

# *Australian Water: A Unique Investable Asset*

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Blue Sky Water Partners



**Investment design & fund raising specialists**



# Introduction

*There is a globally unique opportunity to derive an investment return from the acquisition and management of Australian Water Entitlements.*

As one of the driest continents on the planet, water plays an important role in Australia's economic, political, social and environmental landscape.

While the issue of water scarcity and its management is a global one, it has been addressed more proactively in Australia than just about any other country in the world. The Federal and State Governments have cooperated to establish a national water market designed to optimise economic, social and environmental outcomes by facilitating the transfer of water amongst and between water users and non-users.

As a result, Australia is one of the few countries in the world with a robust legal and regulatory framework that allows investment returns to flow from the acquisition and management of Water Entitlements.

With an estimated capitalisation in excess of A\$25 billion the opportunity is meaningful for institutional investors. As providers of patient, long-term capital, investors in the Australian Water Entitlements Fund will fulfil an enduring market need, consistent with the principles of Australia's National Water Initiative. Namely, providing liquidity to Australia's water markets and helping facilitate the movement of water to its highest economic use.

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# The Role of Government - Establishing and Regulating a Market for Water

*The National Water Initiative seeks to optimise economic, social and environmental outcomes via the establishment of a national water market that facilitates the transfer of water amongst and between water users and non-users.*

The effective management of Australia's water resources is a key priority for the Federal and State Governments. The Federal Government provides national leadership on water reform.

## The National Water Initiative 2004

The National Water Initiative (NWI) is Australia's enduring blueprint for water reform and represents a shared commitment by Australian Federal and State Governments to increase the efficiency of water use, leading to greater certainty for investment and productivity, for rural and urban communities, and for the environment. Through it, Australian Governments have agreed on actions to achieve a more cohesive national approach to the way Australia manages, measures, plans for, prices, and trades water.

## Water for the Future 2008

Water for the Future, the Federal Government's A\$12.9 billion strategy, is built on four key priorities:

- Taking action on climate change;
- Using water wisely;
- Securing water supplies; and
- Supporting healthy rivers

As part of this initiative the Federal Government is developing a Basin Plan to establish Sustainable Diversion Limits in the Murray Darling Basin. These Sustainable Diversion Limits will limit the amount of surface and groundwater than can be taken from the Basin for consumption.

## The Water Act 2007 (Cth)

The Water Act 2007 (Cth) and the Water Amendment Act 2008 (Cth) established the Murray Darling Basin Authority (MDBA) as the single body responsible for ensuring that the Basin's water resources are managed in an integrated and sustainable way. The MDBA oversees water planning by considering the Basin as a whole, rather than state-by-state.

## Restoring the Balance in the Murray Darling Basin Program

This \$3.1 billion Federal Government program seeks to restore the balance in the Murray Darling Basin through the buy-back of Water Entitlements from willing sellers. These Water Entitlements are used for environmental purposes to protect and restore the health of the Basin's rivers, wetlands and floodplains. As at 28 February 2011, the Federal Government had deployed \$1.6 billion, acquiring a total of 965 GL<sup>1</sup> of Water Entitlements.

<sup>1</sup>A Gigalitre (GL) = 1000ML = approximately twice the volume of Sydney Harbour .

# The Murray Darling Basin Plan

*Over the past 20 years the regulatory framework of the MDB has continually evolved, however the aims have remained consistent.*

The MDBA's draft Basin Plan was released in early October 2010. It is a comprehensive body of work including extensive scientific analysis of the Basin's ecology, identification of key environmental assets and key ecosystem functions and a quantification of their water requirements. It includes detailed hydrological modelling and an assessment of social and economic impacts of meeting environmental watering requirements. The proposed Basin Plan sets out a range of Sustainable Diversion Limits (SDLs) which represent the long term average annual volumes of water which can be taken for consumptive use for both surface and groundwater. In general, the draft Basin Plan recommends reductions to current levels of water extraction in the range of 27-37% across most river systems of the Basin.

