



Audit of Water Trading Function

SunWater

November 2010

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1. Introduction

SunWater has commissioned BDO to carry out an independent audit of SunWater's water trader function. This report is the second such review to be carried out.

In Queensland, three types of water trading are available:

1. permanent trades of water allocations and interim water allocations
2. leases of water allocations
3. seasonal assignment of water available under a water entitlement (also called a temporary allocation or trade).

Our review relates to how SunWater facilitates the market in seasonal assignments of water. It has done so by outsourcing the water trader function to Psi-Delta Pty Ltd, who provide advice on water marketing, and who use Elders retail network to match sellers and buyers of seasonal assignments.

1.1 Objective

The objective of the audit is to independently assess whether SunWater's water trading activities and arrangements comply with its obligations under the Water Trading Code of Conduct.

Code of Conduct

In January 2007, SunWater issued a "Water Trading Code of Conduct" to give buyers confidence that it is acting with integrity and thereby helping to ensure an effective water market.

A revised Code was issued in October 2010 – the main change being to take up the recommendation in the previous audit to modify the Code to reflect the fact that the Water Trader function was outsourced, rather than being carried out internally.

The key features of the Code are:

- **Market Facilitation and Education**
 - provision of timely and relevant information on allocations, new or augmented infrastructure, volumes and prices, through the SunWater website or that of DNR (now part of the Department of Environment and Resource Management).
- **Transparent Trading Processes**
 - publication of the volume and timing of water allocations that SunWater will trade and whether they will be released by permanent transfer, term allocation or temporary transfer.
- **Pricing**
 - trading can take place through a public exchange, by tender or auction or through direct negotiation with customers through the SunWater broker.

- no price discrimination for the same product delivered at the same time.
- **Approval of Trades** – for seasonal assignments:
 - no discrimination between those involving customers and SunWater.
 - approved in accordance with criteria in temporary trade application forms on SunWater’s website.
- **Disclosure** – standard water delivery and trading contracts to be on SunWater’s website.
- **Compliance**
 - SunWater to maintain procedures to ensure compliance with the Code.
 - an annual audit by an independent external party to report on SunWater’s compliance.
- **Ring-fencing** – ensuring the water trader only has access to market information that is available to every other market participant.
- **Dispute Resolution** - customer access to a binding process.
- **Breaches** – to be reported immediately to Queensland Treasury, investigated by an independent body, and, if the Code has been breached, the nature and resolution of the breach to be disclosed in SunWater’s annual report.

A full copy of the revised Code of Conduct (at October 2010) is at Appendix 1.

1.2 Deliverable

The deliverable from the review is a report which:

1. identifies the adequacy of internal procedures to ensure compliance with the Code of Conduct;
2. assesses actual compliance, including:
 - an assessment of the current internal mechanisms associated with the protection of confidential information;
 - an assessment of the current internal mechanisms associated with the disclosure of market information;
 - an assessment of the non-discriminatory approval of water trades; and
3. provides recommendations on areas in which SunWater’s internal mechanisms and procedures can be improved.

2. Background

2.1 National Water Initiative

The 2006 *National Water Initiative Water Trading Study* conducted by PWC for the Department of the Prime Minister and Cabinet assessed the need for market supervision and the enforcement of trading rules in the emerging water market in Australia. The study recommended that:

Processes for managing trades and the entitlement registers should be subject to a regular audit program to ensure the internal controls around these processes are adequate to [ensure] compliance with trading and entitlement rules.

For example, arrangements should be introduced to ensure the operational staff who manage trade are appropriately 'ring-fenced' from decisions that are likely to impact market process and are unable to use any 'inside information' for personal gain.

Tools that govern the conduct of market intermediaries, such as codes of conduct, accreditation or licensing in the sector, are not required at the present time. However their need should be reviewed periodically.

