



Australian
Competition &
Consumer
Commission

Water Charge (Termination Fees) Rules

Final advice

December 2008



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Contents

Abbreviations	v
Glossary.....	viii
Summary.....	xiii
ACCC consultation	xiii
When should termination fees be levied?	xiv
Level of the termination fee multiple.....	xv
New and existing contracts	xvi
Future review	xviii
Amendments to the draft rules	xix
1 Introduction.....	22
1.1 Consultation process	22
1.2 Basin water charging objectives and principles.....	24
1.3 Governance and charging arrangements	25
1.4 The remainder of the water charge rules.....	27
2 Calculating and imposing termination fees	29
2.1 When a termination fee may be imposed.....	29
2.2 Method for calculating termination fees	32
3 The termination fee multiple.....	34
3.1 The level of the termination fee multiple.....	34
3.2 Materiality of termination fees on the financial viability of operators	37
3.3 Third party impacts from termination	43
3.4 Rationalisation opportunities	46
3.5 ACCC’s final advice	49
4 The total network access charge	51
4.1 The total network access charge	51
4.2 Shadow access fees	54
4.3 Fees that an operator may impose upon termination	57
5 Adjustments to the termination fee	60
5.1 Adjusting the termination fee for tax	60
5.2 Adjusting the termination fee for avoided costs	64
6 Negotiating higher termination fees	66
6.1 When a higher termination fee may be approved	66
6.2 Process for approving higher termination fees.....	69
7 Application and implementation	73
7.1 Compliance and enforcement.....	73
7.2 Application of the rules	75
7.3 Monitoring and review	78
Appendix A: List of submissions received.....	80

A1.	Issues paper submissions	80
A2.	Position paper submissions	81
A3.	Draft advice submissions	82
Appendix B: Basin water charging objectives and principles		83
B1.	Water charging objectives	83
B2.	Water charging principles	83
Appendix C: Current arrangements		85
C1.	Governance and regulatory arrangements	85
C2.	Charging arrangements of operators	86
C3.	The access, exit and termination fee protocol	88
Appendix D: Illustrative examples of the economic effects of termination fees		91

Abbreviations

ACCC	Australian Competition and Consumer Commission
the access, exit and termination fee protocol	the Murray–Darling Basin Agreement Schedule E protocol on access, exit and termination fees
the access, exit and termination fee report	ACCC, <i>A regime for the calculation and implementation of exit, access and termination fees charged by irrigation water delivery businesses in the Southern Murray–Darling Basin</i> , advice to the Australian, New South Wales, South Australia and Victorian Governments, November 2006
the Act	<i>Water Act 2007</i> (Cth)
Basin	Murray–Darling Basin
BIL	Barossa Infrastructure Limited
CI	Coleambally Irrigation, constituting the dual cooperative of CICL and CIMCL.
CICL	Coleambally Irrigation Cooperative Limited
CIMCL	Coleambally Irrigation Mutual Cooperative Limited
CIT	Central Irrigation Trust
DEWHA	Department of Environment, Water, Heritage and the Arts (Cth)
ESC	Essential Services Commission of Victoria
FMIT	First Mildura Irrigation Trust
Frontier Economics	Frontier Economics Pty Ltd
GMW	Goulburn–Murray Water
GST	Goods and services tax
GWMW	Grampians–Wimmera–Mallee Water
the issues paper	ACCC, <i>Issues paper on water charge rules for fees or charges payable to irrigation infrastructure operators</i> , May 2008
JWSS	Joint Water Supply Scheme
LMW	Lower Murray Water

MDB Agreement	Murray–Darling Basin Agreement
MDB Authority	Murray–Darling Basin Authority
MI	Murrumbidgee Irrigation
MIL	Murray Irrigation Limited
Minister	Minister for Climate Change and Water
ML	megalitre (1 million litres)
MRFF	Macquarie River Food & Fibre
MVWDAA	Murray Valley Water Diverters Advisory Association (NSW)
NFF	National Farmers Federation
NPV	net present value
NSWIC	New South Wales Irrigators’ Council
NSWFA	New South Wales Farmers Association
NWI	National Water Initiative
the position paper	ACCC, <i>Position paper on water charge rules for termination fees</i> , August 2008
PwC	PricewaterhouseCoopers
recommended rules	revised draft water charge rules for termination fees
RIT	Renmark Irrigation Trust
RGA	Rice Growers Association of Australia
SAMI	South Australian Murray Irrigators
SRI	Southern Riverina Irrigators
SA Water	South Australian Water Corporation
State Water	State Water Corporation (NSW)
SUN	SunWater
TBG	The Bondi Group
TPA	the <i>Trade Practices Act 1974</i> (Cth)

TNIS	Trangie–Nevertire Irrigation Scheme
WACC	weighted average cost of capital
WCID	West Corurgan Irrigation District
WMI	Western Murray Irrigation

Glossary

This glossary endeavours to provide practical meanings of terms; however, readers may need to consider the legal meaning of some terms under the *Water Act 2007* (Cth) and obtain legal advice on these definitions, if required.

access service	service provided by an operator for the transportation of water using the operator's irrigation network
access fee	fee imposed by an operator for the provision of access services. Access fees may include multiple components (for example, a fixed fee component and a variable fee component)
allocative efficiency	a situation in which resources are used to produce goods and services that provide the maximum benefit to society. An important condition for allocative efficiency is that prices for services reflect the value society places on the next best alternative use of the resources used to produce the service.
Basin Plan	the plan (amended from time to time) adopted by the Minister under section 44 of the Act.
capital expenditure	expenditure that the operator recovers from customers over multiple pricing periods (rather than wholly recovering the cost in the same period in which it is incurred)
civil penalty	a court-ordered pecuniary penalty (sum of money) ordered to be paid where a person has been found to contravene the water charge rules
disconnection fee	a fee to recover the costs incurred in disconnecting an irrigator from an operator's irrigation network, but not the costs associated with reconfiguring or rationalising an irrigation network as a consequence of the disconnection.
discount rate	the comparative value of a dollar at some future time and its present value.
economic life	the period during which an asset may be put to profitable use. It is typically shorter than an asset's engineering life.
engineering life	the period over which an asset is expected to physically be able to provide a particular service. It does not consider whether the service is still demanded by customers.
ex ante	before the fact—ex ante is contrasted with ex post

ex post	after the fact—ex post is contrasted with ex ante
exit fee	a fee levied by an irrigation infrastructure operator on the transfer of a water entitlement out of the operator’s network or irrigation district (excluding any fee associated with the costs of processing that transfer)
fixed costs	costs that do not vary with the volume of water delivered
full cost recovery	recovery of all costs, including: <ul style="list-style-type: none"> ▪ operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes ▪ provision for the cost of asset consumption (depreciation) ▪ provision for the cost of capital (rate of return)
irrigator	a person who receives water delivery services from an irrigation infrastructure operator—may include a person who receives water for any reason, such as for stock and domestic purposes
irrigation district	an area or district that is supplied with water via an infrastructure supply network, (channels, pipes and other structures) operated and maintained primarily to supply water for use within that district
irrigation infrastructure operator	any person or entity who owns or operates delivery or drainage infrastructure for the purpose of delivering irrigation water to another person (e.g. an irrigator)
irrigation network	the delivery and drainage infrastructure of an operator
joint water supply scheme	means any work which is used or proposed to be used for the purpose of supplying water for irrigating the land or lands of any occupier or occupiers other than the land or lands of the occupier or occupiers of the site of the work.
net present value	the value of a whole stream of future payments discounted by an appropriate discount rate
non-systematic risk (diversifiable risk)	risk which is not limited to a class of assets where variations in results are idiosyncratic with a low correlation. Non-systematic risk can be eliminated by diversification. For example, project-specific or firm-specific risk can be eliminated by either investing in many projects or holding the stocks of many companies.
on-farm investment	investment by irrigators in their irrigation activities—includes investment in assets, such as plantings and livestock, on-farm irrigation equipment (e.g. pumps), water

	storage facilities (e.g. farm dams) or ongoing human capital investments (such as the knowledge of how to grow specific crops)
operator	an irrigation infrastructure operator
rationalisation	a reorganisation to increase efficiency. May result in an expansion or reduction of network size or an alteration of strategy pertaining to particular irrigation districts within an irrigation network.
regulated water charge	charge to which the water charge rules (Division 1 of Part 4 of the <i>Water Act 2007</i>) may apply. This includes fees and charges payable to an irrigation infrastructure operator for access to, or terminating access to, the operator's network
renewals annuity approach	method of financing capital expenditure. Converts (using an appropriate discount rate) the forward-looking long-term expenditure on renewing and rehabilitating assets into a smoothed path for revenue that is then recovered through prices; the renewals annuity approach represents ex ante or up-front contributions from customers to expenditure yet incurred by the operator
shadow access fee	the fixed access fee that would be charged if fixed access fees were set to recover all fixed costs and no variable costs (i.e. if variable access fees set at a level to recover all variable costs and no fixed costs)
systematic risk (non-diversifiable risk)	the risk that is common to an entire class of assets. It cannot be diversified away, except to the extent that another class of assets can be included in the portfolio. Risks associated with events affecting individual firms (such as a fire) are diversifiable.
termination fee	any fee or charge payable to an operator for either terminating access or surrendering a water delivery right
total network access charge	the amount on which the termination fee multiple is applied in order to calculate a maximum termination fee. The total network access charge is the sum of all fixed access fees otherwise payable by an irrigator in a financial year for access to an operator's irrigation network, excluding connection/disconnection fees and fees under approved contracts (see section 6.1).
unbundle	the process of separating water delivery rights and water access rights so that each can be separately tradeable

water access right	any right conferred by or under a law of a state to hold water from a water resource or to take water from a water resource—this includes stock and domestic rights, riparian rights, a water access entitlement, a water allocation and any other right relating to the taking or use of water
water access entitlement	open-ended or perpetual access to a share of the water resource that is available for consumption as specified in a water plan
water charge rules for termination fees	water charge rules for fees or charges payable to operators in relation to terminating access to an operator’s irrigation network (or services in relation to such termination), or surrendering a right to delivery of water through the operator’s irrigation network.
water delivery right	a right to have water delivered by an infrastructure operator
water service infrastructure	infrastructure for the storage, delivery or drainage of water
weighted average cost of capital	the weighted average of its different sources of finance – namely debt and equity. It is the rate or return typically adopted by regulators, and reflects an estimate of the opportunity cost of capital. The capital asset pricing model is often used to estimate the returns required by equity holders, and the cost of debt is normally estimated from the observed or estimated debt financing costs of comparable businesses.

Summary

The *Water Act 2007*¹ (the Act) creates new institutional and governance arrangements to address the sustainability and management of water resources in the Murray–Darling Basin (the Basin). The Act builds on earlier reform initiatives, including the National Water Initiative (NWI) and the Murray–Darling Basin Agreement (MDB Agreement), and is supplemented by federal government funding commitments of around \$10 billion.²

A key element of this reform is the removal of barriers to water trade to facilitate the operation of efficient water markets and provide opportunities for water trading.³ Water trading will allow water to be traded to its highest value use.

The reforms also aim for consistent application of rules across the Basin.⁴ Consistency will promote the efficient functioning of water markets⁵ by removing distortions to trade and by sending signals to water users about efficient investment in water service infrastructure.

The Act gives the Minister for Climate Change and Water (the Minister) the role of making water charge rules. The Australian Competition and Consumer Commission’s (ACCC) role is to advise the Minister on those rules and monitor and enforce compliance with the rules.⁶

The ACCC’s advice to the Minister comprises recommended rules along with a final advice outlining reasons for the approach recommended. This paper sets out the ACCC’s final advice on water charge rules for termination fees.

ACCC consultation

In May 2008 the ACCC released an issues paper on water charge rules for fees or charges payable to irrigation infrastructure operators (the issues paper)—including termination fees—that sought information and submissions from interested parties. The ACCC received 30 submissions, which can be viewed at www.accc.gov.au. In August 2008, the ACCC released a position paper on water charge rules for termination fees (the position paper) containing preliminary positions on matters such as when a termination fee may be levied, how termination fees should be calculated and the

¹ As amended by the *Water Amendment Act 2008* which commenced 15 December 2008.

² The Intergovernmental Agreement on the National Water Initiative (NWI) between the Australian Government and the governments of New South Wales, Victoria, Queensland, South Australia, Western Australia, the Australian Capital Territory and the Northern Territory (as amended from time to time). The NWI (2004) built on the ‘Water Reform Framework’ agreed by the Council of Australian Governments (COAG) in 1994, which was incorporated within the National Competition Policy Agreement in 1995.

³ See section 10 and schedules 2, 3 of the Act.

⁴ Clause 3(7) of schedule 2 of the Act.

⁵ Clause 2(c) of schedule 2 of the Act.

⁶ Sections 93(2), 94 and 100A and 100D of the Act.

quantum of the termination fee multiple. The ACCC received 20 submissions, which can be viewed on its website.

In October 2008, the ACCC released its draft advice on water charge rules for termination fees (draft advice) and draft water charge rules for termination fees (draft rules) converting the positions contained in the advice into draft rules. The draft advice amended certain preliminary positions reached in the position paper resulting from stakeholder submissions. Examples included the adoption of the 10x multiple for the termination fee and the inclusion of contractual negotiation for higher termination fees. The ACCC received 19 submissions, which can be viewed on its website.

The ACCC has undertaken extensive consultation in developing its final advice, including the review of 69 submissions to the issues paper, position paper and draft advice and conducting 51 meetings with stakeholders (including public forums) over a 12 month period.

When should termination fees be levied?

The Act aims to promote the efficient use of and investment in irrigation infrastructure and on-farm infrastructure and facilitate the efficient functioning of water markets.⁷ Water charge rules for termination fees are necessary to contribute to these objectives.

Irrigation infrastructure operators (operators) face ongoing costs for maintaining irrigation infrastructure. Many of these costs are fixed—that is, they are incurred by the operator whether or not an irrigator chooses to terminate access.

If irrigators terminate access without paying termination fees then operators may not be able to recover their committed fixed costs. Over time this may compromise the viability of operators, service standards and investment. The prospect of irrigators leaving without paying termination fees creates revenue uncertainty for operators which may undermine investment.

Accordingly the ACCC reaffirms its draft advice to allow operators to impose termination fees. As was noted in the draft advice, there are some qualifications to this position:

- Termination fees should only be permitted when an irrigator terminates access to the operator's irrigation network.
- The operator must not apply termination fees on the sale of water access rights (no exit fees).
- Termination fees should be calculated using actual fixed access fees (not shadow access fees).
- Termination fees should be capped.

⁷ See sections 3, 10 and schedules 2, 3 of the Act.

Box 1

Final advice: when termination fees should be levied

1. An operator may only impose a termination fee when:
 - (a) an irrigator terminates access to the operator's irrigation network
 - (b) access is deemed to have been terminated because the irrigator has failed to meet obligations associated with their water delivery right.
2. When an irrigator terminates access to an operator's irrigation network, the operator may only recover the unavoidable ongoing costs associated with providing those access services through imposing a termination fee, and may not recover these costs through any fees or charges levied on a water access right (exit fees should not be imposed).

Level of the termination fee multiple

If termination fees are set too high they can act as a barrier to rationalisation and water trade. In cases where irrigators terminate access as well as selling their water access rights, termination fees need to be subtracted from the proceeds gained from selling water access rights to determine the net returns to the irrigator. The higher the termination fee, the lower the net returns, and the lower the incentive for the individual to trade water for a given water price.

The challenge for the ACCC is to balance the legitimate interests of operators against the objective of facilitating trade. The approach proposed in the draft advice, which is reaffirmed in the final advice, is to cap the level of termination fees.

Submissions commented extensively on the appropriate level of the termination fee multiple. Many irrigators submitted that the current termination fees imposed by operators are too high,⁸ while operators largely supported the current practice of using a termination fee multiple of 15x.⁹

Setting the maximum termination fee multiple requires balancing the need to provide certainty for operators and irrigators to undertake efficient investments against providing price signals for operators to achieve allocative efficiency in the provision of access services (e.g. incentives for rationalisation).

⁸ D Barclay, draft advice submission, p. 1; D Star, draft advice submission, p. 1; P Leslie & D Ferguson, draft advice submission, p. 1; J R Rorke, position paper submission, p. 3; D Crowhurst, position paper submission, p. 1; G Doherty, position paper submission, p. 1; D W Sehestedt, issues paper submission, p. 1.

⁹ NSWIC, draft advice submission, p. 4; MRFF, draft advice submission, p. 2; TNIS, draft advice submission, p. 4; SRI & RGA, draft advice submission, p. 2; GMW, draft advice submission, p. 1; CI, draft advice submission, p. 4; MI, draft advice submission, p. 6; MIL, draft advice submission, p. 7; CIT, position paper submission, p. 2; RIT, position paper submission, p. 2; TBG, position paper submission, p. 3; NSWIC, position paper submission, p. 2; WMI & CI, position paper submission, pp. 3-4; TNIS, position paper submission, p. 4; MIL, position paper submission, p. 3; MI, position paper submission, p. 6.

Operators have largely submitted that a termination fee multiple of 15x would be acceptable. However, the ACCC considers that the arguments presented in support of a multiple of 15x are based on:

- insulating remaining irrigators from price increases to an inappropriate degree
- providing revenue certainty over a longer period than may be economically efficient
- an under-appreciation of the range of mechanisms available to operators to manage revenue uncertainty and realise rationalisation opportunities.

The ACCC considers that a more appropriate multiple would be less than 15x. Economic efficiency supports providing incentives for operators to supply only those services required by their customers and to restructure their operations when certain services are no longer required. Insulating irrigators from access fee increases in this manner removes the price signals necessary to achieve such efficiency.¹⁰

There is no clear level for the termination fee multiple. However, the ACCC considers that the multiple in the final advice represents a reasonable balance between facilitating the efficient functioning of water markets and providing efficient investment incentives. A multiple of 10x delivers the operator between 12 to 15 years of access fees which provides an extended period of revenue stability for operators and fee stability for irrigators. This should be sufficient to give operators time to assess the impact of water trading on demand and to adjust their operations if necessary.

Box 2

Final advice: level of the termination fee multiple

3. Except where approved by the ACCC, the maximum termination fee that an operator may impose upon the termination of access (in whole or in part) is to be:
 - (a) the sum of the annual amounts of all fixed access fees associated with the access services provided for the year in which the access is terminated, multiplied by 10.

New and existing contracts

In the draft advice, the ACCC noted the possibility that some efficient investments may only be viable with cost recovery periods longer than those implied by the termination fee multiple proposed.¹¹ Some stakeholders submitted that operators and irrigators

¹⁰ The ACCC engaged Frontier Economics to examine the impact of the ACCC's decision to reduce the termination fee multiple from 15x to 10x on remaining irrigators ongoing production decisions. Frontier Economics concluded that the increase in access fees for remaining irrigators is unlikely to be sufficient affect irrigators' ongoing production decisions given the significance of other factors relevant to their decisions (including water prices, produce prices and farm yields). Refer Frontier Economics, *Termination fees and landholder considerations*, December 2008, p. 45 [available on the ACCC website].

¹¹ See section 6.2 of the draft advice.

should be able to enter into contractual arrangements without interference from the water charge rules for termination fees.¹²

As outlined in the draft advice, there are a number of mechanisms other than a termination fee that an operator may utilise to mitigate risks of future reductions in demand.¹³ Nonetheless, such measures are not always sufficient to provide the required certainty to an operator to undertake an otherwise efficient investment.¹⁴

Where both an operator and its customers are willing to enter into contractual arrangements that include higher termination fees and those termination fees reasonably relate to the recovery of capital expenditure associated with major investments, there would appear little justification for preventing such agreements.¹⁵

Under certain circumstances, it is likely that irrigators would be willing to enter into negotiated contracts for termination fees in excess of the cap proposed by the ACCC—for example, if the irrigator benefits from significant improvement in the reliability and quality of services.

On balance, the ACCC considers that the rules should allow contracts between irrigators and operators to specify higher termination fees than a multiple of 10x, provided that the higher termination fees are required to support capital expenditure associated with major investments and contracts are entered into following ‘good faith’ negotiations.

The final advice reflects this position and provides for the approval (by the ACCC) of termination fee arrangements within existing and new contracts.

In granting approval for a termination fee contained in a contract, the ACCC must be satisfied that the termination fee (however calculated) is

- clearly stated within the contract
- relates to capital expenditure that occurs within five years of the inception of the contract
- is reasonably required to recover the capital expenditure
- is a product of a genuine contract stipulating the rights and obligations of the parties.

¹² NSWIC, draft advice submission, p. 5; TBG, position paper submission, p. 4.

¹³ See section 3.2 of the draft advice.

¹⁴ See section 6.1.

