SHEPHERD+ WEDDERBURN

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MEASURES TO ENSURE A LEVEL PLAYING FIELD

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A. INTRODUCTION

The purpose of this presentation is to discuss the measures put in place as part of establishing the market framework in Scotland, which are designed to promote a level playing field between Business Stream and new entrants.

The presentation will begin by examining the context within which the level playing field measures have been introduced before going on to consider the range of measures put in place, including the Governance Code, and how these measures have been tested and developed since market opening.

B. CONTEXT FOR MEASURES

In formulating their initial proposals for retail competition in 2004, Scottish Ministers clearly recognised the key importance of providing a level-playing field for all retailers. Indeed, this need was identified by them as part and parcel of the arrangements for establishing what was to become Business Stream. As the policy memorandum for the Bill for the 2005 Act (the Bill) put it:

> "*The Bill confers on Scottish Ministers powers to direct Scottish Water to establish a subsidiary, with a view to ensuring the separation of its statutory and licensed activities. The Executive does not consider that Scottish Water should be subject to the licensing regime in so far as it discharges its core functions as the physical provider of water and sewerage services. Scottish Water is bound by statute to perform these functions, usually to prescribed standards, and it is not desirable for these to be additionally subject to licence conditions. On the other hand, Scottish Water's retail activities must not be placed in an advantageous or disadvantageous position in relation to other retailers. In terms of the provision of retail services, Scottish Water will be in direct competition with other retailers, and must not use or be thought to be using, its position as sole provider of wholesale services, to put its competitors at a disadvantage*".
>
> *To achieve these aims, Ministers are being given powers to require Scottish Water to establish a separate, wholly owned, retail subsidiary to be responsible for all retail activities. Scottish Water's wholesale and retail activities will be accounted for separately, and the subsidiary will be treated in the same way as other retailers for the purposes of the licensing regime. The retail arm will be subject to the same regulation as other retailers, and treated by Scottish Water's wholesale business in the same way as other retailers*" (paragraphs 55 and 56).

The relationship between the level playing field imperative and the degree or nature of the separation between Scottish Water and Business Stream was also explicitly addressed in the policy memorandum, which addressed concerns raised earlier by respondents to the Scottish Government's earlier consultation. According to the memorandum:

> "*Most respondents expressing a clear view on this subject were in favour of the separation of Scottish Water into wholesale and retail arms. They were generally very concerned that a genuine separation should take place, including separation of accounts. Some felt that even with these provisions, Scottish Water retail would still retain an advantage over other retailers, and in response to these concerns more explicit provision to ensure the full legal separation of Scottish Water's retail subsidiary has been made in the Bill*" (paragraph 58).

Significantly, the Scottish Government's position on separation shifted during Stage 2 consideration of the Bill with the introduction of an amendment to the Bill which replaced the requirement to establish a retail subsidiary with one to establish a retail undertaking. In explaining the amendment, the Deputy Minister for Environment and Rural Development, said:

"*We want Scottish Water to have flexibility in the way in which it establishes its own retail undertaking to ensure that it has the best chance of success. As the bill is phrased, Scottish Water may choose to establish a subsidiary.* [The amendment][…] *provides that Scottish Water is not tied to the subsidiary model, but free to create a subsidiary or a partnership or to make some other arrangements to put the undertaking in place*".

Thus, it can be seen that Scottish Water was left with a choice by the 2005 Act as to the legal form adopted for, and as to its own ownership relationship with, the new retail undertaking.

Ultimately, of course, the decision made by Scottish Water and approved by the Scottish Ministers was to establish Business Stream as a company incorporated under the Companies Acts which was (and remains) 100% owned by Scottish Water.

The 2005 Act recognises the level playing field imperative by incorporating, the following provision at section 13(8):

"*After the* [retail] *undertaking is established, Scottish Water must not treat it any more or less favourably than it treats —*
(a) in relation to services as respects the supply of water, other water services providers; and
(b) in relation to services as respects the provision of sewerage and the disposal of sewage, other sewerage services providers".

