HORNE
LEGAL

Customs House

Level 3, 31 Alfred Street
Sydney NSW, 2000

t: (02) 9664 3030
tim@hornelegal.com.au

ACCC Water Markets Inquiry submission of Horne Legal

Horne Legal acts for various irrigator groups and individual irrigators in the southern basin.

We refer to our phone conference with the ACCC on Tuesday, 15 December 2020 in which we reviewed, amongst other things, the following:

1. Development of new trading products and management of constraints in delivery of water (including recognition of priorities) – introduction of Delivery Entitlements (**DE**) by Irrigation Infrastructure Operators (**IIO**) and their adverse impacts; and
2. The availability to the public of information on water market activities and tradeable water right holdings. In particular, the opaque disclosures of information by IIO's with respect to rule changes, trading products and lack of transparency for expansions of areas gazetted for irrigation which impacts upon market integrity.

We deal with each of the above below.

1. The development of the DE

A delivery entitlement is generally defined as an entitlement to have water delivered to land within an irrigation area. It gives the holder access to a share of the available capacity in the channel that supplies water to a property.

When IIO's were directed by the ACCC to allow water to be traded out of their irrigation infrastructure systems to other systems or valleys, IIO's introduced the concept of a DE for each megalitre owned by a landholder.

Historically, a landholder owned one delivery entitlement for each water entitlement that it owned. The amount of delivery entitlements were distributed within an irrigation infrastructure system in accordance with what that system could physically deliver (and drain).

A DE was originally fixed to a property and ensured that remaining IIO shareholders would not be burdened by water being traded out of the IIO system. It also acted as an equilibrium for IIO constraints in times of peak demands (after hierarchy of water order priorities were met). That is to

say, in times of peak demand, a landholder's flowrate was determined by the class of water entitlement owned (high security has priority to general security) and then the proportion of DE held on a channel with respect to the other landholders with outlets on the channel.

The DE was problematic for the Federal Government in its water buybacks, because it did not require delivery of the water within the IIO (nor accept the obligation to pay for this right annually). Therefore, originally, a DE was not valuable because it was a contractual commitment to the IIO to pay annual fixed charges to receive water (irrespective of whether or not the water entitlement holder had water delivered to the landholding or not) and due to Government buybacks there were surplus DE available in the network. If a landowner could not transfer their DE obligation, in order to extinguish the DE, they are generally required to pay ten years of fixed fees.

Unfortunately, due to the non-transparent decisions of various IIOs, a DE is now of greater:

a. value; and
b. importance,

in the irrigation infrastructure system, which is not in the best interest of all IIO shareholders and in contravention of the water entitlement priorities as set out in the Water Management Act 2000 (*NSW*).

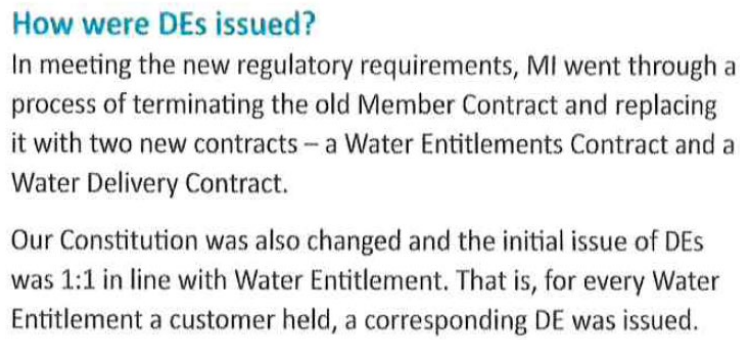
a. What is the right?

The legal right to have water delivered has never been clearly defined. The longstanding precedent of water being delivered to customers when they demand it has been distorted by the development of the water markets (and movement of water within irrigation systems, regions and states). In a river operator sense this is seen by the MDBA breaching the physical constraints of the river (ie. at the Barmah Choke) to meet the irrigation demands of "unregulated greenfield developments" downstream in the mid-Murray river.

Within IIO's this has manifested itself in the creation of a "concept" called DE which does not appear to have a legal property right, yet it has the effect of eroding genuine financial instruments under the Corporations Act, being the shares in the IIO of water entitlement holders, in addition to real property rights. IIO appear to have created a market for this financial instrument from nothing by giving it a coupon (the yield being in the form of water, not money) and making it tradeable despite having no transparency or supervision (save for by the IIO itself). If the "water return" that is given to DE holders is removed, this addresses some of the concern with respect to its use. However, further oversight is also required with respect to the conflicting interests for the creation of further DE by IIOs who have not consulted with their shareholders or acted in their best interests.

In the case of Murrumbidgee Irrigation (**MI**) shareholders have been forced to pay for expansions so that they can maintain the same level of access to their water entitlement (not because they need or desire more DE). The amount that is paid to MI by different MI customers for the purchase (or "co-contribution") of DE is not disclosed though we are informed that this amount does vary and in some cases no payment was provided for DE. In other instances, shareholder water is traded in order to fund a co-contribution by MI itself. We also understand that there have been customer co-contributions requested (to obtain DE) for expansions that have not taken place (a highly questionable transaction). This is not a uniform or consistent approach and impacts upon market integrity when other customers are required to pay for DE.

b. Issues with the DE



How were DEs issued?

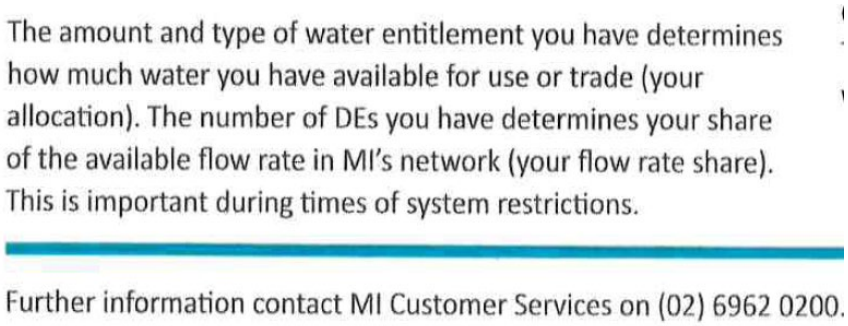
In meeting the new regulatory requirements, MI went through a process of terminating the old Member Contract and replacing it with two new contracts – a Water Entitlements Contract and a Water Delivery Contract.