¹⁵ The access, exit and termination fee report espoused the benefits of ex ante long-term contracts in relation to access to irrigation networks, stating that ‘contractual agreements of this nature would provide certainty to irrigators and infrastructure operators as to their respective obligations. They would guarantee transparency to the funding of investments and ensure that irrigators are aware of their future obligations prior to the construction of infrastructure. Moreover, because irrigators are made aware of their obligations before entering into the contract, early termination payments would not affect any decision to leave the irrigation system’ [See pp. 20–21 of the access, exit and termination fee report].

Box 3

Final advice: New and existing contracts

4. The ACCC may approve the imposition of higher termination fees in new or existing contracts. The ACCC's assessment will consider whether:
 - the termination fee relates to capital expenditure that has been carried out or is reasonably expected to occur within 5 years of the inception of the contract
 - the operator imposes an access fee payable for the recovery of the capital expenditure
 - the termination fee does not exceed an amount reasonably required to recover the capital expenditure
 - irrigators agreed to the higher termination fees
 - negotiations between the irrigator and operator were conducted in good faith
 - the operator cannot unilaterally change the termination fee in the future

Future review

There is limited data on a number of issues relevant to termination fees.¹⁶ The lack of data means it is not possible to accurately assess the impact of termination fees on water trading, infrastructure investment, rationalisation and service standards.

Because of the lack of data and the uncertainty about the impact of water trading and the drought, the ACCC considers a further review is warranted. The position paper proposed that a review commence in 2013 and conclude in 2015.¹⁷

Submissions reflected a mixed response by stakeholders. Numerous submissions argued that the importance of the issues means that the review should be conducted earlier.¹⁸ Conversely, some submissions contended that any review should be delayed in order for these important issues to be adequately assessed.¹⁹

The ACCC has recommended that the water charge rules for termination fees come into effect for all irrigation infrastructure operators on 1 July 2009. Given this, beginning a review in 2012 and concluding the review in 2013 provides for (up to) four years of

¹⁶ For more, see section 7.3.

¹⁷ See section 4.4 of the position paper.

¹⁸ SRI & RGA, draft advice submission, p. 4; NSWIC, position paper submission, p. 5; NFF, position paper submission, p. 3; WMI & CI, position paper submission, p. 11; MIL, position paper submission, p. 5.

¹⁹ RIT, position paper submission, p. 2.

data, including two years of data collected after the expected finalisation of the Basin Plan.²⁰

This timing would also bring forward the conclusion of the review by two years from the date recommended in the position paper, which is desirable for a number of reasons:

- It allows for an earlier assessment of the provisions covering approving termination fees in contracts, which may be eased after the rules have been in effect for a sufficient period of time.
- The recommended termination fee multiple of 10x will be less than those multiples recommended by the ACCC in the position paper corresponding with the first 2 years of the review period and will be equal or greater than the multiples corresponding to the final 2 years of the review period. This balance is only maintained when the review is brought forward.
- On balance, submissions favoured bringing forward the review.

Box 4

Final advice: future review

5. The Minister may request the ACCC to review the water charge rules relating to termination fees, with the review to commence after 1 July 2012 and conclude before 30 June 2013.

Amendments to the draft rules

In preparation of the final advice, the ACCC has not substantially altered any of the positions reached in the draft advice. Amendments to the draft rules have been made to better reflect the intent of the advice or to clarify matters as requested in submissions.²¹

The wording of the draft rules has been amended to provide further clarity to stakeholders regarding the application of the rules. For instance; the composition of the total network access charge,²² the matters the ACCC will consider when approving contracts,²³ the ability to levy other fees and charges at the point of termination,²⁴ and the interaction between the base termination fee (capped at 10x annual fixed access fees as represented by the total network access charge) and a higher termination fee approved under contract.²⁵

²⁰ For more information refer to DEWHA website: <http://www.environment.gov.au/water/publications/mdb/pubs/mdba-transition.pdf>, accessed on 6 October 2008.

²¹ WMI, draft advice submission, p. 4; MI, draft advice submission, p. 3; SA Gov, draft advice submission, p. 2.

²² See the definition of total network access charge in the recommended rules.

²³ See rule 8 of the recommended rules.

²⁴ See rule 10 and subrule 5(2) of the recommended rules.

²⁵ See rule 7 and part (e) of the definition of total network access charge in the recommended rules.

To provide more certainty to market participants, and to prevent the approval process being used to delay termination, the draft rules have been amended to include a time period for operators to apply for approval. The ACCC considers that a period of three months provides an appropriate opportunity for operators to submit an application to the ACCC for approval of a termination fee after agreeing a new contract. For existing contracts, operators will have three months from the commencement of the cap on termination fees to submit an application. To accelerate the approval process, the draft rules have also been amended and now require operators to provide information about the relevant contracts at the time of application.

The ACCC has also revised its draft rules to make it more apparent that trade, transfer or assignment of water rights does not constitute termination.

Appendix E outlines the amendments made to the draft rules in further detail.

1 Introduction

The Murray–Darling Basin (the Basin) extends across five states and territories and is Australia’s most important agricultural region.

The *Water Act 2007*²⁶ (Cth) (the Act) creates new functions for the Australian Competition and Consumer Commission (ACCC). These include developing draft water market rules and water charge rules for consideration by the Minister for Climate Change and Water (the Minister), and advising the new Murray–Darling Basin Authority (MDB Authority)²⁷ on water trading rules. The Act also requires the ACCC to monitor compliance with, and enforce,²⁸ the water market rules and water charge rules.

This chapter explains the consultation process adopted by the ACCC in developing its advice on termination fees, and explains the objectives of the Act and what they mean for the water charge rules for termination fees. The chapter also explains how the water charge rules for termination fees fits into the ACCC’s broader role in providing advice on water charge rules.

1.1 Consultation process

In developing its final advice on water charge rules for termination fees the ACCC undertook an extensive consultation process. The ACCC released an issues paper, position paper and draft advice for comment. The ACCC received 69 submissions in response to these papers. All written submissions received are publicly available on the ACCC’s website.

The issues paper on water charge rules for charges payable to irrigation infrastructure operators (the issues paper) was released for public consultation on 30 May 2008. The issues paper addressed all regulated water charges payable to irrigation infrastructure operators (operators)—that is, fees for access as well as termination. Submissions in response to the issues paper were due on 15 July 2008. The ACCC received 30 written submissions, many of which addressed termination fees.

Following the issues paper, the ACCC split its consultation process on the charges rules into two, with one process addressing termination fees and the other access fees. The processes were split to allow the ACCC to bring forward its advice on water charge rules for termination fees. The ACCC’s advice on water charge rules for other charges payable to irrigation infrastructure operators (e.g. access fees) will be finalised by the end of June 2009.

On 15 August 2008, the ACCC released the position paper on water charge rules for termination fees (the position paper) for public consultation. The position paper set out

²⁶ As amended by the *Water Amendment Act 2008* which commenced 15 December 2008.

²⁷ For more information refer to DEWHA website: www.environment.gov.au/water.

²⁸ Part 8 of the Act provides the ACCC with a suite of mechanisms to enforce water market rules and water charge rules.

the ACCC's preliminary positions on exit fees, termination fees and the methodology used for determining termination fees. Submissions in response to the position paper were due on 15 September 2008, and the ACCC received 20 written submissions.

The ACCC's draft advice on water charge rules for termination fees (the draft advice), including draft water charge rules for termination fees (the draft rules) and accompanying explanatory statement, was released for public consultation on 17 October 2008. Submissions in response to the draft advice, including the draft rules and explanatory statement, were due on 17 November 2008, and the ACCC received 19 written submissions.

The ACCC held six public forums following the release of the draft advice and draft rules as part of its consultation process. The public forums on the water charge rules for termination fees were run concurrently with the public forums on the water market rules and were held at:

- 30 October 2008 Renmark, South Australia
- 30 October 2008 Mildura, Victoria
- 10 November 2008 Dubbo, New South Wales
- 13 November 2008 Shepparton, Victoria
- 13 November 2008 Deniliquin, New South Wales
- 14 November 2008 Griffith, New South Wales.

At each stage of the consultation process, the ACCC invited comment from Basin state Ministers, operators, interested stakeholders and the public. The ACCC also published notices in national and regional newspapers and on the internet notifying stakeholders of the public forums and inviting submissions in response to the issues paper, position paper, and draft advice.

The ACCC held 51 meetings with key stakeholders throughout the public consultation process and engaged Frontier Economics Pty Ltd (Frontier Economics) and PricewaterhouseCoopers (PwC) to prepare reports on key issues. The reports prepared by Frontier Economics and PwC that accompanied the draft rules are available on the ACCC's website.

The consultation process also provided stakeholders with the opportunity to discuss issues directly with Commissioners,²⁹ ACCC staff and ACCC consultants and present detailed case study information for consideration, namely:

- Central Irrigation Trust (CIT), Western Murray Irrigation (WMI) and Barossa Infrastructure Limited (BIL) made available detailed information for the presentation of case studies based on significant investments in irrigation infrastructure for the purpose of estimating maximum implied termination fee

²⁹ Including public forums and meetings with organisations such as CIT (meeting held on Wednesday 5 November 2008) and NFF (meeting held on Friday 12 November 2008) between Commissioners, ACCC staff, CIT and NFF.

multiples. The information provided the ACCC with a practical comprehension of the impact on investment decisions of various termination fee multiples.³⁰

- In response to the draft advice, Coleambally Irrigation (CI) made detailed information available to Frontier Economics and PwC in preparation of their final reports on the impact of termination fees on remaining irrigators' production decisions and the adjustment of termination fees for income tax.
- CIT met with Commissioners and ACCC staff to discuss the impact of the ACCC's draft advice to cap the level of the termination fee multiple at 10x.³¹ CIT provided the ACCC with information on the impact of future access fees on remaining irrigators. The ACCC reviewed the analysis and presented various pricing options to CIT to manage the associated impacts.³²

The final advice takes into account all of the submissions, comments made in public forums and the reports from independent experts. The final advice is reflected in a set of revised draft water charge rules for termination fees (recommended rules).

1.2 Basin water charging objectives and principles

The Act states that water charge rules must contribute to achieving the Basin water charging objectives and principles.³³ The Act also states that in providing advice to the Minister on termination fees, the ACCC must have regard³⁴ to the governance and charging arrangements of operators.

The Basin water charging objectives and principles in the National Water Initiative (NWI) and the Act are contained in full in appendix B.³⁵ In summary, the water charging objectives and principles provide that termination fees should:

- promote the efficient use of and investment in irrigation infrastructure and on-farm infrastructure
- facilitate the efficient functioning of water markets.

To achieve these objectives, charges for required services should be at a level that is sufficient to maintain the business viability of operators and the efficient maintenance

³⁰ See section 3.2 of this advice and appendix G of the draft advice.

³¹ CIT, meeting held on Wednesday 5 November 2008 between Commissioners, ACCC staff and CIT

³² The analysis confirmed the ACCC's advice that a termination fee multiple of 10x provides between 12 and 15 years of equivalent access fees. Pricing options included the postponement of access fee increases until termination fee reserves are exhausted, an immediate and lower increase in access fees, marginal cumulative increases in access fees and the impact of offsetting productivity gains. See section 3.4 for a generic discussion on quantum of productivity gains to offset the impact of moving from 15x to 10x.

³³ Schedule 2 of the Act.

³⁴ See appendix C for more information on the governance and charging arrangements of operators within the Basin.

³⁵ The Basin water charging objectives were also discussed in chapter 3 of the issues paper, section 2.2 of the position paper and section 1.4 of the draft advice.

of the operator's infrastructure. There may be a degree of common interest between irrigators and operators in providing a sufficient revenue stream. The operator has a legitimate interest in achieving a commercial return on its investment, while the irrigator has an incentive to ensure that returns are sufficient for the operator to maintain and invest in the relevant infrastructure.

Charges should ensure sufficient revenue streams to allow efficient delivery of the required services. While this objective intends to ensure the business viability of operators, economic efficiency also requires that operators have incentives to minimise their costs subject to meeting appropriate or agreed service standards. Furthermore, fees and charges should generate revenue streams necessary for providing only those services required by customers, and include incentives for operators to restructure their operations when certain services are no longer required.

An efficient, well-functioning water market can reveal the value of water to existing and potential users and create incentives for users to seek improved technical productivity, innovate and improve water use efficiency. This leads to more productive and efficient use of water resources over time.³⁶ However, if termination fees are set at inefficient levels signals to irrigators will be distorted. For example, if termination fees are too high, the net returns from termination are too low and efficient termination and trade decisions will be distorted.

Efficient pricing of access services allows for the correct signals to be revealed in water markets about the value of water in use. This allows reallocation of water in response to changes in the cost of providing access services. Similarly, an efficiently functioning water market can create incentives for users to innovate and improve water use efficiency.

This paper explains how the proposed termination fee rules promote efficient trade and efficient investment in and use of irrigation infrastructure.

1.3 Governance and charging arrangements

In providing advice to the Minister about proposed water charge rules in relation to regulated water charges payable to infrastructure operators, including termination fees, the ACCC must have regard³⁷ to the:

- governance arrangements of those operators
- current charging arrangements of those operators
- history of charging arrangements of those operators.

Considerable diversity exists in the number, size and ownership arrangements of operators across the Basin.

³⁶ National Water Commission, *2005 NCP follow-up assessment of water reform progress*, May 2007, p. 1.2.

³⁷ See appendix B for more information on the governance and charging arrangements of operators within the Basin.

Irrigation networks have been privatised in New South Wales³⁸ and South Australia,³⁹ and most of these operators have a cooperative structure in which the members/irrigators are shareholders in the entity that owns the shared irrigation network.

In Victoria and Queensland the majority of water service infrastructure—including irrigation networks—remains with a small number of government-owned authorities.⁴⁰ These statutory authorities must submit their corporate plans each year to the responsible Minister to ensure compatibility of their business directions with government policy.

In Victoria, an independent economic regulator, the Essential Services Commission (ESC), is responsible for making determinations about prices and service standards. In Queensland, SunWater (SUN) determines its prices in consultation with its customers for each irrigation scheme through a three-tiered negotiation process. If negotiations fail during this process, the government may intervene to set the level for prices⁴¹. In New South Wales and South Australia however, there is no substantive government or independent regulatory oversight exists in respect of the pricing of operators.

An operator typically provides two main services to its customers: to make available capacity for the delivery of water for use in irrigation and to make available capacity for the drainage of water previously used in irrigation.

Charges for the provision and use of access services generally consist of two components—a volumetric fee and a fixed fee. The two parts of this charging structure reflect the two cost components faced by operators: fixed and variable costs. In addition to access fees, it is common for operators to impose a fee upon the termination of access.

Historically, water access rights were bundled together with the right to a share of the capacity of an operator's irrigation network. That is, when an irrigator bought or sold a water access right, the irrigator simultaneously bought or sold the right to access the operator's irrigation network. A fee levied by an operator on the transfer of a water access right out of the operator's network or irrigation district⁴² is referred to as an exit fee while, as noted above, a fee levied by an operator when an irrigator ceases to use (and pay for) access services is referred to as a termination fee.

In April 2007 the Murray–Darling Basin Agreement Schedule E protocol on access, exit and termination fees (the access, exit and termination fee protocol) was agreed upon by jurisdictional governments. It addresses:

- when a termination fee can be applied
- the structure and form of the termination fee

³⁸ Not including assets used for the purpose of providing bulk water, which are under the ownership and control of State Water, a NSW government-owned bulk water supplier.

³⁹ The exception is the South Australian Water Corporation (SA Water).

⁴⁰ SUN provides access services to the majority of Queensland irrigators within the Basin.

⁴¹ Qld Gov, response to ACCC request for information, 19 February 2008, p. 5.

⁴² Excluding any fee associated with the costs of processing that transfer.

- the amount of the termination fee
- adjustments to the termination fee.

These jurisdictional governments are at different stages in giving effect to this agreement. In consulting on water charge rules for termination fees, stakeholders have been engaged with reference to their current charging and governance arrangements.⁴³

The ACCC's final advice is largely consistent with the access, exit and termination fee protocol.⁴⁴ Where the ACCC has varied from the protocol (and in turn the current charging arrangements of operators), it has done so to take into account the Basin water charging objectives and principles listed in appendix B and discussed in section 1.2.

1.4 The remainder of the water charge rules

As illustrated in box 5 (below), the water charge rules consist primarily of three components:

- rules for charges payable to operators
- rules for bulk water charges
- rules for charges for the recovery of water planning and management costs.

For charges payable to operators, the Act states that water charge rules may address fees or charges for:

- access to the operator's irrigation network (or services provided in relation to that access)
- changing access to the operator's irrigation network (or services provided in relation to that access)
- terminating access to the operator's irrigation network (or services provided in relation to that access)
- surrendering to the operator a right to the delivery of water through the operator's irrigation network.⁴⁵

This final advice details the ACCC's recommendations on water charge rules for fees or charges for terminating access and/or surrendering a delivery right (water charge rules for terminating fees). The ACCC's advice on water charge rules for the other charges payable to operators (charges for access to an operator's network), bulk water charges, and charges for the recovery of water planning and management costs will proceed under separate processes.

The development of advice on water charge rules for termination fees has been progressed separately to align timing with the water market rules. Fees or charges for

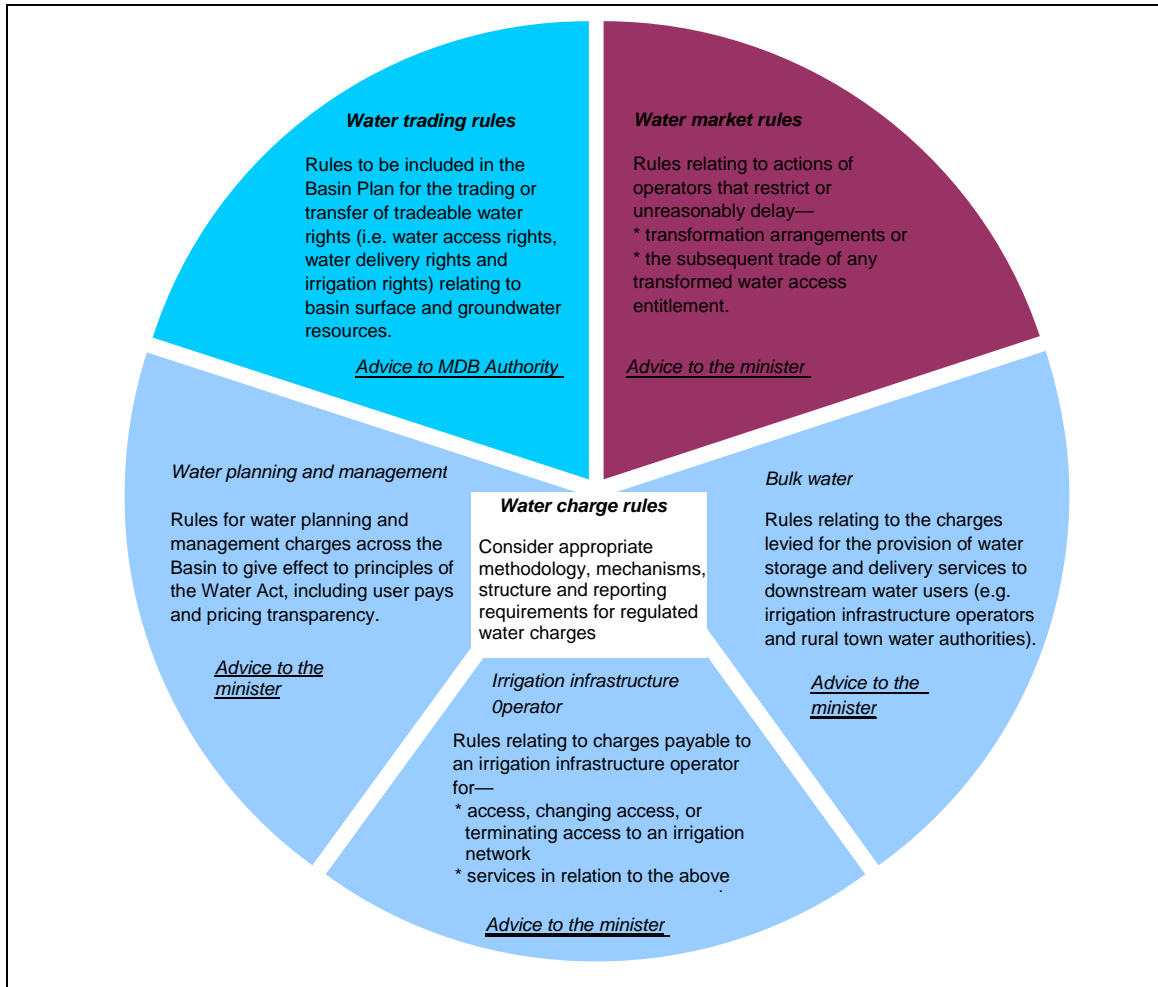
⁴³ For more, see appendix C of the final advice and appendix B of the position paper.

⁴⁴ Appendix C3 compares the ACCC's final advice on water charge rules for termination fees to the provisions of the access, exit and termination fee protocol relating to termination fees.