The National Water Commission carried out a biennial assessment to assess progress in implementing the National Water Initiative. It recently issued a discussion paper seeking feedback for the 2011 Biennial Review, due to be released in mid-2011. The 2009 Biennial Review found that:

The level of confidence in market intermediaries is critical to the continued growth and efficient operations of water markets. The Commission recognises that significant efforts have been made to improve confidence in market intermediaries, in particular through the provision of better information about rights and obligations under consumer protection legislation by relevant authorities (such as the ACCC). While the Commission is concerned about reported incidents of misconduct, and acknowledges arguments in favour of regulation from some market participants, there is not yet a compelling case for industry-specific regulation of market intermediaries beyond the generally available trade practices and consumer protection regulations.

2.2 NWC Risk Assessment

The Commission based this finding partly on a 2007 report by the Allen Consulting Group *Improving market confidence in water intermediaries* which discovered a small proportion of brokers in some locations engaging in inappropriate and possibly misleading behaviour with the potential to harm traders' interests. However, it found that the risk of significant consumer harm is not large due to broader market conditions.

Consultations by the Allen Consulting Group did not reveal any significant problems with the conduct of exchanges in their direct dealings with traders, but it did note some issues with the conduct of exchanges and brokers in their dealings with approvals authorities, principally in regard to non-adherence to protocols associated with the approvals process.

The Commission found that there are a number of factors that mitigate against the risk of significant misconduct and harm to irrigation water traders currently:

- the examples of misconduct are not widespread—they are isolated cases;
- there are legal proceedings pending on some of the cases in New South Wales—so if claims have substance, fraudulent operators should become known to regional communities and it would be expected that market forces would reduce the probability of these businesses practices continuing to operate;
- there exist remedies for at least some of the observed cases of misconduct that, *prima facie*, would appear to be contrary to general market regulations—the Commonwealth *Trade Practices Act* and state-based fair trading legislation; and
- there are many intermediaries in the market place and there is healthy competition in the provision of brokering services—thus, traders have a choice of brokers and exchanges through which to buy and sell water.

In relation to the latter point, we note that, in Queensland, many irrigators negotiate seasonal trades with each other ‘off-market’, rather than using the intermediary of SunWater’s water trader. To do this, they can lodge the Application for Temporary Transfer (see Appendix 2) by mail, at a SunWater branch or, if they are registered online, by using the portal at www.sunwateronline.com.au.

2.3 Seasonal Trading in 2009-10

In 2009-10, SunWater’s Water Trader processed 54 temporary water trades, totalling 10,356.46 megalitres¹. The total value of these trades was \$444,436.2, giving an average price of \$43/megalitre.

2.4 SunWater’s Procedures

The trading of seasonal water assignments has been outsourced to Psi-Delta Pty Ltd.

Psi Delta’s role involves the following processes:

- selling rights to annual water use for SunWater-held allocations as seasonal assignments;
- developing an Annual Water Trading Plan consistent with SunWater’s Scheme Water Trading Strategies (which in turn are based on its Annual Portfolio Strategy). The Plan is to contain:

¹ This differs slightly from the total quoted in Psi Delta’s annual report for 2009-10.

- location of trades (Water Exchange, direct negotiations, auction or tender);
 - volumes to be traded;
 - trading frequency and timing;
 - predicted reserve prices;
 - KPIs agreed with SunWater.
- reporting:
 - a monthly trust account reconciliation;
 - quarterly reports;
 - an annual report;
- development of a Quality Management Plan;
- planning, strategy and publicity, including annual tours of the 10 largest schemes;
- having accounts with SunWater for each scheme at which water is to be traded. SunWater is to transfer to these accounts all volumes that are announced in the Scheme Trading Strategies or become available;
- providing access to the process and systems for itself and Elders to facilitate the annual water trading audit; and
- payment of:
 - a sales commission;
 - an annual fee for trading plans, marketing and reporting;
 - the reimbursement of approved expenses; and
 - an incentive of a proportion of the excess of sales revenue over marketing costs and SunWater's minimum prices.

The administration of water sales is carried out by Elders, whose local offices and agents act as the first contact point for customers. The offices are co-ordinated by Elders' Queensland Manager for Rural Properties.