Our Constitution was also changed and the initial issue of DEs was 1:1 in line with Water Entitlement. That is, for every Water Entitlement a customer held, a corresponding DE was issued.

Source: MI Delivery Entitlements FAQs 21 June 2018

If MI commenced with a set amount of DE and these have a value, every time MI issue/sell more DE it dilutes the existing DE holders rights. If this has not been in the best interests of shareholders, the directors of MI have breached their fiduciary duties. From what we have seen, we cannot see how these expansions, on a net basis, are even close to being a benefit to existing shareholders.

To our understanding, not all DE holders have been consulted about this dilution. In our view, if a landholder has always held the same number of DE and has never agreed to accept lower flowrates or been compensated by the IIO (or another landholder) in any way, it is unclear on what basis an IIO could subsequently diminish their flowrate in order to deliver volumes of water further down the system, in priority to this existing landholder with DE.


The amount and type of water entitlement you have determines how much water you have available for use or trade (your allocation). The number of DEs you have determines your share of the available flow rate in MI's network (your flow rate share). This is important during times of system restrictions.

Further information contact MI Customer Services on (02) 6962 0200.

Source: MI Delivery Entitlements FAQs 21 June 2018

Furthermore, if a DE is a contractual right to a flowrate in an area of the system, it is unclear on what basis MI can deny a DE holder from dealing with this right, such as gifting it to a neighbour or leasing it to another party or allowing temporary use. Despite this, it appears that this is the intention of MI.

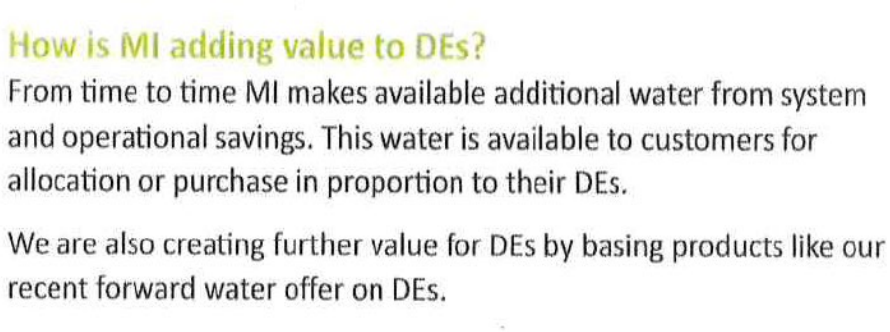
MI are conflicted because it benefits significantly from restricting the use of DE (and creation of artificial demand not linked to the underlying product). It creates a new market to sell/issue more DE even where such DE is of no justification or benefit (save for the MI generated perception of it assisting with flowrate at peak times) to customers. Put in other words, if the system is designed to allow a certain flowrate down a lateral channel – on what basis can MI say that this entire flowrate cannot be called upon by allowing all the outlets on the channel to call for the water jointly and distribute the flowrate between themselves. This is discussed further at [2e.] below. The position adopted by MI does not result in an even playing field for smaller customers and requires proper oversight and review by the ACCC.

Restricting flowrates to these landholdings (even if only at peak times) significantly reduces their value as they are unable to be used as they have been set up. It is comparable to the threat of having electricity cut off to a refrigerated warehouse/storage business. It is likely that it only requires one event for the business to lose its product and force it to relocate or cease to operate. The value of the property is diminished because it no longer has reliable access to water. MI play upon this potential threat by emphasising a potential impact on flowrate (without showing how) and this induces shareholders to purchase more DE – due to being unwilling to "risk" the loss of access to their pre-existing flowshare.

If flowrate is impacted upon, eventually, smaller to medium sized operators will exit their business and the DE bubble will burst because the demand that was artificially created due to a perception of loss of flowrate will dissipate. Larger operations will no longer be willing to pay for unnecessary DE

volumes and the IIO will ultimately collapse or revert to its shareholders for re-capitalisation – both of which have wider implications on the entire region where the IIO is located.

c. Giving DE's value



How is MI adding value to DEs?

From time to time MI makes available additional water from system and operational savings. This water is available to customers for allocation or purchase in proportion to their DEs.

We are also creating further value for DEs by basing products like our recent forward water offer on DEs.

Source: MI Understanding Flowrates FAQs 21 June 2018

It appears that in the case of MI, they have expanded the concept of the DE to allow for speculation by giving it "value" through enhancements. In other words, MI gives 5% of the total volume of DE held by a person in water as an "enhancement" allocation.

MI is highly conflicted because it gifts its shareholder water to certain customers (not all customers) in exchange for their commitment to make annual payments to it in the form of fees. It is a subsidy which disproportionately benefits the larger customers (who already receive another separate "prudent" discount from MI). In our view, this is a misapplication of company property. It results in many customers paying fees to MI for an entitlement to have delivered to them, a volume of water that they will never use, nor are capable of using. MI is the only party which can authorise the transfers of DE (accordingly, it acts as the Exchange) and without proper oversight, this:

i. could be manipulated to obtain better outcomes for itself; and
ii. is susceptible to insider trading.

Closer inspection and oversight of transfer records for the parties that traded in DE before important rule changes were announced is necessary. There is a common perception that many parties with inside information have benefitted from trading in (or front-running) DE rule changes/related announcements.

Furthermore, MI require a minimum 250 DE before an enhancement can be granted. This is highly inequitable and anti-competitive to smaller operators who own a lower volume of DE due to the nature of their business and the class of licence (ie. high security instead of general security or supplementary).

