

Droughts, Deluges, and (River) Diversions: Valuing Market-Based Water Reallocation Rafey, W, 2023

Dongchen He

Environmental Reading Group

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Research Question

This paper studies

- value of water
- value of water trade and reallocation

By

- recovering parameters from an agricultural production model
- conducting a counterfactual analysis

Firm \times Year \times Crop Panel Data, from 2007-2015

- Survey on water trading in the southern Murray-Darling Basin (sSMB), water ownership, input choice, output levels
- Australian Bureau of Meteorology (BOM), rainfall, temperature, evaporation
- state government: regulatory records of regional water allocation caps
- Murray-Darling Basin Authority (MDBA): water trading data on transaction prices and trade flows

Summary statistics

TABLE 1—WATER RIGHTS, TRADING, AND PRICES

	$N \times T$	Mean	St. dev.	q10	q25	q50	q75	q90
<i>Panel</i>								
Total irrigation, ML	2,059	679.0	1,377.1	18	70	210	641.9	1,564.6
Permanent rights, nominal ML	2,059	876.4	1,246.6	74.8	160	406	1,084	2,257.1
Permanent rights, realized ML	2,059	519.1	815.9	31.5	84	231.8	600.5	1,268.9
Buy annual water, $\{0, 1\}$	2,059	0.321	0.467	0	0	0	1	1
Volume bought, ML	661	288.7	462.2	20	40	100	320	736
Sell annual water, $\{0, 1\}$	2,059	0.199	0.399	0	0	0	0	1
Volume sold, ML	409	135.3	155.7	20	42	90	160	300
Buy entitlements, $\{0, 1\}$	976	0.092	0.289	0	0	0	0	0
Entitlements bought, nominal ML	90	251.7	528.4	1.9	8.5	50	250.2	522.5
Sell entitlements, $\{0, 1\}$	976	0.154	0.361	0	0	0	0	1
Entitlements sold, nominal ML	150	298.2	499.9	2.9	20	130.5	356.8	702.5
<i>Within</i>								
Ever trade annual water rights, $\{0, 1\}$	1,094	0.600	0.490	0	0	1	1	1
Ever buy annual water rights, $\{0, 1\}$	1,094	0.407	0.491	0	0	0	1	1
Ever sell annual water rights, $\{0, 1\}$	1,094	0.271	0.444	0	0	0	1	1
Ever buy and ever sell, $\{0, 1\}$	1,094	0.078	0.268	0	0	0	0	0
Annual trade frequency	656	0.829	0.248	0.500	0.600	1	1	1
Annual buy frequency	656	0.535	0.432	0	0	0.500	1	1
Annual sell frequency	656	0.349	0.434	0	0	0	1	1
Annual buy and sell frequency	656	0.055	0.204	0	0	0	0	0
<i>Market</i>								
Annual regional water price, AU\$/ML	2,059	234.5	198.9	24.6	55.0	160.3	338.7	621.9
Transaction-level water price, AU\$/ML	80,599	227.3	252.8	40	62	123	309	500
Transaction-level volume, ML	80,599	100.8	275.3	7	15	40	100	200

Reduce Form Evidence

TABLE 2—ANNUAL WATER TRADING DECISIONS AND RAINFALL

	Dependent variable: Buy, $\mathbf{1}\{\Delta_{it} > 0\}$			
	(1)	(2)	(3)	(4)
<i>Panel A. Annual purchases</i>				
$\ln(\text{net_rainfall}_{it})$	−0.162 (0.032)	−0.059 (0.034)	0.00002 (0.035)	−0.143 (0.050)
$\ln(\text{water_endowment}_{it})$	0.006 (0.010)	0.019 (0.010)	0.022 (0.010)	−0.080 (0.026)
Year fixed effects	✓	✓	✓	✓
Region fixed effects		✓	✓	
Region × year fixed effects			✓	
Farm fixed effects				✓
Observations	2,059	2,059	2,059	2,059
Adjusted R^2	0.111	0.139	0.184	0.397
<i>Panel B. Annual sales</i>				
$\ln(\text{net_rainfall}_{it})$	0.141 (0.030)	0.029 (0.031)	−0.00003 (0.032)	0.063 (0.037)
$\ln(\text{water_endowment}_{it})$	0.040 (0.009)	0.026 (0.009)	0.023 (0.009)	0.044 (0.023)
Year fixed effects	✓	✓	✓	✓
Region fixed effects		✓	✓	
Region × year fixed effects			✓	
Farm fixed effects				✓
Observations	2,059	2,059	2,059	2,059
Adjusted R^2	0.084	0.126	0.165	0.459