In practice, Elders' water sales process involves:

- queries from SunWater account holders are handled by the salesperson in the relevant Elders branch, who negotiates a price at least equal to SunWater's minimum price. The buyer signs an Application for Temporary Transfer form which is approved by Elders' Queensland Manager for Rural Properties or its water trading administrator. Once the buyer's funds are deposited to its trust account, the Elders administrator faxes the temporary transfer form to SunWater and prepares a sales advice showing the sales value and its commission and sends it to Psi Delta.

SunWater's process for announcing allocations is for:

1. the Yield Hydrology team to:
 - a. initiate or review announced allocations;
 - b. calculate allocations by reviewing the storage and usage data in SWIMS and confirming its currency with the regional office;
2. the Water Accounting and Standards team to:
 - a. audit the announced allocation calculation;

- b. communicate the announced allocation by email to customers and, where required by the relevant ROP, by press release.

2.5 Information Flows

Market Sensitive Information

For intended temporary transfers of SunWater's allocations, market sensitive information relates to the volume of forthcoming allocations to be announced by SunWater. This information determines the supply of water available for sale in the scheme or sub-scheme and would generally be a major determinant of its price, together with knowledge of likely demand for that water from other potential buyers.

In practice, potential buyers can estimate the volume of water to be allocated by:

- reference to the water sharing formula in the ROP or IROP for that scheme or sub-scheme; or
- observation of inflows and of the water level in the catchment.

It is evident that the likely volume of forthcoming releases is not market sensitive information and that SunWater does not hold information on likely demand levels. Therefore, SunWater does not have access to market-sensitive information.

Confidential Information

Besides the market-sensitive information, the confidential information SunWater could access regarding water trading may be the prices that individual account holders are willing to pay for water. However, now that online SunWater Exchange has been decommissioned, this ceases to be a risk.

2.6 Complaints

Enquiries to the areas of Queensland Treasury to which complaints against SunWater would be channelled – the Office of Government Owned Corporations and the Economic and Structural Policy Unit - indicate that no complaints have been received since the Ring Fencing protocols have been in place.

As well, SunWater has advised it is not aware of any complaints, and has not reported any in its 2009-10 annual report.

3. Findings and Recommendations

3.1 Findings

Our review found:

1. no shortcomings in relation to SunWater's internal procedures:
 - to ensure compliance with the Code of Conduct;
 - relating to the protection of confidential information and the disclosure of market information;
2. no indication of discriminatory approval of water trades and no record of disputes notified to SunWater or Queensland Treasury;
3. that SunWater has in practice complied with the Code.

3.2 Recommendation

The review identified no areas in which a recommendation to improve SunWater's relevant internal mechanisms and procedures was required.

Appendix 1: Code of Conduct (at October 2010)



Water Trading Code of Conduct

Authors: P. McGahan & J. Thornton
Review Date: Oct 2010

Status:
Mandatory

Availability:
internet/intranet

Target Audience:
General public/ SunWater staff/ Water Trader

Purpose & Scope

The purpose of this Code of Conduct is to set out how SunWater will carry out its water trading activities within the portfolio strategy and scheme trading strategies approved by the SunWater Board. These activities comprise SunWater's water trading through permanent and temporary transfers, and term allocations.

SunWater seeks to put in place mechanisms to establish a well designed trading framework for its own allocations that is transparent and provides clarity to market participants. At the same time, SunWater seeks to allow a formative water market to develop in a competitive environment that can deliver economic benefits to water users and regional economies.

Objectives

The objectives of this Code are to:

- Ensure open and transparent access to a water trading market for buyers seeking to purchase water;
- Set out to market participants how SunWater will go about trading its water allocations;
- Provide an auditable process and policies to enable market participants to have confidence that SunWater is complying with its Code;
- Develop and grow water markets for the benefit for all water allocation holders and water users;
- Provide the opportunity to educate water users so as to develop an informed market; and
- Assure integrity within the water trading market.

