



Audit of Water Trading Function during 2008-09

SunWater

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1. Introduction

SunWater has commissioned BDO to carry out an independent review of SunWater's water trader function. This report is for the period 2008-09.

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 assignments 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 in the schemes it operates across Queensland. During the period 2008-09, SunWater did so by outsourcing the water trader function to Psi-Delta Pty Ltd, which provided advice on water marketing and used the Elders retail network to help market and initiate water sales across Queensland.

1.1 Objective

The objective of the audit is to independently assess whether SunWater's water trading activities and arrangements during 2008-09 complied 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.

The first audit report, for 2007-08, recommended that the Code be modified to reflect the fact that the Water Trader function was outsourced, rather than being carried out internally. This recommendation was subsequently implemented.

The key features of the Code were:

- **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.

1.2 Scope of Review

The review involved carrying out procedures solely to address this objective. The results of the review are to be used solely for this purpose and not for any other purpose.

The engagement was conducted in accordance with Australian Auditing Standards applicable to agreed-upon procedures engagements. The procedures that were performed did not constitute an audit in accordance with Australian Auditing Standards or a review in accordance with Australian Auditing Standards applicable to review engagements and, consequently, no audit assurance is expressed.

1.3 Deliverable

The deliverable from this 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. 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;

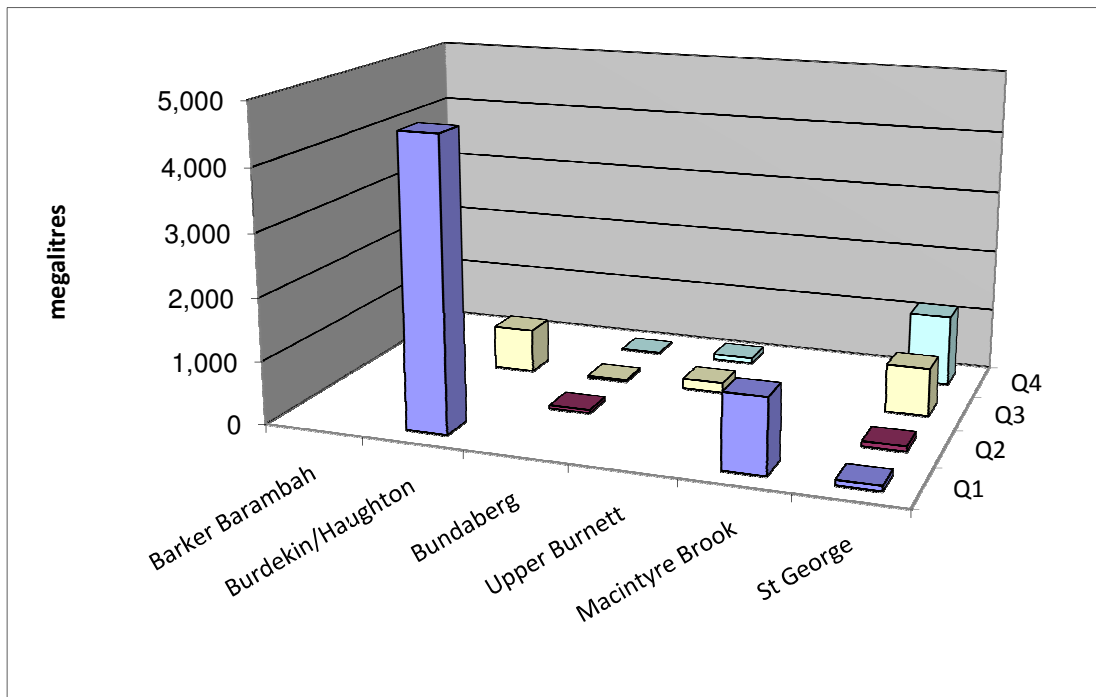
- there exist remedies for at least some of the observed cases of misconduct that, *prima facie*, would appear to be contrary to general market regulations—the Commonwealth *Trade Practices Act* and state-based fair trading legislation; and
- there are many intermediaries in the market place and there 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, it is noted that in Queensland, many irrigators negotiate seasonal trades with each other ‘off-market’, rather than using the intermediary of SunWater’s water trader. To register the trade, both parties sign the Application for Temporary Transfer (see Appendix 2), which is then lodged with SunWater.

