

The Water Services (Governance Code) (Amendment) Directions 2016

DIRECTIONS ISSUED TO SCOTTISH WATER and SCOTTISH WATER
BUSINESS STREAM

BY

THE WATER INDUSTRY COMMISSION FOR SCOTLAND

UNDER PARAGRAPH 4.C. OF THE WATER SERVICES (GOVERNANCE
CODE) DIRECTIONS 2013 AND PARAGARPH 2 OF ORDINARY LICENCE
CONDITION 8 IN THE WATER SERVICES AND SEWERAGE SERVICES
LICENCES HELD BY SCOTTISH WATER BUSINESS STREAM.

25 July 2016

1. Legal background to the directions

- A. The Water Services (Governance Code) Directions 2013, made by the Commission under section 11 of the Water Services etc (Scotland) Act 2005, and ordinary licence condition 8 in both the water services and sewerage services licences held by Scottish Water Business Stream under section 6 of that 2005 Act, require Scottish Water and Scottish Water Business Stream to comply with the governance code which the Commission has directed as being in force from time to time.
- B. Paragraph 4.C of those 2013 directions and paragraph 2 of those ordinary licence conditions 8, enable the Commission to issue further directions relieving either company of its obligations under the governance code or modifying it.
- C. Having consulted generally, and in particular with Scottish Water and Scottish Water Business Stream, the Commission now makes these directions under those paragraphs 4.C and 2.
- D. In issuing these directions the Commission is not prevented from issuing further directions, of a general or specific nature, to Scottish Water, Scottish Water Business Stream or any other person on the same subject matter as these directions or on any other matter which the Commission considers appropriate in accordance with its powers.

2. Citation, commencement and interpretation

- A. These directions may be cited as the Water Services (Governance Code) (Amendment) Directions 2016.
- B. These directions will come into force on the date on which they are made and will remain in force until varied or revoked by the Commission.
- C. In these directions words and expressions shall, unless stated otherwise, have the same meaning as in the Water Services (Governance Code) Directions 2013 and the ordinary licence conditions of the water services and sewerage services licences held by Scottish Water Business Stream.

3. Amendment of the governance code

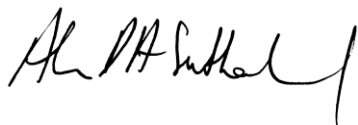
- A. The governance code is amended by the deletion of paragraph 6.2(c) and its replacement with the following new paragraph 6.2(c):

“Business Stream must ensure it has a robust financial structure that is appropriate for the competitive retail market- it must earn a rate of return on its Regulated Business that is at least equivalent to that required by a stand-alone market participant and reflects the particular risks which it faces and, if requested to do so by the Commission, provide details of the return which its Regulated Business has achieved together with an explanation of why that return is reasonable in all the circumstances.”

- B. An updated version of the governance code, reflecting this amendment is attached to these directions.

Done at Stirling, 25 July 2016

For and on behalf of the Water Industry Commission for Scotland



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Alan DA Sutherland, Chief Executive

GOVERNANCE CODE

1. Background and Purpose

Under the Water Services etc. (Scotland) Act 2005 (the **2005 Act**), Scottish Water established Scottish Water Business Stream Limited (**Business Stream**) to become a licensed provider of retail water and sewerage services to customers in Scotland.

1.1 Business Stream overview

For the purposes of this code Business Stream has two businesses:

- a. A business consisting of the provision of water and sewerage related goods and services to customers as a licensed provider of water and sewerage services in Scotland, and a range of activities connected with such provision (referred to in this code as the Regulated Business); and
- b. A business consisting of the provision of water and sewerage related goods and services to customers outwith Scotland, and any other goods and services that are not related to water and sewerage, (referred to in this code as the Non-Regulated Business).

From 1 April 2008, new entrants have been offering services to non-household customers in competition with Business Stream's Regulated Business. However, Business Stream started as the incumbent retailer and has remained wholly owned by Scottish Water.

1.2 Key principles and objectives

In all the circumstances it is essential that the Regulated Business is operated and managed transparently and in a way that is fair to other licensed providers of water and sewerage services in Scotland. The performance of the Regulated Business must also not be affected by the performance of the Non-Regulated Business.