In 2019/20 an amount equivalent to 26% of total MI operations revenue was derived from "investments" of which we understand to be majority comprised of the revenues generated from trading water. With all of the market-sensitive information known to MI (including amounts of enhancements to be provided and their timing), the importance of this amount of revenue creates an extremely big conflict of interest for MI with its own shareholders.

d. Imbalance of bargaining position

There is a large imbalance of bargaining position because MI gives itself the right to simply cut off properties from accessing water if they do not pay their fixed DE charges. If a landholder cannot sell the DE to a third party, they must still pay the equivalent of ten years of annual charges to exit the liability. Furthermore, we are informed that the shareholders (and/or DE holders) who did not agree with the changes proposed by MI, were told by MI that they could not access water from the system unless (and until) they agreed. This placed the shareholders under significant duress and powerless to negotiate because their livelihood depended upon access to the system for water.

In effect, MI has expanded its footprint to justify selling/issuing more DE in order to increase gross revenue and create a market for the trading of a product (ie. the DE).

In doing so:

i. As the exchange, MI collects a fee for each transaction; and
ii. MI can manipulate the market with statements such as you are at risk of losing flow-share.

In expanding the footprint (ie. issuing more DE to pay for this), MI have created a secondary and further demand for more DE to be issued by introducing the complication of an impact on flowrate by the expansion. In other words, as MI sell/issue more DE it dilutes the DE already owned by landholders and forces them to purchase/commit to more DE in order to protect their position. If all landholders do this, it continues to drive up the cost of DE and gross revenues received by MI. This is despite MI simply coercing its shareholders into paying fees on something that they'll never utilise (ie. for volumes of water that will never be delivered). MI incentivises these customers to consider themselves as "investors" in DE by giving to them the water from the shareholders as a subsidy/kickback/bonus. This does nothing to increase administrative and operational efficiencies for the benefit of the shareholders of MI.

When we have questioned shareholders if they could sustain the MI charges without the enhancement water, the answer has consistently been "no". We are informed that the extra commitment is only made in order for these customers to protect flow rates (as their landholdings

and businesses are designed around having access to water – lower flowrates can mean water is unable to be applied correctly/efficiently). MI is therefore basing its future operational strategy on convincing customers to pay for more DE than they need, which is quite risky and lacks foresight given that this encourages smaller properties to exit the system. These exits would likely reduce the impact of the flowrate issue – or diminish the value at the top of the system (where traditional horticulture was predominately setup) whilst constraints at the bottom could persist. In other words, it is an unsustainable financial practice, and the only party which currently supervises it, is incentivised to not be transparent and continue to give out shareholders water in order to cover its own costs. As opposed to reducing administrative and operational costs which is a focus of most conventional organisations.

In 2019/20 MI generated $20,184,000 in revenue from fixed charges (ie. DE). It was able to generate a further $4,617,000 from further charges to customers and $2,047,000 from selling shareholders water. On the other hand, its expenses were $24,675,000.

Despite selling/exchanging 60GL of shareholders water (which is worth over $7,000 a megalitre – in total, we estimate more than $420 million) for PIIOP or Government funds in recent years to improve efficiencies and automation of the MI system, as seen below in [1g.] operational efficiencies have not improved and the expenses of MI have increased by more than 16% in the past five years (they were $21,127,000 in 2015). The focus on increased customer revenue masks the increase in operational inefficiencies and coupled with the continual transfers and sales of shareholder water to third parties, it is unsustainable. Without the intervention of the ACCC shareholders will be left exposed when customers leave the system. Using shareholder water as an inducement or subsidy to keep the customers is inappropriate and unsustainable.

Today the board (and shareholders) of MI permit this to continue, however that is not something which can be relied upon into the future. A change in position by the Governments or shareholders could cause this bubble to burst, with the holders of DE stuck with a ten year contractual commitment to MI that they need to wash out for the volumes of water they do not intend to ever have delivered.

If MI needs a cash injection to keep it afloat and pay operational expenses, it can do so by selling the shareholders water or asking the shareholders for capital contributions. Customers must therefore be incentivised to become shareholders of MI to share in the risks of the scheme and also the benefits. This incentive should occur through the distribution of the water savings created by MI to its shareholders.

If the argument of an IIO is that the enhancement water encourages payment of DE, then why does it not sell all of the enhancement water on the open market to bring down the cost of DE uniformly? Those customers who want the extra water could simply purchase it on the open market and not by way of this financial instrument created by the IIO. However, even if this approach was adopted, it still does not compensate shareholders adequately for the risk that they assume with respect to the company. It would also fail in wet years when water prices are low.

Therefore, the most appropriate and sensible approach is to distribute efficiencies to shareholders and if shareholders elect to sell this water to fund their costs, that is their right. If customers do not pay their DE then this is a liability for the company/shareholders and this extra water savings can be used (or sold) to cover this risk. Therefore, if shareholders are of the view that system expansions (which may impact on their flowrate and conveyance water) is in their best interest, then they will accept the subsequent impacts upon them. Conversely, forcing the shareholders to underwrite a newly created market in DE that is overseen by the IIO itself (which has many serious conflicts) is a recipe for disaster.

e. Lack of transparency

If DE holders knew all of the information about other DE in the system, they may elect to not pay for new DE or choose to not maintain all of their existing DE liabilities (which would reduce revenues for MI). Accordingly, there is a clear perception that the MI administration is incentivised to create as much DE as possible, whilst providing as little information as possible about the DE market, in order to ensure that landholders continue to buy (or request them) and commit to pay for them for at least 10 years.

There is no proper basis to restrict the information from being transparently disclosed, save that MI would risk customers uncovering that they do not require excessive DE. Accordingly, without full transparency, market integrity is impacted upon because it is easily possible for misinformation to be spread to create profitable buy or sell opportunities for market participants/speculators.

f. Sold or issued?

MI say that they do not sell DE, that they simply “issue” DE. However, MI has a clear financial interest to issue as much DE as possible – because this correlates to higher revenues for it. Consequently, MI has been expanding its irrigation area and infrastructure, in most cases without

consultation with landholders, councils and its own shareholders. This is despite the Council of Australian Governments agreeing (on 25 February 1994)[1] that:

> 3(iii) that future investment in new schemes or extensions to existing schemes be undertaken only after appraisal indicates it is economically viable and ecologically sustainable.

