australia. Clearer specification of water property rights, proper accounting for water, removing barriers to trade, and pricing which seeks to better reflect the true economic cost of the resource has extended the scope for water markets to drive improvements in water use efficiency and deal with rural water-management related environmental externalities.

Each of these elements is pursued by Australia's blueprint for water reform, the National Water Initiative (NWI). The NWI Agreement was signed by all governments at the 29 June 2004 Council of Australian Governments meeting (with the exception of Tasmania which signed the Agreement on 3 June 2005, and Western Australia which is yet to sign). The NWI builds on the previous

Council of Australian Governments (COAG) framework for water reform signed by the Australian Government and all state and territory governments in 1994.

The overall objective of the NWI is to achieve a nationally compatible market, regulatory and planning based system of managing surface and groundwater resources for rural and urban use that optimises economic, social and environmental outcomes (paragraph 23, NWI). Achieving this objective will involve making careful judgements in order to optimise the mix of markets, planning and regulation for water management in Australia.

In this context, results of the study will be useful to shape the mix of institutional settings for managing water on the ground.

Issues

In our view, the Productivity Commission's Issues Paper (December 2005) provides a good coverage of the ground which the study should traverse, and the major emphases the study should pursue. The comments below provide some considerations to assist the Productivity Commission to further scope its work and to analyse different market mechanisms for their practicality and effectiveness.

As the Issues Paper recognises, any examination of market mechanisms to achieve rural water use and environmental improvements has to be nested in the broader development of water markets in Australia.

In the Commission's view, there is a judgement to be made about to what extent, and in what ways, the study should focus on issues central to the development of water markets in Australia. This is especially true in light of the separate work being commissioned by the parties to the NWI on future design of water markets (to meet clauses 61(i) and (ii) of the NWI)

Nevertheless, there are two areas (at least) where the study might serve its core aims, and add value to the wider work on water market design.

Improving the scope and efficiency of existing water markets will reinforce the incentives for landholders to improve water use efficiency and adopt water-related farm management strategies. It is a proposition worth testing that there may be little need for separate market incentives for landholders to improve water use efficiency because these incentives are already embodied in existing markets. It would be beneficial, then, if the study were able to establish whether existing water markets are capable of optimising investment in rural water use efficiency, as a starting point to examine other market mechanisms (including those which may require new institutional design).

Secondly, there would be some benefit in the study establishing (briefly and clearly) those conditions or design features which are necessary in water markets to optimise rural water use efficiency and environmental outcomes. These would be useful watchpoints as the broader design and evolution of water markets and the institutional arrangements supporting them unfold over the next year or so.

Obviously, the National Market-Based Instruments Pilot Program projects under the National Action Plan for Salinity and Water Quality demonstrate the potential for market mechanisms to be used to manage rural water-use related environmental externalities. It is important, however, that a range of issues are examined in any discussion of mechanisms proposed to manage environmental externalities. For each mechanism, these include a consideration of:

- environmental effectiveness (ability to achieve goals);
- cost effectiveness ($ per unit of outcomes);
- distributional consequences;
- administrative feasibility (implementation and enforcement); and
- acceptability (to a range of stakeholders, including take-up by key agents in the market).

In particular, it would be beneficial if the study evaluated the complexity and related costs associated with establishing market mechanisms, as there are a range of planning and regulatory settings for managing environmental externalities with very different implications for cost. This is relevant to the point made in the background about getting the right mix of market, planning and regulatory instruments to achieve outcomes consistent with the NWI.

Institutional capability should also be considered in this context. The scope of the market mechanisms must match the institutional capacity to implement them. The issue of skills, incentives and culture is therefore important and it would improve the practical relevance of the study if this was examined. Consideration might also be given to the incentives, institutions or skills required for an environmental manager to interact as a market participant in the context of dealing with rural-water management environmental externalities.

Regardless of the mechanism used, a valuation process is required to measure the environmental benefits of management decisions. It would be valuable if the study could consider whether an analytical tool or environmental metric that facilitates the comparison of rural water-management decisions with respect to their impact on the environment is required. It is possible that such a tool would increase transparency and help limit ad hoc decision-making.

Overall, the National Water Commission looks forward to the study making a major contribution to our understanding of the practical issues for applying market mechanisms in these areas, including suggestions on how

governments and agents can make the transition to more effective use of market mechanisms to meet rural water use efficiency and environmental outcomes.

Please do not hesitate to contact me or Will Fargher (02-6102 6039; will.fargher@nwc.gov.au) if you require further information.

Kind regards

Malcolm Thompson

6 February 2006