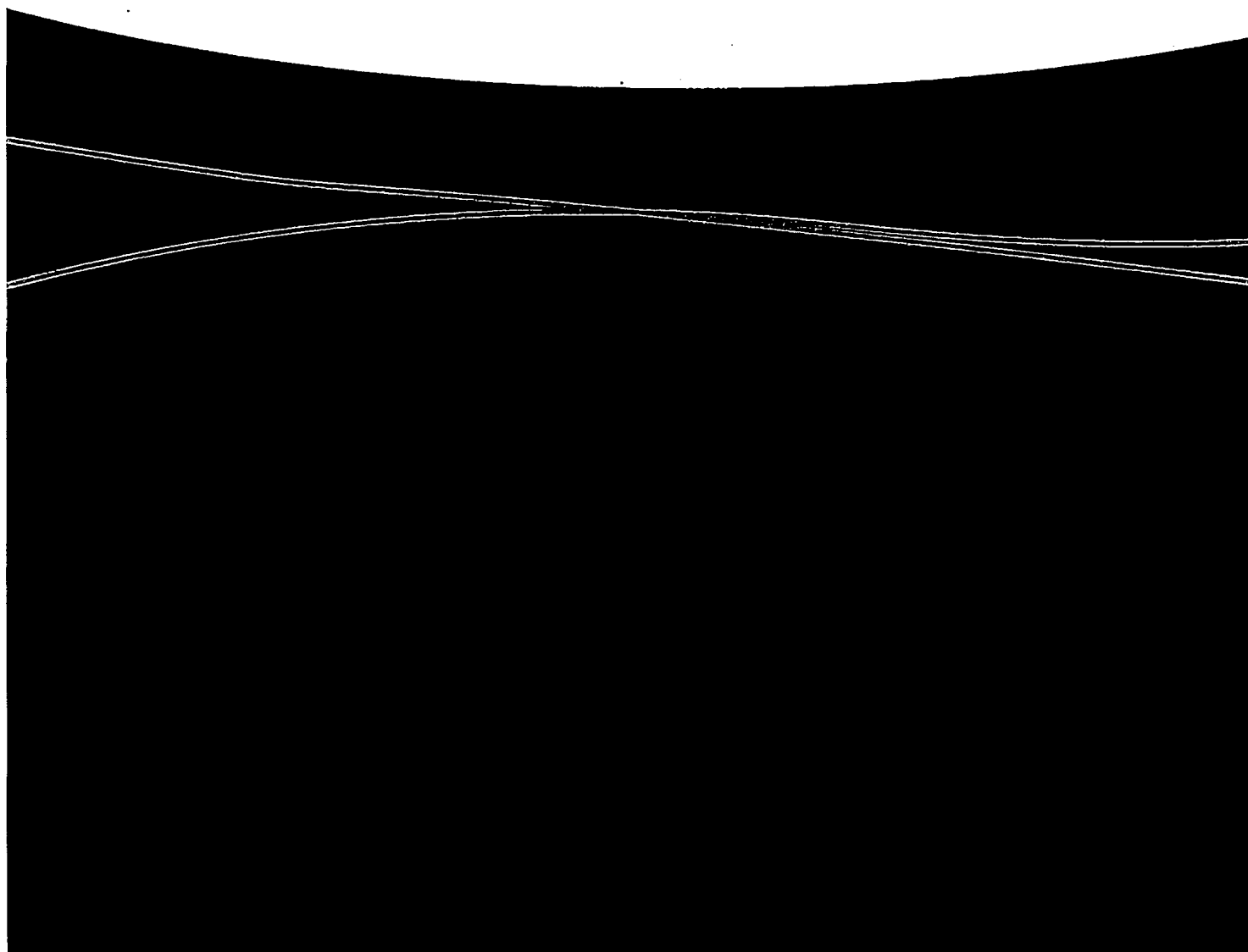




Government of South Australia

*South Australian Government Submission to the
Productivity Commission Draft Research Report
on Market Mechanisms for Recovering Water in
the Murray-Darling Basin*

15 February 2010



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1. Introduction

The South Australian Government welcomes the opportunity to provide input into the Productivity Commission's review of Market Mechanisms for Recovering Water in the Murray Darling Basin. The South Australian Government views market-based approaches as the most efficient way to direct water to its highest value use, including for the environment.

The South Australian Government's submission in October 2009 to the Productivity Commission's Issues Paper focussed on a number of key themes which are summarised below.

Impediments to new and established water purchase mechanisms

- It is essential that market distortions be removed to facilitate the movement of water to its highest value use, be that environmental, irrigation, industrial, critical human or stock needs.
- In particular, the interim 4 per cent limit on trade in entitlements in Victoria must be removed immediately.