Code Undertakings:

1. Market Facilitation and Education

SunWater will make market information publicly available through its website. This information will include:

- Up to date announced allocations for each scheme;
- Development proposals for new or augmentation of water infrastructure in each scheme
- Release of new water allocation (permanent and temporary)
- SunWater trading intentions for each scheme
- The total volume available in a particular water supply scheme at any time, and volumes used and the residual volumes potentially available for trading in the market (based on the most recent data available);
- Historic information on water use;



Water Trading Code of Conduct

Authors: P. Mogahan & J. Thornton
Review Date: Oct 2010

Status:
Mandatory

Availability:
Internet/intranet

Target Audience:
General public/ SunWater staff/ Water Trader

- Total volumes traded over the current Water Year;
- Historic information on trading prices
- Regulated price information and, where available, commercial delivery prices
- Storage levels and streamflows and
- Historic rainfall.

Where SunWater is not the custodian of all market information, it will provide links to the relevant websites, such as the Department of Natural Resources and Mines.

2. Transparent Trading Processes

SunWater will publish, for all its Water Supply Schemes where it holds any water allocations that it can trade, information as to how it will release the water allocations it holds, for either permanent transfer, term allocation, or temporary transfer to the market.

This information will include:

- The volume of water to be made available by product (that is permanent, lease or seasonal assignment); and
- The timing of volumes to be made available;

These trading intentions will be made available on SunWater's website from time to time as appropriate. SunWater will utilise the services of an out-sourced external trader as a broker of all temporary trades of SunWater announced allocations.

3. Pricing

In general, SunWater will operate within normal market mechanisms when it trades or leases its allocations. This may take the form of:

- Trading through a public exchange;
- Offering its products through a tender or auction process outside of any public exchange; or
- Through direct negotiation with customers, via the SunWater broker.

4. Non-discriminatory Pricing

SunWater will not discriminate in its pricing between different customers where the same product is being traded at the same point in time.

5. Approval of Trades

In performing its function of approving trades between customers, SunWater will decide approvals in accordance with the published criteria and conditions applying to the type of trade.



Water Trading Code of Conduct

Authors: P. McGahan & J. Thornton
Review Date: Oct 2010

Status:
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Availability:
Internet/Intranet

Target Audience:
General public/ SunWater staff/ Water Trader

5.1 Approval of Seasonal Assignments (Temporary Trades)

In approving Seasonal Assignments (temporary trades) SunWater will:

- Not discriminate between seasonal assignments involving customers and seasonal assignments involving SunWater; and
- Decide approvals in accordance with published temporary trade criteria contained in temporary trade application forms published in the SunWater web site.

5.2 Approval of Permanent Trades

5.2.2 Interim Water Allocations (IWA)

Permanent trades of IWA will be approved by the Department of Natural Resources in accordance with the relevant Interim Resource Operation Plan published on the Department's website.

5.2.3 Water Allocation

Permanent trades of water allocation will be approved by the Chief Executive. SunWater will not discriminate between sales involving customers and those involving SunWater.

5.3 Approval of Term Allocations

In approving term allocations SunWater will:

- Not discriminate between leases involving customers and those involving SunWater; and
- Decide approvals in accordance with the relevant scheme Resource Operation Plan or Interim Resource Operation Plan published on the Department of Natural Resources website.

6. Disclosure of Contract Details

SunWater's standard water delivery and water trading contracts will be made available on its website.

7. Compliance

SunWater will establish and maintain appropriate internal procedures to ensure that it complies with the undertakings within this Code of Conduct.



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SunWater will demonstrate the adequacy of these procedures through an annual audit that will be conducted by an independent external party. The audit will report on SunWater's compliance with this Code, Water Trading Policies and Procedures.

The terms of reference for the audit will be available on SunWater's website.

The Audit report, with commercially sensitive information removed, will be published on SunWater's website.

8. Ring-fencing

To assist in promoting competition and assuring integrity in water trading in schemes owned by SunWater, SunWater will put in place systems and procedures through its ring-fencing arrangements to ensure its water trader only has access to market information that is available to every other market participant. The ring-fencing arrangements will be documented in the "Ringfencing Guidelines" which will be published on SunWater's website. SunWater will utilise the services of an out-sourced external trader as a broker of all temporary trades of SunWater announced allocations.

9. Binding Dispute Resolution

All customers and prospective customers will have access to a binding dispute resolution process for complaints in respect to SunWater's compliance with this Code that cannot be resolved through negotiation.