⁴⁵ Subparagraphs 91(1)(a)(i)–(iv) of the Act.

terminating access and/or surrendering a water delivery right (termination fees) may influence irrigators' decisions to trade water. Water charge rules for termination fees will therefore complement water market rules in facilitating the efficient functioning of water markets.

Box 5 - Roles of the ACCC under the Act



2 Calculating and imposing termination fees

While termination fees may be a legitimate mechanism for operators to address uncertainty over future demand for access services,⁴⁶ operators have incentives to impose termination fees above efficient levels.⁴⁷ The water charge rules should therefore provide some control over the imposition of termination fees.

This chapter outlines the regulatory framework recommended by the ACCC, including:

- the method for restricting the level of termination fees that may be imposed
- clarifying the types of conduct that should constitute termination.

Components of the methodology used in calculating maximum termination fees, such as the termination fee multiple and the total network access charge, are discussed in further detail in chapters 3–5.

2.1 When a termination fee may be imposed

The ACCC maintains its recommendation that operators should not be able to compel termination, but that termination should only occur following:

- a request to terminate by the irrigator
- the irrigator failing to meet certain obligations associated with access to the operator’s irrigation network (only where those obligations or extent of the failure is considered significant enough to warrant termination by default).

Compulsory termination of access in proportion to water access rights traded outside the operator’s area of operations denies irrigators the benefit of having the option of retaining access to the irrigation network.

Many submissions argued that compulsory termination is necessary because customers without water access rights are unlikely to have sufficient assets or cash flow to meet their access fee obligations.⁴⁸ However, concerns about security over the payment of future access fees are being addressed through the provisions of the water market rules.⁴⁹

In response to the draft advice, Goulburn–Murray Water (GMW) supported the ACCC position⁵⁰ regarding the situations in which termination fees may be imposed, while WMI⁵¹ and Southern Riverina Irrigators (SRI) & Rice Growers’ Association Australia

⁴⁶ See chapter 6 of the draft advice.

⁴⁷ See p. 59 of the draft advice.

⁴⁸ WMI, issues paper submission, p. 19; CIT, position paper, p. 4; SRI & RGA, position paper submission, p. 4; RIT, position paper submission, p. 2; TBG, position paper submission, p. 3.

⁴⁹ See section 10.2 of ACCC, final advice, *water market rules*, December 2008.

⁵⁰ GMW, draft advice submission, p. 1.

⁵¹ WMI, draft advice submission, p. 1.

(RGA)⁵² reaffirmed previous submissions that operators should be allowed to compel termination following the transfer of water access rights outside the operator's irrigation district.

Submissions in response to the draft advice did not provide any new information in support of compulsory termination following water trade. WMI stated that 'history shows when water is sold the farm is unlikely to ever return to full production',⁵³ and similarly SRI & RGA submitted that⁵⁴

The retention of delivery entitlements may indicate their short term irrigation intentions, but it is likely their actual long term usage will not match their intentions...We believe that farms with a significant portion of their entitlements sold off should be considered unlikely to return to full production.

Whether or not farms return to full production after they have sold water access rights is a matter for the individual irrigators, not the ACCC or the operators. The value to the irrigator and consequently the operator is in the option of retaining delivery and having the flexibility to rationalise on-farm operations and remain connected to the system. The ACCC considers that irrigators should be allowed to retain access (and therefore retaining any associated obligations such as payment of access fees and security) without holding water access rights.

Operators have expressed concerns that some irrigators will not pay access fees once they have sold water access rights. These are legitimate concerns. The ACCC has addressed these concerns in its water market rules by allowing operators to hold the value of the termination fee as security where an irrigator holds a delivery right that is more than 5 times the volume of water under the irrigation right.⁵⁵

The ACCC maintains its position that compulsory termination should not be provided in the water charge rules for termination fees as a response to security for payment of future access fees.

The ACCC has revised its draft rules to clarify that trade, transfer or assignment of water access rights does not constitute termination.

WMI enquired as to whether termination by reason of an irrigator failing to meet obligations associated with access would occur 'if an outlet is disconnected and no water supply or delivery is required'.⁵⁶

Termination by reason of failure to meet certain obligations will depend on the precise terms and conditions of the access arrangements for each irrigator. The obligations that any irrigator has failed to fulfil must be an essential or sufficiently important condition such that a breach would constitute termination of the access arrangement, or the

⁵² SRI & RGA, draft advice submission, p. 3.

⁵³ WMI, draft advice submission, p. 1.

⁵⁴ SRI & RGA, draft advice submission, p. 2.

⁵⁵ see section 10.2 of ACCC, final advice, *water market rules*, December 2008.

⁵⁶ WMI, draft advice submission, p. 5.

magnitude of the breach must be sufficiently large to constitute termination of the access arrangement.

Although ultimately dependent upon the precise conditions of access in each case, the ACCC does not consider that having no water delivered would typically constitute a breach of an access agreement, particularly as termination is of a right of access rather than the physical connection and delivery of water. Not utilising a right of access to an operator's irrigation network reduces capacity constraints and may therefore improve the service level received by other irrigators. It would appear counter-intuitive for operators to require actual delivery of water as an essential condition of an access agreement.

It must be noted that the Act limits the scope of the water charge rules for termination fees to regulating the fees that may be payable to an irrigation infrastructure operator upon termination or surrender of a right of access. The water charge rules for termination fees (and hence the recommended rules) are therefore unable to address the circumstances in which termination may occur, but only the fees that may be imposed in various circumstances.

Box 6

6 *Termination fee may be imposed in certain circumstances*

- (1) An irrigation infrastructure operator may impose a fee calculated in accordance with rule 7 if—
 - (a) a person who holds a right of access to the operator's irrigation network terminates or surrenders the whole or any part of that right or services provided in relation to that right by notice in writing given to the operator; or
 - (b) the operator, by notice in writing given to a person who holds a right of access to the operator's irrigation network, terminates the whole or any part of that right or services provided in relation to that right in accordance with a contract applicable to the right on the grounds that the person is in breach of the person's obligations under that contract.
- (2) Subrule (1) does not apply—
 - (a) if—
 - (i) the holder of the right of access to an irrigation infrastructure operator's irrigation network is not liable to pay charges to the operator in respect of the right; and
 - (ii) a fee in respect of the termination or surrender of the right or a part of the right is not specified in any contract or arrangement between the

holder and the operator; or

- (b) if the holder of the right of access to an irrigation infrastructure operator's irrigation network—
 - (i) is provided by the operator with a service for the storage of water in addition to the service for the delivery of water; and
 - (ii) the charges for the service for the storage of water are included in the charges in respect of the right of access.

2.2 Method for calculating termination fees

The level of termination fees is important for achieving efficient investment decisions as well as efficient rationalisation and trade (for more, see sections 3.1 and 3.4). Operators appear to have incentives to set high termination fees. Given the natural monopoly characteristics of irrigation infrastructure, operators may attempt to earn greater returns by setting high termination fees to restrict exit. By sharing fixed costs across its customer base (either number of customers or volume of water access rights serviced) cooperatively-managed operators appear to have incentives to maximise this base. Coupled with water trade and competition between operators for water entitlements, operators are likely to discourage exit and outward trade so as to limit any third party impacts for remaining customers. Considering these incentives, the draft advice recommended capping the level of termination fees.

The purpose of a termination fee is to recover a share of the fixed costs that cannot be avoided upon termination of access. Termination fees should therefore be based on fixed access fees, which are levied to recover the fixed costs of providing customers with access services. As a result of this approach, termination fees will change with any changes in access fees.

Only a small proportion of irrigators are likely to incur a termination fee, whereas the majority of irrigators will have an incentive for it to be set as high as possible.⁵⁷ However, most of the fees and charges set by operators are constrained through either an independent regulator or the ownership structure of the operator. Basing termination fees on access fees will therefore provide a check on the level of termination fees because irrigators who seek to terminate access will face fees based on the same costs that are incorporated into the ongoing access fees faced by customers who remain serviced.

⁵⁷ At any one point in time, it is unlikely that a majority of an operator's customers want to terminate. Therefore the majority of irrigators are those that want to remain connected to the irrigation network, and have incentives to keep access fees low. Termination may lead to fixed costs of maintaining the network being spread across a smaller customer base, resulting in increased access fees (in the absence of avoidable fixed costs and realised efficiency gains). The majority will then have incentives to set termination fees high to prevent termination or obtain revenue to off-set any increases in access fees.

Some submissions advocated calculating maximum termination fees by reference to the net present value (NPV) of future access fees over the weighted average remaining useful economic life of the operator's assets.

The ACCC does not consider a NPV approach to calculating maximum termination fees to be appropriate. Providing operators with a termination fee equivalent to the NPV of fixed access fees provides few incentives for operators to rationalise their networks, reduce costs and improve efficiency over time.⁵⁸

The ACCC reaffirms its position to cap termination fees as a multiple of annual access fees, in keeping with its draft and preliminary position⁵⁹ and previous advice in the Access, Exit and Termination Fee Report.⁶⁰

Box 7

7 Calculation of termination fee

A fee imposed by an irrigation infrastructure operator under subrule 6(1) must not exceed—

- (a) the amount determined by multiplying by 10—
 - (i) where the whole of a right of access, or services provided in relation to the whole of such a right, are terminated or surrendered, the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given; or
 - (ii) where a part of a right of access, or services provided in relation to a part of such a right, are terminated or surrendered, the proportion of the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given, being the proportion that is applicable to that part of the right; or
- (b) if the fee for the termination or surrender of a right of access or a part of a right of access, or of services provided in relation to the whole or a part of such a right, are provided for in a contract or arrangement between the operator and the holder of the right, the fee determined in accordance with the contract—

whichever is the lesser.

⁵⁸ See pp. 63-64 of the draft advice and p. 23 of the position paper.

⁵⁹ See p. xiv of the position paper.

⁶⁰ See section 6.5 of the access, exit and termination fee report.

3 The termination fee multiple

The ACCC considers there to be no clear level for the termination fee multiple,⁶¹ so it is necessary to strike a balance between setting the termination fee multiple too high or too low.⁶² Setting the multiple is not a deterministic process, rather multiple objectives are considered, which in this instance requires decisions about trade-offs.

This chapter outlines the ACCC's advice on the termination fee multiple and the issues considered in reaching its decision.

3.1 The level of the termination fee multiple

Where the termination fee is at a level less than the net present value of the stream of an operator's unavoidable ongoing costs, an irrigator can avoid contributing to a portion of these costs by terminating access. If the unavoidable ongoing costs associated with providing access services are not met through equivalent charges (fixed access fees or termination fees), the operator may face the risk of 'stranded' costs or must recover these costs through increasing access fees for remaining irrigators. Faced with this risk, operators may refrain from undertaking otherwise efficient investment.

If the termination fee is set too high—above the net present value of unavoidable ongoing costs—irrigators may remain connected to the irrigation system even if it is more efficient for them to trade water and terminate access. In this situation, high termination fees deter efficient rationalisation. Where the termination fee influences irrigator decisions on how much water to use, high termination fees may also distort the efficient functioning of the water market.

Submissions commented extensively on the appropriate level of the termination fee multiple. Submissions from irrigators typically argued that the current termination fees imposed by operators are too high,⁶³ while operators largely supported current practice of using a termination fee multiple of 15x.⁶⁴

In support of a termination fee multiple of 15x, operators generally argued that:

- there is a need to align the termination fee with the engineering life of assets⁶⁵
- rationalisation opportunities are limited⁶⁶

⁶¹ See section 4.2 of the position paper.

⁶² See chapter 3 of the draft advice.

⁶³ D Barclay, draft advice submission, p. 1; M Gatacre, draft advice submission, p. 1; D Star, draft advice submission, p. 1; J R Rorke, position paper submission, p. 1; D Crowhurst, position paper submission, p. 1; P Leslie & D Ferguson position paper submission, p. 1; G Doherty, position paper submission, p. 1.

⁶⁴ NSWIC, draft advice submission, p. 4; MRFF, draft advice submission, p. 2; TNIS, draft advice submission, p. 4; MI, draft advice submission, p. 7; MIL, draft advice submission, pp. 5-7; RIT, position paper submission, p. 2; WMI & CI, position paper submission, p. 4.

⁶⁵ GMW, issues paper submission, p. 9; CIT, position paper, pp. 3-4.

- financial viability of operators is threatened with lower termination fees⁶⁷
- the termination fee should ensure that there are no third party impacts resulting from an irrigator's decision to terminate.⁶⁸

To consider the engineering life as the appropriate asset life is to assume that demand for the service will be sustained over this period (before consideration of rationalisation opportunities). In the case of access services, the ability for an irrigator to change their land-use decisions (dry land, less water intensive irrigation etc.) creates substitutes for irrigated land use that may render access services redundant at some future point. In addition, there is potential for significant change in water availability in coming decades, which is likely to significantly affect the demand for access services.

Providing termination fees based on the engineering life of assets provides operators with revenue security in relation to an asset over a period longer than it might be considered economically useful. Operators would be shielded from risks that other businesses would usually be unable to avoid. Similarly, remaining irrigators would be shielded from any price impacts resulting from termination. Efficiency supports providing incentives for operators to provide only those services required by their customers and to restructure their operations when certain services are no longer required. Insulating irrigators from third party impacts in this manner removes the price signals necessary to achieve such efficiency.

The position paper highlighted that there are a variety of mechanisms available to operators when dealing with demand risk and revenue uncertainty.⁶⁹ The draft advice acknowledged that recovery of capital over periods shorter than the engineering life of an asset is a useful way of addressing demand risks. The draft advice also indicated that termination fees that provide revenue certainty over the engineering life of assets are not necessary to maintain the financial viability of operators.⁷⁰

To assist the ACCC in understanding the potential consequences⁷¹ of its recommendation to reduce the termination fee multiple for remaining irrigators, it sought to review the incremental impact of termination on future access fees for remaining irrigators and the impact of changes in access fees on irrigated farm production costs and gross margins. The review included both hypothetical and actual case studies.

⁶⁶ WCID draft advice submission, p. 2; MRFF draft advice submission, p. 4; MI, draft advice submission, pp. 5–6; GMW, position paper submission, p. 8; TBG, position paper submission, p. 4; WMI & CI, position paper submission, pp. 6–7.

⁶⁷ CIT, position paper, p. 4; SRI & RGA, position paper submission, p. 4; RIT, position paper submission, p. 2; TBG, position paper submission, p. 3.

⁶⁸ TNIS, draft rules submission, p. 4; WCID draft rules submission, p. 2; NFF issues paper submission, p. 10.

⁶⁹ See section 4.2.2 of the position paper.

⁷⁰ See section 3.1 of the draft advice.

⁷¹ Clause 2(e) of Schedule 2 of the Act.

The analysis, undertaken by Frontier Economics and available on the ACCC website⁷² considered the materiality on farm profitability of using a termination fee multiple of 8x rather than 15x. Frontier Economics also compared the impact of the 8x termination fee multiple to other factors, such as output prices, yields and water prices.

The results suggest that the impact of reducing the termination fee multiple over most foreseeable rates of termination has a lesser impact on the decision of irrigators to terminate relative to other considerations and, all other things being equal, is unlikely to have a bearing on the financial viability of operators or the on-farm investments of remaining irrigators.

The impact on future access fees of a reduction in the termination fee multiple below the 15x advocated by operators will be higher with greater levels of irrigators terminating (e.g. 30 per cent reduction in demand). However, at higher levels of termination there are likely to be off-setting avoided costs that may be achieved from rationalisation and subsystem retirement.

The ACCC considers that while opportunities for physical rationalisation of irrigation networks may be limited in the short-term, operators could do more to rationalise and innovate with respect to pricing arrangements and the use of alternative measures to manage risk (e.g. by removing postage stamp pricing, moving to full cost recovery⁷³ and reducing⁷⁴ or waiving the termination fee in certain circumstances). Operators appear to be advocating a multiple of 15x in place of a combination of legitimate approaches to managing demand uncertainty (which includes termination fees).

Considering all of the above, a more appropriate multiple is less than 15x (25 to 39 years of access fees). While some submissions from irrigators questioned the need for termination fees at all,⁷⁵ the ACCC acknowledged in the draft advice that termination fees are one of a variety of mechanisms that operators may utilise to manage demand risk.⁷⁶

Many operators provide access services in the absence of fixed-term or fixed-obligation access agreements. In these situations irrigators may each form expectations about the stability of prices and/or the obligation of all irrigators to contribute towards unavoidable ongoing costs. In turn, these expectations are likely to influence complementary on-farm investments. In addition, short term opportunities for rationalisation following termination (without coordination) may be limited. In these circumstances, operators may wish to utilise termination fees.

⁷² Frontier Economics, *Termination fees and landholder considerations*, October 2008. Available on the ACCC website.

⁷³ As noted in section 3.1 of the draft advice, systematic risks are more appropriately managed through a WACC return included within access prices. This is reflected in clause 3 of schedule 2 of the Act that incorporates WACC within the definition of full cost recovery.

⁷⁴ For example, see: the minister, *Irrigator groups invited to submit proposals for selling water entitlements*, media release, 9 October 2008.

⁷⁵ D W Sehestedt, issues paper submission p. 1; G Doherty, position paper submission, p. 1.

⁷⁶ See p. 16 of the draft advice.

In addition to analysing the impact on irrigators' gross margins and production decisions, the ACCC undertook a comparison of water delivery arrangements for certain operators to review the implied termination fee multiples associated with the recovery of new investment capital.⁷⁷

The results of the case studies revealed that the termination fee multiple proposed in the draft (10x) provides for a reasonable period of certainty associated with the recovery of initial capital for new investments.⁷⁸ The analysis also revealed that the implied termination fee multiple is sensitive to assumptions about the profile for the recovery of capital, the discount rate and the term of the contract. In certain circumstances, longer periods of capital recovery may be warranted.⁷⁹ As a result, the ACCC proposed in the draft to allow higher termination fees negotiated under new and existing contracts, provided they are approved by the ACCC (see chapter 6).

In arriving at a position on the level of the termination fee multiple, the ACCC also acknowledged that the most significant changes in demand for access services are likely to occur over the next five years as trade opportunities open up and the Australian government continues its water purchasing and infrastructure modernisation programs.⁸⁰ The result is likely to be a net reduction in irrigation water-use across the Basin.

On balance of the above considerations, including the proposal to move straight to a new termination fee multiple rather than phasing it in, the ACCC in its draft advice recommended a termination fee multiple of 10x in conjunction with the review of the rules commencing in 2012 and concluding in 2013 (see section 7.3).

3.2 Materiality of termination fees on the financial viability of operators

Some submissions expressed the view that the financial viability of operators is threatened by lower termination fees⁸¹ and that termination fees should shield

⁷⁷ As opposed to ongoing major periodic maintenance. See appendix G of the draft advice.

⁷⁸ The results for the three case studies presented in the draft advice (BIL, CIT (Loxton) and WMI (Buronga)) revealed maximum implied multiples of 7.6, 7.0 and 10.4 respectively. See appendix G of the draft advice.

⁷⁹ For the WMI (Buronga) case study, using a straight-line profile for the recovery of capital rather than front-loading recovery (as implemented by WMI) results in a maximum implied termination fee multiple of 15x. See p 22 of the draft advice.

⁸⁰ Under the 'Water for the future' program, the Australian government expects to spend \$3.1 billion to purchase water from the Basin over 10 years, refer to DEWHA website: <http://www.environment.gov.au/water/mdb/entitlement-purchasing/>, viewed on 6 October 2008. Under the IGA of Murray-Darling Basin Reform 3 July 2008, the Commonwealth committed to in-principle support of priority projects worth \$3.7 billion which was to include modernisation of current infrastructure http://www.coag.gov.au/coag_meeting_outcomes/2008-07-03/index.cfm - viewed at 10 December 2008)

⁸¹ WCID, draft advice submission, p. 2; SRI, draft advice submission, p. 3; MRFF, draft advice submission, p. 2; CIT, position paper submission, p. 4; SRI & RGA, position paper submission, p. 4; RIT, position paper submission, p. 2; TBG, position paper submission, p. 3.

remaining irrigators in perpetuity from any rises in access fees directly resulting from termination.⁸²

As previously mentioned,⁸³ the ACCC does not consider that operators should be insulated from risks that other businesses would be unable to avoid, or that remaining irrigators should continue to receive a service in perpetuity that is effectively subsidised by departing irrigators. The ACCC does recognise, however, that many irrigators form a 'club' to share the high fixed costs associated with irrigation delivery and may make significant investments on-farm in reliance on (explicit or implicit) club arrangements for the obligations of members to contribute towards a reasonable share of ongoing fixed costs.

As discussed in the previous section, to better understand the impact of a cap on termination fees on irrigators and operators, the ACCC commissioned Frontier Economics to provide advice. Frontier Economics' report was released for comments in October 2008 along with the ACCC's draft advice.