Mechanisms that could be used to diversify the range of options to purchase water entitlements

- Purchases of water for environmental purposes must take into account the short and long-term environmental objectives to be achieved.
- If these objectives were better clarified in the Restoring the Balance program, the choice of market mechanism for recovering water could be aligned with environmental asset watering needs, leading to maximum value for money.
- It is important that the program does not attempt to address structural adjustment issues while also trying to address environmental objectives. Different, but complementary, instruments are required to address environmental needs and structural adjustment. South Australia supports the continuation of the Small Block Irrigators Exit Grant, subject to modifications to reduce complexity, improve timeliness and address inefficient land use consequences.
- It is necessary to ensure appropriate sequencing of investments in irrigation infrastructure to avoid potential adverse consequences.

Environmental water recovery

- There is an urgent need to purchase significant quantities of water to address critical immediate environmental priorities.
- In order to meet the spectrum of environmental watering needs and to give the Commonwealth Government the maximum amount of flexibility over entitlement use, the Commission is encouraged to consider how the allocation of storage capacity rights may increase the efficiency of water use, not just for the environment but for all users.

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2. Comments on Draft Report

South Australia supports the majority of the Commission's findings and recommendations and believes that the points raised in our submission on the Issues Paper have been adequately addressed in the Draft Report. However, South Australia would like to raise a number of additional comments and issues for consideration in the finalisation of the Productivity Commission's research.

South Australia's comments have been structured around the main headings in the Findings and Recommendation section of the draft report and are as follows.

2.1 Water Use in the Murray Darling Basin

South Australia supports draft finding 2.1.

The prospect of climate change adds to the imperative to consider the balance between environmental and consumptive uses of water.

2.2 Development of Water Markets

South Australia supports draft finding 3.1.

Water markets are more developed in the Southern Basin than in the north.

The development of water trade rules by the ACCC and their utilisation in the Basin Plan will strengthen the market framework within the MDB.

South Australia agrees that all institutional barriers to trade should be immediately removed. In particular, the following impediments to trade have significant implications for the price and efficiency of water allocation across the Basin:

- Victoria's 4% limit;
- New South Wales' restrictions on water purchases by the Commonwealth;
- Victoria's preferential treatment of entitlements purchased by the Commonwealth for environmental purposes.

These create significant market distortions by limiting entitlement sellers and purchasers (be they irrigators, governments, urban water authorities or other water users) as to where they can source or sell their entitlements and the prices at which they can buy and sell. These impacts have been recognised by the ACCC in their *Water Market Rules Draft Advice* Dec 2009 Chapter 4.

South Australia also supports in principle draft finding 3.2.

Market intermediaries have developed alongside the market.

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The possible use of intermediaries by the Commonwealth should be investigated in more detail. The report implies that the use of intermediaries will assist in reducing transaction costs associated with water purchases. This is not always the case and should not be assumed for all water transactions.

South Australia believes that additional costs, such as brokerage fees or service charges relating to the use of intermediaries for Commonwealth purchases of environmental water, need to be taken into account when assessing the likely benefits and risks of such an approach.

It may be that the size of the Commonwealth's transactions to date is such that the purchases have a high market profile and limit the usefulness of using intermediaries.

South Australia recommends further evaluation of the relative benefits of using intermediaries.

2.3 Allocating Environmental Water

South Australia supports draft finding 4.1.

Environmental benefits of water recovery tend to be focused in the region from which the water is recovered.

The lack of trade opportunities in the Northern Basin requires the Commonwealth to have a clear, conservative 'no regrets' strategy. Reduced trading opportunities in the Northern Basin is likely to lead to greater costs associated with purchasing too much water or an inappropriate portfolio of water entitlements, compared to the southern MDB, where allocation trade can compensate for any misjudgement in entitlement purchases.

South Australia supports draft finding 4.2.

Determining the allocation of water between competing uses solely on the basis of the scientific assessment of environmental water requirements may not achieve the best outcome for the community.

We agree that there is a need for the Basin Plan to consider community preferences relating to the tradeoffs between environmental and consumptive use, so that a balanced result is delivered across the environment, economy and regional communities. However, the development of the Basin Plan should be progressed in such a manner as to provide a long-term sustainable balance and one that is not skewed inappropriately in the direction advocated by any particular interest group.

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2.4 Recovering Water through non Market Means

South Australia agrees with draft finding 6.1.

Under the arrangements of the *Water Act 2007*, the determination of environmental water needs and sustainable diversion limits without consideration of community preferences, may not maximise overall returns.

We agree that water should be directed to uses where it is most valued. It is likely that the allocation of water between competing uses solely on the basis of science may not result in a balanced outcome.