Scottish Water and Business Stream have adopted this code as a statement of the principles governing their relationship. These principles will ensure that the following objectives are met:

- a. Subject to section 3.1 below, Business Stream can take all strategic and operational decisions with respect to the Regulated Business independently of Scottish Water and its other subsidiaries;

- b. Subject to section 3.2 below, Business Stream can take all strategic and operational decisions with respect to the Non-Regulated Business independently of Scottish Water and its other subsidiaries;
- c. Scottish Water can protect its statutory and corporate governance obligations as the owner of Business Stream without compromising the independence of Business Stream;¹
- d. Transactions between Scottish Water or any of its other subsidiaries and Business Stream are carried out at arms' length and on a normal commercial basis;
- e. Information flows between Scottish Water or any of its other subsidiaries and Business Stream are restricted to those set out explicitly in this code so that competition between Business Stream and other licensed providers occurs on a level playing field; and
- f. Business Stream has a robust financial structure that is appropriate for the competitive retail market- it must earn a rate of return on its Regulated Business equivalent to that required by a stand-alone new entrant. The financial relationship between Scottish Water and Business Stream is transparent and complies with the Commission's regulatory requirements.

1.3 Legal background

This code has been developed in negotiation between the Water Industry Commission for Scotland (**the Commission**), Scottish Water and Business Stream. Each of the companies is required to be a party to and comply with this code, under the following regulatory provisions:

- a. For Scottish Water, directions issued under section 11 of the 2005 Act.
- b. For Business Stream, ordinary conditions of its permanent water services and sewerage services licences.

For the avoidance of doubt, compliance with this code by Scottish Water also includes compliance by all of Scottish Water's other subsidiaries.

The Commission may treat any breach of this code as a breach of the regulatory provisions set out above.

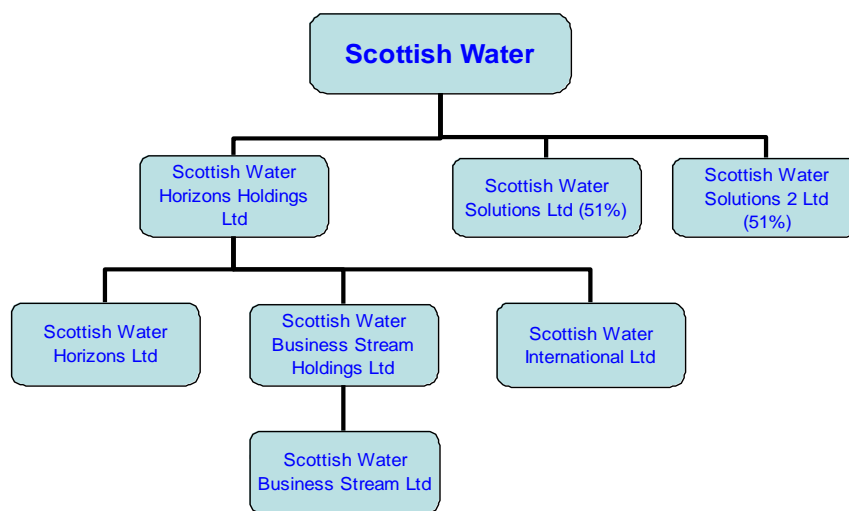
¹ Section 13 of the Water Services etc. (Scotland) Act 2005.

The code commences on 17 May 2013 and may only be amended or terminated with the consent of the Commission or at the Commission's initiative.

This code is substituted for and replaces the code contained in the Water Services (Governance Code) Directions 2008.

1.4 The Scottish Water Group

The current Scottish Water group structure is set out below. Scottish Water will inform the Commission within seven days of any changes to the group structure.



2. Relationship between Scottish Water, SWBSH and Business Stream

Scottish Water has established a holding company (Scottish Water Business Stream Holdings Limited (**SWBSH**)) to take responsibility for Scottish Water's interest in Business Stream as set out in this Code.

SWBSH has a general supervisory role with regard to the Regulated Business of Business Stream. It will approve the Business Plan of the Non-Regulated Business referred to in section 4.3 a) below and have the ability to invest new capital in Business Stream. Neither Scottish Water nor SWBSH's parent company (Scottish Water Horizons Holdings Limited (SWHHL)) will have any role, except that required by Statute, in the activities of Business Stream's Regulated Business.

