

GOVERNANCE CODE

1. Background and purpose

Under the 2005 Act, Scottish Water established Scottish Water Business Stream (Business Stream) to become a licensed provider of retail water and sewerage services. From 1 April 2008, new entrants will offer services to non-household customers in competition with Business Stream. However, Business Stream starts as the incumbent retailer and will remain wholly owned by Scottish Water.

Scottish Water and Business Stream have adopted this Governance Code as a statement of the principles governing their relationship. These principles will ensure that:

- Business Stream can take decisions independently of Scottish Water.
- Scottish Water can protect its statutory obligations as the owner of Business Stream without compromising the independence of Business Stream.¹
- Transactions between Scottish Water and Business Stream are carried out at arms' length and on a normal commercial basis.
- Information flows between the two companies are controlled so that competition between Business Stream and other licensed providers occurs on a level playing field.
- Business Stream has a robust financial structure that is appropriate for the competitive retail market. The financial relationship between Scottish Water and Business Stream is transparent and complies with the Commission's regulatory requirements.

This Governance 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 Governance Code, under the following regulatory provisions:

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

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

The code commences on the date Business Stream is granted its permanent water services and sewerage services licences.

The code may only be amended or terminated with the consent of the Commission or at the Commission's initiative.

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

2. Relationship between Scottish Water, SWBSH and Business Stream

In order to promote the independence of Business Stream, Scottish Water will establish a holding company to take responsibility for Scottish Water's interest in Business Stream. The holding company, Scottish Water Business Stream Holdings Limited (SWBSH), will:

- Take decisions that the Scottish Water Board would otherwise take in respect of Business Stream;² and
- 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.

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

Scottish Water is subject to public finance rules. The Chief Executive of Scottish Water is therefore personally accountable for the use and probity of funds used by Scottish Water and all its related companies. In recognition of this position, the finance director of Scottish Water may also be on the board of SWBSH.

However, the finance director of Scottish Water may not be the Chief Executive 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 where formal ratification by the SW Board is legally required. Other Scottish Water directors will not play any role in taking decisions about Business Stream and will not be party to any confidential information concerning Business Stream, beyond the initial creation and capitalisation of SWBSH.

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

Figure 1 shows the decision-making roles of Scottish Water, SWBSH and Business Stream. This shows that Scottish Water has a strictly limited involvement with Business Stream, relying on SWBSH for the majority of decisions.

Figure 1: Decisions

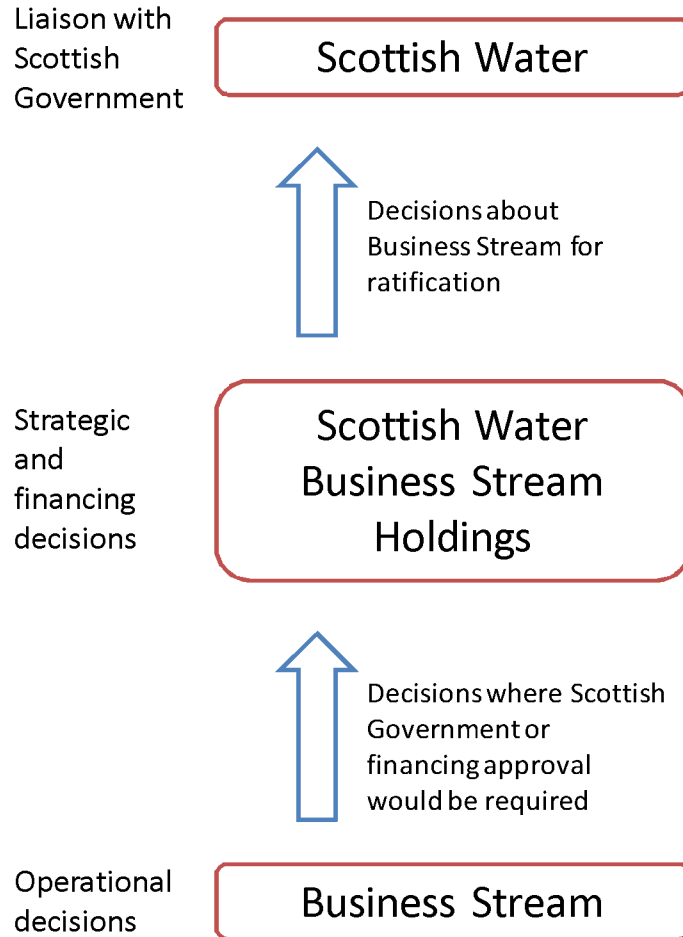


Figure 2 shows how directors are appointed to the SWBSH and Business Stream boards.