There is still considerable uncertainty as to how the entitlements purchased by the Commonwealth will ultimately be held and therefore taken into account when the MDBA sets sustainable diversion limits. It is unclear whether they will be permanently removed from the consumptive pool and thereby credited to the environment, or be retained as entitlements that are held by the Commonwealth Environmental Water Holder (CEWH) to be used for environmental watering needs as required. To ensure the future efficiency of the MDB water market, these allocations should be incorporated in the sustainable diversion limits, so that the water market is not unduly influenced by the CEWH and any process it may initiate to allocate this water.

South Australia supports draft recommendation 6.1.

Basin jurisdictions should clarify how the risk assignment provisions will apply to the reduction in water availability likely under the Basin Plan, and believes that such clarification will allow irrigators to make optimal investment and divestment decisions.

South Australia supports draft finding 6.3.

Purchasing water products from the market is generally the most effective and efficient means of acquiring water.

In making the decision on whether to source water for the environment through market purchases or by investing in infrastructure to realise water savings, South Australia believes the Commonwealth needs to take into consideration the other community benefits that may be achieved through infrastructure investment, beyond the direct water savings achieved.

It should be noted that infrastructure investments in the Lower Lakes region in South Australia have addressed water security concerns as well as irrigation water use (such as in the Langhorne Creek region). These investments have reduced reliance on the Lower Lakes by these water users and increased the flexibility of managing the Coorong and Lower Lakes.

2.5 Designing a Portfolio of Water Products

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South Australia supports draft finding 7.1 and draft recommendation 7.1.

The Commonwealth should adopt a portfolio approach to purchasing water products, and not focus solely on water entitlements.

However, the difficulties and time required to increase the level of market sophistication and participation should not be underestimated. This would also likely have an impact on the Commonwealth's costs. These issues should be investigated in more detail before a final recommendation on the matter is made.

2.6 Mechanisms of the Buyback

South Australia supports draft finding 8.1.

Acquiring water entitlements from active markets is likely to be efficient.

South Australia supports draft finding 8.2.

Allowing bids for combinations of entitlements and prices as part of a single bid could improve the efficiency of the tender process.

South Australia supports draft finding 8.3.

The effectiveness of the tender process could be improved by making the offers to sell binding on potential sellers. However, making tender offers binding will only be a reasonable approach where the parties are bound to conclude transactions within a relatively short time frame.

South Australia supports draft finding 8.4.

The effectiveness and efficiency of the tender process should be improved wherever practical.

South Australia believes the current tender processing timeframes could be reduced and could be improved significantly by altering the sequence of conveyancing steps.

It is suggested that the Productivity Commission consider recommending reasonable timeframes for transaction completion, based on market experience.

2.7 Governance and Institutional Issues

South Australia supports draft finding 9.1.

Providing information summarising environmental water holdings by the Commonwealth would improve market transparency.

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South Australia supports draft finding 9.2.

The market could be improved by clarifying governance arrangements on coordination of environmental watering activities between the various levels of government.

South Australia supports draft finding 9.3.

Better systems are needed to coordinate the mix of water purchases.

Request for information

The Commission has requested comments on the role of the Commonwealth Environmental Water Holder in holding and trading water products once the Basin Plan has been fully implemented. South Australia believes that governance arrangements for coordinating environmental water holdings should be clarified (particularly those held under the Living Murray Initiative and the Commonwealth Environmental Water Holder).

In relation to the trade of water products held for environmental purposes, South Australia believes it is likely to be more cost effective to try and get the mix right in the first instance, but adjustments should be made to the portfolio if they are required to optimise environmental outcomes. Any trade of water products held for the environment should be undertaken under clear governance arrangements and for the purpose of meeting agreed objectives. The Commonwealth Environmental Water Holder should be subject to the same water market rules as any other market participant.

However, the Commonwealth may well become a dominant player in some entitlement and allocation markets by virtue of the amount of entitlements it holds and the allocations that they accrue. There is potential for the Commonwealth to be perceived to be acting as, both 'poacher and gamekeeper', influencing allocation decisions on one hand, and trading in them on the other.

South Australia suggests that the Productivity Commission, possibly in consultation with the ACCC and Australian Securities and Investment Commission (ASIC), may undertake a review to assess the likely market power and influence of the Commonwealth, identify the governance issues that may arise as a result, and recommend appropriate governance measures that could be instituted, having reference to the measures that ASIC would adopt in analogous commercial circumstances.

The Productivity Commission has commented on governance and institutional issues in relation to sustaining rural communities. South Australia recognises that where "existing government policies and programs are deemed insufficient to achieve the objective of helping to secure a long-term future for irrigation communities, ... (sic)...options for a more targeted adjustment program should be investigated".