In all Business Stream's activities, both in its Regulated and Non-Regulated Businesses, Scottish Water, SWHHL and SWBSH must take particular care to ensure that their decision-making processes and involvement permit the

board of directors of Business Stream to act independently and ensure that, so far as reasonably practicable, the judgments of the board of directors of Business Stream are respected.

2.1 SWBSH role

Business Stream's holding company, SWBSH, will:

- a. Take decisions that the Scottish Water board would otherwise take in respect of Business Stream;²
- b. Provide financial backing for Business Stream as the sole shareholder and sole source of funding, receiving Business Stream dividends and insulating the remainder of Scottish Water's business from the financial fortunes of Business Stream;
- c. Take decisions for Scottish Water by making appointments to and removals from the Business Stream board in respect of its Chairman and independent non-executive directors. In exercising this function, SWBSH will ensure that Business Stream can still act independently and at arms' length from both Scottish Water and SWHHL, save as expressly permitted by this code or required by law;

Whilst SWBSH is to appoint directors to, and may remove directors from, the Business Stream board, Business Stream must still take decisions independently of Scottish Water, SWHHL and SWBSH.

Before appointing or removing any director SWBSH will also notify the Commission of its intention to make such appointment or removal.

2.2 The SWBSH board

SWBSH's board will comprise the Chief Executive of Business Stream, the non-executive directors of Scottish Water, the Scottish Water Chairman and the Finance Director of Scottish Water.

The Finance Director of Scottish Water should be on the board of SWBSH because Scottish Water is subject to public finance rules and, as such, the Chief Executive of Scottish Water is accountable for the use and probity of funds used by Scottish Water and all its related companies.

² Section 3 describes the types of decisions that Business Stream must refer to SWBSH.

However, the Finance Director of Scottish Water may not be the Chief Executive or Chair of SWBSH as he will be, by the very nature of his role, fully abreast of all operational matters within Scottish Water.

In advising the board of SWBSH, the principal focus of the Finance Director of Scottish Water will be to provide advice such that the board can act in a manner consistent with the statutory responsibilities of Scottish Water. He will also be available to advise the SWBSH board on financial matters or other issues requiring the agreement of the Scottish Government.

Decisions in relation to Business Stream by the board of SWBSH will be final, except in relation to the activities of the Non-Regulated Business (but then only where formal ratification by the SWHHL board and/or the Scottish Water board is legally required). No director of SWHHL or of Scottish Water will play any role in taking decisions about the activities of Business Stream's Non-Regulated Business and no such director will be party to any confidential information concerning that Non-Regulated Business, save as expressly permitted by this code or required by law.

3. Business Stream's decision making powers

Scottish Water has a responsibility to establish a separate undertaking to participate in the Scottish retail market. Under this code, Scottish Water will exercise its ownership responsibilities through SWHHL and SWBSH. Business Stream will be a wholly owned subsidiary of SWBSH, but it will take decisions independently of Scottish Water, SWHHL and SWBSH.

Other than as set out below, the Business Stream board has independence from Scottish Water, SWHHL and SWBSH.

3.1 Decisions relating to the Regulated Business

In relation to its Regulated Business, Business Stream only needs to seek approval from SWBSH in limited circumstances. These are:

- a. Where the decision would also require the approval of the Scottish Government;
- b. Where the decision relates to any new financing of Business Stream (whether as regards the level of dividend or as regards the deployment of new capital); and/or
- c. Where required by law.

For the avoidance of doubt, the use by Business Stream of its own funds in relation to its Regulated Business does not, of itself, require any approval by Scottish Water, SWHHL or SWBSH.

In respect of a decision under paragraph b) above, it will be sufficient for Business Stream to submit a business case to SWBSH detailing the proposed costs, benefits and expected outcomes and confirming that the additional borrowing required will not put Business Stream in breach of the financial covenants set out in section 6.2 below.

Business Stream must take particular care to ensure that its decision-making processes in relation to the Regulated Business allow it to demonstrate independence when contemplating transactions with Scottish Water or other subsidiaries of Scottish Water. Through its compliance officer Business Stream must define how it will achieve this and publish its procedures in this regard.