Submissions received in response to the draft advice raised concerns about the approach adopted by Frontier Economics in its report on the materiality of termination fees on production decisions of remaining irrigators.⁸⁴ It was suggested that results indicating future price rises for remaining irrigators were unacceptable⁸⁵, and to calculate the effect of the termination fee by its effect on the gross margin per hectare of rice production is unwise.⁸⁶ The selection of rice, horticulture and dairy case studies was criticised for being too generalist.⁸⁷

CI provided a detailed response to the Frontier Economics report, re-producing outputs with variations to underlying assumptions, including localised data. CI expressed the view that reducing the termination fee multiple has an impact on the decision of irrigators to terminate and is likely to have a bearing on the financial viability of operators.⁸⁸

In response, the ACCC commissioned Frontier Economics to review submissions and provide an update of its report. Frontier Economics made the following amendments prior to the release of its final report (which accompanies the final advice):

- The inclusion of fixed farm costs as an alternative approach to make gross farm budgets more commensurable with farm profitability.
- The use of base case prices for water allocations as the basis for the opportunity cost of water.

⁸² NSWIC, draft advice submission, p. 4; SRI & RGA, draft advice submission, p. 3; TNIS, draft advice submission, p. 4; MRFF, position paper submission, p. 9; RIT, position paper submission, p. 2.

⁸³ See section 3.1 of the draft advice.

⁸⁴ Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, October 2008. Available on the ACCC website.

⁸⁵ MRFF draft advice submission, p. 5.

⁸⁶ SRI, draft advice submission, p. 3.

⁸⁷ WMI, draft advice submission, p. 6.

⁸⁸ CI, draft advice submission, p. 8.

- An extended discussion regarding the impact of increasing fixed access fees in times of drought.
- Discussion of sensitivity of results to the 15x multiple and 20x multiple (NPV unavoidable ongoing costs) such that relative impacts are considered and compared.
- Discussion of sensitivity of results to different charging structures by operators—the balance between fixed and variable access fees.

Frontier Economics also updated the analysis to reflect the ACCC's draft advice to cap the level of the termination fee multiple at 10x annual fixed access fees. The results reported below therefore reflect the impact on remaining irrigators' production decisions resulting from the ACCC's draft advice to reduce the multiple from 15x to 10x annual fixed access fees.

The results of Frontier Economics' final report reveal that, under average-normal weather conditions, termination of 30 per cent of delivery rights translates to a 1 per cent to 2.5 per cent reduction in farm profitability.⁸⁹

The results of the final report demonstrate that changes in total water costs are greatest for Loddon horticulture (grapes) and the impact on the gross margin is greatest for Murray rice (termination of 30 per cent of delivery rights translates to a reduction in gross margin of 2.46 per cent). Table 1 provides details.

The results are within the observable variation of the market price of water, market price of agricultural crop and crop yield. In fact, the average annual variations in these other inputs are likely to far outweigh the impact on gross margins resulting from the incremental impact of the ACCC's draft advice on the termination fee multiple.⁹⁰

⁸⁹ Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, December 2008, p34.

⁹⁰ Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, December 2008, p45.

Table 1 – impact of reducing the termination fee multiple on farm profitability

Termination of delivery rights	Change in fixed water charges (%)	Change in total water charges (%)	Change in total costs (%)	Change in gross margin FINAL (%)
<i>Murray rice</i>				
6 per cent	+ 2.1	+ 0.35	+ 0.19	- 0.37
15 per cent	+ 5.9	+ 0.98	+ 0.52	- 1.01
30 per cent	+ 14.3	+ 2.38	+ 1.25	- 2.46
<i>Murrumbidgee rice</i>				
6 per cent	+ 2.1	+ 0.37	+ 0.18	- 0.22
15 per cent	+ 5.9	+ 1.03	+ 0.51	- 0.60
30 per cent	+ 14.3	+2.49	+ 1.25	- 1.45
<i>Loddon horticulture (grapes)</i>				
6 per cent	+ 2.1	+ 0.46	+0.03	- 0.13
15 per cent	+ 5.9	+ 1.26	+0.08	- 0.36
30 per cent	+ 14.3	+ 3.07	+ 0.20	- 0.87

Numerical example of when 6%, 15% and 30% termination occurs

Note: under average-normal weather availability conditions, assessing the impact of the ACCC's decision to reduce the multiple from 15x to 10x.

Source: Frontier Economics Pty Ltd

To put these changes into context, table 2 below compares the impact on Murray rice gross margins resulting from a 6 per cent termination to equivalent impacts on gross margins from changes in the market price for water, market price for rice and the yield from rice.

Table 2 – Relative impact of termination on remaining irrigators

Termination of:	6 per cent	
<i>leads to</i>		
a decrease in Murray Rice gross margins by:	0.37 per cent	(\$4.62/ha)
<i>The same effect on Murray Rice margins would occur from:</i>		
an increase in the market price of water by	0.7 per cent	(e.g. from \$45 per ML to \$45.31 per ML)
<i>or</i>		
a decrease in the market price of rice by	0.12 per cent	(e.g. from \$440 per tonne to \$439.46 per tonne)
<i>or</i>		
a reduction in the yield of rice by	0.13 per cent	(e.g. from \$8.5 tonne per hectare to \$8.49 tonne per hectare)

It is important to note that the results have assumed that operators cannot realise any savings from avoided fixed costs at rates of termination up to and including 30 per cent of their delivery rights. While short-term rationalisation opportunities may be limited in a situation where one-third of irrigators elect to terminate, it would be in the operator's (and remaining irrigators') best interests to co-ordinate termination and realise the maximum possible efficiency savings from rationalisation (see section 3.4).

In assessing the third party impacts of termination on production decisions, Frontier Economics concluded:

There have been concerns that setting the termination fee based on 10 times the infrastructure access fee will have a adverse impact on remaining irrigators compared with a multiple of 15 times. If the full extent of this difference is passed through to irrigators, this would result in increased fixed infrastructure costs being paid by remaining irrigators if some irrigators terminate.

Under normal-weather availability conditions, however, these increases are unlikely to be sufficient to affect irrigators' production decisions in the short-run and have significantly less of an impact than changes in the market price (opportunity cost) of water, the on-farm price of the agricultural product or crop yield.

In the longer run, high rates of termination may affect long-term profitability but decisions for subsequent irrigators to terminate will still be driven by other considerations, such as expected changes in the market price (opportunity cost) of water, the on-farm price of the agricultural product and crop yield.⁹¹

⁹¹ Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, December 2008, p 45.

Under dry conditions, Frontier Economics also noted that increased fixed costs may affect farm incomes and profitability more considerably. Termination was found to have more of an impact under drought conditions.⁹²

Frontier Economics has assumed that the increased access fees will be passed onto remaining irrigators immediately upon termination. While this is a timing issue, in the context that a 10x multiple provides for 12 to 15 years of equivalent access fees, such a time period may assist remaining irrigators (especially during drought years). Operators may elect not to pass on higher access fees to remaining irrigators in the short term but rather wait until termination fee reserves have been exhausted.

If dry conditions persist, however, then it is important to not overly hinder adjustment of irrigators to retire land from irrigation (to dryland production or other functions) so that areas of irrigated land reduce.

The results suggest that the impact of reducing the termination fee multiple as proposed in the draft (10x) has, over most foreseeable rates of termination, less of an impact on the decisions of irrigators to terminate relative to other considerations and, all other things being equal, is unlikely to have a bearing on the financial viability of operators or the on-farm investments of remaining irrigators.

In addition to analysing the impact on irrigators' gross margins and production decisions, the ACCC undertook a comparison of water delivery arrangements for BIL, CIT (Loxton district) and WMI (Buronga district) to review the implied termination fee multiples associated with the recovery of new investment capital.⁹³

The results of the case studies (see table 3) reveal that the termination fee multiples adopted are broadly consistent with the 10x multiple proposed in the draft advice.⁹⁴

Table 3 – Maximum implied termination fee multiple for the recovery of capital expenditure

Irrigation operator (district)	Maximum implied termination fee multiple
BIL (Barossa)	7.6
WMI (Buronga)	10.4
CIT (Loxton)	7.0

Source: Appendix G ACCC draft advice

⁹² It is estimated that at 30 per cent termination (upper limit for the study), the reduction in farm profitability (as proxied by an adopted gross farm budget or farm cash income) extends from 1.4 per cent under average-normal conditions to 4.8 per cent under drought conditions (2006–07) for Murrumbidgee broadacre. Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, December 2008, tables 9 and 11.

⁹³ See section 3.4 of the draft advice.

⁹⁴ See section 3.4 of the draft advice.

The ACCC maintains the view expressed in its draft advice that the recommended multiple (10x) provides reasonable investment certainty. The analysis did illustrate, however, that there could be limited situations where longer periods of capital recovery may be warranted.⁹⁵ As a result, and consistent with the draft advice, the ACCC recommends allowing higher termination fees negotiated under new and existing contracts, provided they are approved by the ACCC (see chapter 6).

3.3 Third party impacts from termination

Many submissions in response to the draft advice,⁹⁶ reiterating positions presented in previous submissions,⁹⁷ stated that the water charge rules for termination fees should ensure that there are no third party impacts resulting from termination.

Some submissions argued that economic efficiency requires third party impacts to be wholly negated through termination fees. Trangie–Nevertire Irrigation Scheme (TNIS) submitted that:⁹⁸

It is not equitable or economically efficient to allow departing members to increase the costs of those remaining by allowing termination fees that are less than adequate to cover the ongoing costs of those departing.

Some stakeholders⁹⁹ also submitted that this result is a perverse and unintended outcome contrary to the Basin water charging objectives and principles.

As acknowledged in the draft advice,¹⁰⁰ setting the termination fee multiple below the level that wholly eliminates third party impacts from termination is not an unintended outcome, but rather recognition of the need to balance providing investment certainty with providing incentives for achieving allocative efficiency (rationalisation).

The ACCC recognises that there may be third party impacts resulting from termination. However, while the total cost of providing access services may be re-apportioned among a reduced customer base following termination, this redistribution represents a monetary impact rather than any economic efficiency implication. Apart from disconnection costs (which operators may under the recommended rules recover

⁹⁵ For the WMI (Buronga) case study, using a straight-line profile for the recovery of capital rather than front-loading recovery (as implemented by WMI) results in a maximum implied termination fee multiple of 15x. See appendix G of the draft advice.

⁹⁶ WCID, draft advice submission, p. 2; SRI & RGA, draft advice submission, p. 3; SA Gov, draft advice submission, p. 2; MRFF, draft rules submission, p. 2; NSWIC, draft advice submission, pp. 2, 4–5; TNIS, draft advice submission, p. 4; GMW, draft advice submission, p. 2.

⁹⁷ WMI & CI, position paper submission, p. 9; MIL, position paper submission, p.2; NFF, position paper submission, p. 4.

⁹⁸ TNIS, draft advice submission, p. 4.

⁹⁹ MVWDAA, draft advice submission, p. 3; MRFF, draft advice submission, p. 5.

¹⁰⁰ See chapter 3 of the draft advice.

through disconnection fees),¹⁰¹ the cost of providing access services—as opposed to the price of access—is unlikely to increase as a result of termination.¹⁰²

Although the redistribution of access costs through an increase in access prices following termination may not represent an inefficient third party impact, as mentioned in section 3.3, fluctuations in prices may impact negatively on investment certainty. Providing a termination fee multiple that balances investment certainty with incentives for rationalisation, will limit the impact of termination on third parties. Section 3.2 indicated that the access fee impact on remaining irrigators from termination using a termination fee multiple of 10x compared to 15x is unlikely to influence ongoing production decisions.

In addition, setting termination fees too high may distort price signals necessary to achieve allocative efficiency (including rationalisation). The adjustment of access fees following termination signals to remaining irrigators the cost of providing the access services into the future. The subsequent decisions of other irrigators on whether to continue consuming access services signals to operators the demand for and viability of the irrigation network. Using termination fees to ensure that access fees do not increase as a result of termination dilutes these price signals, since some of the cost of providing access services is instead being recovered through termination fees.

The ACCC considers that a termination fee multiple of 10x provides an appropriate balance between limiting third party impacts to maintain investment certainty, and not eliminating third party impacts to allow price signals to be sent regarding efficient rationalisation.

Many submissions¹⁰³ also commented that third party impacts from termination should be limited on equity grounds. Macquarie River Food & Fibre (MRFF) submitted that ‘to contemplate any level of negative impact on others from trade is an issue of equity and income redistribution’.¹⁰⁴ WCID submitted that ‘the individual’s rights to permanently trade water now appear to be well enshrined, what is not being catered for are the rights of those left behind’.¹⁰⁵

The ACCC considers that, consistent with the Basin water charging objectives and principles,¹⁰⁶ the recommended rules should not discriminate between different classes of irrigators. Under the recommended rules, all irrigators have equal opportunity to terminate or retain access. Irrigators that wish to retain access services must then face the cost of those access services, just as departing irrigators have evaluated the cost of retaining access relative to the cost of termination.

¹⁰¹ See section 4.3.

¹⁰² For a multiple of 10x, and a discount rate of 4.0 per cent, the annual cumulative productivity gain required to extend the equivalent years of access fees from 13 years (10x) to 23 years (15x) is up to 1.03 per cent for terminations up to 30 per cent (see footnote 133).

¹⁰³ CI, draft advice submission, p. 1; WCID, draft advice submission, p. 2; MRFF, draft advice submission, p. 5; TNIS, draft advice submission, p. 4.

¹⁰⁴ MRFF, draft advice submission, p. 5,

¹⁰⁵ WCID, draft advice submission, p. 2.

¹⁰⁶ Schedule 2 of the Act.

Some submissions claimed that the water charge rules for termination fees should favour remaining irrigators since they represent a majority of irrigators. For instance, GMW stated:¹⁰⁷

the lower the termination fee payable...(a minority of landowners) the higher the access fee that must be paid in future years by those that wish to retain delivery services (the majority). In striking a balance...it seems prudent for a regulator charged with protecting consumer interests to bias an arbitrary multiple towards the majority.

Analysis conducted by Frontier Economics suggests that reducing the termination fee multiple over most foreseeable rates of termination has a lesser impact on the decision of irrigators to terminate relative to other considerations.¹⁰⁸ All other things being equal, this is unlikely to have a bearing on financial viability. On the other hand, submissions from irrigators¹⁰⁹ indicate that termination fees represent a significant cost to individual irrigators, with the potential to influence decisions to terminate and trade, and the rationalisation of irrigation networks.¹¹⁰ It does not therefore follow that remaining irrigators should demand greater consideration simply because they represent a majority of irrigators.

Submissions also raised issues of community structural adjustment and the wider social impacts associated with water trade and termination.¹¹¹ MRFF submitted that termination may lead to:¹¹²

higher fixed charges for drought stricken remaining members and flow-on socio economic impacts. ACCC notes that none of these flow on implications are part of its terms of reference, however they are a direct consequence of the rules and must be taken into account.

Similarly, WCID submitted that:¹¹³

Water entitlement termination impacts in a detrimental nature on land value of the dewatered property and therefore impacts on neighbouring property values, termination impacts on local government rating regimes and impacts upon the food producing ability of an area.

¹⁰⁷ GMW, draft advice submission, p. 1.

¹⁰⁸ Frontier Economics, *Termination fees and landholder considerations*, report prepared for the ACCC, December 2008, p45.

¹⁰⁹ D Barclay, draft advice submission, p. 1; M Gatacre, draft advice submission, p. 1; D Star, draft advice submission, p. 1; J R Rorke, position paper submission, p. 2; D Crowhurst, position paper submission, p. 1; P Leslie & D Ferguson, position paper submission p. 3; G Doherty, position paper submission, p. 1.

¹¹⁰ A reduction in the termination fee multiple is directly represented as a reduction in the termination fee payable by a departing irrigator. However, the corresponding reduction in termination fee revenue received by an operator (and passed through to remaining irrigators in higher access fees) is spread over the total remaining customer base.

¹¹¹ MVWDAA, draft advice submission, p. 3; WCID, draft advice submission, p. 2; SRI & RGA, draft advice submission, p. 3; MRFF, draft advice submission, p. 2; NSWIC, draft advice submission, p. 4.

¹¹² MRFF, draft advice submission, p. 2.

¹¹³ WCID, draft advice submission, p. 2.

GMW also commented on the impact of termination on land values, stating:¹¹⁴

The decision to terminate...is a decision to relegate irrigable land to dry land without an external water supply. The resulting change in land value, including extinguishment of future real options for use of the land, will be the main consideration for a landowner.

The ACCC recognises that land values may be influenced by the capacity for the land to be serviced by an operator. However, termination itself may not lead to the extinguishment of future options to irrigate the land. Many operators¹¹⁵ have submitted that rationalisation opportunities are likely to be limited, at least in the short term. Where irrigation networks are unlikely to be decommissioned in the short term, the serviceability of land and real option value within land values would be expected to be largely maintained over this period.

The ACCC acknowledges that termination is often associated with the trade of water, which may have wide-reaching implications for irrigation communities. That said, and as mentioned in the position paper,¹¹⁶ the ACCC considers that ameliorating wider social implications associated with structural adjustment resulting from water trade should be addressed through wider policy instruments.¹¹⁷

Termination fees are imposed to ensure departing irrigators make some level of contribution only to an operator's ongoing unavoidable costs. As previously mentioned, setting termination fees in this way is important for achieving allocative efficiency in access services whilst providing an appropriate level of certainty for future investment in irrigation networks. Termination fees are therefore a narrow mechanism unsuited to addressing wider social implications.

3.4 Rationalisation opportunities

Submissions from operators in response to the draft advice¹¹⁸ reiterated that rationalisation opportunities are likely to be limited. SRI and RGA expressed concern that 'there will be little scope for rationalisation and efficiency gains in most irrigator terminations',¹¹⁹ and WCID stated that 'rationalisation of channel systems can only be effective if long lengths of channel are decommissioned on the lower end of channel systems'.¹²⁰

¹¹⁴ GMW, draft advice submission, p. 2.

¹¹⁵ MIL, draft advice submission, p. 4; WCID draft advice submission, p. 2; MRFF draft advice submission, p. 4; MI, draft advice submission, pp. 5–6; GMW, position paper submission, p. 8; TBG, position paper submission, p. 4; WMI & CI, position paper submission, pp. 6–7.

¹¹⁶ See section 4.3.6 of the position paper.

¹¹⁷ For more information refer to DEWHA website: www.environment.gov.au/water
The COAG Working Group on Climate Change and Water undertook a review in 2008 of the wider policy instruments that currently exist in respect of structural adjustment programs. See <http://www.environment.gov.au/water/action/pubs/coag-project-review-structural.pdf> [accessed on 15 July 2008].

¹¹⁸ WMI, draft advice submission, p. 2; MI, draft advice submission, pp. 5-6.

¹¹⁹ SRI & RGA, draft advice submission, p. 3.

¹²⁰ WCID, draft advice submission, p. 2.

The ACCC recognises that rationalisation opportunities may be limited in the short term, but that operators could do more with pricing arrangements, coordinated infrastructure rationalisation programs and utilising other mechanisms for addressing revenue uncertainty.¹²¹ As submitted by N Rolfe in response to the draft advice:¹²²

At present there are a number of irrigator groups within MIL who are proposing to decommission their supply channels (“sub system retirement”) and sell their water and delivery entitlements to DEWHA...The irrigators are proposing to sell all their entitlements to DEWHA and decommission their channels. There would be no ongoing cost to MIL in relation to the maintenance of these channels or in infrastructure situated thereon. ...The proposed retirement of various channels are not random by nature and MIL would achieve efficiency gains as a result of such retirements.

The Australian Government has also, as part of its Water for the future program of water purchases, invited groups of irrigators to work with operators and other directly affected parties to develop coordinated proposals for selling water entitlements to the government and decommissioning or altering irrigation networks.¹²³

Coordinated programs for the reconfiguration and decommissioning of irrigation infrastructure currently exist in some irrigation networks across the Basin. In its Shepparton Modernisation Project,¹²⁴ GMW has identified that ‘it is possible that up to 25% of all infrastructure can be removed and [GMW] could still supply all current serviced properties’.¹²⁵ In relation to coordinating rationalisation projects, GMW stated that¹²⁶

Goulburn-Murray Water will offer compensation for infrastructure to be decommissioned. The key objective is to offer sufficient funds to undertake required on-farm works due to the change in service points, whilst ensuring all other customers are no worse off due to the change.

¹²¹ See p. 16 of the draft advice.

¹²² N Rolfe, draft advice submission, p. 6.

¹²³ Australian Government, media release, *Irrigator groups invited to submit proposals for selling water entitlements*, 9 October 2008, available at: <http://www.environment.gov.au/water/mdb/entitlement-purchasing/irrigator-proposals.html> [accessed on 8 December 2008].

The Australian Government has also indicated that it will consider making a contribution towards the cost of infrastructure works where such a contribution could be justified in terms of the key priorities of the Water For The Future program.

¹²⁴ GMW, *Shepparton modernisation project*, available at: <http://www.g-mwater.com.au/projects/modernisation/sheppartonmodernisationproject>, [accessed on 2 December 2008].