It is unclear if MI presented to the Minister economic and environmental impact studies in its application to extend the irrigation footprint when, for example, it recently added 8,300 hectares of Ballandry station to its footprint. It has not been disclosed to us if it was the owners of Ballandry who instigated this expansion (we note, they have not utilised their access to irrigation, but have seen a substantial increase in the value of this land which was subsequently listed for sale) or if it was MI who approached the owners to obtain their commitment to pay a fixed charge annually to it in the form of DE. It is also presently not known why MI did not publicise its intention to expand the system and the due diligence that it had conducted to justify it (such as the economic and ecological reviews required by COAG).

Either way, this causes a significant conflict between shareholders and the MI administration. The rights of shareholders are being eroded (through loss of water, flow rates and land value from increase in irrigation area), their liabilities are increased and the total risk to the IIO is also increased. The increased risk manifests in such ways as:

i. Lack of conveyance water to deliver all shareholder water orders – this occurred in 2008 when MI attempted to "shut down the system" in March, despite many orchards and high security entitlement holders needing to continue irrigation. An increase in the size of the system and channels (together with sale/transfer of conveyance water for PIIOP funding that hasn't improved system efficiencies) makes this increasingly likely to reoccur;
ii. In the event of a crash in almond prices or an unforeseen event such as a disease which impacts production, it may not be possible for many new DE owners in the expanded areas to maintain volumes of water being delivered and their fixed DE charges. This would likely burden the shareholders with underwriting the maintenance of the system to ensure that they can continue to receive their water. We note that in the current circumstances, the shareholders already underwrite these customers by having their water shared amongst the bigger customers. However, this arrangement will likely be challenged;
iii. Drainage issues from poorly planned expansions which may also be in breach of the Operating Licence. Rectification works are the responsibility of MI, to be paid for by its

[1] Council of Australian Governments' Communique, 25 February 1994 Attachment A

shareholders. MI may also be sued by landholders, insurers and local councils if it has caused property damage and losses from flooding (the losses which are underwritten by shareholder assets).

Having the "inside information" about what expansions will be undertaken by the IIO to its footprint impacts upon the property market. With respect to "Ballandry" in 2018 (shortly after being added to the footprint) it was listed for sale by Ray White and contained the following statement.

Water Delivery Entitlements

Access to water through the Northern Branch Canal is of paramount importance. 45,455 Delivery Entitlements will attach to the irrigation development block.

The southern section of the aggregation adjoins the Northern Branch Canal through part of the property the vendor has contracted to purchase land that has 527 metres frontage to the Northern Branch Canal.

Source: Ray White, Ballandry Station Investor Memorandum 27 June 2018

This property currently does not utilise any irrigation endeavours. It also has an extraordinarily large amount of DE and yet it does not have any access to receive this water. The "co-contribution" made by the owner of Ballandry for the expansion of the IIO footprint to include it, has provided it with a very large financial benefit because:

i. Irrigation land is significantly more valuable than dryland;
ii. The 45,455 DE are tradeable and worth several millions of dollars; and
iii. The yield on the DE can, and often, exceeds their cost of maintenance.

If the MI shareholders co-contribution business case for the Ballandry expansion was based upon generating additional income from increased water usage in order to offset the financing costs to build and expand the network – it has failed. The property is not using any water and shareholders are underwriting the cost. Meanwhile the owners have had no restrictions/requirements placed upon them by MI and are free to profit from this expansion and gross oversight.

g. Expansions and/or PIIOP projects have not improved efficiency

3.6 Supply efficiency

Table 11 illustrates the simple efficiency of MI's supply system to be at 83% for 2018/19. The simple efficiency provides insight into how the supply system is managed under the season's climatic conditions, whilst balancing irrigation demand and minimising system losses.

Table 11 Supply efficiency from 2018/19 and previous years

Year	Diversions (ML)	Deliveries (ML)	Conveyance (ML)	Simple Efficiency (%)
2018/19	586,752	487,204	99,548	83%
2017/18	945,805	800,963	144,842	85%
2016/17	780,083	621,094	158,003	80%
2005/06	1,036,519	829,990	206,529	80%

10

Source: MI Compliance report 2018/19

MI have used PIIOP money to assist with the expansion of its footprint and yet there is no greater efficiency in the delivery of its water (see table above from MI compliance report which shows that the simple efficiency has only moved from 80% to 83% in the past fifteen years despite shareholders giving up 60GL of their water - which has the same value as high security - to PIIOP programs).

NBC expansion approved

The project to expand the Northern Branch Canal (NBC) will go ahead in the upcoming winter shutdown period. This project extends our area of operations into Ballandry Station and will bring more water to the area, deliver higher flow rates for NBC customers and reduce costs for all customers in the longer term.

Last year we used government funding (PIIOP2) to undertake modernisation works on the NBC in order to improve is flow capacity. This involved upgrading regulators from the offtake near Yenda to Blackgate Escape on the northern end of the canal.

The new suite of works will further increase the flow capacity of the NBC and is being jointly funded by customers. When complete the NBC will be able to deliver up to 750ML per day - more than double the original capacity.

Source: MI News in Brief April 2017 newsletter

In an article with the Australian Water Association, the CEO of MI, Mr Brett Jones stated:

> "*Expanding the capacity of the Northern Branch Canal will allow us to deliver more water and higher flow rates to better meet the needs of customers' farming operations.*"

As noted above, Ballandry would be serviced by the Northern Branch Canal (**NBC**) and has an extremely large volume of DE which it does not occupy. In 2017, when the NBC expansion was completed by MI, it changed its rules to award "enhancements" to DE holders instead of shareholders. In practical terms, in 2017/18 a 3% enhancement for Ballandry equated to

approximately 1,313ML. The spot price of water was $400 per ML. Consequently, the enhancement was worth $525,200 and cost just $431,000.

This has increased gross revenue for MI but the expansion has caused a significant increase in losses from seepage, leakage and evaporation. This is one example of DE being unnecessarily created which has caused other landholders on the NBC to commit to more DE in order to preserve their flowrate. Ultimately efficiencies and benefits to shareholders and customers drop, however DE revenue for MI increase.