3.2 Decisions relating to the Non-Regulated Business

In relation to its Non-Regulated Business, Business Stream will need to seek approval from SWBSH:

- a. For its Business Plan referred to in section 4.3 a) below;
- b. Where the decision would also require the approval of the Scottish Government;
- c. Where the decision is not consistent with the Business Plan referred to in section 4.3 a) below;
- d. Where the decision relates to any new financing of Business Stream; and/or
- e. Where required by law.

For the avoidance of doubt, the use by Business Stream of its own funds in relation to its Non-Regulated Business consistent with the Business Plan approved pursuant to section 4.3 a) below does not, of itself, require any approval by Scottish Water, SWHHL or SWBSH. In respect of a decision under paragraph c) above, it will be sufficient for Business Stream to submit a business case to SWBSH detailing the proposed costs, benefits and expected outcomes and confirming that the internal rate of return on the proposal is at least 12% or such other figure as may be agreed between Business Stream and SWBSH. In respect of a decision under paragraph d) above, the consent of SWBSH should not be unreasonably withheld.

4. Provision of confidential information by Business Stream

4.1 Ordinary course provision

In the ordinary course of business, (e.g. under the Market Code) the parties may exchange confidential information. However, each party must ensure that such exchanges are kept to the necessary minimum and confidential information is kept confidential and used only for the purpose for which it was exchanged.

4.2 Information relating to the Regulated Business

4.2.1 Business Plan

Business Stream will present to SWBSH by no later than 31 March in each year a summary of its Business Plan setting out the strategy for the Regulated Business for the following three years.

4.2.2 Quarterly updates

Business Stream will provide to SWBSH quarterly updates on the following key financial performance indicators in relation to Business Stream's Regulated Business:

- a. Total sales;
- b. Gross profit;
- c. Profit before tax;
- d. Cash balances; and
- e. Aged debt statistics.

4.2.3 Quarterly Strategy performance updates

Business Stream will provide to SWBSH quarterly updates on Business Stream's performance against its Business Plan setting out the strategy for the Regulated Business.

4.2.4 Financial updates

Business Stream will provide to SWBSH by no later than 30 June each year:

- a. Confirmation that the Regulated Business achieved the return on equity prescribed by section 6.2(c) of this code for the preceding year; or
- b. Confirmation, approved by a resolution of the Directors of Business Stream and signed by a Director of Business Stream, that the Board of Business Stream have a reasonable expectation that it will earn the at least the hurdle rates agreed in this Code on both its regulated and non-regulated activities.
- c. If such confirmations cannot be provided, a detailed explanation of the reasons why it cannot be.
- d. If Business Stream becomes aware of any matter which causes it to believe that any confirmation provided under this section 4.2.4 is no longer reliable, it shall inform SWBSH immediately, in writing, and provide reasons why such confirmation is not reliable.

4.2.5 Restrictions

For the avoidance of doubt, any information on the Regulated Business provided by Business Stream to SWBSH:

- a. under sections 4.2.1, 4.2.2 and 4.2.3 above must not be passed to Scottish Water, SWHHL, or any employee or agent of either company (other than the Finance Director of Scottish Water) save where permitted by this code; and
- b. under section 4.2.4 above may be passed to the Board of SWHHL.

4.3 Information relating to the Non-Regulated Business

Business Stream will provide to SWBSH the following information about its Non-Regulated Business:

- a. By no later than 31 March in each year, its Business Plan setting out the strategy for the Non-Regulated Business for the following three years;
- b. Quarterly updates on performance against the Business Plan and on the financial health of the Non-Regulated Business;
- c. Confirmation annually (to be provided by no later than 30 June each year) that the Non-Regulated Business is performing as planned;
- d. If, at any point during each financial year, the Non-Regulated Business is not performing as planned, confirmation that steps are being taken (and disclosure of those steps) to ensure that the Business will perform to plan going forward; and

- e. Quarterly updates about the progress of the steps being taken and the improvement in performance of the Non-Regulated Business until such Business is performing to plan.

For the avoidance of doubt, any information provided to SWBSH under this section 4.3 may be passed by SWBSH to the Board of SWHHL.