¹²⁵ GMW, *Shepparton modernisation project*, available at: <http://www.g-mwater.com.au/projects/modernisation/sheppartonmodernisationproject>, [accessed on 2 December 2008].

¹²⁶ GMW, *Shepparton modernisation project*, available at: <http://www.g-mwater.com.au/projects/modernisation/sheppartonmodernisationproject>, [accessed on 2 December 2008].

As part of its Pyramid–Boort Future Management Strategy,¹²⁷ GMW has identified rationalisation strategies that ‘if successfully implemented, will improve the overall efficiencies of the total network’,¹²⁸ generating ‘3,527 ML of water savings’ from evaporation, seepage and leakage savings.¹²⁹ Similar to the Shepparton Modernisation Project, the Pyramid–Boort Future Management Strategy envisages coordinating rationalisation through a ‘compensation and incentive package’¹³⁰ to ‘provide the landowner with sufficient compensation to encourage the irrigation network to be reconfigured’.¹³¹

On the other hand, in response to the position paper, WMI & CI submitted that CI would not experience any rationalisation opportunities until there had been 30 per cent termination.¹³²

The ACCC acknowledges that there are a range of different types of irrigation networks across the Basin, each with varying cost and demand characteristics, and that rationalisation opportunities for certain operators may be more limited. Nonetheless, the ACCC considers that there is scope for operators in terms of coordinated reconfiguration, rationalisation, and innovation of pricing policies.¹³³

As the Australian Government recognises,¹³⁴ where infrastructure is to be decommissioned there may be savings in conveyance water, which can be retained to

¹²⁷ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_water.pdf [accessed on 2 December 2008]

¹²⁸ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, p. 5, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_water.pdf [accessed on 2 December 2008].

¹²⁹ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, p. 5, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_water.pdf [accessed on 2 December 2008].

¹³⁰ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, p. 5, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_water.pdf [accessed on 2 December 2008].

¹³¹ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, p. 5, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_water.pdf [accessed on 2 December 2008].

¹³² WMI & CI, position paper submission, p. 8.

¹³³ For a multiple of 10x, and a discount rate of 4.0 per cent, the annual cumulative productivity gain applied to ongoing fixed costs, required to extend the equivalent years of access fees from 13 years (10x) to 23 years (15x) is: at 10 per cent termination – 0.33 per cent; at 20 per cent termination – 0.67 per cent; at 30 per cent termination – 1.03 per cent. The ESC has required that water authorities include a 1 per cent per annum productivity improvement on growth adjusted business as usual expenditure. See ESC, *2008 water price review, regional and rural businesses water plans 2008–2013 – draft decision*, March 2008, p50.

¹³⁴ Australian Government, media release, *Irrigator groups invited to submit proposals for selling water entitlements*, 9 October 2008, available at

the benefit of the operator. In addition, as noted by GMW, ‘modernisation funds can go further if [GMW] have less infrastructure to upgrade’,¹³⁵ and ‘it makes sense to implement the asset rationalisation element in the first instance to ensure that any available “modernization” funds are not wasted on under-utilised or stranded assets’.¹³⁶

3.5 ACCC’s final advice

Setting the maximum termination fee multiple requires a balance of providing certainty for operators and irrigators to undertake efficient investments and price signals for operators to achieve allocative efficiency in the provision of access services.

Operators have largely submitted that a termination fee multiple of 15x would be acceptable. However, the ACCC considers that the arguments presented in support of a multiple of 15x (25 to 39 years of equivalent access fees) are based on:

- insulating remaining irrigators from price increases to an inappropriate degree
- providing revenue certainty over a longer period than may be economically efficient
- an under-appreciation of the range of mechanisms available to operators to manage revenue uncertainty and realise rationalisation opportunities.

The ACCC considers that a more appropriate multiple would be less than 15x. Economic efficiency supports providing incentives for operators to supply only those services required by their customers and to restructure their operations when certain services are no longer required. Insulating irrigators from access fee increases removes the price signals necessary to achieve such efficiency.

Equally, termination fees should not be prohibited in situations where greater revenue certainty is required for an otherwise efficient investment to be undertaken. The analysis presented in section 3.2 indicates that a termination fee multiple of 10x is likely to provide a sufficient period over which to recover the initial capital for most foreseeable investments. However, there may be situations where longer periods of capital recovery may be warranted, and that some irrigation networks may have limited rationalisation opportunities, at least in the short term. Accordingly, the ACCC recommends allowing higher termination fees negotiated under new and existing contracts, provided they are approved by the ACCC (see chapter 6).

The ACCC reaffirms its draft advice that a termination fee multiple of 10x, in conjunction with a process for approving higher negotiated termination fees and a

<http://www.environment.gov.au/water/mdb/entitlement-purchasing/irrigator-proposals.html> [accessed on 8 December 2008].

¹³⁵ GMW website: <http://www.g-mwater.com.au/projects/modernisation/sheppartonmodernisationproject>, viewed on 2 December 2008.

¹³⁶ GMW, Irrigation infrastructure–refurbishment and investment reconfiguration–Pyramid–Boort Future Management Strategy, p. 7, available at http://www.abare.gov.au/interactive/Outlook07/files/dayTWO/Kent_Water.PPT [accessed on 2 December 2008].

review conducted by 2013, provides an appropriate balance. A multiple of 10x provides between 12 and 15 years of equivalent access fees.¹³⁷

Box 8

7 *Calculation of termination fee*

A fee imposed by an irrigation infrastructure operator under subrule 6(1) must not exceed—

- (a) the amount determined by multiplying by 10—
 - (i) where the whole of a right of access, or services provided in relation to the whole of such a right, are terminated or surrendered, the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given; or
 - (ii) where a part of a right of access, or services provided in relation to a part of such a right, are terminated or surrendered, the proportion of the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given, being the proportion that is applicable to that part of the right; or
- (b) if the fee for the termination or surrender of a right of access or a part of a right of access, or of services provided in relation to the whole or a part of such a right, are provided for in a contract or arrangement between the operator and the holder of the right, the fee determined in accordance with the contract—

whichever is the lesser.

¹³⁷ See p. 23 of the draft advice.

4 The total network access charge

The recommended rules provide that termination fees should be calculated as a multiple of the total network access charge (see section 2.2). As a result there is a need to qualify what constitutes the total network access charge, including whether the total network access charge is a shadow access charge or the sum of actual access charges and whether other fees and charges may be levied at the time of termination. This chapter discusses these issues.

4.1 The total network access charge

Termination fees are paid for terminating access to the operator's irrigation network. As such, the total network access charge should include all fixed fees and charges imposed by an operator for providing access to its irrigation network (both for delivery and drainage¹³⁸ services).

It should be noted that the total network access charge is only a figure derived for the purposes of calculating a termination fee, and the rules about the total network access charge are only for that purpose. While the total network access charge is based on actual charges, operators are neither obliged to impose a total network access charge (or charges that would constitute a total network access charge) nor must they ensure that any charges imposed comply with any rules relating to total network access charges. However, operators must calculate termination fees with reference to the appropriate total network access charge and derive this charge in a manner consistent with the water charge rules for termination fees.

The recommended rules provide that only those fees and charges that are fixed charges should be included in the total network access charge. Fixed charges are those that do not vary with the quantity of water delivered or drained. Since termination fees are only required to cover unavoidable costs, they should not compensate operators for variable costs.

The draft advice stated that the total network access charge may include fees or charges for:

- fixed operating expenditure (e.g. annual maintenance, administration costs, debt servicing costs)
- any annuity associated with periodic network maintenance and renewal, based on forecasts of prudent and efficient costs
- contributions to future capital expenditure for maintaining the current level of service¹³⁹
- contributions to future capital expenditure for improving the level of service, provided that the infrastructure operator has committed to the expenditure (e.g. the expenditure has been included in the Network Servicing Plan).¹⁴⁰

¹³⁸ See appendix E1 of the draft advice.

¹³⁹ Including expenditure necessitated by mandated improvements in standards for items such as health and safety and metering.

Where charges relating to access to delivery and drainage services are bundled with other charges, there is the potential for termination fees to recover more than just the unavoidable ongoing costs associated with providing delivery and drainage services. The ACCC considers that only fixed access fees for delivery and drainage services should be included in the calculation of the total network access charge.¹⁴¹

Fees and charges levied to recover costs other than delivery and drainage services should not be included in the total network access charge. Examples of such charges include:

- water planning and management charges (e.g. Government environmental levies imposed on operators that are passed through to irrigators, which may be because irrigator-owned operators hold group water access entitlements)
- administrative fees and charges associated with undertaking certain actions – such as fees for processing water trades
- fees and charges associated with connection and disconnection
- bulk water charges, as they relate to access to bulk storage infrastructure rather than irrigation infrastructure
- charges levied under contracts with termination fee arrangements approved by the ACCC (see section 6.1).

Operators that currently bundle fixed access fees with other charges will need to unbundle and separately identify fixed access fees in order to impose a termination fee.¹⁴²

An operator may impose a number of fixed fees and charges for providing access to its irrigation network. For example, an operator may impose a charge per hectare as well as a charge per ML of water delivery right. Under the recommended rules, termination fees are to be calculated as a multiple of the total of all these fixed access fees and charges. In addition, operators may impose fixed access fees at varying frequencies. Some operators may impose annual charges, while others may charge monthly, quarterly or biannually. The recommended rules provide that termination fees be calculated as a multiple of the equivalent annual amounts of the relevant charges.

Under the recommended rules, an operator may not impose a termination fee where an irrigator is not liable to pay charges to the operator. It should not be onerous for operators to impose ongoing fixed access fees and to do so would be consistent with the objectives and principles of the Act.¹⁴³

In response to the draft advice, the South Australian government submitted that including in the total network access charge any contribution to future capital

¹⁴⁰ For more, see p. 63 of ACCC, *position paper on water charge rules for infrastructure operators*, September 2008.

¹⁴¹ This does not mean that operators should not be able to impose and bill for access fees in conjunction with other fees and charges.

¹⁴² See p. 27 of the draft advice.

¹⁴³ Schedule 2, clauses 2(d) and 3(7).

expenditure for maintaining the current level of service is ‘open ended and assumes that the current level of service will be required well into the future’.¹⁴⁴

In clarifying, the draft advice simply stated that the total network access charge may include such contributions. There is no implicit assumption that levels of service are to be maintained. Rather, should contributions be made in relation to maintaining the level of service then this contribution may be included in the calculation of the total network access charge. Any decision on services levels remains with operators, as do decisions about access fees.¹⁴⁵

Box 9

total network access charge, for the purposes of the calculation of a fee under rule 7 in respect of the termination or surrender of a right of access to an irrigation infrastructure operator's irrigation network, means the total amount payable in respect of a financial year by a terminating irrigator, including amounts payable in respect of the recovery of expenditure on capital works, but does not include—

- (a) any amount calculated by reference to the number of units or volume of water actually delivered to the terminating irrigator; or
- (b) if a service for the storage of water is provided in addition to the service for the delivery of water, any amount in respect of the service for the storage of water; or
- (c) any amount imposed as a fee in respect of the costs of connecting, or disconnecting, the terminating irrigator to the operator's irrigation network; or
- (d) any amount that exceeds an amount based on the recovery of the costs (whether recurrent or capital) incurred by the operator in relation to the provision of the right of access or services provided in relation to that right; or
- (e) if a fee payable under a contract is approved under rule 8, any amount payable under the contract in respect of the recovery of expenditure on capital works relating to the operator's irrigation network carried out, or to be carried out, within 5 years after the contract was entered into.

¹⁴⁴ Government of South Australia, draft advice submission, p. 2.

¹⁴⁵ Subject to the rest of the water charge rules – see section 1.4.

4.2 Shadow access fees

Numerous submissions commented on the need to calculate termination fees by reference to shadow access fees.¹⁴⁶ The submissions argued that irrigators prefer access fees that have a relatively high variable component, particularly during periods of drought.¹⁴⁷ Variable fees more closely align fees with irrigators' on-farm income. Submissions in response to the draft advice noted that the calculation of termination fees based on actual access fees would result in operators altering tariff schedules to more closely align with costs.¹⁴⁸

In its draft advice, the ACCC maintained the position that calculating termination fees based on a shadow access fee breaks the nexus between the fees payable upon termination of access and fees payable on retaining access. This may distort irrigators' decisions whether to retain, trade or terminate water delivery rights as the present value of ongoing access fees is likely to be less than the equivalent termination fee. As both represent a cost to irrigators in their decisions to continue irrigating or to terminate access and trade, the greater the disparity between actual access fees and shadow access fees (and therefore between termination fees), the more likely that irrigators' decisions will be distorted.¹⁴⁹

Some submissions¹⁵⁰ in response to the draft advice maintained that operators should retain the option of calculating termination fees by reference to a shadow access fee. TNIS submits that:¹⁵¹

the inability to charge Shadow Access Fees in a termination fee calculation leaves TNIS in a difficult position. We either have to start charging our members full cost recovery in a time of continuing drought and poor cash flow, or allow those members terminating to pay a termination fee based on an access charge well below full cost recovery.

The ACCC acknowledges that operators must make decisions about the appropriate level of access fees having regard to any cash flow pressures on customers during the drought. However, as discussed further in section 3.4, economic efficiency requires that irrigators face the full cost of their consumption decisions. Calculating termination fees based on the full cost of providing access services (the shadow access fee) while access fees are below full cost recovery distorts the decisions of irrigators to terminate or retain access, and dilutes price signals to operators about rationalisation and the efficient level of service provision.

The example in box 10 describes the situation where the termination fee (\$65) exceeds the present value of future fixed access fees (\$50). The result is the irrigator remaining connected to the network when it is more efficient for the irrigator to switch to non-

¹⁴⁶ TNIS, draft advice submission, p. 5; SUN, position paper submission, p1; WMI, position paper submission, p23; MI position paper submission, p9

¹⁴⁷ TNIS, draft advice submission, p. 5; MRFF, draft advice submission p. 2.

¹⁴⁸ WCID, draft advice submission, p. 3; Mi draft advice submission, p. 7; WMI draft submission p. 2.

¹⁴⁹ See pp. 64–65 of the draft advice.

¹⁵⁰ MRFF, draft advice submission, p.3; TNIS draft advice submission, p. 5.

¹⁵¹ TNIS, draft advice submission, p. 5.

irrigated activities. Using a 10x multiple, where the shadow access fee is \$6.5 per ML (\$65) and the actual access fee is \$5.0 per ML (\$50), the shadow access fee can be shown to distort efficient irrigator decision making.

Box 10 – Example of shadow access fees and inefficient consumption decisions

Example 3 (see appendix D)

Suppose instead that an irrigator currently connected to the operator's network earns a return *before paying their water delivery charges* of \$90, that water delivery charge for that irrigator is \$50, and that there is a termination fee of \$65. The irrigator then privately receives \$40 of net benefit from undertaking their irrigation activities.

Now suppose that the irrigator could earn a return of \$100 through non-irrigated (dryland) activities. The irrigator is more productive in non-irrigated activities than in irrigated activities ($\$100 > \90). However, because the termination fee is greater than the water delivery charge ($\$65 > \50) the net return to the irrigator from non-irrigated activities is less than the net return from irrigated activities ($\$100 - \$65 = \$35 < \$90 - \$50 = \40).

In this case, the irrigator will not terminate and switch to non-irrigated activities even though it would be more efficient for them to do so.

In a similar context, Murrumbidgee Irrigation (MI) raised the issue of the comparative efficiency of operators, and suggested that, particularly in situations where the termination fee is embedded in the market price of water, more efficient operators will be disadvantaged by imposing lower termination fees (for a given multiple)¹⁵². MI proposed that termination fees be calculated with reference to an industry average of annual fixed access fees (each for gravity and pumped services).¹⁵³

As noted in the draft advice,¹⁵⁴ water prices reflect the value of water in its alternate use. In order for the government (or anyone) to purchase water from a potential seller, it will need to compensate the seller for the value the seller is expecting to obtain from using the water in irrigation.

The value of using the water in irrigation will naturally be dependent upon delivery costs, which in turn are dependent on the relative efficiency of the operator. Since termination fees (at a multiple of 10x fixed access fees) are less than the amount of access fees expected to be paid over the term of the right to access,¹⁵⁵ the relative efficiency of an operator will have a larger effect on the value of water in use than the termination fee. An efficiency gain of an operator will¹⁵⁶ therefore increase prices for water within the operator's irrigation district (because of the greater value of water in use) by more than the corresponding decrease in the water price due to the reduction in

¹⁵² MI, draft advice submission, p. 4.

¹⁵³ MI, draft advice submission, p. 6.

¹⁵⁴ See p. 65 of the draft advice.

¹⁵⁵ For further discussion see appendix E4 of the draft advice.

¹⁵⁶ All other things being equal.

the termination fee (that is embedded in the water price).¹⁵⁷ Therefore, all other things being equal, if the government purchases water from the area of operations of a relatively more efficient operator, it is not because of termination fees but rather the value of water use in that area.¹⁵⁸

In addition, averaging the total fixed access fee used in calculating termination fees raises similar concerns to those addressed in the shadow access fee discussion above and is likely to be problematic in practice given the variety in physical delivery characteristics, service standards and other non-price considerations. Furthermore an averaging approach may distort efficient investment decisions without complex adjustments for service quality and reliability (an artificial signal to suppress access fees below the full efficient cost of providing the required service).

The ACCC maintains its position that termination fees should not be calculated by reference to shadow access fees or an average of access fees, but rather as multiple of actual fixed access fees.

Box 11

7 *Calculation of termination fee*

A fee imposed by an irrigation infrastructure operator under subrule 6(1) must not exceed—

- (a) the amount determined by multiplying by 10—
 - (i) where the whole of a right of access, or services provided in relation to the whole of such a right, are terminated or surrendered, the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given; or
 - (ii) where a part of a right of access, or services provided in relation to a part of such a right, are terminated or surrendered, the proportion of the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given, being the proportion that is applicable to that part of the right; or
- (b) if the fee for the termination or surrender of a right of access or a part of a right of access, or of services provided in relation to the whole or a part of such a

¹⁵⁷ An efficiency gain by an operator will create upward pressure on relevant water prices (through the value of water in use) and downward pressure on water prices (through lower termination fees). However, the upward pressure is likely to prevail over the downward pressure.

¹⁵⁸ For a given value of water used in irrigation (eg. \$100), all other things being equal, an irrigator that has lower input costs (eg access fees of \$50 vs \$60) will need a higher price per ML to incentivise trade (eg. \$50 vs \$40). Where the government indirectly pays for the termination fee through the price of water, the gross price will need to be \$100 in both cases (net profit in irrigation *plus* termination fee – being present value of access fees). Where the value of water used in irrigation in the more efficient area is less than \$100 (eg. \$90) this will be the driver for purchases in this area.

right, are provided for in a contract or arrangement between the operator and the holder of the right, the fee determined in accordance with the contract—

whichever is the lesser.

4.3 Fees that an operator may impose upon termination

Effective water charge rules for termination fees require constraints on the capacity of operators to bypass the termination fee cap by imposing other fees to raise revenue that would otherwise be recovered through termination fees.

Termination fees are one mechanism that operators can use to manage revenue uncertainty and ensure that the ongoing unavoidable costs of operating the irrigation network are recovered. Accordingly, the recommended rules allowed operators to impose termination fees when an irrigator terminates access.¹⁵⁹

Additionally, operators may require payment of disconnection fees in order to make an irrigator's termination effective and recover any administrative and direct costs of disconnecting a terminating irrigator from the irrigation network.

The draft advice provided for the levying of disconnection fees which recover the reasonable costs incurred by the operator by reason only of disconnecting an irrigator from the irrigation network.

The draft advice prevented disconnection fees from including any costs associated with rationalising or reconfiguring the irrigation network (e.g. decommissioning costs) other than the point of connection with the irrigator.

Submissions to the draft advice, from both operators and irrigators agreed that operators may need to recover additional costs incurred from disconnecting an irrigator.¹⁶⁰

MRFF, WCID and SRI & RGA submitted that disconnection fees should also recover costs of decommissioning or reconfiguring irrigation networks as a result of termination. WCID argued that disconnection fees should include:¹⁶¹

the actual cost of decommissioning, restoration of open channels, road crossings, rail crossings etc., possibly coupled with the need to provide stock domestic supplies via pressurized pipe lines.

¹⁵⁹ See sections 2.1 of draft advice.

¹⁶⁰ N Rolfe, draft advice submission, pp. 6–7; WCID, draft advice submission, p. 2 SRI & RGA draft advice submission, p. 3, MRFF, draft advice submission, p. 3.

¹⁶¹ WCID, draft advice submission, p. 2.

Similarly, MRFF submitted that:¹⁶²

MRFF believes that there needs to be a separate and explicit provision for the event of decommissioning costs able to levied on exiting members (or at the very least, acceptance of the need for a multiple of 15). To our knowledge ACCC has not given regard to the OH&S issues flagged in earlier submissions by MRFF, which may in fact require the decommissioning of defunct irrigation schemes.