The South Australian Government agrees that the investigation of targeted adjustment programs is much broader than infrastructure and water entitlement issues. For reasons

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of both portfolio responsibility and expertise, further investigation may be better conducted through an agency other than DEWHA.

The South Australian Government would welcome a more explicit recommendation by the Productivity Commission on institutional arrangements regarding adjustment programs for irrigation communities.

2.8 Overcoming Impediments

South Australia strongly supports draft finding 10.1 and recommendation 10.1.

All restrictions on out-of-area trade and limits on the amount of entitlements that can be sold should be eliminated immediately. While some concessions around the 4% Interim Threshold Limit have been granted by the Victorian Government to the Commonwealth so that the Commonwealth may meet its program objectives, it still nonetheless represents a significant market distortion, as does the New South Wales limit on the sale of water entitlements for environmental purposes.

South Australia supports draft finding 10.2 and draft recommendation 10.2.

Cost reflective pricing for water delivery is likely to improve the efficiency of water trading and the MDB Authority should consider ways of expanding the ability of water users to 'carry over water'.

3. Other Issues Requiring Consideration

South Australia notes that the draft report outlines some concerns with buybacks producing a 'swiss cheese' effect in agricultural areas. Although termination fees have recently been instituted to address irrigation authorities' concerns over the stranding of infrastructure assets, some Commonwealth purchasing programs have explicitly prohibited any restructuring after irrigators have left the industry. This locks in the swiss cheese result for years, which ultimately leads to sub-optimal outcomes. While it is acknowledged that further work is required to refine the pricing of water delivery costs by irrigation authorities, it would be an inefficient and ineffective strategy to prevent trade from certain areas on the basis of preserving levels of infrastructure use.

South Australia would like to emphasise that while it supports the continuation of the Small Block Exit Grant (which has been linked to the buyback), it notes that some of the current conditions associated with this package (such as the requirement that vines be pulled out and that irrigation activity cease on that land) inhibit restructuring opportunities within regions. This is particularly the case in the Riverland where soldier settlement land parcels are too small to realise viable economies of scale. The Small Block Exit Grant could potentially provide neighbouring farms with this expansion opportunity, but this is currently prohibited.

The Grant should also operate in an environment in which free trade of water entitlements is possible to maximise its effectiveness.

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South Australia considers that some of the conditions associated with this Grant should be revised. Applicants have also raised concerns about the time taken to process applications.

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3.1 Technical/Factual Comments

Other technical and factual comments on the draft report follow.

Page XL – Title of section 'Allocating environmental water' would read better as 'Allocating water to the environment'.

Page XXV paragraph 2 – This paragraph states (in relation to risk assignment) that 'all jurisdictions were to incorporate these provisions in their own legislation'. This is incorrect. The NWI requires a risk assignment framework to be adopted, but clearly allows for alternative models to that contained in the NWI IGA. This point is acknowledged in the body of the draft report (page 112, paragraph 2).

Page 221 – There is an incorrect statement in the 'overcoming impediments' section. On page 221, it states that South Australia is in the process of unbundling delivery rights and that this is expected to be completed in 2010. There is no obligation to separate a water delivery right (ie there is no NWI, COAG or other water reform commitment that requires such action). South Australia has amended its *Natural Resources Management Act 2004* to enable such an entitlement to be issued as a separate (unbundled) entitlement, but we are yet to identify a situation where it is in fact necessary to issue delivery entitlements. This amendment became operational from April 2009.

Page 222 – The paragraph 'The National Water Commission reported... South Australia allows carryover as an emergency drought measure, but those arrangements are not permanent', is not necessarily correct. The Special Accounting provisions under Clause 123 of the Murray-Darling Basin Agreement 2007 allow South Australia to carryover any deferred entitlement. South Australia introduced an administrative arrangement for carryover from 2007-08, but prior to this if Special Accounting was in force, South Australia already had carryover by default.

Page 234 Table B.1 – This table should be labelled to say that the amounts shown are indicative targets and financial contributions only – actual amounts have differed (particularly in relation to the spread of Commonwealth funding).

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Page 240 Table B.3 – A more up to date record of South Australia's water recovery measures is provided below (shown in long term cap equivalent to make it consistent with the other jurisdictions measures that have been listed).

Measure	Estimated cost/GL \$/GL (LTCE)	Quantity recovered GL (LTCE)	Total cost \$m
Securing Government Held Water	1.50	13.00	19.51
Purchases from Willing Sellers Stage 1	2.21	5.00	11.06
Securing Government Held Water and Purchases from Willing Sellers	2.56	17.00	43.48

Page 243 – The cost per ML should be updated to reflect the amounts provided in the table above.