In response to this NBC expansion and being told that their flowrate would be impacted, landholders asked questions such as:

a. What drainage impact mitigations have been borne by the landholders if there is an increase in flow;
b. What flood mitigation has been designed to stop third party impacts on landholders adjacent and further downstream;
c. Where is the environmental impact study given the expansion abuts a National Park mountain reserve with seven tributaries;
d. How many delivery entitlements already exist;
e. How many delivery entitlements are on offer;
f. How many delivery entitlements are in the system;
g. How can we see who is ordering on the same day;
h. How much flowrate can we get if everyone on the channel orders water at the same time;
i. Why were they only notified in late February of such a large planned expansion scheduled to commence that winter;
j. Why is the business case commercial in confidence to shareholders; and
k. Are there any plans for further expansions?

The response of MI is that it would not provide this information and hoped the developer would be good corporate citizens and ensure they would mitigate their impact. This is despite drainage being a component of the MI IIO Operating Licence.

h. The ultimatum for landholders in the MI scheme

Accordingly, in the eyes of some of our clients, the ultimatum to them was to the following effect:

> *We have expanded the irrigation footprint of MI and are expanding the canals primarily to deliver more water to the new landholdings that have been added to the MI footprint. In 2012, MI shareholders water was traded in PIIOP 1 to install/replace regulators, bridges and other infrastructure which, despite some protests, have now been removed or replaced to*

enable a subsequent expansion. Despite this waste of funds, loss of water and the fact that the expansion of the footprint increases the risk of having insufficient conveyance water, we will now give away more of the shareholders conveyance water in order to receive further PIIOP funds to help repeat the process. That is, use the PIIOP funds to underwrite more expansions to attract new customers to pay to us fees for DE.

However, we (as in MI, and not the landholders receiving the benefit of the infrastructure upgrades) still require you to help pay additionally in co-contributing and underwriting this expansion.

*Because you do not receive any benefit for this expansion we may <u>give</u> to you (not <u>sell</u> to you), DE which you can trade through us to other people for money or now fully constrain your system to prevent others accessing their usual share of water. We acknowledge that you likely will never actually order as much water as you will now be contractually required to pay to have delivered to you, and that this only benefits MI and the new landholdings in the footprint, however we will make this DE product **valuable** by giving you "enhancement water" which we only give to the larger customers (who have more than 250 DE) and this water will be usually worth more than your annual charges – so in that sense it's an investment that you can profit from also.*

If you do not help pay for the expansion to benefit these new landholders, we can no longer guarantee your flowrates will stay at their historical levels. We understand that your business and infrastructure is built upon obtaining these flowrates so we recommend that you buy more DE. In fact, we wish to facilitate this for you.

In order to help you make a fully informed decision about whether or not you need to take on these extra liabilities and contribute to expanding the system for the benefit of these new landholders, unfortunately we cannot tell you any information about:

a. *Number of DE's on your channel;*
b. *Who owns the DE's;*
c. *What are the total constraints on a system/channel;*
d. *What is the flowrate if all people on a channel order water at the same time;*
e. *When other DE's are being used; or*
f. *Any other planned expansions or changes that may impact you and this business decision.*

We are not concerned that our rule to give "enhancement water" to customers (ie. DE holders) over shareholders will be overturned despite this water being the property of shareholders which was formerly distributed to them (and not to DE holders). We do not see any conflict in distributing the shareholders asset to customers to incentivise them to pay for our administrative costs. In our view the shareholders interests are better served by increasing revenues in this manner, as opposed to distributing their water to them and cutting our administration costs.

Accordingly, either you pay for more DE or you may not get your water when you order it, even if your water is high security and has priority as per the Water Management Act.

i. Breach of fiduciary duty

The granting of "bonus" water that was formerly the property of shareholders and WE owners to newer DE holders through products such as "enhancements" or "efficiency water" is a breach of fiduciary duty by the IIO directors because it is not in the best interests of shareholders to use their water to subsidise the IIO charges to its customers.

This practice does not encourage the IIO to be more efficient with running its operations. An example of this is headcounts at various IIO remaining stagnant over recent years despite:

i. the amount of water being delivered has been negligible for consecutive years; and
ii. shareholder assets (ie. water) being traded away to increase efficiencies and to pay for automation.

An IIO should incentivise customers to become a shareholder by distributing the "enhancement water" to them. It should not sell water into the market because it has access to non-publicly available information which puts shareholders at a disadvantage when trading for their own water against the IIO.

The evidence to support this contention is set out above at [1d.].

j. Murray Irrigation Limited "efficiency" water

Murray Irrigation Limited (**MIL**) is another IIO in the southern basin. In around 2009, 17% of the volume of water entitlements owned by MIL shareholders was taken from them without notice or compensation. We have been instructed that the justification for this was that it was the amount of "conveyance" water that was factored into the licenced volume to move the water from Lake Mulwala to the landholdings within the MIL footprint.

Despite this loss to MIL shareholders, MIL now distributes the "efficiencies" that it generates in delivering water to the landholdings amongst DE holders. Consequently, water that was once owned by shareholders is now distributed amongst DE holders. This is inequitable and has negatively impacted on the value of water entitlements (whilst also subsidising DE costs from shareholder assets).

Whilst we acknowledge that MIL are not in the business of creating DE to impact upon flowrates or to drive up gross revenues, we respectfully request that the ACCC intervene to set a uniform policy across the industry and water markets for DE.

2. Expansion of areas within irrigation scheme without notice or consultation

Presently, an IIO has no obligation to make public an application to expand an irrigation zone. This is despite such an application having a direct, and in our view, significant, impact upon the markets (for WE, DE and land prices).

Pursuant to section 51(2) of the Water Management (General) Regulation 2018 (*NSW*) it is only the Minister who is required to publicise an application when it exceeds 15% of the total area within an IIO footprint.

Consequently, it appears that this rule has been circumvented by some IIOs having made several applications to expand – of which the applications individually did not exceed 15%, however, collectively they would have.