2.3 Seasonal Trading in 2008-09

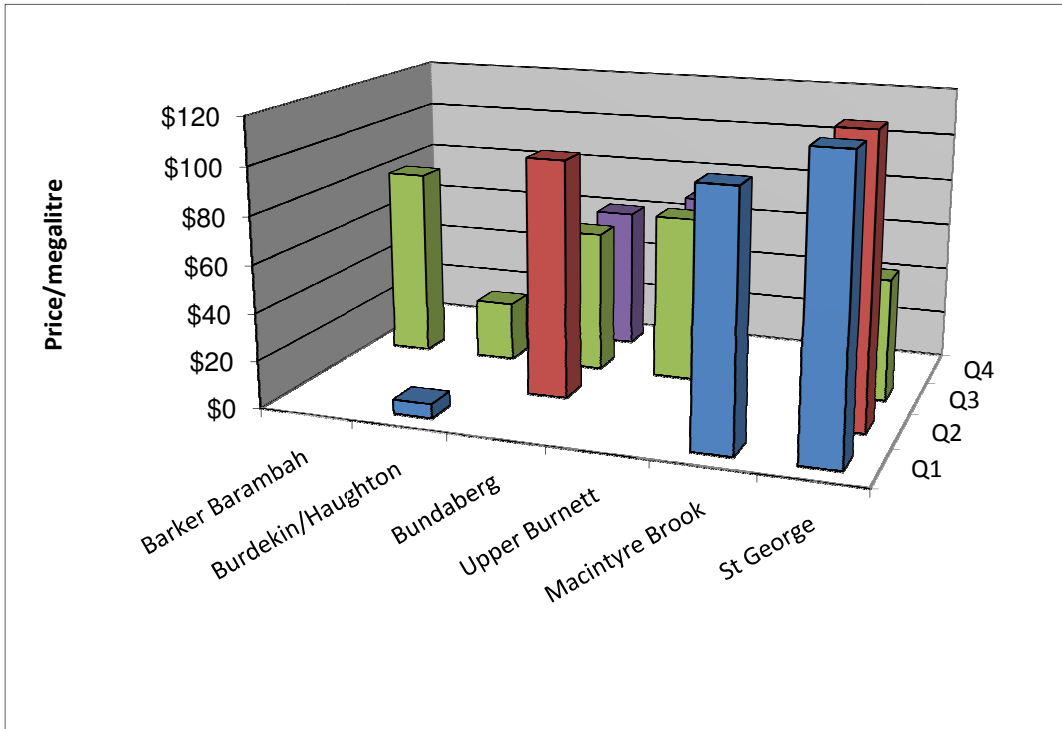
In 2008-09, SunWater’s Water Trader processed 37 temporary water trades (2007-08: 21), totalling 7,910 megalitres (2007-08, 6,080). The total value of these trades was \$353,419 (2007-08: \$519,709), giving an average price of \$44.68/megalitre (2007-08: \$85.48). The decline in average prices was attributed to higher rainfall in key irrigation areas, while the increase in volumes reflected some large one-off sales. As Figure 1 shows, most sales were from the Burdekin Haughton and Macintyre schemes (and all of these were made in July 2008).

Figure 1: Volumes of Temporary Water Trades



The average prices per megalitre from these sales is shown in Figure 2.