Model

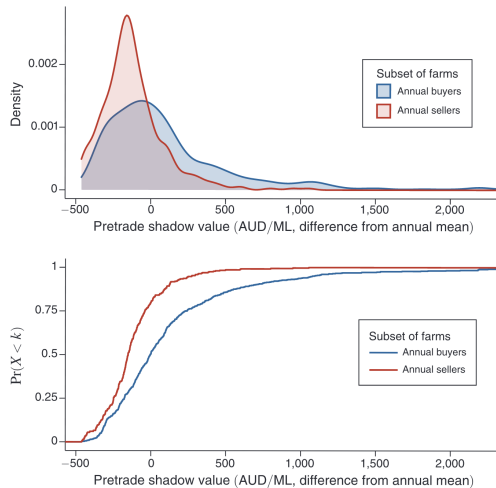
- In year t , firm i produces crop c for hectares of land K_{ict} , with irrigation volumes W_{ict} , and other inputs X_{ict} including labor and total materials. Effective rain water is $R_{ict} = (E_{ict}^R - E_{ict}^V)K_{ict}$.
- Output is given by

$$\begin{aligned} Q_{ict} &= e^{\omega_{ict} + \varepsilon_{ict}} F_c(W_{ict}, X_{ict}, K_{ict}, R_{ict}) \\ &\equiv e^{\omega_{ict} + \varepsilon_{ict}} \left[\alpha_c (W_{ict} + \vartheta_c R_{ict})^{\frac{\sigma_c - 1}{\sigma_c}} + (1 - \alpha_c) K_{ict}^{\frac{\sigma_c - 1}{\sigma_c}} \right]^{\frac{\sigma_c}{\sigma_c - 1} \beta_c w} \prod_{j \in \{L, M\}} (X_{ict}^j)^{\beta_{cj}}, \end{aligned}$$

Estimation Results

	Perennial (1)	Annual irrigated (2)	Annual nonirrigated (3)	Dairy (4)
<i>Irrigation</i>				
Average irrigation-output elasticity $E\left[\frac{\partial f_c}{\partial w}\right]$	0.246 (0.037)	0.206 (0.029)	0.230 (0.061)	0.164 (0.051)
Interquartile range of $\frac{\partial f_c}{\partial w}$ across i, t	[0.207, 0.301]	[0.151, 0.265]	[0.222, 0.240]	[0.104, 0.209]
Tenth to ninetyeth percentile range	[0.141, 0.326]	[0.087, 0.297]	[0.215, 0.245]	[0.075, 0.263]
<i>Water-land aggregator</i>				
Scale coefficient, β_{EW}	0.631 (0.047)	0.526 (0.070)	0.311 (0.097)	0.782 (0.043)
Irrigation share, α_c	0.599 (0.046)	0.513 (0.016)	—	0.385 (0.125)
Land share, $1 - \alpha_c$	0.401 (0.046)	0.487 (0.016)	0.409 (0.007)	
Rainwater coefficient, ϑ_c	1.081 (0.151)	1.048 (0.163)	0.591 (0.007)	0.148 (0.245)
Elasticity of substitution, σ_c	1.575 (0.199)	1.451 (0.218)	3.211 (1.137)	
<i>Other factors</i>				
Labor elasticity, β_{cL}	0.352 (0.016)	0.201 (0.015)	0.335 (0.027)	0.147 (0.007)
Materials elasticity, β_{cM}	0.186 (0.008)	0.404 (0.021)	0.558 (0.030)	0.110 (0.003)
Feed share, α_F				0.615 (0.125)
Pasture-feed elasticity of substitution, σ_F				3.331 (2.161)
Returns to scale, $\sum_j \beta_{cj}$	1.169 (0.050)	1.131 (0.081)	1.204 (0.088)	1.039 (0.043)
J-statistic	0.969	1.103	1.456	1.004
Adjusted R^2	0.807	0.797	0.802	0.876
Observations	510	170	208	254