In any event, the lack of transparency with respect to an IIO undertaking a proper planning process in expanding the footprint and infrastructure has the potential to undermine market integrity and confidence. The value of a DE and land are directly impacted by this information.

In comparison, at a local government level – impacted landholders and interested parties would be notified and given an opportunity to respond to a development application. Environmental and economic impacts are normally assessed by a planning authority. In contrast, IIOs have not been transparent in their expansions which has been to the detriment of their shareholders (who have lost conveyance water and flow capacity as a result - without proper consultation).

We acknowledge that an IIO is not a planning authority, however, we submit that an IIO should not be allowed to make such significant planning decisions with no oversight or transparency. Without such oversight, it is not possible for other consumers within the market to make fully informed decisions. It is also problematic for local councils and other important community stakeholders.

A proper planning process that moderates what volumes of water can be shifted (and delivered) to other regions protects consumers (and an IIO) by allowing them both to implement their business plans with confidence. IIOs that have expanded their systems to accommodate new landholdings in an attempt to increase gross revenues have jeopardised the entire system. For example, finance institutions may be reluctant to provide longer term accommodation to farming businesses when the regional infrastructure, security of licence priority and access can be changed without notice.

a. Objects of the Water Act 2007

It appears that Federal Government "grants" for efficiencies (or inflated value water buybacks), have incentivised the development of cheaper and previously non-irrigated areas. As a consequence of this, IIO's have competed to attract to their schemes, more water for delivery than their infrastructure could sustain.

For example, it was possible to purchase cheaper general security water entitlements from NSW Murray Valley and trade it for funding for efficiency projects in the Murrumbidgee valley. We are informed that no distinction was made by the Federal Government with respect to the valley of the underlying water entitlement which allowed landowners in the Murrumbidgee valley to receive Murrumbidgee valley prices (which are much higher) in exchange for the Murray Valley water. This arbitrage, together with complicity from the IIO has in part lead to a greater development and expansion of irrigation footprints in the Murrumbidgee Valley and a decrease of volumes being delivered in the Murray Valley. This is despite the MIL system being developed to receive greater volumes of water (there are no real constraints before the Mulwala Canal) and the Murrumbidgee Valley requiring intensive expansions to accommodate these changes.

In our view, expanding areas under irrigation (and not reducing them) is repugnant to the primary objects of the Water Act 2007 such as:

> *to achieve efficient and cost effective water management and administrative practices in relation to Basin water resource*.[2]

The solution to deliver more water in a constrained system to a greater area has been to create more DE. As discussed above, this means greater gross revenue to the IIO but significantly higher market risks and adverse outcomes (ie. loss of access to flow capacity) to pre-existing IIO shareholders who have not been consulted or compensated for the change. In addition to being oppressive to existing shareholders of the IIO, this does not encourage competition between IIO on the basis of efficient operations.

In our view, this approach by various IIO is illegal and in contravention of the:

a. Water Management Act 2000 (*NSW*);
b. National Water Initiative 2004 (NWI); and
c. Corporations Act 2001 (*Cth*).

[2] Section 3(g) Water Act 2007 (*Cth*)

We request that the ACCC require a process akin to a development application (**DA**) to a local council for expansions to gazetted irrigation areas and the issuance and trading of DE. Furthermore, IIO's should be required to make available a live and transparent network system overview, for all customers and shareholders to have visibility over customer orders, water availability, constraints, inflows and drainage. It is our understanding that this information is already collated and visible to IIO's, they simply do not share it with their shareholders and customers.

The alternative is that this encourages the construction of inefficient on-farm storages which is at a further cost to landholders. In addition to the construction costs and loss of productive land, the inefficiencies associated with having on farm storages (such as through evaporation and seepage) to combat the water flow issue is quite extreme in comparison to the simple solution of not expanding irrigation zones without proper planning, consultation and where necessary, compensation.

b. Inside information

Recently, in MI the irrigation footprint was expanded without notification to, or consultation with, the MI shareholders. The consequence of this is that for those people who knew that the footprint would be expanded, they had the opportunity to purchase non-irrigation farmland and see its value increase substantially when it was re-gazetted as irrigation land. The impact on the integrity of the market is akin to a council privately and confidentially granting a Development Application for a re-zoning of land – allowing a select few insiders to benefit from this information to the exclusion of all others.

c. Breach of IIO operating licence - drainage

The lack of planning process can cause an IIO to potentially breach its operating licence conditions with respect to ensuring appropriate drainage.

In the recent addition to the MI footprint of 8,300 hectares for the Ballandry property, which is at the foothills of a mountain range which, in large rainfall events, acted as a buffer to retain large volumes of water from cascading into the valley below. We are informed that the drainage system in place prior to this expansion was already considered inadequate. When "dryland" areas become "irrigation land" the soil becomes "charged with water" and when it is also developed for agricultural production it is designed to discharge water as quickly and efficiently as possible. Consequently, this recent expansion will likely exacerbate flooding.

MI shareholders will be negatively impacted because:

i. MI will need to pay to implement drainage;

ii. Landholders surrounding recent expansions (or downstream) may incur damages or loss to:

1. Crops;
2. Livestock;
3. Infrastructure;
4. Permanent plantings; and/or
5. Human life due to mobility issues.

iii. MI faces potential legal actions by local councils and insurance companies for causing the flooding;

iv. Impacted landowners will likely face increasing insurance premiums to account for the increased flood risk associated with the area; and

v. Impacted landowners face potential asset devaluation of their land due to increased flood risk.