The Water Industry Commission for Scotland (the Commission) has been careful to emphasise the central importance of the level playing field in its work in establishing the market framework. In its 2nd licensing consultation in autumn 2005, for instance, the Commission set out its position on the key ingredients of an effective retail market as follows:

"*We believe that:*
• The retail market that is established should be effective, with retailers able to enter and exit the market as appropriate.
• All licensed providers should compete on a level playing field.
• There should be effective communication between Scottish Water and licensed providers (for example in relation to information exchange), and clarity about who has responsibility for specific market functions" (page 4).

In considering Business Stream's application for permanent licences, the Commission had careful regard to the level playing field imperative and how it should be reflected in its licensing decision, having regard to the choice made by Scottish Water on the form which Business Stream would take.

The Commission specified three tests that Business Stream had to pass before it could be granted permanent licences, all of which were seen as essential underpinnings of a level playing field:

- first, Business Stream's activities and assets needed to be demonstrably separate from those of Scottish Water;
- second, Business Stream's governance had to be demonstrably separate; and
- third, Business Stream had to be financially viable and independent of Scottish Water.

Only when Business Stream had passed these three tests in January 2008 did it receive permanent water and sewerage licences allowing it to operate freely within the market. Until it met these tests, new retailers were able to sign up customers for transfer at market opening and Business Stream was unable to respond. Clearly, Business Stream had a strong incentive to acquire permanent licences by the time of market opening in April 2008 since it would have been at risk of erosion of its customer base from that point, without being able to win former customers back.

C. LEVEL PLAYING FIELD MEASURES

The Commission has worked with Scottish Water and Business Stream to put in place a set of complementary measures designed to underpin and reinforce the level playing field imperative set out in the 2005 Act and reflected in the three principles the Commission identified for the grant of permanent licences to Business Stream.

And it is important to reiterate at this point that the Commission made sure that Business Stream (and Scottish Water) had a clear message (in terms of key principles) as to what measures needed to be put in place and clear incentives (in terms of constraints on full market participation) to cooperate with the Commission in order to do that.

The measures can be broadly broken down into three categories: (a) measures to establish a regulated (as opposed to negotiated) market access regime; (b) measures to achieve effective business, IT and operational separation between Scottish Water and Business Stream and (c) measures to guarantee the governance and financial ring-fencing of Business Stream.

(a) Regulated access measures

One of the priorities of the Commission in establishing a regulatory framework for retail competition in Scotland has been to ensure that access to the market is provided on a regulated and not a negotiated basis. That is to say, in particular, those who require to interact with Scottish Water as the monopoly wholesaler should not have to negotiate individual access arrangements (including price and non-price terms), but should instead be able to obtain enter the market on the basis of a set of clear and transparent access arrangements, applying consistently across all retailers, which are established by or with the approval of the Commission.

A number of the key instruments put in place by the Commission or under its direction or guidance as part of market opening, in particular:

- the Market and Operational Codes;
- the template Wholesale Services Agreement; and
- the Disconnections Document;

were therefore be seen by the Commission as making an important contribution to the establishment of a truly level playing field for all retailers.

(b) Business, IT and operational separation

As part of the process for granting permanent licences to Business Stream, the Commission worked with Scottish Water and Business Stream to put in place arrangements – governed by a set of directions made under s.11 of the 2005 Act and complementary licence conditions – to bring about and thereafter secure an effective separation between Scottish Water and Business Stream at a business, IT and operational level.

A key element of these separation requirements is the principle that Business Stream not have access to information relating to the monopoly wholesale business, or at least should not have access on terms different to those available to all other retailers. This principle is articulated in the s.11 directions in the following way:

> "*Scottish Water shall establish and maintain managerial and operational systems which prevent any licensed provider from accessing any confidential information unless:*
> *(a) such confidential information relates to an eligible customer who was an eligible customer of that licensed provider at the time such information was divulged; or*

(b) the Commission's consent has been granted to a licensed provider to access such confidential information in any particular circumstance;
(c) Scottish Water is expressly required to provide such access by the operational code or the wholesale services agreement between it and the relevant licensed provider.
For the purposes of this sub-paragraph, confidential information means information relating to or derived from Scottish Water's business which is not published or otherwise legitimately in the public domain" (paragraph 3A).