Opportunities for rationalisation and the extent that rationalisation costs should be recoverable through termination fees were considered by the ACCC.

As stated in the draft advice, termination fees provide a contribution from terminating irrigators to an operator's unavoidable costs. These unavoidable costs may constitute the maintenance and renewal of a section of an irrigation network, or alternatively, the decommissioning or reconfiguration of that section, depending on which is the least-cost solution. Termination fees therefore already provide a contribution from terminating irrigators to the costs of decommissioning assets. Increasing disconnection fees would provide for the over-recovery of these costs (double-counting).

The ACCC considers that submissions have not provided new information to support disconnection fees including recovery of decommissioning costs, and maintains its position in the draft advice.

There may be other charges unrelated to termination that have accrued and must be paid upon the irrigator terminating access, such as access fees for the period in which the irrigator terminates that may not yet have been paid. The recommended rules do not prevent an operator from recovering the amounts of all regulated water charges owing to it by a departing irrigator at the time of termination.

Box 12

5 *Prohibition of certain fees and charges*

- (1) Except as expressly authorised under Part 3, an irrigation infrastructure operator must not impose, demand or receive, or cause to be imposed, demanded or received, a fee, charge or payment of any kind for or in respect of the termination or surrender of the whole or a part of a right of access to the operator's irrigation network or of services provided in relation to that right or a part of that right.

Civil penalty: 200 penalty units.

- (2) Subrule (1) does not apply to fees authorised under the *Water Market Rules 2009*.

...

¹⁶² MRFF, draft advice submission, p. 4.

6 Termination fee may be imposed in certain circumstances

- (1) An irrigation infrastructure operator may impose a fee calculated in accordance with rule 7 if—
 - (a) a person who holds a right of access to the operator's irrigation network terminates or surrenders the whole or any part of that right or services provided in relation to that right by notice in writing given to the operator; or
 - (b) the operator, by notice in writing given to a person who holds a right of access to the operator's irrigation network, terminates the whole or any part of that right or services provided in relation to that right in accordance with a contract applicable to the right on the grounds that the person is in breach of the person's obligations under that contract.
- (2) Subrule (1) does not apply—
 - (a) if—
 - (i) the holder of the right of access to an irrigation infrastructure operator's irrigation network is not liable to pay charges to the operator in respect of the right; and
 - (ii) a fee in respect of the termination or surrender of the right or a part of the right is not specified in any contract or arrangement between the holder and the operator; or
 - (b) if the holder of the right of access to an irrigation infrastructure operator's irrigation network—
 - (i) is provided by the operator with a service for the storage of water in addition to the service for the delivery of water; and
 - (ii) the charges for the service for the storage of water are included in the charges in respect of the right of access.

...

10 Disconnection fee

- (1) Subject to subrule (2), nothing in these Rules prevents an irrigation infrastructure operator imposing a fee in respect of the reasonable costs incurred by the operator by reason only of removing or disabling a physical connection between the operator's irrigation network and the infrastructure of a person who holds or has held a right of access to that irrigation network.
- (2) A fee imposed for the purposes of subrule (1) must be identified as a disconnection fee, whether or not it is payable at the same time as a fee under Part 3.

5 Adjustments to the termination fee

As noted from the previous chapter, the termination fee multiple should be calculated as a multiple of the total network access charge, which is the sum of actual access fees or charges. In consultation, stakeholders raised issues about adjustments to the termination fee multiple—for example, for taxation liabilities incurred upon termination or costs avoided as a result of termination. This chapter discusses these issues.

5.1 Adjusting the termination fee for tax

Some stakeholders have argued that the methodology for setting maximum termination fees should include an adjustment to account for taxation liabilities that occur as a result of termination. Two income tax-related issues may arise in relation to termination fees. Firstly, a timing issue may exist as termination fees result in an increase in taxable income in the initial period and a decrease in taxable income in future periods as access fees are foregone. Secondly, the principle of mutuality, which in particular circumstances may apply to the receipt of access fees,¹⁶³ may not apply to the receipt of termination fees.¹⁶⁴ In this scenario taxable income increases in the initial period of receipt of the termination fee (which may, at least in some cases, not be offset by future reductions in the operators tax liability).

The ACCC considers that no adjustment to termination fees should be made to account for income tax. In the year a termination fee is received the additional tax liability that arises should, in the most part, be offset by a reduction in access fees and associated outgoing taxation liabilities once termination has occurred.¹⁶⁵

It is possible under limited circumstances for a permanent tax disadvantage to occur where an operator in the year of receipt of the termination fee realises an additional tax liability which is not offset by a future reduction in taxation liabilities.¹⁶⁶ Given the different tax profiles of the operators, such situations were identified to occur in only limited circumstances.¹⁶⁷ Further, adopting a higher termination fee multiple to address possible taxation disadvantages could create windfall gains for some operators.

With regards to the issue of the mutuality principle (which appears unique to CI) the receipt of access fee income by Coleambally Irrigation Mutual Cooperative Limited (CIMCL) is non-assessable. CI raised concerns that the receipt of termination fee income could be assessable, resulting in a permanent tax disadvantage to CIMCL and consequently CI.

¹⁶³ Section 5.2 of the draft advice.

¹⁶⁴ CI, draft advice submission, p. 9.

¹⁶⁵ See section 4.3.4 of the position paper.

¹⁶⁶ For example, where in the years after the receipt of the termination fee the operator remains in a tax loss position in perpetuity.

¹⁶⁷ For example, where mutual non assessable income is swapped for assessable termination fee and the level of termination of delivery rates is in excess of 30% of the access fees. PwC, *ACCC termination fee report*, September 2008, p32.

To help assess CI's concerns the ACCC sought advice from PwC before releasing the draft advice. PwC advised that it may be arguable that termination fee income could be treated as non-assessable income where the mutuality principle applies to the receipt of the underlying access fees.¹⁶⁸

In any event, the Act requires that the rules contribute to the Basin water charging objectives and principles, including that pricing policies should ensure consistency across sectors and jurisdictions.

In undertaking its role in regulating prices for businesses in other sectors, the ACCC typically applies benchmark tax assessments, ensuring the approach is applied consistently across the sector and does not create situations where decisions are made based upon specific individual circumstances. Providing for a ruling that allows adjustments based on individual business structures works against the objective of consistency across sectors and jurisdictions. It may also create incentives to migrate towards those types of structures.

The ACCC sought further advice from PwC on the materiality of a permanent tax timing disadvantage and the mutuality principle in light of information provided in submissions in response to the draft advice. In providing the ACCC with an update of its report for the final advice, PwC reviewed relevant submissions to the draft as well as liaising directly with CI on the issue of the mutuality principle and the materiality of any specific permanent income tax disadvantage.

With regards to the materiality of any permanent tax disadvantage PwC concluded that:

... there are only limited circumstances where a permanent tax disadvantage may arise from the receipt of Termination Fees.

In many circumstances the advance receipt of Access Fees in the form of Termination Fees, would either be non-assessable, offset by the Operator's carry forward tax losses or would merely cause a tax timing disadvantage that would be recouped in future years... In these circumstances it is arguable that no gross up is appropriate.¹⁶⁹

In relation to the mutuality principle, PwC concluded that:

it would seem arguable that if the arrangements are such that the Access Fees are exempt from tax by virtue of the principle of mutuality that the replacement Termination Fees received by the Operators from Irrigators could similarly be excluded from assessable income even in scenarios where an Irrigator leaves the collective.¹⁷⁰

PwC undertook a case study of the materiality of taxation liabilities that accrue against the termination of delivery rights. PwC examined the taxation implications on CI resulting from a 6, 15 and 30 per cent termination of delivery rights. PwC also examined the impact of termination on a hypothetical entity identical to CI except for its dual cooperative structure. CI operate as a dual mutual (CIMCL) and an operating cooperative (CICL). The case study assumed, consistent with the proposition presented

¹⁶⁸ PwC, *ACCC termination fee report*, September 2008.

¹⁶⁹ PwC, *ACCC termination fee report*, September 2008 (updated December 2008), p 32.

¹⁷⁰ PwC, *ACCC termination fee report*, September 2008 (updated December 2008), p 23.

by CIMCL that CIMCL's access fee income is non-assessable by virtue of the mutuality principle, but termination fees are treated as taxable. The hypothetical or counterfactual business operates as a single entity whose income (access fees and termination fees) is assessable (this represents the more typical tax treatment for an operator which is subject to tax¹⁷¹).

PwC concluded:

when a comparison is made with the after tax position of a fully taxable Operator, the taxation of the Access Fees in a mutual structure retains its advantage against a fully taxable Operator until the level of terminations approximate 40%...Furthermore a material permanent disadvantage is not likely to be suffered by the mutual Operator until the 30% level of terminations.¹⁷²

The results at appendix D of the PwC report conclude that upon inclusion of investment returns that accrue with the receipt of termination fees, the impact on CI at 30 per cent termination where the principle of mutuality does not apply is 7.9 per cent.¹⁷³ Even without co-ordination of termination, this is likely to be offset by efficiency savings where approximately one-third of irrigators terminate (see section 3.4).

The ACCC reaffirms its advice that no adjustment should be made to the termination fee multiple for income tax on the grounds:

- The income tax impact for the majority of operators is neutral (zero effective tax rate).¹⁷⁴
- The likelihood of any material permanent tax disadvantage is limited and any impact is likely to offset by gains from the deduction of avoided costs.
- Advice from PwC suggests that it is arguable that the principle of mutuality will apply to the receipt of termination fee income where underlying access fee income is non-assessable for this reason.
- A tax uplift of 30 per cent (as currently employed by certain operators¹⁷⁵) is excessive.¹⁷⁶
- The draft rules do not preclude an operator from recovering taxation liabilities through underlying access fees.
- Providing for a ruling that allows adjustments based on individual business structures works against the objective of consistency across sectors and

¹⁷¹ Importantly we note that the tax profiles of the operators vary from government owned exempt, government owned taxable, taxable company, to a dual cooperative where part of its access fee income is non-exempt non assessable.

¹⁷² PwC, *ACCC termination fee report*, September 2008 (updated December 2008), p 34.

¹⁷³ PwC, *ACCC termination fee report*, September 2008 (updated December 2008), p 35

¹⁷⁴ The position not to adjust termination fees for tax will contribute to consistency in pricing policies across the Basin – see clause 3(7) of schedule 2 of the Act.

¹⁷⁵ MIL, position paper submission, p. 5, WMI & CI, position paper submission, p. 9.

¹⁷⁶ The current position of including a 30 per cent tax up-lift is not efficient as it is in excess of effective tax rates (neutral or zero). The over-recovery of termination fee income may also distort water trade. See subparagraphs 2(a)(i)(ii) and 2(c) of the Act. PwC, *ACCC termination fee report*, September 2008 (updated December 2008), p 36

jurisdictions and may create incentives to migrate towards those type of structures.¹⁷⁷

- None of the operators have provided any information to the ACCC or its adviser PwC to render these findings as invalid.

WMI submitted that it currently includes a Goods & Services Tax (GST) component in its termination fee, and that the water charge rules for termination fee should clarify the treatment of GST.¹⁷⁸

The ACCC considers that whether any fee or charge for a good or service should include a GST component is a matter for the Australian Taxation Office (ATO). The ACCC notes that supplies of water and supplies of rights to receive supplies of water are GST-free.¹⁷⁹ It could be argued that as termination fees represent a fixed payment obligation (similar to a lump-sum payment of future access fees) for a right to receive supplies of water, that termination fees may also be GST-free.¹⁸⁰ Submissions did not provide any information to suggest that access fees and termination fees would not be GST-free.

The ACCC also notes that if the access fees that comprise the total network access charge, and which are multiplied by 10 to obtain a termination fee, are figures inclusive of GST (or income tax for that matter), then the termination fee will necessarily also include the proportionate GST component. Therefore to avoid over-recovery, where the access fees used in calculating termination fees are inclusive of GST, the termination fees should not be increased further for GST.

The ACCC considers that sufficient uncertainty exists not to provide an adjustment to termination fees for GST.

Box 13

7 Calculation of termination fee

A fee imposed by an irrigation infrastructure operator under subrule 6(1) must not exceed—

(a) the amount determined by multiplying by 10—

(i) where the whole of a right of access, or services provided in relation to the whole of such a right, are terminated or surrendered, the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given; or

(ii) where a part of a right of access, or services provided in relation to a part of

¹⁷⁷ Rules are designed to ensure pricing policies are applied consistently. See clause 3(7) of schedule 2 of the Act.

¹⁷⁸ WMI, draft advice submission, p. 6.

¹⁷⁹ Under section 38-285 and paragraph 9-30(1)(b) respectively of the *A New Tax System (Goods and Services Tax) Act 1999*.

¹⁸⁰ The termination fee is not a disconnection fee.

such a right, are terminated or surrendered, the proportion of the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given, being the proportion that is applicable to that part of the right; or

- (b) if the fee for the termination or surrender of a right of access or a part of a right of access, or of services provided in relation to the whole or a part of such a right, are provided for in a contract or arrangement between the operator and the holder of the right, the fee determined in accordance with the contract—

whichever is the lesser.

5.2 Adjusting the termination fee for avoided costs

An operator may be able to reduce its costs when an irrigator terminates access. For example, if the terminating irrigator is at the end of a channel, the operator may be able to close part of the channel. As discussed in chapter 4.1, it is inefficient for termination fees to include those costs that can be avoided as a direct result of terminating access.

The level of the termination fee multiple provides some certainty over investment decisions made by operators and irrigators, but also provides incentives for operators to undertake efficient rationalisation of their irrigation network.

The implication for the level of the multiple is that it should not provide for a contribution towards ongoing costs in perpetuity. The adjustment to the multiple provides for an implicit deduction of avoidable costs, or those ongoing costs that may be avoided at some future point when the existing network is rationalised and/or reconfigured. In other words, avoidable costs are partially taken into account through the level of the termination fee multiple rather than specific adjustments once avoided costs are recognised.

TNIS submitted that it “agrees that any costs avoided should not be deducted from the termination fee as these will be largely negligible until rationalisation can occur”.¹⁸¹

The proposed cap on the level of the termination fee multiple may provide sufficient incentives for operators to adjust the multiple downwards in advance of termination.¹⁸² This may occur where the incremental cost of servicing particular irrigators exceeds their revenue contribution through fixed access fees, and remaining irrigators would be better-off with these costs being avoided.

¹⁸¹ TNIS, draft advice submission, p. 4.

¹⁸² As opposed to an ex post adjustment.

Box 14

7 *Calculation of termination fee*

A fee imposed by an irrigation infrastructure operator under subrule 6(1) must not exceed—

- (a) the amount determined by multiplying by 10—
 - (i) where the whole of a right of access, or services provided in relation to the whole of such a right, are terminated or surrendered, the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given; or
 - (ii) where a part of a right of access, or services provided in relation to a part of such a right, are terminated or surrendered, the proportion of the total network access charge payable to the operator by the holder of the right in respect of the financial year in which notice of termination or surrender is given, being the proportion that is applicable to that part of the right; or
- (b) if the fee for the termination or surrender of a right of access or a part of a right of access, or of services provided in relation to the whole or a part of such a right, are provided for in a contract or arrangement between the operator and the holder of the right, the fee determined in accordance with the contract—

whichever is the lesser.

6 Negotiating higher termination fees

Where both an operator and its customers are willing to enter into contractual arrangements that include higher termination fees and those termination fees are reasonably required to recover capital expenditure associated with major investments, there appears little justification for preventing such agreements.¹⁸³ Providing flexibility to market participants to enter into privately negotiated arrangements¹⁸⁴ for major investment will promote the efficient use of and investment in irrigation networks¹⁸⁵ and the efficient functioning of water markets.¹⁸⁶

This chapter discusses the recommendation to allow the ACCC to approve a privately negotiated termination fee in excess of the termination fee cap, and the process for applying for and granting an approval.

6.1 When a higher termination fee may be approved

An operator may be able to use a number of mechanisms other than a termination fee to mitigate risks of future reductions in demand. The ACCC recognises, however, that circumstances may arise in which such measures are not sufficient to provide the requisite certainty to an operator to undertake an otherwise efficient investment.¹⁸⁷

It is envisaged that irrigators, under certain circumstances, would be willing to enter into negotiated contracts that include termination fees in excess of the cap proposed by the ACCC. Situations may arise where an irrigator:

- is faced with a significant improvement in the reliability and quality of supply
- may be offered lower access fees to enter into longer-term agreements
- has significant on-farm investments.

¹⁸³ The ACCC's access, exit and termination fee report espoused the benefits of ex ante long-term contracts in relation to access to irrigation networks, stating that 'Contractual agreements of this nature would provide certainty to irrigators and infrastructure operators as to their respective obligations. They would guarantee transparency to the funding of investments and ensure that irrigators are aware of their future obligations prior to the construction of infrastructure. Moreover, because irrigators are made aware of their obligations before entering into the contract, early termination payments would not affect any decision to leave the irrigation system' [see pp. 20–21 of the access, exit and termination fee report].

¹⁸⁴ Where there is genuine negotiation.

¹⁸⁵ Clause 2(a) of schedule 2 of the Act.

¹⁸⁶ Clause 2(c) of schedule 2 of the Act.

¹⁸⁷ The case studies presented in section 3.3 of the draft advice and detailed in appendix G of the draft advice show that the implied termination fee multiples for the recovery of the value of the initial investment are around 10x, which is consistent with the ACCC's position. However, it is noted that the implied termination fee multiple is sensitive to the time period and discount rate and only three case studies were presented.

Operators are likely to have incentives to restrict termination,¹⁸⁸ and limited competition in access services may mean that there is a significant inequality in bargaining power between operators and irrigators. This inequality may be greater for existing contracts, where irrigators could not have relied during negotiations on the water charge rules for termination fees as a ‘fall-back’ position. The cooperative or ‘club’ nature of irrigator-owned operators also introduces the capacity for a degree of coercion or peer pressure, potentially influencing negotiations.

On balance the ACCC considers that termination fees agreed to in existing contracts should be honoured and new agreements as to termination fees able to be entered into. However, the ACCC remains concerned that termination fees contained in contracts may not be appropriate where the fee is not reasonably required to recover the cost of major investment and may not be the result of genuine negotiation.

The draft advice states that the ACCC could approve the imposition of termination fees where the fees are contained within existing or new contracts. To ensure that approved termination fees are reasonably required to recover the cost of major investment and are the result of genuine negotiation, the draft advice stated that the ACCC must be satisfied that:

- the termination fee (however calculated) is clearly stated within the contract
- the provisions of the contract or agreement were agreed to by the parties in the course of fair and reasonable negotiation
- the termination fee relates to capital expenditure that has occurred or is expected to occur within five years of the inception of the contract
- the provisions of the contract or agreement allows for the operator to impose access fees for the recovery of the capital expenditure
- the termination fee is reasonably required to recover the capital expenditure.

The ACCC also proposed to develop guidelines on the approval of termination fees contained in contracts to set out matters that the ACCC intends to consider when granting an approval. The guidelines would provide greater certainty to participants about the approval process.

The guidelines would elaborate on matters such as fair and reasonable negotiation, including that:

- neither party has engaged in unconscionable conduct, for example:
 - the parties have had a reasonable opportunity to consider the offer, including the ability to obtain legal, financial or other advice
 - there was no coercion or pressure exerted on any party to enter into an agreement
- the contract is a written contract signed by all relevant parties
- all relevant information has been made available to the parties to the negotiation.

¹⁸⁸ See section 3.1 of ACCC, position paper, *water charge rules for infrastructure operators*, September 2008.

In response to the draft advice, WMI¹⁸⁹ and the NFF¹⁹⁰ supported the approval of higher termination fees contained in contracts.

The ACCC considers that submissions in response to the draft advice have not provided any new information about the negotiation of higher termination fees, and the ACCC maintains the position in its draft advice.

The proposed approval process would not be a review of the efficiency of the underlying investment to which the contract relates. Rather, the focus of the ACCC in determining whether to give approval would be on whether the termination fee contained in the contract was negotiated on fair and reasonable terms, the fee relates to capital expenditure that has occurred or is expected to occur within five years of the inception of the contract and the fee is reasonably required to recover the capital expenditure.¹⁹¹

The draft advice did not provide for the approval of arrangements for when a termination fee may be imposed. An approval made under the rules should only be in relation to the level of a termination fee. Therefore, the recommended rules that address the situations in which a termination fee may be imposed should still apply to all existing and new contracts (see section 2.1).

Box 15

8 *Approval of additional fee payable under certain contracts relating to capital works*

- (1) If, under a contract between an irrigation infrastructure operator and one or more holders of rights of access to the operator's irrigation network in relation to the carrying out, within 5 years after the entering into of the contract, of capital works relating to the irrigation infrastructure operator's irrigation network, provision is made for the payment by a terminating irrigator of a fee relating to the recovery of that capital expenditure, a party to the contract may, within the period referred to in subrule (2), apply to the ACCC for approval of that fee as a fee payable by each terminating irrigator in addition to the fee determined under rule 7.