In our view this likely breaches the directors' duty to act in the best interest of all shareholders because of the adverse impacts on all other MI shareholders due to:

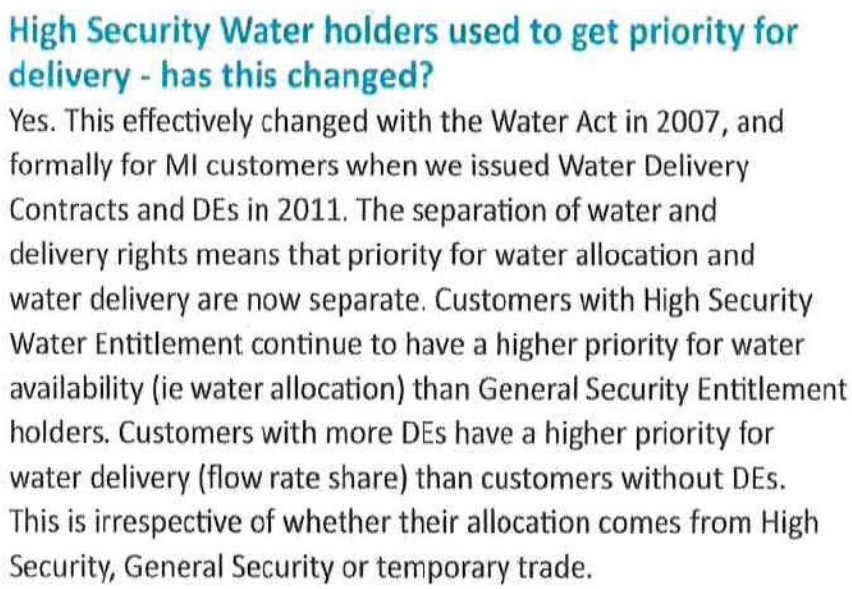
a. The amount of land with access to irrigation had increased, thereby devaluing other irrigation properties owned by shareholders (or impeding their properties growth); and

b. The amount of "conveyance" water required to deliver water to the expanded footprint increased and the cost of this is socialised amongst all other MI shareholders;

d. DE does not override the WMA licence priorities

In recognition of the need to protect industries such as horticulture which require a consistent amount of water, high security licences were issued by the NSW Government to these operators. These licences had priority over other forms of licences such as general security or supplementary, however, we note, that they were for a significantly lower volume of water than other forms of licences. In the view of Horne Legal, using the DE system to deny flow capacity to high security licence holders is illegal on the basis that it contravenes the priorities of water allocation set out in section 58 of the Water Management Act 2000 (*NSW*) (**WMA**).

Despite this, the view of MI with respect to high security is that it does not have priority for delivery. This is set out below in its FAQs.



High Security Water holders used to get priority for delivery - has this changed?

Yes. This effectively changed with the Water Act in 2007, and formally for MI customers when we issued Water Delivery Contracts and DEs in 2011. The separation of water and delivery rights means that priority for water allocation and water delivery are now separate. Customers with High Security Water Entitlement continue to have a higher priority for water availability (ie water allocation) than General Security Entitlement holders. Customers with more DEs have a higher priority for water delivery (flow rate share) than customers without DEs. This is irrespective of whether their allocation comes from High Security, General Security or temporary trade.

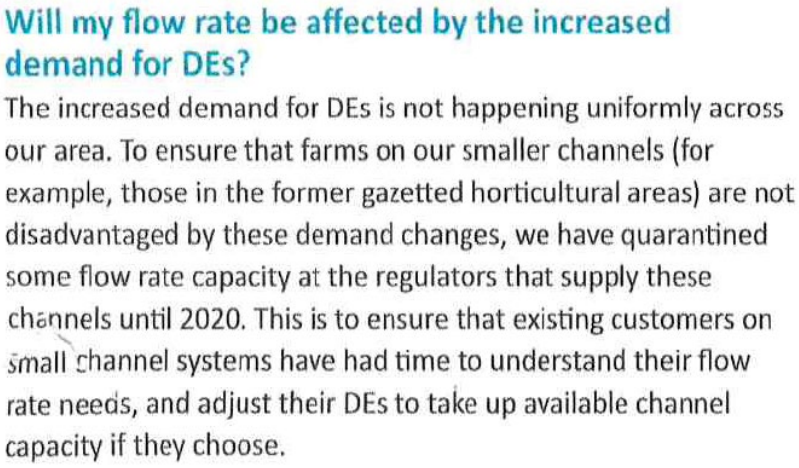
In our view, the legislation is clear, high security licence holders have priority over general and supplementary licence holders and this extends to the physical delivery of water. This has also been the interpretation of the Courts in NSW.

In *Murrumbidgee Horticulture Council Inc v Minister for Land and Water Conservation* [2003] NSWLEC 213, Pain J of the Land of Environment Court of NSW stated:

> *28. The Council was concerned that cl 49 could operate so that if a general security access licence holder placed an order for water before a high security access licence holder, and it is then determined that there is insufficient water supply to satisfy all users, the general security access licence holder's order would take priority over the high security licence holders who had not put in an order before the general security access licence holder for water to be supplied. That is, orders would be fulfilled on a "first in, first served" basis. This would be in contravention of the priority between access licence holders specified in s 58 of the Act.*
>
> *29. The Minister and Council agreed that the alternative, and preferable, construction is that the decision in relation to priority is made at the time of delivery of the water when orders have been received. At the time water is released priority is given to orders from the class of access licence holders in par (a). This would ensure the priority specified in s 58 of the Act is maintained. I see no reason to disagree with this interpretation of the operation of cl 49.*

Clause 49 of the Murrumbidgee Valley Water Sharing Plan 2002 is elaborated upon further to clarify this issue of priority, in clause 73 of the draft Murrumbidgee Valley Water Sharing Plan 2020. Accordingly, despite the apparent intentions of MI to interfere with this, we do not see this priority issue changing in the near future.

If MI have not allowed for this in its water delivery and channel capacity/constraint calculations, should all of the existing horticulturalists call for water at peak times, there is a potential that MI may not be able to also meet the demands of customers with significantly greater DE, for example, newly created almond plantations that also require large volumes of water at critical times. If the process of expanding the system and the issuance of DE was more transparent, stakeholders could have more confidence in it to withstand these stresses. Presently, the flowrate has been "quarantined" (see below). We request that the ACCC direct that this "quarantine" remain in place until this issue has been properly ventilated.



Will my flow rate be affected by the increased demand for DEs?