Shadow Value

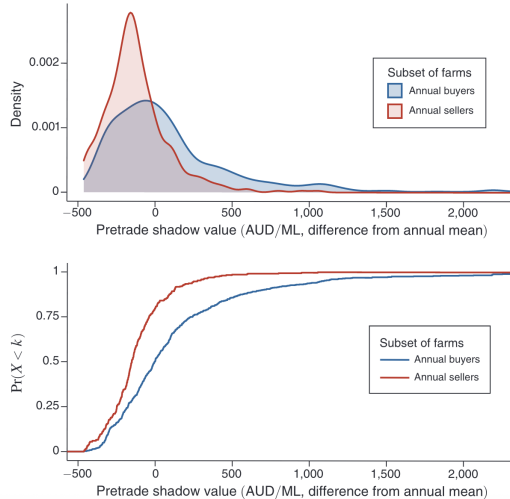


Trade from Low to High

TABLE 4—WATER TRADING DECISIONS AND ESTIMATED PRODUCTIVITY

	<i>Dependent variable:</i>							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
<i>Panel A. Buy annual allocations</i>								
<i>Productivity, $\hat{\omega}_{it}$</i>	0.059 (0.019)		0.071 (0.020)		0.069 (0.018)		0.078 (0.030)	
<i>Productivity innovation, $\hat{\xi}_{it}$</i>		0.086 (0.028)		0.102 (0.030)		0.078 (0.028)		0.147 (0.039)
<i>Lagged productivity, $\hat{\omega}_{i,t-1}$</i>		0.031 (0.027)		0.045 (0.028)		0.044 (0.025)		0.065 (0.042)
<i>Panel B. Sell annual allocations</i>								
<i>Productivity, $\hat{\omega}_{it}$</i>	-0.032 (0.018)		-0.033 (0.018)		-0.036 (0.018)		-0.012 (0.026)	
<i>Productivity innovation, $\hat{\xi}_{it}$</i>		-0.039 (0.029)		-0.029 (0.030)		-0.016 (0.031)		-0.038 (0.040)
<i>Lagged productivity, $\hat{\omega}_{i,t-1}$</i>		-0.053 (0.023)		-0.032 (0.024)		-0.037 (0.022)		-0.051 (0.044)
Year fixed effects	✓	✓	✓	✓	✓	✓	✓	✓
Region fixed effects			✓	✓	✓	✓		
Region \times year fixed effects					✓	✓		
Farm fixed effects							✓	✓
Observations	2,059	976	2,059	976	2,059	976	2,059	976
Adjusted R^2	0.116	0.148	0.146	0.181	0.190	0.236	0.401	0.443

Marginal Value of Trade



Gains from Trade I

- First, calculate pre-trade irrigation $W_{ict}^a = W_{ict} - \Delta_{ict}$,
- Then, calculate profit

$$\Pi_{it}(W_{it}) = \max_{X_{it}} \sum_c P_{ict} e^{\omega_{ict}} F_c(W_{ict}, X_{ict}, K_{ict}, R_{ict}) - P_{X,it} \cdot X_{ict} - \Gamma_{it}^W(W_{it})$$

, and profit from gain is

$$GFT_t = i \sum_i \Pi_{it}(W_{it}) - i \sum_i \Pi_{it}(W_{it}^a)$$

, then calculate the sum of discounted value over 2007-2015

$$GFT = \sum_t \delta_t GFT_t$$

Gains from Trade II

$GFT = 2.3$ billion AUD.

TABLE 5—REALIZED GAINS FROM WATER TRADING

	Gains from trade			Reallocation	
	Percent	Percent, traders	AUD/ML	Realloc (percent)	Traders (percent)
Annual	0.051 [0.016, 0.071]	0.091 [0.037, 0.127]	338.52 [−21.23, 467.53]	0.133 [0.117, 0.148]	0.51 [0.48, 0.53]

Heterogeneity in Gains from Trade

See paper