A copy of SunWater's dispute resolution framework will be made available on SunWater's website.

10. Breaches of SunWater's Water Trading Code of Conduct

Immediately upon becoming aware that the breach has occurred, SunWater will provide a report of any breach of any of its commitments under this Code of Conduct to Queensland Treasury.

Potential breaches of the Code will be investigated by an independent body agreed between both parties. The final report of the investigation will be provided to Treasury.

Where it has been found that SunWater has committed a breach of Code, the nature and resolution of the breach will be publicly reported in SunWater's Annual Report.

11. Revisions to the Code of Conduct

Revisions to this Code of Conduct will be approved by Shareholding Ministers prior to implementation and will be published on the SunWater web site.

After three years of operation of the Framework, a full review will be undertaken within nine (9) months. The three years of operation will occur at 30 June 2010, with the review required by 31 March 2011

Appendix 2: Application for Temporary Transfer



APPLICATION FOR TEMPORARY TRANSFER

Part A – Seller Details	
Customer Account ID <input style="width: 100%;" type="text"/>	Water Account ID <input style="width: 100%;" type="text"/>
Account Holders _____	(Print Name)
_____	(Print Name)
Who can we contact regarding this application? (MUST be a Contact Profile on this account)	
Name _____	Phone _____
Address _____	Alternate Phone _____
_____	Fax _____
Select Preferred Notification Method	Email: <input type="checkbox"/> Email Address _____
	SMS Message: <input type="checkbox"/> Mobile Phone # _____
Part B – Buyer Details	
Customer Account ID <input style="width: 100%;" type="text"/>	Water Account ID <input style="width: 100%;" type="text"/>
Account Holders _____	(Print Name)
_____	(Print Name)
Who can we contact regarding this application? (MUST be a Contact Profile on this account)	
Name _____	Phone _____
Address _____	Alternate Phone _____
_____	Fax _____
Select Preferred Notification Method	Email: <input type="checkbox"/> Email Address _____
	SMS Message: <input type="checkbox"/> Mobile Phone # _____
Part C – Transfer Volume Details	
Seller's Nominated Transfer Volume _____	ML Water Year _____ / _____
Part D – Transfer Statement	
<p>This application is made under the standard Water Supply Contract and is a Seasonal Water Assignment under the Water Act 2000. The Seller warrants that they have sufficient water available under their contract with SunWater for the proposed temporary transfer. The Seller requests to reduce the volume available to them by the Nominated Transfer Volume and the Buyer requests to increase the volume available to them by the Assessed Volume. The Buyer warrants they have approval under the Integrated Planning Act for their pump taking the water. The Buyer and Seller acknowledge that they have read and agree to the Transfer Conditions on the back of this form and acknowledge that in addition to the Transfer Conditions this application will be assessed by SunWater in accordance with the Local Conditions for the water supply scheme in place on the day that SunWater receives this application.</p> <p>This form must be signed by ALL those listed as Customers on the Water Supply Contract or listed as holders of the Interim Water Allocation/Water Allocation ("Relevant Signatories"). The Relevant Signatories may sign this form personally, or an authorised person may sign on their behalf. SunWater accepts the signatures of persons authorised to sign under a SunWater "Appointment of Agent Form", and persons authorised to sign under a relevant Power of Attorney, where a copy of that Power of Attorney is attached/already submitted. Authorised persons should specify on whose behalf they are signing, and whether they are signing under an Appointment of Agent Form or a Power of Attorney. Please note, a SunWater Online Customer Principal does not have authority to sign a manual temporary transfer form. By signing this you are agreeing that you have read the current local conditions for the relevant Scheme available from sunwateronline.com.au. or from SunWater.</p>	
<p>Signed by all Relevant Signatories</p> <p>Seller's Signature(s): _____ Date: _____</p> <p>Signed on behalf of Seller Specify where relevant: <input type="checkbox"/> Under Power of Attorney (copy attached/already submitted)</p> <p style="padding-left: 150px;"><input type="checkbox"/> Under Appointment of Agent Form <input type="checkbox"/> Multiple/Combined Delivery Form</p> <p>Buyer's Signature(s): _____ Date: _____</p> <p>Signed on behalf of Seller Specify where relevant: <input type="checkbox"/> Under Power of Attorney (copy attached/already submitted)</p> <p style="padding-left: 150px;"><input type="checkbox"/> Under Appointment of Agent Form <input type="checkbox"/> Multiple/Combined Delivery Form</p>	