Figure 2: Directors

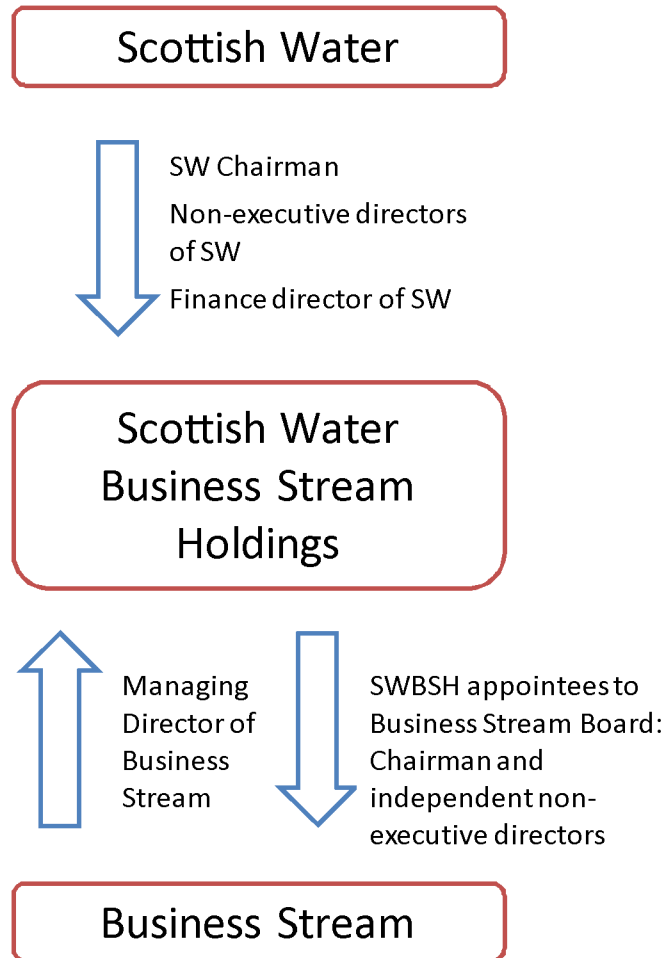
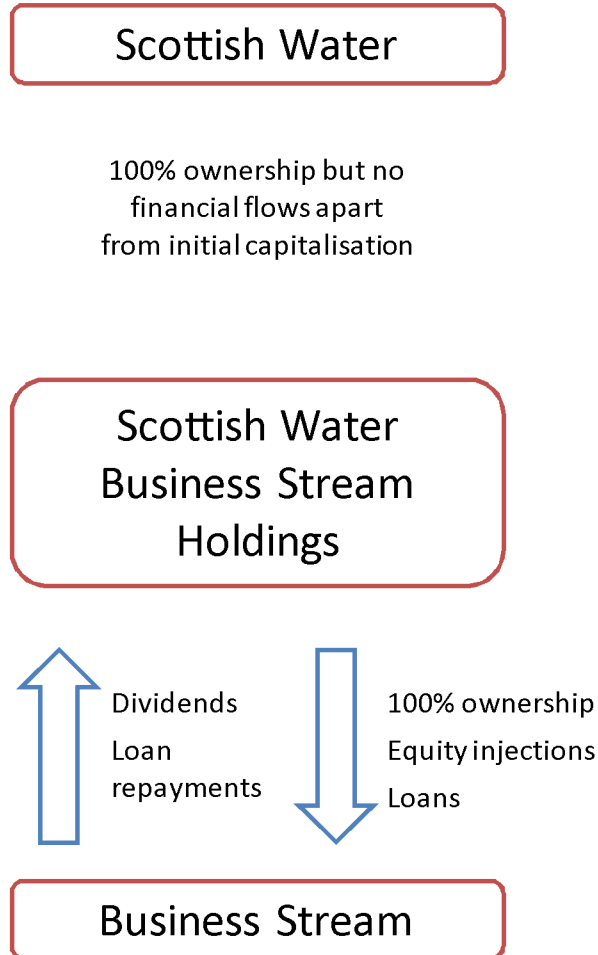


Figure 3 shows the financial flows between SWBSH and Business Stream. There are no financial flows between Scottish Water and SWBSH given that SWBSH takes responsibility for Scottish Water's interest in Business Stream.

