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Draft water market rules

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AUSTRALIAN COMPETITION AND CONSUMER COMMISSION
2008



Process for advice to the Minister

- Deadline – December 2008
- Consultation
 - Issues paper (April 2008)
 - Position paper (July 2008)
 - Draft advice (October 2008)



What are water market rules?

- Market rules **are not** trading rules
- Relate to the actions of **irrigation infrastructure operators** who hold a group water access entitlement on behalf of their member irrigators that prevent or unreasonably delay **transformation** or trade of a transformed irrigation right



Which operators are covered?

- Operators which
 - hold a group water access entitlement; and
 - operate infrastructure to deliver water to another person for the primary purpose of irrigation; and
 - are a ‘legal entity’
- Size and structure are not relevant

What is transformation?

- Transformation arrangements are those that
 - allow a person's entitlement to water under an **irrigation right** against the operator to be permanently transformed into a water access entitlement that is **held by someone other than the operator**; and
 - would reduce the share component of an **operator's** water access entitlement

Transformation arrangements

Irrigation infrastructure
operator owns:

300 ML water access entitlement

Three irrigators own:

**100 ML irrigation
right**

**100 ML irrigation
right**

**100 ML irrigation
right**

Irrigation infrastructure
operator owns:

200ML water access entitlement

Two irrigators own:

**100 ML irrigation
right**

**100 ML irrigation
right**

One irrigator owns:

**100 ML water
access entitlement**



What is the purpose of the water market rules?

- Free up trade that might otherwise be prevented because of restrictions imposed by an operator



Draft water market rules

- **Do not** require operators to transform all irrigation rights
- Transformation is voluntary and can only be triggered by an irrigator
 - An irrigator would need to consider the costs and benefits
- Provide more flexibility, irrigators can
 - Transform, hold a statutory entitlement in their own right, and retain delivery (continue to pay access fees)
 - Transform and simultaneously trade part of their irrigation right, and retain delivery (continue to pay access fees)
 - Transform and simultaneously trade, and choose to terminate all delivery rights (a termination fee may apply)

Issues to consider (irrigator)

- Benefits from transformation
 - Not subject to operator trading restrictions – only state restrictions would apply
 - Holding a statutory right may provide more favourable access to finance
 - Greater flexibility in range of dealings
- Costs from transforming
 - May involve higher administration costs for water delivery to the operator which could be passed on to the irrigator
 - May lose membership benefits



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What do the draft water market rules and draft advice say?

Draft water market rules

- Explicitly prohibit actions that **prevent** or **unreasonably delay** transformation arrangements unless identified as permissible
- Permissible restrictions balance interests of individuals wishing to transform against those of operators and remaining irrigators
- Require transparency and set out timeframes for actions by operators

Permissible restrictions

- Adjustments to take into account conveyance losses (subject to the rules)
- Regulated water charges, including termination fees and unpaid access charges
- Security for ongoing access fees (subject to the rules)
- Legal or equitable interest
- Installation of water meters when delivery is ongoing
- Requirements expressly permitted under state law or a related instrument

Irrigation rights & conveyance losses

- Irrigators require clarity of their irrigation right, including conveyance losses to transform
 - Where possible, operators should hold water access entitlements to cover fixed conveyance losses
 - Where a separate entitlement is not held, an operator can adjust an irrigation right for fixed conveyance losses
 - Any adjustment should be in accordance with the irrigator's share of the total fixed conveyance losses of the network and details of the calculation to be provided to the irrigator
- In the event of confusion or disagreement, the draft rules set out a process for clarifying an irrigation right and calculating conveyance losses, including a dispute resolution process

Ongoing delivery

- Operators must, if requested by an irrigator, provide ongoing delivery
 - an irrigator would continue to pay access fees and an operator may also request security for payment of future access fees
- An operators cannot
 - Impose compulsory termination of delivery rights
 - Impose discriminatory terms and conditions on delivery

Delivery contracts

- A delivery contract is to be made available prior to transformation as the terms and conditions could contribute to an irrigators decision to transform
- The operator must offer a delivery contract with terms and conditions equivalent to those under the irrigation right, subject to variations necessary as a consequence of transformation
- Parties may agree to other terms as required by negotiation
- To ensure operators do not use negotiation to 'unreasonably delay' transformation, irrigators may request formal negotiation which can include a dispute resolution process



Security for future payment of access fees

- Concern that irrigators may transform to avoid payment of a termination fee
- An operator can request security for ongoing delivery before allowing the transformation or trade of more than 80% of an irrigation right
- Operators may request security up to 100% of the applicable termination fee
- Irrigators can choose the form of security
 - irrigation right, unencumbered water access entitlement, bank guarantee, security bond or any other form of security as agreed