The draft Basin Plan is now open for community consultation. Considering the extent of the proposed reductions to water extraction, the initial feedback from irrigators and Basin communities has been highly emotive. As a consequence, the Federal Government has committed to conduct a parliamentary inquiry into the social and economic impacts of the proposed Plan, as well as the wording of the Water Act to ensure a triple bottom line outcome is determined giving equal weights to environmental, social and economic outcomes. The inquiries are expected to report in April 2011.

While the final level of sustainable diversion limits are yet to be determined, it is now anticipated the final figure for reductions will be close to 2,000GL, representing a 14% reduction in the current diversion limits.

The long term aim of the Basin Plan is to ensure the Murray Darling Basin remains a healthy river system capable of supporting its natural environment as well as irrigated agriculture. One of the specific aims of the Basin Plan is to facilitate a properly functioning and enhanced water market by ensuring market rules are consistent across all Basin States; access to information is improved; buyers and sellers can operate with confidence with minimal administrative delay; and water is allowed to reach its higher value use thereby helping to optimise economic, social and environmental outcomes within the Basin.

Regardless of the final outcomes of the Basin Plan within the range indicated by the draft Plan (or lower), the unequivocal commitment by the Federal Government (and Opposition parties, and environmental lobby) to purchase water for the environment will remove much of the uncertainty which prevailed in the market since 2007/08 and increasingly so in 2009/10.

# Water as an Asset Class – Characteristics

## *Water as an asset class:*

- *Transferable*
- *Valued at Market*
- *Divisible*
- *Fungible*

Rather than allowing the unlimited extraction of water from communal sources (eg. rivers), the various Governments Authorities regulate its use via a quota or entitlement system.

A Water Entitlement is an ongoing legal entitlement to exclusive access to a share of water from a specified water resource. The owner of a Water Entitlement may extract water from the specified resource in accordance with the terms and conditions set out in the relevant water resource plan.

Water Entitlements are recorded in a publicly accessible Government controlled register. They are exclusive, separate from land title and legally enforceable. Water Entitlements can be bought, sold and leased.<sup>2</sup>

A Water Entitlement does not provide a guaranteed volume of water to the owner. Rather it gives the owner the right to access an annual allocation of water from the specified water resource. A Water Allocation is the annual volume of water made available under a Water Entitlement and may change from year to year. It is prescribed by the relevant Water Authority and typically expressed as a percentage of the Water Entitlement volume. Like Water Entitlements, Water Allocations can also be bought and sold.

Extracting water from a regulated resource without a Water Entitlement or contrary to the terms of the Water Entitlement and its associated Water Allocation is an offence to which significant penalties apply.

Water Entitlements and Water Allocations have the following characteristics:

**Transferable:** Water Entitlements and annual Water Allocations can be bought, and sold within defined geographic regions. Water Entitlements can be transferred via private treaty, brokers and exchanges.

**Valued at Market:** Valuations of traded Water Entitlements can be obtained monthly following disclosure by relevant water authorities. Valuations of Water Allocations are available on a daily basis.

**Divisible:** Water Entitlements can be subdivided or amalgamated within their specified consumptive pool.

**Fungible:** Water Entitlements are freely interchangeable within a specified consumptive pool.

**Classified by Reliability:** Water Entitlements are assigned different levels of reliability or security. Reliability is defined as the frequency with which water allocated under a Water Entitlement can be supplied in full. For example, a high reliability Water Entitlement may receive a 100% Water Allocation during all but the most severe droughts.

<sup>2</sup> The terminology of the Australian water market does differ from State to State. In most States, Water Entitlements are known as a Water Licence, Water Access Licence or Water Share.

# The Australian Water Market

*The Australian water market comprises 28 million ML of surface and ground water, with an estimated value in excess of \$25 billion.*

The Australian Water Entitlement market comprises approximately 28 million megalitres (ML)<sup>3</sup> of surface and groundwater with an estimated value in excess of A\$25 billion.<sup>4</sup> Figure 1 shows the distribution of surface and groundwater across the States and Territories of Australia.