...

¹⁸⁹ WMI, draft advice submission, p. 2.

¹⁹⁰ NFF, draft advice submission, p. 1.

¹⁹¹ It should be noted that while the ACCC proposes to approve termination fees contained in contracts for the purpose of the water charge rules, the ACCC will not be approving the validity of contracts generally (eg. contract terms not relating to termination). Since the recommended rules provide for approval of termination fees imposed in contracts, it is a condition of approval that a legitimate contract exists. If a contract containing a termination fee approved by the ACCC is subsequently set aside by a court, then the ACCC's approval of the termination fee contained in that contract will effectively be revoked.

(3) If—

- (a) an application is made to the ACCC under subrule (1) for approval of the fee as determined in accordance with a contract referred to in that subrule; and
- (b) the ACCC is satisfied that the contract—
 - (i) relates to, or is made in anticipation of, the carrying out by the irrigation infrastructure operator, within 5 years after the contract is entered into, of capital works relating to the operator's irrigation network; and
 - (ii) provides for fees payable for access to the operator's irrigation network by the holders of rights of access that reasonably relate to the recovery by the operator of expenditure on those capital works in an amount not exceeding the actual, or a reasonable estimate of, expenditure by the operator; and
 - (iii) provides for a fee payable to the operator by a terminating irrigator that was agreed by each party to the contract in the course of fair and reasonable negotiation, is clearly stated and is not subject to variation without the agreement of the holders of the rights of access; and
- (c) the ACCC is satisfied that the operator advised the holders of rights of access who are parties to the contract of the general effect of these Rules; and
- (d) the ACCC, in accordance with this rule, and having regard to the water charging objectives and principles, approves the fee referred to in subparagraph (b)(iii)—

the fee is payable by each terminating irrigator.

6.2 Process for approving higher termination fees

The recommended rules provide that an application for approval must be accompanied by a copy of the contract or agreement and contact details of all parties to the agreement.

To accelerate the approval process, the ACCC considers that operators should provide additional details to the ACCC regarding the nature and timing of the investment under the contract at the time of application.

The recommended rules also require operators to provide any information about the contract requested by the ACCC.

Once a request for approval has been received along with all the required information, the recommended rules provide the ACCC with 30 business days to make a decision to either approve or not approve a termination fee contained in a contract or agreement. The ACCC may extend the period by another 30 business days by notifying the parties of the contract or agreement of the extension of the time period, as well as reasons for the extension. The ACCC may provide a written request for the provision of additional information. The time taken for the request to be fulfilled does not contribute towards the 30 business day period for the making of a decision to approve or not approve a termination fee.

The approval process should provide a sufficient level of certainty to operators and irrigators in order to facilitate the efficient functioning of water markets¹⁹² and promote the efficient use of and investment in irrigation networks.¹⁹³ The recommended rules provide that if the ACCC does not make a decision or notify of an extension to the period in which to make a decision within 30 business days of receiving a completed application, then the termination fee within the contract or agreement is taken to have been approved. The final advice recommends that an approval by the ACCC is valid for as long as the relevant provisions in the contract, and that variations to contract provisions that affect termination fees may require re-approval.

While the ACCC intends to issue guidelines on the approval of higher termination fees, the ACCC considers that greater certainty about its role in approving higher termination fees could be provided in the rules. The recommended rules state that the Basin water charging objectives and principles should guide any decision regarding the approval of a higher termination fee.

Any approval process should be conducted in a timely and transparent manner, consistent with the Basin water charging objectives.¹⁹⁴ The ACCC will endeavour to resolve applications for approval of termination fees within contracts or agreements as quickly as is practicable in the circumstances of each case.¹⁹⁵ The ACCC will issue guidelines that outline the approval process, information required by the ACCC, standard application forms and matters that the ACCC may take into account when making a decision whether to approve a termination fee.

There may be a brief period of time between the commencement of the water charge rules for termination fees and when the ACCC is able to approve termination fees contained in existing contracts. This would result in a period of time in which termination fees within an existing contract could not be imposed, even though the ACCC may intend to approve the existing contract. This issue is discussed further in section 7.2.

¹⁹² Clause 2(b) of schedule 2 of the Act.

¹⁹³ Clause 2(a) of schedule 2 of the Act.

¹⁹⁴ Clauses 2(d) and 2(e) of schedule 2 of the Act.

¹⁹⁵ It is noted that there may be a considerable amount of requests for approval received by the ACCC in the period leading to the commencement of the water charge rules for termination fees (recommended to be 1 July 2009). This may influence the time required to process requests for approval.

Submissions did not comment on the process for approving higher negotiated termination fees.

To provide more certainty to market participants, and to prevent the approval process being used to delay termination, the ACCC considers that the recommended rules should include a time period in which operators can apply for approval. The ACCC considers that a period of three months provides an appropriate opportunity for operators to submit an application to the ACCC for approval of a termination fee after agreeing to a new contract. For existing contracts, operators will have three months from the commencement of the cap on termination fees to submit an application.

Box 16

8 *Approval of termination fee payable under certain contracts*

- (1) If, under a contract between an irrigation infrastructure operator and one or more holders of rights of access to the operator's irrigation network in relation to the carrying out, within 5 years after the entering into of the contract, of capital works relating to the irrigation infrastructure operator's irrigation network, provision is made for the payment by a terminating irrigator of a fee relating to the recovery of that capital expenditure, a party to the contract may, within the period referred to in subrule (2), apply to the ACCC for approval of that fee as a fee payable by each terminating irrigator in addition to the fee determined under rule 7.
- (2) The period within which an application may be made under subrule (1) for the approval of a fee under a contract referred to in that subrule is—
 - (a) the period commencing on the day after these Rules are registered and ending at the expiration of 6 months after that day; or
 - (b) the period of 3 months after the date on which the contract was entered into—whichever is the later.

...
- (4) If a person makes an application to the ACCC under subrule (1) for approval of a fee determined in accordance with a contract referred to in that subrule and provides the ACCC with—
 - (a) a copy of the contract; and
 - (b) the contact details of the parties to the contract; and
 - (c) such details of contracts entered into, and arrangements made, for the carrying out of capital works relating to the operator's irrigation network within the period referred to in subparagraph (3)(b)(i) as are sufficient to

confirm that the works have been, are being or are to be carried out; and

- (d) any further information requested by the ACCC—
the ACCC—
 - (e) must decide whether or not to approve the fee; and
 - (f) must give notice in writing of its decision to each of the parties to the contract; and
 - (g) if it decides not to approve the fee, must include in the notice under paragraph (f) the reasons for refusing approval.
- (5) If the ACCC does not make a decision under subrule (4) within a period of 30 business days after receiving an application under subrule (1), the ACCC is taken to have made a decision, at the end of that period, to approve the fee and to have given notice of the decision under paragraph (4)(f).
- (6) In calculating a period of 30 business days referred to in subrule (5), disregard, if the ACCC has requested further information in relation to the application, a day during any part of which the request, or any part of the request, remains unfulfilled.
- (7) If the ACCC—
- (a) is unable to make a decision within the period of 30 business days referred to in subrule (5); and
 - (b) within that period gives written notice to the person who makes an application under subrule (1) explaining why the ACCC has been unable to make a decision on the fee within that period of 30 business days—
- the period of 30 business days referred to in subrule (5) is extended by a further period of 30 business days.

7 Application and implementation

This chapter discusses the timing of the commencement of the water charge rules for termination fees, the range of operators that may be subject to the rules, and the appropriate measures for enforcing the rules. The chapter also discusses both ongoing monitoring of the rules and the provision for a formal review.

7.1 Compliance and enforcement

For the water charge rules for termination fees to be effective, provision must be made for:

- penalties or remedial action that may be taken in response to breaches of the rules
- the enforcement agency responsible for investigating and enforcing breaches of the rules
- information gathering powers to assist the enforcement agency in undertaking its roles.

The Act provides for the ACCC to be the sole enforcement body for the water charge rules and water market rules.¹⁹⁶

The *Water (Consequential Amendments) Act 2007* (Cth) amended the *Trade Practices Act 1974* (Cth) (the TPA) to provide the ACCC with the power to issue a notice under section 155 of the TPA in relation to a designated water matter (including the water charge rules).¹⁹⁷ Notices issued under section 155 of the TPA can be used to compel parties to provide information to the ACCC in relation to its role in enforcing the water charge rules for termination fees. The ACCC is required to have a reason to believe that the party to which the section 155 notice is issued can produce the requested information. Therefore section 155 notices empower the ACCC to undertake its role of investigating compliance with the rules.

The Act provides a range of remedies to address breaches of water charge rules, including court orders, court-enforceable undertakings and, for rules that are designated as civil penalty provisions, infringement notices and court-ordered pecuniary penalties.¹⁹⁸

In deciding which rules should be designated as civil penalty provisions, the ACCC considered which contraventions are likely to be most damaging to the Basin water charging objectives and principles. The ACCC recommends that rule 5 of the recommended rules, which prohibits the imposition of termination fees otherwise than in accordance with the rules, be designated as a civil penalty provision.

The imposition of termination fees has the potential to adversely impact water trade, land-use decisions and decisions about investment and configuration of irrigation

¹⁹⁶ Section 137(b) of the Act.

¹⁹⁷ Section 155(9A) of the TPA.

¹⁹⁸ Part 8 of the Act. See section 8.1 of the draft advice.

networks and on-farm assets. Investment in irrigation infrastructure and on-farm assets often involves large up-front costs. These assets tend to have few alternative uses and the investment, once made, is largely considered sunk. In addition, even after the initial investment in infrastructure has been made, there are relatively high on-going fixed costs that must be incurred to operate and maintain the infrastructure. In order to avoid the large sunk costs associated with inefficient investment decisions being made, it is important that the enforcement provisions deter the imposing of termination fees in a manner or at a level prohibited by the rules.

The timing of actions (which may include termination) to facilitate water trade decisions are important in order to realise the benefits of trade, including timely access to water markets. Rule 5 of the recommended rules should therefore be designated as a civil penalty provision to ensure that contraventions are quickly and easily enforceable through the option of infringement notices.

While certain rules may be designated as civil penalty provisions, the ACCC may decide to address compliance matters administratively or through measures other than an infringement notice or seeking the imposition of a civil penalty by the court, depending on the circumstances of each matter.

The ACCC anticipates a cooperative approach to information gathering by all parties in the first instance. The ACCC intends to primarily rely on complaints from aggrieved parties, supplemented with analysis of publicly available information and information shared by other government agencies. The ACCC notes that in many cases the conduct of operators is already well scrutinised by irrigators. Irrigators who make complaints should be confident that the ACCC will investigate and undertake enforcement action where appropriate.

The primary outcomes that the ACCC seeks to achieve in undertaking its enforcement activities are to:

- ensure that the offending conduct ceases so that the damage occurring in the market is minimised
- prevent the offending conduct from recurring
- clarify interpretation of the Act, regulations, water charge rules and water market rules
- in appropriate circumstances, penalise offenders.

The ACCC has discretion in deciding whether to take enforcement action and the nature of any enforcement action. The ACCC will consider a number of factors when deciding whether to take enforcement action and which enforcement option to adopt. In general, the ACCC aims for a proportionate enforcement response taking into account the impact of the breach, the circumstances surrounding the breach and operator's compliance programs and compliance culture. More specifically, the ACCC's considerations are likely to include:

- the nature and extent of the contravening conduct
- the amount of loss or damage caused

- the circumstances in which the conduct took place
- the deliberateness of the contravention and the period over which it extended
- whether the contravention arose from senior management or at a lower level
- whether the operator has a corporate culture conducive to compliance with the water charge rules, as evidenced by educational programs and disciplinary or other corrective measures implemented in response to an acknowledged contravention
- whether the operator has shown a willingness to cooperate with the ACCC in relation to the contravention.

If a breach of the water charge rules for termination fees is relatively minor, the matter may be addressed administratively. The ACCC may advise the relevant operator that the behaviour in question has been recorded as inconsistent with the requirements of the water charge rules, and that scrutiny of the operator's behaviour will be heightened in future. These options do not preclude the ACCC from taking other enforcement action if an administrative enforcement action proves to be ineffective.

Box 17

5 *Prohibition of certain fees and charges*

- (1) Except as expressly authorised under Part 3, an irrigation infrastructure operator must not impose, demand or receive, or cause to be imposed, demanded or received, a fee, charge or payment of any kind for or in respect of the termination or surrender of the whole or a part of a right of access to the operator's irrigation network or of services provided in relation to that right or a part of that right.

Civil penalty: 200 penalty units.

7.2 Application of the rules

The Act provides for the water charge rules to include transitional arrangements in introducing water charge rules.¹⁹⁹ The Act also allows the ACCC to consider whether all operators should be subject to the water charge rules to the same degree.²⁰⁰ This section examines these issues.

The Basin water charging objectives and principles would be best achieved with universal application of the water charge rules for termination fees, which would ensure certainty for all market participants regarding their rights and obligations and facilitate

¹⁹⁹ Section 92(3)(k) of the Act.

²⁰⁰ Section 92(8) of the Act.

efficiently functioning water markets.²⁰¹ Termination fees may influence the decisions of irrigators to trade water, and this influence is unlikely to be significantly affected by size, governance arrangements or any other characteristics of operators. The ACCC therefore considers that the water charge rules for termination fees should apply to all operators, irrespective of geographic location, subject to the provisions of the Act.²⁰²

Amendments to the Act following the intergovernmental agreement entered into by the Australian Government and the governments of New South Wales, Victorian, South Australian, Queensland and Australian Capital Territory governments on 3 July 2008 will, once commenced, allow relevant jurisdictional governments to opt in to the application of the Act to the whole jurisdiction, and not just those areas within the Basin.²⁰³ The ACCC considers that the termination fee rules should apply to those irrigation areas covered by the intergovernmental agreement where the relevant jurisdictional government opts in.

It should also be noted that the application of the water charge rules for termination fees is limited in its scope by what is provided for under the Act. Most notably, the application of the water charge rules for termination fees is currently limited to termination fees imposed by irrigation infrastructure operators. The ACCC considers that in some cases there may be ambiguity around whether a particular entity falls within the definition of irrigation infrastructure operator and therefore the application of the water charge rules for termination fees. In relation to Joint Water Supply Scheme's (JWSS), the ACCC considers that a JWSS will be likely to meet the definition of an operator where it is incorporated and uses its water service infrastructure for purposes of delivering water for the primary purpose of being used for irrigation. In this way, it will be providing those services to another person. The situation is less clear where a JWSS is not incorporated, even if it provides delivery services to another person who is not a member of that JWSS.

New South Wales Irrigators' Council (NSWIC) submitted that 'under no circumstances should existing contractual relationships be altered by the ACCC'.²⁰⁴ The ACCC acknowledges that private contractual agreements should generally be honoured, however also notes that operators typically exhibit natural monopoly characteristics, the cooperative nature of many operators may introduce coercion and peer pressure, and that there is likely to be significant inequality in the bargaining positions of irrigators and operators. Since existing contracts were entered into in the absence of enforceable rules relating to termination fees that would address any significant inequality in bargaining positions, the ACCC cannot be satisfied that existing contractual arrangements reflect genuine negotiation between operators and irrigators.

²⁰¹ Clause 2(c) of schedule 2 of the Act.

²⁰² This is to include Victorian operators that impose termination fees consistent with the access, exit and termination fee protocol as directed by the ESC. See ESC, *Goulburn–Murray Water determination, water price review 2008–2013*, June 2008, p. 31.

²⁰³ Paragraph 6.18 of the intergovernmental agreement on Murray–Darling Basin reform.

²⁰⁴ NSWIC, draft advice submission, p. 5. The application of the water charge rules for termination fees to existing contractual arrangements is addressed in section 6.1.

Submissions from operators stated that the rules should include a transition period that provides sufficient time for market participants to adjust to new regulatory arrangements.²⁰⁵ The majority of these focused on a three to five year transition period.

By contrast N Rolfe submitted that ‘the cap [on the termination fee multiple] should be introduced as soon as possible’.²⁰⁶ Similarly M Gatacre recommended ‘that the ACCC advises the Minister that the implementation date should be effective immediately... Delaying or post dating the implementation date would create severe financial hardship to all those sellers’.²⁰⁷ D Barclay requested that the ‘ACCC brings forward (to start immediately) the provision that Termination Fees can not be forced on Irrigators’.²⁰⁸

The proposed termination fee rules are not dissimilar to the current regulatory arrangements for exit and termination fees that are within the access, exit and termination fee protocol. The final positions are also relatively simple to understand and apply in practice. Consequently, operators should not require a large amount of time to adjust to them.

Operators typically set annual prices from 1 July each year. To ensure that the regulatory arrangements guiding the imposition of charges by operators do not alter within a single charging period, the ACCC recommends that the water charge rules for termination fees take effect from 1 July 2009.

The ACCC considers that a commencement date for the water charge rules of 1 July 2009²⁰⁹ provides operators with the necessary time to adjust their internal pricing policies and undertake consultation with customers about the changes. A 1 July date also provides sufficient time for the ACCC to inform stakeholders of the rules, and to establish procedures for investigating and enforcing the rules.

In order to remove the uncertainty surrounding what termination fees may apply while the ACCC is in the process of approving existing contracts, the ACCC recommends that the provisions of the water charge rules for termination fees that relate to approvals commence prior to 1 July 2009. The ACCC may then receive applications and make approvals before 1 July 2009. In such cases the early approval of termination fees contained in existing contracts will provide greater certainty to participants about their obligations in the 2009–10 irrigation season.

Box 18

2 Commencement

²⁰⁵ NSWFA, issues paper submission, p. 2-3; MIL, issues paper submission, p. 37; WMI, issues paper submission, p. 25.

²⁰⁶ N Rolfe, draft advice submission, p. 8.

²⁰⁷ M Gatacre, draft advice submission, p. 1.

²⁰⁸ D Barclay, draft advice submission, p. 1.

²⁰⁹ Other than the rules relating to the approval of higher termination fees contained in contracts (see section 6.1) which the ACCC has recommended to have an earlier commencement.

(1) Part 1 and rule 8 commence on the day after these Rules are registered.

(2) The remaining provisions of these Rules commence on *1 July 2009*.

7.3 Monitoring and review

It is generally prudent to monitor any new regulatory arrangements to ensure that they have the intended effect on the behaviour of market participants, and to better understand where participants may need guidance on the intention and application of the new arrangements. The Act states that the ACCC is to monitor compliance with the water charge rules.²¹⁰ The ACCC also recommends a formal review of the water charge rules, including termination fees.²¹¹

The Act states that the details of the ACCC's monitoring program are to be contained in an agreement between the ACCC and the Minister.²¹² This agreement is yet to be made. That said, the ACCC recommends that it would be pertinent for the ACCC to monitor:

- compliance with the rules as part of its enforcement functions
- the implications of the rules for market participants—to provide additional information for the proposed review of the rules.

As stated in section 7.1, the ACCC anticipates a cooperative approach to information-gathering by all parties in the first instance. The ACCC intends to keep reporting requirements to the minimum necessary for fulfilling its functions.

In addition to any ongoing monitoring of the application and effects of the water charge rules for termination fees, the ACCC considers that a formal review of the rules should be conducted. A review may be necessary because of:

- a lack of reliable data on:
 - the extent to which operators face a risk of under-recovery of capital expenditure
 - the extent to which irrigators face a risk of under-recovery of on-farm investment
 - the extent to which operators and irrigators are able to effectively reach negotiated outcomes for these issues.
- a significant degree of uncertainty regarding the long-term impacts of:
 - further liberalisations of water trading
 - extended drought

²¹⁰ Section 95 of the Act.

²¹¹ See section 4.4 of the position paper.

²¹² Section 95(3) of the Act.

- the government's program of water purchases
- the government's program of irrigation infrastructure modernisation.

The timing of any review is influenced by the ability to collect sufficient information. The ACCC considers that any review would require a number of years of information about the impact of the water charge rules for termination fees.

The ACCC recommends beginning a review in 2012 and concluding it in 2013. This allows collection of (up to) four years of data, including two years of data following the expected finalisation of the Basin Plan.²¹³

In response to the draft advice, GMW supported a review²¹⁴ during 2012–13. Conversely, SRI & RGA argued that the review:²¹⁵

should be both sooner and ongoing. It is unclear how long the government water buy back program will continue and until this situation is resolved, there will need to be (an) ongoing review.

In considering timing of the review the ACCC balanced the benefits of having an early review against the lack of data available from holding a review too early. More specifically:

- most submissions favoured having a review as early as possible
- similarly, data over several years is required to assess the effectiveness of the provisions for approving termination fees in contracts (see chapter 6).

The ACCC considers 2012–13 to be the earliest that sufficient data will be available for a review.

²¹³ For more information refer to DEWHA website:
<http://www.environment.gov.au/water/publications/mdb/pubs/mdba-transition.pdf>, accessed on 6 October 2008.

²¹⁴ GMW, draft advice submission, p. 3.