State requirements

- Operators can impose restrictions if they are specifically required under state law
- If a jurisdiction requires an operator to impose restrictions on its behalf, these arrangements must be explicit
 - Minimum irrigation right holdings for stock and domestic supplies
 - Environmental regulations or licence conditions
 - The 4 per cent cap

Administrative process

- ACCC will develop a base set of application forms for voluntary adoption
- Processing applications may be cost recovered directly from a transforming customer
- Total timeframe to process an application is 20 business days
- An operator is required to notify the applicant and ACCC if they cannot meet the timeframe
- 'Stop-clock' provisions apply if delays are a result of someone other than the operator



Implementation

- The rules are legal instruments when made by the Minister (early 2009)
- A transitional period (until 1 September 2009) for operators to make existing arrangements compliant
- Operators must
 - establish transparent processes for how to transform and/or trade
 - advise their customers of the water market rules
- The ACCC preparing guidance material and pro-forma documentation for voluntary adoption to reduce compliance burden



Next steps- consultation process

- ACCC seeking submissions to inform final advice
 - submissions due **10 November** 2008
- ACCC interested in **all** views particularly
 - Whether any other restrictions on transformation should be identified as permissible and why
 - Other issues not already considered
 - Issues already considered however where there is new information /data
- The Minister will publicly release the ACCC's final advice
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Draft water charge (termination fee) rules

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AUSTRALIAN COMPETITION AND CONSUMER COMMISSION
2008



Outline

- What the ACCC has been asked to do?
- Background
- ACCC draft advice
- Major issues
- Striking the right balance
- Next steps



What has the ACCC been asked to do?

- Minister for Climate Change and Water
 - Advice on the making of water charge rules relating to
 - Terminating access to an operators irrigation network
 - Surrendering to the operator a right to the delivery of water through an operators irrigation network
 - Have regard to
 - Objectives and principles of the *Water Act 2007*
 - Governance and current and historic charging arrangements



Background

- Termination Fee expressed as lump-sum (multiple of access fee)
- Mechanism to manage uncertainty
- In 2006 ACCC provided advice to State and Comm. Governments
- Recommendations featured in Schedule E to the MDBA (2007)



ACCC draft advice

- Termination fees are necessary
- Voluntary termination (no exit fees)
- Multiple capped at 10x (12-15 years)
- No adjustments
- Ability to negotiate higher fee under contract
- Review of rules 2012-2013 (recommended)

Arguments for high termination fees

- Investment certainty
 - Operators and irrigators make long-term investment decisions
- Failure to meet access fee ‘obligations’ may
 - undermine efficient investment decisions
 - undermine an operators financial viability
- **What is a reasonable term of ‘obligation’?**

Arguments for low termination fees

- Efficient delivery of required service - rationalisation
 - Existing configuration may not be the most efficient
 - Remaining irrigators benefit from avoided costs (inefficient/expensive to service)
 - Without co-ordination short-term rationalisation opportunities may be limited
- Irrigators should face the cost of service delivery
 - Cannot shield operators from market forces

Arguments for low termination fees

- Termination fee is one of many mechanisms:
 - Full cost recovery (incl. WACC return)
 - Efficient price discrimination (signal full cost)
 - Altering depreciation profile
 - Negotiating fixed-term supply contracts
 - Up-front customer contributions
 - Rationalising or reconfiguration of network
 - Termination fees
- **Role of termination fee in providing certainty over efficient investments?**



Striking the right balance

- Balance between providing investment certainty (large investments and stability of prices) and incentives for rationalisation (efficient delivery of required services)
- Multiple of 8 times (8 to 10 years)
- Multiple of 10 times (12 to 15 years)
- Multiple of 15 times (20 to 39 years)

Striking the right balance

Investment certainty

- Investment certainty (high termination fees)
 1. Recovery of capital invested by operator/irrigator
 - Large scale on-farm and irrigation delivery
 2. Stability of prices
 - Essential inputs (chemicals, water, fuel etc.)
 - Water = Ongoing maintenance - opex and renewals

Striking the right balance

Investment certainty (recovery of capital)

- 3 case studies
 - BIL (Barossa)
 - CIT (Loxton)
 - WMIL (Buronga)
- Objective to calculate maximum termination fee to recover value of initial investment under 100% termination (any year of loan term)



Striking the right balance

Investment certainty (recovery of capital)

	TERM	MAX TERM. FEE
BIL	15 YEARS	7.6
CIT (LOXTON)	8 YEARS	7.0
WMIL (BURONGA)	32 YEARS	10.4



Striking the right balance

Investment certainty (recovery of capital)

- Case studies
 - Consistent with **10x** multiple
 - Alternate mechanisms being employed (front-load)
- ACCC acknowledged that greater certainty may be required (above 10x – WMIL Buronga 15x)
- **ACCC to approve new and existing contracts**