The directions require Scottish Water to put in place practices and procedures to be implemented in order to ensure compliance with this principle and in terms of which Scottish Water will:

"*(a) maintain independent managerial and operational functions which are separate from those of any licensed provider;*
(b) implement systems to ensure secure use or access to:
(i) premises used by persons involved in the operation of Scottish Water's core functions;
(ii) any systems for recording, processing or storage of data to which personnel of Scottish Water have access;
(iii) equipment, facilities or property used in connection with Scottish Water's core functions; and
(iv) services of personnel engaged in Scottish Water's core functions; and
(c) manage the transfer of any personnel from Scottish Water to any licensed provider" (paragraph 3B).

Alongside the information ring-fencing requirements and the management, IT and operational implications which flow from them, the directions (and the complementary licence conditions) also impose restrictions on intra-group contracting and cross-subsidies in the following terms:

"*A. Scottish Water shall not give any cross-subsidy to, or receive any cross-subsidy from, the business undertaking without the Commission's consent.*
B. Scottish Water shall not enter into or implement, or agree to enter into or implement, any intra-group contract with the business undertaking, except on terms approved by the Commission.
C. Nothing which Scottish Water is obliged to do or not to do under the Act (or which the business undertaking is expressly required to do or not to do by the Act, either of the initial licences or any other relevant statutory requirement) shall be regarded as a cross-subsidy or as an intra-group contract for the purposes of these directions.
D. […] *references to Scottish Water shall be taken to include references to any business carried on by Scottish Water and to any affiliate of the business undertaking, other than a subsidiary of the business undertaking*" (paragraph 4).

The directions assign responsibility for monitoring and reporting on compliance with all of these requirements to a new office holder to be established by Scottish Water, i.e., the 'Compliance Officer', whose role and duties are described in paragraph 5 of the directions as follows:

"5. Directions in respect of the compliance officer
A. Scottish Water shall ensure, following consultation with the Commission, that a competent person (who shall be known as the "Compliance Officer") shall be appointed for the purpose of facilitating compliance by Scottish Water with the provisions of these directions.
B. Scottish Water shall at all times ensure that the Compliance Officer is engaged for the performance of such duties and tasks as Scottish Water considers it appropriate to assign to him or her for the purposes specified in sub-paragraph 5A above, which duties shall include those set out at sub-paragraph 5E below.
C. Scottish Water shall provide that the Compliance Officer:
(a) is provided with such staff, premises, equipment, facilities and other resources; and
(b) has such access to Scottish Water's premises, systems, information and documentation
as, in each case, he or she might reasonably expect to require for the fulfilment of the duties and tasks assigned to him or her.

D. Scottish Water shall make available to the Compliance Officer a copy of any complaint or representation received by it in respect of any matter arising by virtue of the provisions of these directions.
E. The duties and tasks assigned to the Compliance Officer shall include:
(a) providing relevant advice and information to Scottish Water for the purpose of facilitating its compliance with these directions;
(b) monitoring (in consultation with the Commission) the effectiveness of the practices, procedures and systems adopted by Scottish Water to comply with these directions;
(c) investigating any complaint or representation made available to him or her by the Commission or otherwise in accordance with the practices, procedures and systems adopted by Scottish Water;
(d) recommending and advising upon the remedial action which any such investigation has demonstrated to be necessary or desirable; and
(e) reporting to the Commission (or such other persons nominated by it), at such times and in such manner as it may direct, as to his or her activities.
F. Scottish Water shall produce an annual report:
(a) as to its compliance during the relevant year with the relevant duties; and
(b) as to its implementation of the practices, procedures and systems adopted in accordance with these directions.
G. The report produced in accordance with sub-paragraph 5F above shall in particular:
(a) detail all activities of the Compliance Officer during the relevant year;
(b) refer to such other matters as are or may be appropriate in relation to the implementation of the practices, procedures and systems adopted in accordance with the provisions of these directions; and
(c) set out the details of any investigations conducted by the Compliance Officer, including:
(i) the number, type and source of the complaints or representations on which such investigations were made;
(ii) the outcome of such investigations; and
(iii) any remedial action taken by Scottish Water following such investigations.
H. Scottish Water shall submit to the Commission a copy of the report produced in accordance with sub-paragraph 5F and shall publish the report on its website".