The Murray Darling Basin is the largest single basin and consequently where Australia's most sophisticated and liquid water trading regime exists. Water Entitlements and Water Allocations are transferable across vast distances, within and between river systems. The Water Entitlement market in the Murray Darling Basin has an estimated size of 15 million ML with an estimated value in excess of A\$18 billion. The Murray-Darling Basin generates over A\$15 billion of agricultural production per year.<sup>5</sup>

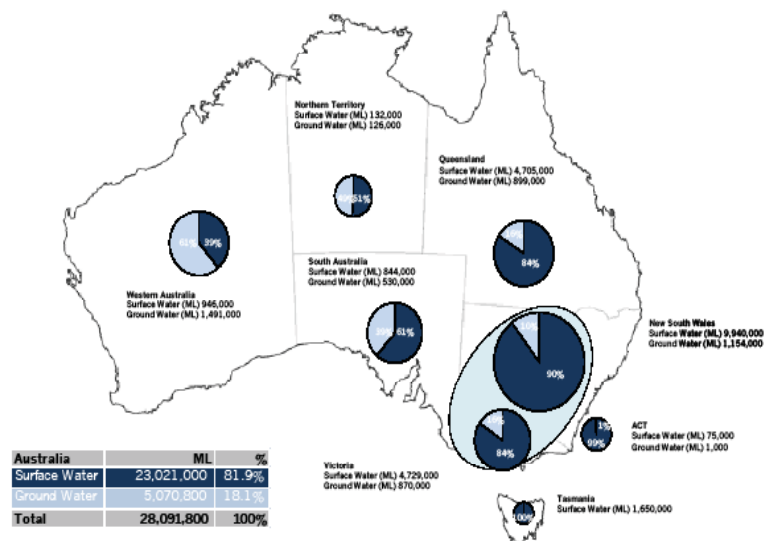


Figure 1: Distribution of Australian surface and groundwater Entitlements<sup>6</sup>

Water Entitlements are traded via an established network of water exchanges, government matching systems, specialist water brokers and rural real estate agents.

<sup>3</sup> 1 Megalitre (ML) = 1 million litres [equivalent to half an Olympic sized swimming pool].

<sup>4</sup> BSWP analysis of relevant state water registers and legislation, as at 31 March 2011.

<sup>5</sup> ABS, 4610: Water and the Murray Darling Basin – A statistical profile - 2005-2006,

<sup>6</sup> Australian Water Trading Report 2008-09, ABS, National Water Commission.

# Australian Water – A Significant Opportunity for Institutional Investors

*Water Entitlements are relatively uncorrelated with traditional assets, with climatic conditions the primary driver of short-term returns.*

The Australian Government's focus on water reform combined with the growing demands placed on Australia's limited water supply, has led to the establishment of a national water market with all the characteristics of an institutional grade investment.

#### Economic value associated with resource scarcity

Water has a market price that reflects supply and demand. The cost of water is a defined input into the calculation of the cost of production.

#### Identifiable and deliverable physical asset

Water is a physical asset that can be identified, measured and traded with certainty. There is no derivative market for Water Entitlements and Water Allocations are physically delivered.

#### Robust legal system defining and governing asset ownership and transfer

The Australian water market is underpinned by a robust legal and regulatory framework with respect to their rights and obligations of market participants.

#### Political support at State and Federal level for an efficient national market

The National Water Initiative 2004 reflects the coordinated efforts of State, Territory and Federal Governments to expand the trade in water.

#### Established and liquid markets

The Australian water market is sufficiently liquid to accommodate the ongoing deployment and divestment of large volumes of capital.

#### Diverse market spanning numerous national water resources

A system of regulated trade across Australian State and Territory creates the ability to construct a suitably diversified portfolio.

#### Combination of capital growth and income returns

While the value of Water Entitlements fluctuates, the long term trend has shown relatively consistent capital growth in the order of 8-12%<sup>7</sup> pa over the past 10 years. This combines with income earned from trading annual Water Allocations (in the order of 4-8%<sup>8</sup> pa).

Importantly, climatic conditions are the primary driver of short-term returns from Water Entitlements. Water Entitlements therefore, have a return profile that is relatively uncorrelated with traditional asset classes, making it one of the few available asset classes to provide a true source of alternative beta.

<sup>7</sup> Blue Sky Water Partners independent industry research

<sup>8</sup> Ibid