Figure 3: Financial flows



3. Role of SWBSH

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

Therefore, Business Stream only needs to seek approval from SWBSH for decisions which would also require the approval of the Scottish Government or decisions on any new financing of Business Stream. For example, if Business Stream sought to diversify its business it would seek the agreement of SWBSH and, if SWBSH agreed, Scottish Water would then approach the Scottish Government.

SWBSH will also take decisions for Scottish Water on appointments to the Business Stream Board. In exercising this function, SWBSH will ensure that Business Stream can still act independently and at arms' length from Scottish Water, as set out further in Section 4 below.

4. Role of Business Stream

Other than as mentioned elsewhere in this code, the Business Stream Board has complete independence from Scottish Water and SWBSH in running its company. In particular, the Business Stream Board has complete control over its operational decisions, subject to its legal and other regulatory obligations.

As mentioned in Section 3 above, SWBSH will be able to appoint directors to the Business Stream Board, provided that Business Stream can still take decisions independently of Scottish Water. SWBSH will appoint the Chairman and independent non-executive directors of Business Stream. Before doing so, SWBSH will notify the Commission of its intention to make such appointments.

Business Stream must take particular care to ensure that its decision-making processes 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.

5. Confidential information

In the ordinary course of business, 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.

SWBSH may request from Business Stream monthly updates on the following key financial performance indicators:

- Total sales;
- Gross profit;
- Profit before tax; and
- Age debt statistics.

For the avoidance of doubt, any such information must not be passed on to Scottish Water or any of its employees (other than the finance director) or agents.

Business Stream must disclose to SWBSH, and it in turn to Scottish Water, the minimum information needed to enable Scottish Water to comply with its group financial reporting obligations to regulatory authorities. Business Stream must provide this information in the time required for Scottish Water to meet those obligations and Scottish Water and SWBSH must not use that information for any other purpose. Apart from this information and the key performance indicators described above, Business Stream must only disclose financial information to SWBSH or Scottish Water that it also makes publicly available at the same time or earlier.

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

1. In relation to SWBSH, the compliance officer of Scottish Water may collate and prepare the Board papers³, carry out normal company secretarial duties and instruct external advisers on legal issues;
2. The Scottish Water Treasury Manager may secure and approve financial transactions, and deal with any insurance issues relating to SWBSH;
3. 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
4. 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 1 to 4 above will receive specific training in relation to:

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

6. Compliance

The parties will ensure that their respective governing rules and those of their subsidiary companies (if any) 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 Governance Code (including the confidentiality provisions).

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

- Advising the board on policies and procedures to ensure the company's compliance with the code;
- Monitoring the company's compliance with the code;
- Investigating complaints arising under the code and recommending remedial action if necessary; and

³ 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.

- Monitoring and advising on meetings between the company and the other party to the code.

With respect to meetings between the parties, the compliance officer's responsibilities include:

- Ensuring an agenda is prepared for each such meeting and reviewing those agendas before the meeting;
- Ensuring notes of each such meeting are circulated to the compliance officer;
- 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
- 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 Governance Code. Scottish Water and Business Stream will bear any reasonable costs of such an audit equally.

7. Financial warranty and covenants

As mentioned above, Business Stream has been provided with sufficient capital to finance its operations 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 from Scottish Water during that year. 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.

The parties will adhere to the following financial covenants:

- SWBSH will lend £58.5 million of "primary debt" to Business Stream on the following terms:
 - SWBSH will charge Business Stream the full cost of interest and fees on debt secured from commercial lenders, and Business Stream will pay 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.
 - Business Stream may repay any part of the outstanding primary debt at any time.

- SWBSH will lend £20 million of “subordinated debt” to Business Stream on the following terms:
 - Interest will accrue on the subordinated debt at an annual rate of 14 per cent calculated on a daily basis.
 - Each six months, Business Stream must pay half of the accrued interest for that six-month period to SWBSH. The other half will be added to a repayment reserve.
 - 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.
- Business Stream will ensure that the return on equity to SWBSH is at least 12 per cent per annum.
- Business Stream will ensure that, at the end of each financial year:
 - The ratio of EBITDA to net interest payable is no less than 3 to 1; and
 - 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.