Striking the right balance

Investment certainty (stability of prices)

- Investment certainty (high termination fees)
- 2. Stability of prices
 - Essential inputs (chemicals, water, fuel etc.)
 - Water = Ongoing maintenance - opex and renewals
- Not capital recovery but price expectations
 - Irrigator – fixed access fees as input cost
 - Operator - financial viability
- ACCC engaged Frontier Economics

Striking the right balance

Investment certainty (stability of prices)

- Frontier Economics reviewed the impact on irrigators production/termination decisions
- Impact on Gross Margin of
 - Reduction in multiple (15x to 8x – ACCC pos. paper)
 - Various rates of termination (6, 15, 30 per cent)
 - Relative to other changes (market price of water, on-farm price of agricultural product and crop yield)



Striking the right balance

Investment certainty (stability of prices)

Termination of delivery rights	Change in gross margin (%)
<i>Murray Rice</i>	
6 per cent	-0.89
15 per cent	-2.44
30 per cent	-5.89
<i>Murrumbidgee Rice</i>	
6 per cent	-0.42
15 per cent	-1.17
30 per cent	-2.81
<i>Loddon horticulture (grapes)</i>	
6 per cent	-0.19
15 per cent	-0.51
30 per cent	-1.23

Striking the right balance

Investment certainty (stability of prices)

- Murray rice example (0.89 per cent reduction in gross margin)

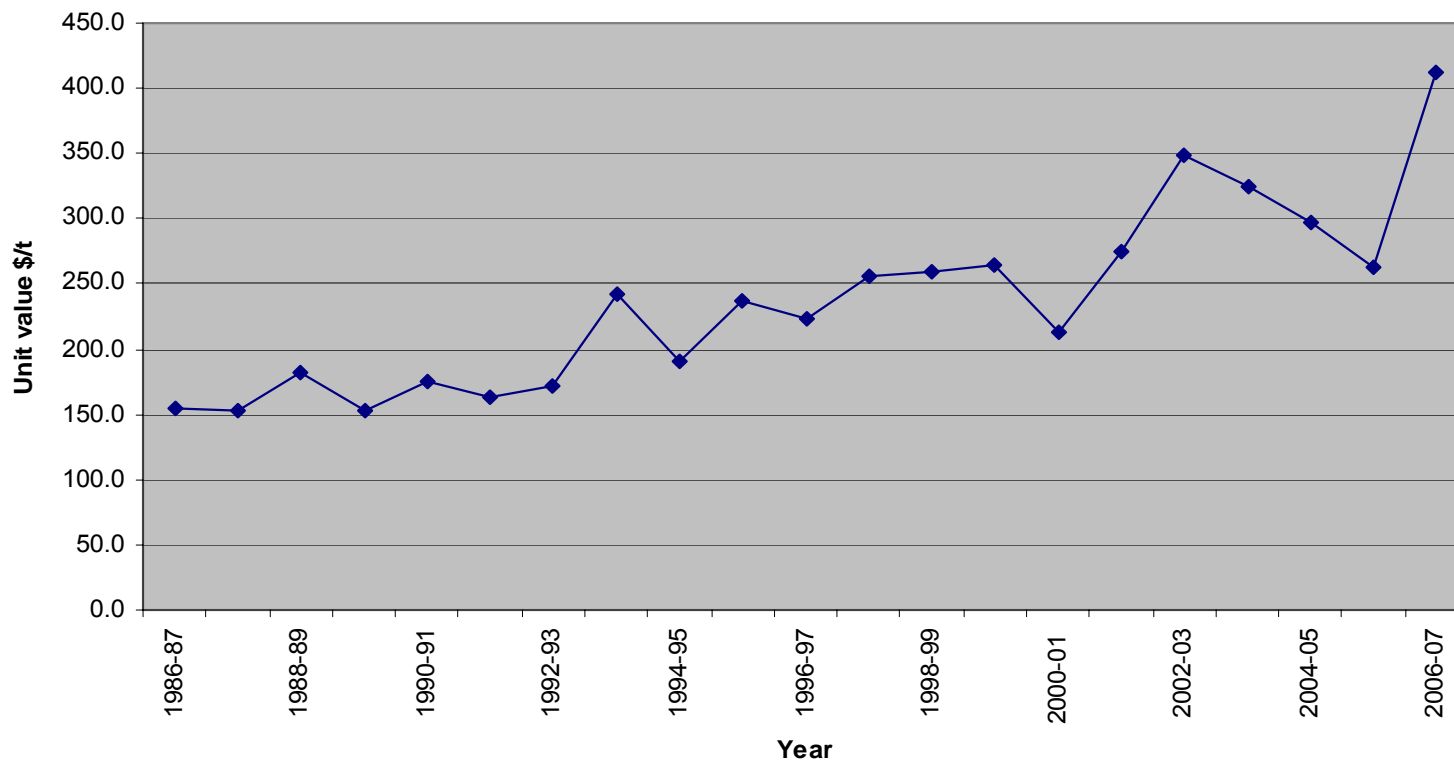
Driver	Direction	Equivalent change
Termination of delivery rights	↓	6 per cent
Market price of water	↑	0.5 per cent
Market price for rice	↓	0.17 per cent
Yield of rice	↓	0.18 per cent