(c) Governance and financial ring-fencing

The final element of the level playing field measures is, of course, the Governance Code (the Code) which came into effect in early 2008 as part of the award to Business Stream of its permanent licences.

The Code is designed to complement and reinforce the other level playing field measures and to give effect to a set of key principles, governing the relationship between Scottish Water and Business Stream, which 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;
- 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 retailers occurs on a level playing field;
- Business Stream has a robust financial structure that is appropriate for the competitive retail market; and
- the financial relationship between Scottish Water and Business Stream is transparent and complies with the Commission's regulatory requirements.

In order to underpin these principles, the Code contains specific provisions in relation to (a) to the establishment of a holding company (Scottish Water Business Stream Holdings Limited (Holdings) interposed between Scottish Water and Business Stream; (b) information flows between Business Stream and Scottish Water; (c) compliance and reporting obligations, and (d) financial covenants.

(a) Holding company provisions

The Code requires that Holdings take full responsibility for Scottish Water's interest in Business Stream and in particular:

- take decisions that the Scottish Water Board would otherwise take in respect of SWBS; and
- provide financial backing for SWBS 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.

The board of Holdings is required to comprise: the non-executive directors of Scottish Water, the Chairman of Scottish Water, the Finance Director of Scottish Water and the Managing Director of Business Stream. Decisions in relation to Business Stream by the Holdings board are required to be final, except where formal ratification by the Scottish Water board is legally required. Scottish Water directors with operational responsibilities must not play any role in taking decisions about Business Stream or be party to any confidential information concerning Business Stream.

Holdings is also required to take decisions on behalf of Scottish Water on appointments to the Business Stream board. In exercising this function, Holdings is to ensure that Business Stream can still act independently and at arms' length from Scottish Water.

The board of Business Stream in turn is required to exercise complete independence from Scottish Water and Holdings in the running of the company. In particular, the Business Stream board must retain complete control over its operational decisions, subject to its legal and other regulatory obligations.

The Code envisages that the Business Stream board will only seek approval from Holdings for decisions which would also require the approval of the Scottish Government. The Code cites as an example the situation in which Business Stream sought to diversify its business. In that scenario it would seek the agreement of Holdings and, if Holdings agreed, Scottish Water would then approach the Scottish Government.

Figure 1: Decisions

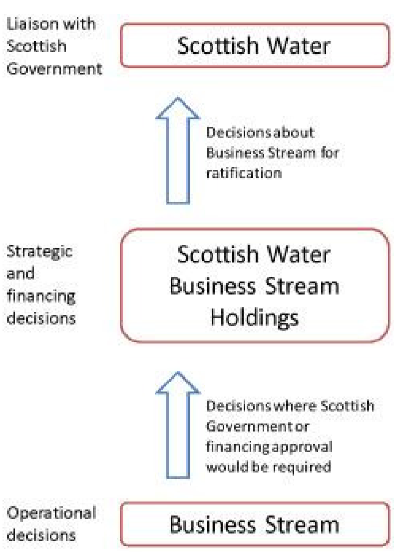
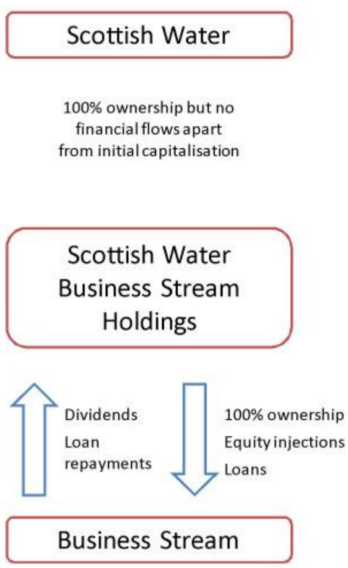


Figure 2: Directors

Figure 3: Financial flows



The Code contains restrictions on the flow of confidential information between Business Stream and Scottish Water.