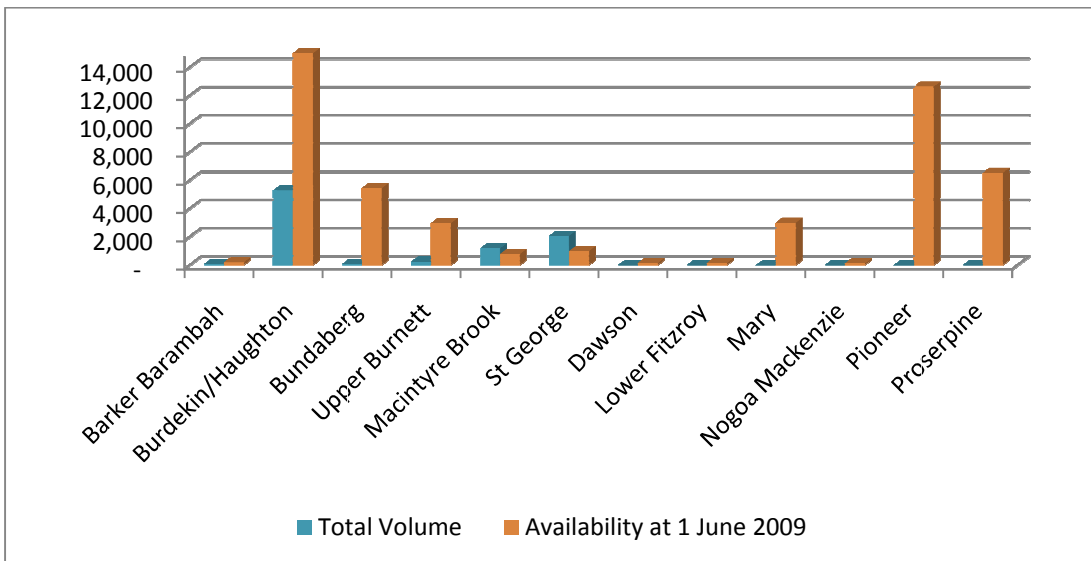
Figure 2: Average Prices Received for Temporary Trades



Comparing Figures 1 and 2 shows there was a largely inverse relationship between volumes and prices, while Figure 2 shows there was significant price variability across the year.

Psi Delta reported during the year a demand for additional temporary water in the Dawson and Barker Barambah. Figure 3 compares the total sales in each scheme compared with the availability of water at 1 June 2009.

Figure 3 Water Sales and Availability



This shows that, towards the end of the year at least, the volume of water available for sale was generally much higher than sales volumes.

2.4 SunWater's Procedures

The trading of seasonal water assignments in 2008-09 was outsourced to Psi-Delta Pty Ltd.

Psi Delta's role involved 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 contains:
 - 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 by SunWater 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 was carried out by Elders, whose local offices and agents act as the first contact point for customers. Elders' water sales process involved queries from SunWater account holders being handled by the salesperson in the relevant Elders branch, who negotiates a price at least equal to SunWater's minimum price¹.

¹ With a reported exception of one sale by an Elders agent below the minimum price. Psi Delta reported that SunWater's minimum prices were above those for private sales between irrigators on the Dawson River, the Burdekin and at St George and recommended they be reduced.

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, and the price at which private sellers are willing to accept.

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

- reference to the water sharing formula in the scheme ROP or IROP; 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 Queensland Treasury (to which complaints against SunWater would be channelled) have indicated that no complaints have been received since the Ring Fencing protocols have been in place.

As well, SunWater had advised that was not aware of any complaints, and it has not reported any in its 2008-09 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

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;
- 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.

SunWater will utilise its online Water Exchange for the temporary trading of SunWater held allocations. SunWater will operate on the Water Exchange in the same way that other customers can use the Exchange to trade their allocations. The Water Exchange provides an anonymous trading mechanism which reduces barriers to trading in SunWater schemes. The Exchange provides trading information and improved trading mechanisms, including:

- Vendor volumes and bids through the Water Exchange, by Scheme;
- Purchase volume and bids through the Water Exchange, by Scheme; and
- Matching of buyers and sellers in the Scheme, through a pool mechanism.

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.

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.

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.

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.

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.

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

Revisions to the Water Trading Framework will be approved by the Ministers for the Queensland Competition Authority 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 of that date.