²¹⁵ SRI & RGA, draft advice submission, p. 4.

Appendix A: List of submissions received

A1. Issues paper submissions

The following parties provided submissions on the ACCC's **issues paper** on water charge rules for irrigation infrastructure operators:

Mr D W Sehestedt

Narromine Irrigation Board of Management

Southern Riverina Irrigation and Rice Growers Association of Australia

NSW Murray Wetlands Working Group

South Australian Murray Irrigators

Bourke Shire Council

New South Wales Irrigators' Council

Central Irrigation Trust

Macquarie River Food and Fibre

Mr M Brady

Mr E O Whittle

Goulburn–Murray Water

Coleambally Irrigators Cooperative Limited

Sun Water

The Bondi Group

Minerals Council of Australia

Murrumbidgee Irrigation

Murray Irrigation Limited

NSW Farmers Association

National Water Commission

Messrs P Ferguson and D Leslie

Mr T Loffler

Callandoon Water Board

Western Murray Irrigation

Department of Natural Resources & Water (Qld)

Victorian Farmers Federation

National Farmers Federation

Department of Sustainability & Environment (Vic)

Department of Water, Land, Biodiversity & Conservation (SA)

A2. Position paper submissions

The following parties provided submissions on the ACCC's **position paper** on water charge rules for termination fees:

Central Irrigation Trust

Southern Riverina Irrigators and Rice Growers' Association (joint submission)

Macquarie River Food and Fibre

SunWater

New South Wales Irrigators' Council

Mr J R Rorke

Renmark Irrigation Trust

The Bondi Group

Goulburn–Murray Water

Western Murray Irrigation and Coleambally Irrigation (joint submission)

Trangie–Nevertire Irrigation Scheme

Murrumbidgee Horticultural Council

Mr D Crowhurst

Messrs P Leslie & D Ferguson

Murray Irrigation Limited

National Farmers' Federation

Murrumbidgee Irrigation

South Australian Government

Mr G Doherty

A3. Draft advice submissions

The following parties provided submissions on the ACCC's **draft advice** on water charge rules for termination fees:

Mr N Rolfe

Mr D Star

West Corurgan Private Irrigation District

Murray Valley Water Diverters Advisory Association (NSW)

Southern Riverina Irrigators and Rice Growers' Association (joint submission)

Government of South Australia

Macquarie River Food and Fibre

Mr D Barclay

Goulburn–Murray Water

Western Murray Irrigation

Mr M Gatacre

Trangie–Nevertire Irrigation Scheme

Coleambally Irrigators Cooperative Limited

New South Wales Irrigators' Council

Mr G Falkiner

Murrumbidgee Irrigation

Murray Irrigation Limited

Mr P Leslie and Mr D Ferguson (joint submission)

Victorian Farmers' Federation

Appendix B: Basin water charging objectives and principles

B1. Water charging objectives

The *water charging objectives* are:

- (a) to promote the economically efficient and sustainable use of:
 - (i) water resources; and
 - (ii) water infrastructure assets; and
 - (iii) government resources devoted to the management of water resources; and
- (b) to ensure sufficient revenue streams to allow efficient delivery of the required services; and
- (c) to facilitate the efficient functioning of water markets (including inter-jurisdictional water markets, and in both rural and urban settings); and
- (d) to give effect to the principles of user-pays and achieve pricing transparency in respect of water storage and delivery in irrigation systems and cost recovery for water planning and management; and
- (e) to avoid perverse or unintended pricing outcomes.

B2. Water charging principles

Water storage and delivery principles

- (1) Pricing policies for water storage and delivery in rural systems are to be developed to facilitate efficient water use and trade in water entitlements.
- (2) Water charges are to include a consumption-based component.
- (3) Water charges are to be based on full cost recovery for water services to ensure business viability and avoid monopoly rents, including recovery of environmental externalities where feasible and practical.
- (4) Water charges in the rural water sector are to continue to move towards upper bound pricing where practicable
- (5) In subclause (4):

upper bound pricing means the level at which, to avoid monopoly rents, a water business should not recover more than:

- (a) the operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes; and
 - (b) provision for the cost of asset consumption; and
 - (c) provision for the cost of capital (calculated using a weighted average cost of capital).
- (6) If full cost recovery is unlikely to be achieved and a Community Service Obligation is deemed necessary:
- (a) the size of the subsidy is to be reported publicly; and
 - (b) where practicable, subsidies or Community Service Obligations are to be reduced or eliminated.
- (7) Pricing policies should ensure consistency across sectors and jurisdictions where entitlements are able to be traded.

Cost recovery for planning and management

See ACCC Water Planning and Management Issues Paper

Environmental Externalities

- (1) Market-based mechanisms (such as pricing to account for positive and negative environmental externalities associated with water use) are to be pursued where feasible.
- (2) The cost of environmental externalities is to be included in water charges where found to be feasible.

Benchmarking and efficiency reviews

- (1) Independent and public benchmarking or efficiency reviews of pricing and service quality relevant to regulated water charges is or are to be undertaken based on a nationally consistent framework.
- (2) The costs of operating these benchmark and efficiency review systems are to be met through recovery of regulated water charges

Appendix C: Current arrangements

C1. Governance and regulatory arrangements

Considerable diversity exists in the number, size and ownership arrangements of operators across the Basin. Irrigation networks have been privatised in both New South Wales²¹⁶ and South Australia²¹⁷, but in Victoria and Queensland²¹⁸ the majority of water service infrastructure, including irrigation networks, remains with a small number of government-owned authorities. Operators in the Basin have varying corporate governance arrangements, with those in Victoria and Queensland substantially different from arrangements in New South Wales and South Australia. The types of arrangements with customers also vary within jurisdictions.

In New South Wales, all operators are privately-owned and the majority of the larger operators are non-listed, not-for-profit companies. Many of the operators have a cooperative structure—the member/irrigators are in effect the shareholders in the entity that owns the shared irrigation network.

Similarly, in South Australia the operators are typically private trusts where the irrigators are the members.

In Victoria, five government-owned statutory authorities²¹⁹ provide access services within the Victorian region of the Basin.²²⁰ Victorian operators must submit their corporate plans each year to the responsible Minister to ensure compatibility of their business directions with government policy. One operator, GMW, is a vertically integrated operator providing bulk water services to other operators, as well as to its own downstream operations and industrial and urban customers.²²¹ Lower Murray Water (LMW) is a horizontally integrated operator providing both rural and urban water services.²²²

SUN, which provides access services to almost all Queensland irrigators in the Basin,²²³ has recently changed its structure from a statutory government-owned corporation to a company government-owned corporation. However, under both arrangements, it is accountable to its shareholding Ministers. SUN organises its access services and fees on the basis of local schemes. The delivery of water is supported by contracts with the water storage operator and the infrastructure operator, respectively. The delivery contract with the infrastructure operator (generally SUN) defines the service standards and delivery conditions as well as the rights and payment obligations of the holder.

²¹⁶ Not including assets used for the purpose of providing bulk water, which are under the ownership and control of State Water, a government-owned bulk water supplier.

²¹⁷ The exception is the South Australian Water Corporation (SA Water).

²¹⁸ SUN provides irrigation delivery services to the majority of Queensland irrigators within the Basin.

²¹⁹ Coliban Water, GMW, LMW, FMIT, and GWMW.

²²⁰ Vic Gov, Response to ACCC request for information, 18 February 2008, p. 7.

²²¹ Vic Gov, Response to ACCC request for information, 18 February 2008, p. 5.

²²² LMW, *response to ACCC request for information*, February 2008, p. 6.

²²³ Two exceptions are the small local operations of Yambocully and Callandoon water boards.

Each governance framework presents a somewhat different set of issues for the development of water charge rules that contribute to the Basin water charging objectives and principles. While the irrigation networks constitute ‘natural monopoly’ infrastructure, the extent to which operators extract monopoly rents from their customers may, in part, depend on the governance structure and existing price setting arrangements.

In Victoria, an independent economic regulator, the ESC, is responsible for making determinations about prices and service standards. The ESC’s process is designed to ensure that operators earn a sustainable revenue stream and monopoly rents are avoided. Any community service obligations imposed by government to achieve wider social or environmental policy objectives are transparently reported by the ESC. Where the funding of these obligations is provided by government, the associated expenditure is excluded from the charging base of operators.²²⁴

SUN determines prices for its water supply schemes in consultation with its customers through a three-tiered negotiation process. SUN reports regularly to the Queensland government and, if negotiations fail, the government may intervene to set the level for prices.²²⁵

In New South Wales and South Australia, no substantive government or independent regulatory oversight exists in respect of operators that are privately-owned. It is worth noting that for the privately-owned operators in New South Wales and South Australia, the nexus between service provider and customer, may reduce the incentive to maximise monopoly profits as lower water delivery costs may actually benefit the members’ own downstream irrigation operations.

C2. Charging arrangements of operators

An operator typically provides two main services to its customers: to make available capacity of its irrigation network for the delivery of water to be used in irrigation; and to make available capacity of its irrigation network for the drainage of water previously used in irrigation (access services).

Fees associated with the provision and use of access services generally consist of two components—a volumetric fee and a fixed fee. The two components or ‘parts’ to this charging structure reflect the two cost components faced by operators: fixed and variable costs.

Fixed costs can be associated with the provision of access services (or making capacity available), including the capital financing costs associated with the renewal of the irrigation network. A number of methods exist for allocating fixed costs across network users. The most common is the number or volume of entitlements held, but other options include allocations per hectare, per property, per connection and per service

²²⁴ In its *Regional and rural businesses water plans 2008–13*, draft decision, the ESC has stated that ‘the value of the contribution should be netted off the regulatory asset base to ensure the business does not recover the costs through prices’, p. 76.

²²⁵ Qld Gov, Response to ACCC request for information, 19 February 2008, p. 5.

point. Fixed costs may also vary between districts, reflecting differences in geography, hydrology and differences in the physical characteristics of infrastructure.

Variable costs can be associated with the physical delivery of water (or the use of capacity), including pumping and other costs that vary with the volume of water delivered. For access services, variable costs are generally lower than fixed costs.

In addition to the fixed and volumetric fees for access services, it is common for operators to levy a fee upon the surrendering of a ‘share of’ or an ‘entitlement to’ access to the operator’s irrigation network—a termination fee.

Historically, water access rights were bundled together with the right to a share of the capacity of an operator’s irrigation network. That is, when an irrigator bought or sold a water access right, the irrigator simultaneously bought or sold a water delivery right. A fee levied by an operator on the transfer of a water access right out of the operator’s network or district²²⁶ is referred to as an exit fee while, as noted above, a fee levied by an operator when an irrigator ceases to use (and pay for) access services is referred to as a termination fee.

The MDB Agreement now requires that water delivery rights be unbundled from any water access right and be recognised through a separate, explicit delivery entitlement by a date no later than 30 June 2010.²²⁷ The holder of a delivery entitlement should be able to choose whether to surrender the delivery entitlement and pay the relevant termination fee or continue to hold the delivery entitlement and pay the annual access fee.²²⁸ This has the effect of promoting the trade of water to more highly valued uses and creates tradeable entitlements to irrigation network capacity, where the market price for such a product can be useful in signalling capacity constraints within the irrigation network.

The states are at different stages in giving effect to this agreement. In Victoria, explicit delivery entitlements (or delivery shares) that specify a flow rate and delivery time have been in effect since 1 July 2007.²²⁹ South Australia has enacted legislative provisions²³⁰ to separately recognise delivery entitlements.

In New South Wales, while some operators have created explicit delivery entitlements to comply with the access, exit and termination fee protocol, others either have not or have instituted a practise of requiring the one-for-one termination of delivery entitlements when the corresponding water access right is transferred out of the operator’s irrigation district.²³¹

²²⁶ Excluding any fee associated with the costs of processing that transfer.

²²⁷ See clauses 6(1) and 6(2) of the access, exit and termination fee protocol.

²²⁸ See clause 11(3) of the access, exit and termination fee protocol.

²²⁹ Minister’s directions on water entitlements made under s. 228 of the *Water Act 1989* (Vic), made on 20 June 2006 and coming into force on 1 July 2007.

²³⁰ Part 3, Division 5 of *Natural Resources Management (Water Resources and Other Matters) Amendment Act 2004* (SA).

²³¹ MIL, *Murray Irrigation Limited water and delivery entitlements structure, transfer rules policy and charges policy*, April 2008.

In Queensland²³², the delivery of water is supported by contracts with the water storage operator and the infrastructure operator respectively. The delivery contract with the infrastructure operator (generally SUN) defines certain conditions, including a fee for terminating the delivery contract. It appears that delivery contracts entered into in Queensland are issued and managed separately from the irrigator's water access right.²³³

According to the access, exit and termination fee protocol, termination fees are to be set at no more than 15x the actual access fee or the shadow access fee. The ACCC has estimated that a termination fee multiple of 15x represents approximately 29 years of discounted future access fees.²³⁴ The access, exit and termination fee protocol states that no exit fees should be levied.

C3. The access, exit and termination fee protocol

In April 2007 the access, exit and termination fee protocol was agreed by jurisdictional governments, which addresses:

- when a termination fee can be applied
- the structure and form of the termination fee
- the amount of the termination fee
- adjustments to the termination fee.

The access, exit and termination fee protocol states that no exit fees should be levied.

Table 4 compares the provisions of the access exit and termination fee protocol relating to termination fees to the ACCC's final advice on water charge rules for termination fees.

Table 4 – Comparisons to the access, exit and termination fee protocol

Access, exit and termination fee protocol	ACCC final advice on water charge rules for termination fees
Holders of delivery entitlements should be able to surrender or all of that entitlement to the relevant infrastructure operator upon payment of any termination fee.	Comparable principle adopted in water charge rules for termination fees. See chapter 2. See rule 6 of the recommended rules.

²³² The access, exit and termination fee protocol applies to the upper River Murray and the River Murray in South Australia and to regulated reaches of the Goulburn, Campaspe, Loddon and Murrumbidgee systems.

²³³ Water access entitlements are termed water allocations in Queensland.

²³⁴ Using a 5 per cent real discount rate.

<p>The holder of a delivery entitlement should be able to choose whether to surrender the delivery entitlement and pay the relevant termination fee, or to continue to hold the delivery entitlement and to pay the annual access fee.</p>	<p>Comparable principle adopted in water charge rules for termination fees.</p> <p>See section 2.1.</p> <p>See rule 6 of the recommended rules.</p>
<p>A termination fee should be calculated by reference to the annual access fee actually levied at the time of termination.</p>	<p>Comparable principle adopted in water charge rules for termination fees.</p> <p>See section 2.2.</p> <p>See rule 7 of the recommended rules.</p>
<p>If an infrastructure operator calculates access fees other than in accordance with clause 10 of the protocol, a termination fee may be calculated by reference to a shadow access fee until 30 June 2010.</p>	<p>The ACCC recommends that shadow access fees not be used in calculating termination fees. Since the water charge rules for termination fees are unlikely to come into effect before 1 July 2009, this will only affect on operators for the 2009–10 financial year.</p> <p>See section 4.2.</p> <p>See rule 7 of the recommended rules.</p>
<p>A termination fee should be a multiple of 15 times the annual fixed access fee (or shadow access fee) levied on the relevant delivery entitlement at the date it is surrendered.</p>	<p>The ACCC recommends that termination fees be calculated as a multiple of 10x the total network access charge levied at the time of termination.</p> <p>Higher termination fees where contained in contracts and are in relation to major investment may be approved by the ACCC.</p> <p>See chapter 3.</p> <p>See rule 7 of the recommended rules.</p>
<p>When calculating termination fees, an infrastructure operator should deduct any future fixed costs of providing continuing core irrigation water delivery services through the infrastructure operator’s network that will be directly and immediately avoided as a result of the surrender of a delivery entitlement.</p>	<p>The ACCC recommends that termination fees not be adjusted for avoided fixed costs. Avoided fixed costs have been partially considered in the level of the termination fee multiple.</p> <p>See section 5.2.</p> <p>See rule 7 of the recommended rules.</p>

<p>An infrastructure operator should only include an allowance for income tax payable by the infrastructure operator when calculating any termination fee to the extent that the infrastructure operator can demonstrate that future fixed costs will be incurred and will not be deducted at a time which is reasonably contemporaneous with the imposition of income tax on the termination fee.</p>	<p>The ACCC recommends that termination fees not be adjusted for income tax.</p> <p>See section 5.1.</p> <p>See rule 7 of the recommended rules.</p>
<p>The multiple (15) should be reviewed by State Contracting Governments, in consultation with the ACCC, before 1 January 2009.</p>	<p>The ACCC has considered and reviewed the relevant provisions of the access, exit and termination fee protocol in providing advice to the Minister on water charge rules for termination fees.</p> <p>The ACCC also recommends that the water charge rules (including the rules relating to termination fees) be reviewed by no later than 2013.</p> <p>See section 7.3.</p>

Appendix D: Illustrative examples of the economic effects of termination fees

Box 19 Effect of termination fees on infrastructure rationalisation

(illustrative purposes only)

Consider an operator that supplies three customers: irrigator A, irrigator B and irrigator C at a total ongoing fixed cost in NPV terms of \$150, with a uniform fixed access fees per irrigator in NPV terms (over the economic life of the network) and a termination fee equal to the NPV of fixed access fees (\$50). Suppose the total fixed cost of the operator can only be changed by shutting-down completely. Termination by one or two irrigators will not alter the total fixed cost.

Also consider that, before paying delivery charges, all three irrigators received (in NPV terms) \$60 of benefit from irrigation activities, but that after some exogenous event (for example, a reduction in commodity prices), irrigators B and C now both receive \$30 benefit from irrigation activities while irrigator A still receives \$60 benefit from irrigation activities (before paying delivery charges).

Initially, the total benefit derived before access fees was \$180 while the cost of providing access services was \$150. Since the total benefit outweighed the cost ($\$180 > \150), it was initially economically efficient for the operator to continue to provide access services to all three customers.

However, following the exogenous event, the total benefit before access fees from irrigation is no longer greater than the cost of providing access ($\$120 < \150). It would now be economically efficient for the network to be shut down.

But irrigators B and C may be unlikely to terminate access. Because irrigators B and C are indifferent between paying a termination fee and continuing to pay access fees (as they equate in NPV terms), they may have no impetus to terminate. This occurs even though they derive less benefit from being connected to the irrigation network than the fixed access fees that they incur when connected ($\$30 < \50).

A termination fee adjusted to a level less than \$50 will provide an incentive for irrigators B and C to terminate.

The operator may be able to induce new customers where the total benefit derived from access (the value to irrigator A and new customers) exceeds \$150, and/or reconfigure the network such that the network remains economically viable in the long-run (i.e. the total fixed cost reduces below \$120).

Box 20 Effect of unavoidable ongoing costs on irrigation decisions

(illustrative purposes only)

Example 1

Suppose an operator incurs ongoing fixed costs for maintaining its irrigation network that are not affected by the level of water delivery rights in the network (that is, terminating or creating water delivery rights does not alter the ongoing fixed maintenance costs).

Suppose that an irrigator currently connected to the operator's network earns a return *before paying their water delivery charges* of \$100, and that water delivery charge for that irrigator is \$80. The irrigator then privately receives \$20 of net benefit from undertaking their irrigation activities.

Now suppose that the irrigator could earn a return of \$30 through non-irrigated (dryland) activities. Without a termination fee, the irrigator could terminate their water delivery rights and switch from irrigated to dryland activities, since their private return would be greater ($\$30 > \20).

However, the irrigated activity is far more productive than the dryland activity ($\$100 > \30) and the unavoidable ongoing cost of maintaining the irrigation network (that the irrigator contributes to through the \$80 water delivery charge) is re-distributed across remaining irrigators. From society's perspective, efficiency is achieved when the productivity of water and land use is maximised. The irrigator's land use decision would be privately optimal but reduces efficiency overall.

Example 2

Now suppose that a termination fee of \$80 is imposed. The return to the irrigator of irrigated activities remains $\$100 - \$80 = \$20$. But now the return to the irrigator from switching to non-irrigated activities is $\$30 - \$80 = -\$50$. In this case, the irrigator will not terminate their water delivery rights, and will remain in the more productive irrigated activity.

Example 3

Suppose instead that an irrigator currently connected to the operator's network earns a return *before paying their water delivery charges* of \$90, that water delivery charge for that irrigator is \$50, and that there is a termination fee of \$65. The irrigator then privately receives \$40 of net benefit from undertaking their irrigation activities.

Now suppose that the irrigator could earn a return of \$100 through non-irrigated (dryland) activities. The irrigator is more productive in non-irrigated activities than in irrigated activities ($\$100 > \90). However, because the termination fee is greater than the water delivery charge ($\$65 > \50) the net return to the irrigator from non-irrigated activities is less than the net return from irrigated activities ($\$100 - \$65 = \$35 < \$90 - \$50 = \40).

In this case, the irrigator will not terminate and switch to non-irrigated activities even though it would be more efficient for them to do so.