Striking the right balance

Investment certainty (stability of prices)

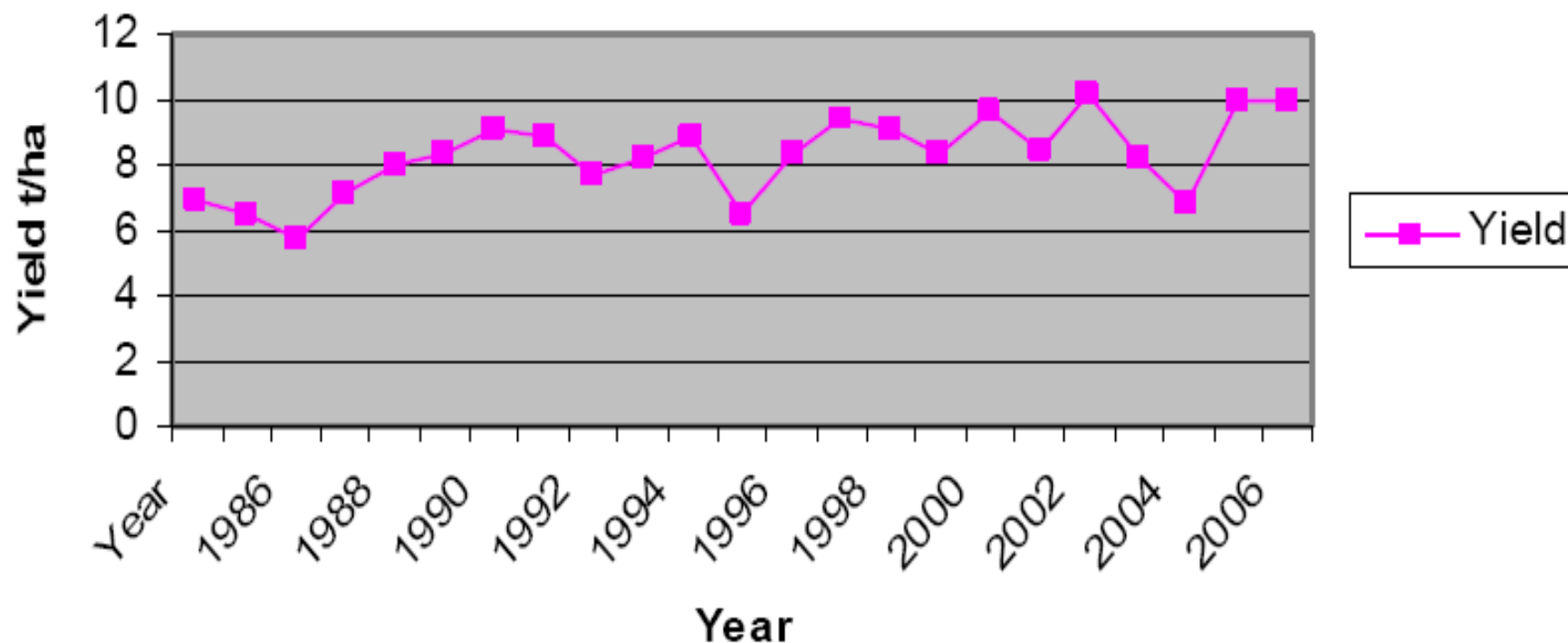
Unit gross value of production 1986-87 to 2006-07



Striking the right balance

Investment certainty (stability of prices)

Rice yield 1985-2007





Striking the right balance

Investment certainty

- Frontier Economics conclusion
 - Termination of neighbouring irrigators is unlikely to affect irrigator's production decisions relative to impact of other factors. Incentives to terminate and remain connected are similarly unchanged
- Investment certainty (eg. price stability) and financial viability is likely to be impacted by other factors which outweigh impact of ACCC's decision on termination fees
- **10x plus contract approval provides requisite investment certainty and represents an appropriate balance of considerations**



Next steps

- Submissions due 17 November
- Final advice provided to the Minister December 2008
- Peter Betson – (03) 9290 1920 or peter.betson@accc.gov.au



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