4.4 Disclosure for legal reasons

Business Stream must disclose to SWBSH, and it in turn to SWHHL and Scottish Water, the minimum information needed to enable SWHHL and Scottish Water to comply with group financial reporting obligations to regulatory authorities. Business Stream must provide this information in the time required for SWHHL and Scottish Water to meet those obligations and SWHHL, Scottish Water and SWBSH must not use that information for any other purpose.

Business Stream shall disclose to SWBSH, and it in turn to the Scottish Water Group Audit Committee, the report title and number of issues identified in each Group Internal Audit report issued to Business Stream and a brief status update on Business Stream's performance in implementing Group Internal Audit agreed actions.

Apart from the information described in sections 4.2 and 4.3 above, Business Stream must only disclose financial information to SWHHL, SWBSH or Scottish Water that it also makes publicly available at the same time or earlier.

4.5 Scottish Water employee access

In addition to the above, Scottish Water may allow the following employees (and their personal assistants) access to the confidential information detailed below:

- a. In relation to SWBSH, the compliance officer of Scottish Water may collate and prepare board papers⁴, carry out normal company secretarial duties and instruct external advisers on legal issues;
- b. The Scottish Water Treasury Manager may secure and approve financial transactions, and deal with any insurance issues relating to SWBSH;

⁴ The compliance officer will act as Company Secretary to SWBSH. All papers relating to the SWBSH board will be held within a password controlled server to which only the company secretary and Scottish Water's finance director will have access.

- c. The Scottish Water Financial Controller and the Scottish Water Group Finance Manager may process any financial transactions or requests for payments of funds to and from SWBSH; and
- d. The personal assistant to the finance director of Scottish Water may access and deal with correspondence in relation to SWBSH or Business Stream on behalf of the finance director.

Further, Scottish Water will ensure that the individuals performing the roles identified in sub-paragraphs a) to b) above will receive specific training in relation to:

- e. This code and the confidentiality obligations imposed thereunder;
- f. The role and purpose of SWBSH;
- g. The security and handling of all SWBSH data; and
- h. The obligations and duties in relation to the separation of Business Stream and Scottish Water generally.

5. Monitoring compliance

The parties will ensure that their respective governing rules and those of their subsidiary companies, are consistent with the requirements of this code.

Both Scottish Water and Business Stream have appointed compliance officers to advise their respective companies on how to comply with their regulatory obligations, monitor and audit compliance and investigate any alleged breaches of regulatory obligations. The compliance officers will also be responsible for complying with these duties in relation to this code (including the confidentiality provisions).

In each company, the compliance officer's responsibilities include:

- a. Advising the board on policies and procedures to ensure the company's compliance with the code;
- b. Monitoring the company's compliance with the code;
- c. Investigating complaints arising under the code and recommending remedial action if necessary; and
- d. Monitoring and advising on meetings between the company and the other party to the code

With respect to meetings between Business Stream and any other subsidiary of Scottish Water, the compliance officer's responsibilities include:

- e. Ensuring an agenda is prepared for each such meeting and reviewing those agendas before the meeting;
- f. Ensuring notes of each such meeting are circulated to the compliance officer;
- g. Attending (or arranging for a delegate to attend) meetings between the parties where decisions material to the maintenance of a level playing field in the market may be taken; and
- h. Formulating and following a plan which sets out how the compliance officer will fulfil these responsibilities.

Compliance officers will report on a regular basis to their board (at least quarterly) on their activities and the company's compliance with its obligations under this code. Each company will arrange for its audit committee to review its compliance with the code annually and publish its findings.

The Commission may instruct independent advisors to audit the parties' compliance with this code. Such audit may include the audit of any subsidiary of Scottish Water. Scottish Water and Business Stream will bear any reasonable costs of such an audit equally.

6. Financial warranty and covenants

6.1 Warranties

As mentioned above, Business Stream has been provided with sufficient capital to finance its Regulated Business and ensure that it should not need further funding from Scottish Water. In recognition of this, Business Stream will warrant publicly to Scottish Water at the beginning of each year that it does not anticipate seeking any funding for its Regulated Business during that year from any one of: Scottish Water; any subsidiary of Scottish Water; or any other person. If Business Stream fails to give this warranty, or breaches the warranty, it must inform the Commission and SWBSH immediately and SWBSH may replace directors on the Business Stream board.