The increased demand for DEs is not happening uniformly across our area. To ensure that farms on our smaller channels (for example, those in the former gazetted horticultural areas) are not disadvantaged by these demand changes, we have quarantined some flow rate capacity at the regulators that supply these channels until 2020. This is to ensure that existing customers on small channel systems have had time to understand their flow rate needs, and adjust their DEs to take up available channel capacity if they choose.

It would also be prudent of the ACCC to acknowledge in its water market inquiry report that these priorities under the Water Management Act 2000 (*NSW*) must be followed by the Murray Darling Basin Authority (**MDBA**) and WaterNSW in delivering water to entitlement holders located on the Murray River. That is to say, in times of peak demand and a delivery shortfall to entitlement holders on the lower Murray River, water called or taken pursuant to high security licences gets priority (to general security).

e. Removal of the practice of "rostering"

The most efficient way to irrigate is to push water over an area quickly. It is highly inefficient to irrigate slowly. As a consequence, due to having low volumes of water for horticulture, in the MI system many horticulturalists have historically operated a channel system on a "rotation" or "roster" basis to maintain high pressure (from higher flowrates). In summary, they have developed systems, which have been endorsed and coordinated by agents of the IIO to allow an individual landholding to share a portion of the DE for a channel on separate days so that all landholdings can maximise the flow of the channel and constraints within existing infrastructure and be efficient with getting water on and off their properties quickly. The current changes to the rules around DE and flow capacity

means that these "roster" systems are obsolete. Given the significance of the change to flowrate from increased DE in the system, it has not been adequately advertised or communicated to MI shareholders. It is clear that most irrigators do not understand the potential consequences of these changes. It has not been discussed with the banking system or other interested stakeholders. The consequence will likely see the brunt borne almost entirely by existing horticulture operations in the MIA. The commentary we have received is that smaller operations feel like they are being "extorted" into purchasing more DE in order to be able to maintain flow rates.

The obvious and most equitable solution is that groups of landholders on a lateral channel are afforded the opportunity to have their entire lateral channel treated as one "outlet". This allows the landholders to organise their internal flow rate arrangements between themselves (provided that they do not exceed – or underutilise – the total flows ordered to the lateral channel). To remove their ability to access historical flowrates simply because MI has expanded its system to benefit a few landholders is highly inequitable and is anti-competitive because it results in the smaller operators being unable to continue to operate their enterprises.

This is contrary to the objectives of the Water Act 2007, namely that it does not benefit the Australian community[3] – rather it benefits a few large corporate enterprises with the financial backing to squeeze out smaller operators and non-local (and more prevalently, non-Australian) shareholders.

f. Impacts of being unable to water fruit trees at peak times

The $13.2 billion Basin Plan has allowed the expansion of irrigation areas at the expense of all historical irrigators. The newcomers have been enabled through the DE system.

If an existing irrigator is unable to obtain the required flow to correctly water their trees/vines in heat waves, the fruit/nut/berries shrink and dehydrate. The tree can abort the berries/fruitlets/nutlets and a crop is lost or severely damaged. It increases the chance of "sunburnt" fruit which decreases its quality (and value). The damage done to the plants' health is often irreversible. The trees/vines can behave in a peculiar manner, which even today is not fully understood. There is a much higher chance of disease, insects and pests increase and production and quality decrease.

Trees/vines take many years to mature. By taking an ad hoc approach to replacing sick trees (and removing them) is also very inefficient because it is harder to manage watering, pesticides, harvest

[3] s3(d)(iii) Water Act 2007 (*Cth*): to maximise the net economic returns to the Australian community from the use and management of the Basin water resources.

etc when they are mismatched sized. Longstanding orchards will lose commercial contracts if quality drops. To replant an orchard/vineyard, the landholder is required to flatten their current orchard, and decommission the infrastructure such as drip tubes and piping which is all electronically connected. This process is highly capital and labour intensive and for most enterprises who have been financed by banks or other institutions, it is not an option due to loss of cashflow, reduced incomes and increased risk to repay capital.

However, this predicament is quite avoidable if these businesses can maintain access to the flowrates (and rosters) as they historically have had. The repercussions of not protecting these rights will likely be the destruction of enterprises, wealth and the fabric of these regional communities.

g. Further adverse impacts and increases in risk

The expansion of irrigation footprints and issuing of more delivery entitlements (rather than less) is repugnant to the objectives of the Basin Plan and MDBC Cap on diversions. The conduct of IIO's in enabling this requires much closer investigation and supervision by the ACCC. It is abundantly clear that pre-existing water entitlement owners and IIO shareholders have been adversely impacted as a consequence and will only be further negatively impacted should the ACCC not intervene.

Historically there was a diversification of IIO shareholders which reduced risk exposure for IIOs (and the other industries and organisations which depend upon them). Today, some IIOs have a very high exposure to almond (or nut) production which, in the event of a market collapse would leave not just the IIO, but also the other industries and enterprises within the IIO footprint heavily exposed. This is extremely problematic for the financial services industry which underpin the commerce within the area as their long term decisions and planning have not incorporated the inability for their clients to access their water at critical times. In light of this, if the IIO fails, or access to sufficient flow rates is removed, it has the potential to induce a widespread recession in these areas.

The value adding operations of, for example, wineries will also be impacted upon if they receive unsuitable product. A likely outcome is increased quality downgrades that can lead to a glut in low quality produce which further places downward pressure on returns and viability. Reduced quality berries increase losses to wineries of higher quality markets. Once established market share is eroded, it is very difficult to be recouped. The winery and potentially region (and country) is viewed as having low quality and inconsistent products which reduce industry profitability and credibility.

In light of the matters raised herein, we respectfully urge the ACCC to:

1. Freeze all extensions to irrigation areas;
2. Direct that IIO's make public all information with respect to applications to expand irrigation scheme footprints since their inception;
3. Direct that there be greater transparency with respect to DE – in particular that scheme network maps be produced to demonstrate constraints and more active consultation be made with shareholders about potential risks of shortfall in delivery;
4. Removal of incentive for DE (as in enhancements or efficiency water) and prudent discounts in order to ensure an even playing field for market participants.

Timothy G Horne
Horne Legal
12 January 2021