SunWater – Phone 13 15 89

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1. What is a temporary transfer

A temporary transfer enables two customers to transfer available water in the current water year. Please note you can now perform temporary transfer online at www.sunwater.com.au.

The seller's remaining available water for the water year will be reduced by the Nominated Transfer Volume. The water available to the buyer will be increased by this volume, less any Loss Adjustment (the Assessed Volume).

The volume available to the buyer is not affected by any increases in Announced Allocation during the water year.

Temporary transfers do not alter the buyer or seller's access conditions for taking water from a channel or pipeline.

2. Volume that can be transferred

The maximum amount the seller may transfer is the volume available to the seller on their water account at the time of application. By signing this form, the seller warrants they have sufficient water available for the temporary transfer. The Seller is encouraged to check their meter reading to determine if such water is available.

Available water balances can be viewed at SunWaterOnline.

If the Seller applies to transfer more than their available water, they will be in breach of their supply contract with SunWater.

3. Application

To apply for a transfer, both the buyer and seller should complete and sign this application form and submit it to their local SunWater Office.

End of Water Year applications - Please ensure the application form is submitted at least five (5) business days prior to the end of the current water year.

SunWater will notify the buyer and seller within 5 business days of receiving all applications (correctly completed) whether the temporary transfer has been approved or refused. The rules applied by SunWater in determining whether to approve or refuse a temporary transfer can be found in the Local Conditions, specific to each water supply scheme. A copy of these Local Conditions is attached. However, the Local Conditions applying to your application will be the Local Conditions in place on the day your application is received by SunWater. A copy of the current Local Conditions can be obtained by contacting SunWater or from www.sunwateronline.com.au

You should contact SunWater prior to signing the application form to ensure you have a current version of the application form and a current copy of the Local Conditions. Your application will not be assessed by SunWater unless you have used the most up-to-date version of the application form.

WARNING

- Any transfer of money between the buyer and the seller is made at their own risk.
- The buyer should not begin accessing the water from a temporary transfer until they receive the written confirmation from SunWater that the temporary transfer has been approved. If a buyer exceeds its existing entitlement and the temporary transfer is refused, SunWater is required to report the buyer to the Department of Environment and Resource Management.
- Customer should be aware that any temporary transfer undertaken in conjunction with a Carryover application is subject to the Carryover Cancellation rules for that Scheme.

4. Land and Water Management Plan

You may wish to contact the Department of Environment and Resource Management to clarify any requirements for a Land and Water Management Plan.

5. Supply Contract

The buyer must have a supply contract with SunWater for delivery of the water prior to the application being made. To accelerate the processing of this form, please ensure all accounts are current.

Where the seller may have an arrangement with SunWater for payment of outstanding charges, SunWater may approve the transfer subject to these proceeds being paid to SunWater to reduce the outstanding amount. You can check your balance if you are registered with SunWaterOnline.

6. Water Charges

The seller's Part A (fixed) charges do not change as a result of the temporary transfer.

The buyer's Part B (consumption) charges apply for all water taken where the Standard Supply Contract applies.

7. Transfer Adjustment Fee

A Transfer Adjustments Fee, equal to the value of SunWater's applied irrigation price subsidy, will be payable where water is transferred from a regulated irrigation pricing use to a non-irrigation use. It is the responsibility of the parties to any such temporary transfer to contact SunWater to ascertain this fee in advance of settlement.

8. Approved of Pumps

The buyer must ensure they have obtained approval under the Integrated Planning Act for their pump. This may include prior approval under a license.

9. Loss Adjustments

Under normal conditions there are no loss adjustments. SunWater will advise applicants if a loss adjustment will be required.