6.2 Covenants

The parties agree to adhere to the following financial covenants:

- a. SWBSH initially loaned £58.5 million of "primary debt" to Business Stream on the following terms:
 - I. SWBSH charges Business Stream the full cost of interest and fees on debt secured from commercial lenders, and Business Stream pays interest at an annual rate of 125 basis points above the 3-month London Inter-Bank Offered Rate on debt that SWBSH has obtained from the Scottish Government; and
 - II. Business Stream may repay any part of the outstanding primary debt at any time.
- b. SWBSH loaned £20 million of "subordinated debt" to Business Stream on the following terms:
 - I. Interest accrues on the subordinated debt at an annual rate of 14 per cent calculated on a daily basis;
 - II. Each six months, Business Stream must pay half of the accrued interest for that six-month period to SWBSH. The other half is added to a repayment reserve; and
 - III. Business Stream may repay any part of the outstanding subordinated debt at any time. The nominal value to be repaid will grow at 7 per cent per annum compounded.
- c. Business Stream must ensure it has a robust financial structure that is appropriate for the competitive retail market - it must earn a rate of return on its Regulated Business that is at least equivalent to that required by a stand-alone market participant and reflects the particular risks which it faces and, if requested to do so by the Commission, provide details of the return which its Regulated Business has achieved together with an explanation of why that return is reasonable in all the circumstances.
- d. Business Stream will ensure that, at the end of each financial year:
 - I. The ratio of EBITDA to net interest payable is no less than 3 to 1;
 - II. Total net borrowings do not exceed 3.5 times EBITDA;

If Business Stream breaches any of the financial covenants it must notify the Commission immediately and, within 60 days of the notification, submit a plan to the Commission for how to remedy the breach. From the point of notification until the Commission decides otherwise, neither SWBSH nor the Business Stream board may make any financial decision without the Commission's prior written approval.

7. Further assurances and provisions

Save as expressly provided for in this code SWHHL shall not be entitled to any more information about Business Stream's Regulated Business than Scottish Water, and shall not be entitled to any greater role in the management of the Regulated Business than Scottish Water.

Any activity that relates in part to Business Stream's Regulated Business shall be classified as an activity of the Regulated Business for the purpose of this code.

7.1 Group compliance

Scottish Water shall secure that each of SWHHL, SWBSH and all other subsidiaries of Scottish Water shall refrain from any action that would be likely to cause Scottish Water or Business Stream to breach any of its obligations under this code and where compliance with this code by Scottish Water requires that a subsidiary of Scottish Water carry out acts, Scottish Water shall secure that such acts are carried out.

Save as required by law Scottish Water shall secure that no subsidiary of Scottish Water other than SWBSH or SWHHL shall have any involvement in the management or operation of Business Stream, and shall have no access to any information about Business Stream unless such information is publicly available.

Nothing in this code shall require Scottish Water or any subsidiary of Scottish Water to breach any applicable laws, for example the Companies Act 2006.

8. CEO meetings

The Chief Executive of Business Stream should meet with the CEO or an Executive Director of Scottish Water at least quarterly. Such a meeting should also be offered to the CEO of any holder of any Water Services or Sewerage Services Licence granted by the Commission.

9. Section 29E schemes

Scottish Water is mindful that it is important that Scotland builds on its reputation for innovation in the provision of water and sewerage services, in particular in the context of Hydro Nation. Scottish Water shall use reasonable endeavours to develop a range of general schemes, (**General 29E Schemes**), which if implemented would be likely to meet the requirements of section 29E of the 2005 Act for departure from a charges scheme.

Scottish Water will consult with each holder of a Water or Sewerage Services License (including Business Stream) about potential Section 29E opportunities and shall offer each holder of a Water or Sewerage Services Licence a reasonable opportunity to comment on such opportunities. At the start of each investment planning period, Scottish Water will publish a forward work plan setting out the engineering, analytical, commercial and other work it will carry out to develop General 29E Schemes. Scottish Water will report annually to the Commission on the steps it has taken in respect of General 29E Schemes.