In particular, Business Stream must only disclose financial information to Scottish Water that it also makes publicly available (at the same time or earlier). So, for example, Scottish Water is not entitled to see Business Stream's accounts before these are published under the Companies Acts. The Code makes an exception to this rule to the extent the information needs to be disclosed by Business Stream in order for Scottish Water to comply with its group financial reporting obligations to regulatory authorities.

(c) Compliance and reporting provisions

The Code requires Business Stream to 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.

The Code builds upon the compliance officer arrangements in place in each of Scottish Water and Business Stream in order to support this requirement. In particular, the Code requires that the compliance officer responsibilities in each organisation include:

- advising the relevant board on policies and procedures to ensure the organisation's compliance with the Code;
- monitoring the organisation's compliance with the Code;
- investigating complaints arising under the Code and recommending remedial action if necessary; and
- attending meetings between the Business Stream and Scottish Water.

The compliance officers are required to report on a regular basis to their respective boards (at least quarterly) on their activities and the organisation's compliance with its obligations under the Code.

In addition, each organisation must arrange for its auditors to review its compliance with the Code annually and publish their findings. Further, the Commission may instruct independent advisors to audit the parties' compliance with this Code at their expense.

(d) Financial warranty and covenant provisions

The Code envisages that Business Stream is provided with sufficient capital to finance its operations and that it should not need further funding from Scottish Water. In recognition of this, the Code requires Business Stream to warrant publically 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 it, it must inform the Commission and Holdings immediately, with Holdings being entitled to replace the directors on the Business Stream board.

The Code also requires Scottish Water and Business Stream to ensure adherence to the following financial covenants:

- Holdings is to lend £58.5 million of "primary debt" to Business Stream on the following terms:
    - Business Stream will make monthly interest payments at an annual rate of 125 basis points above the 3-month London Inter-Bank Offered Rate.
    - Business Stream may repay any part of the outstanding primary debt at any time subject to complying with the agreed financial covenants.
- Holdings 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 month, Business Stream must pay half of that month's accrued interest to Holdings. 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 Holdings 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.

D. DEVELOPMENTS SINCE MARKET OPENING

In February of 2007, the Commission (as part of its role in monitoring compliance) wrote to Scottish Water and Business Stream confirming that they were conducting a review of functional separation. The review would test the progress that each company was making towards meeting the three tests identified as relevant to the permanent licensing of Business Stream. As part of the Commission's review work, Shepherd and Wedderburn (S+W) and consultants LECG met with representatives of both Scottish Water and Business Stream to discuss the separation of the two businesses in each of the three areas identified, drawing on the various action and business plans and regulatory documents which were already in place.

Overview of Process

1. Project plan – there was a project plan agreed with the Commission setting out the review process that was to be conducted and when;
2. a list of questions was then compiled by S+W/LECG against the three tests formulated in Commission letter and agreed with the Commission;
3. letters were sent to Scottish Water/Business Stream re interim Licence and how the Commission was not satisfied that enough had been done to justify permanent Licence;
4. interviews were conducted with Scottish Water and separately, Business Stream and notes of each interview completed and requests for "missing" documentary evidence requested e.g. SLAs, actions plans, etc;
5. a report was sent to Scottish Water/Business Stream from the Commission on 20th March;
6. underlying verification reports were produced by S+W/LECG which were not disclosed to the Commission; and
7. a follow up de-brief meeting was held with Scottish Water to discuss observations and update on progress.

Project Plan

Aim
To prepare a report on the progress that has been made by Scottish Water and Business Stream since 31 October 2006, towards achieving:

- robust and demonstrable separation between the wholesale and retail businesses;
- governance arrangements that ensure independent decision-making for the two businesses; and
- a retail business that is fully financed on a commercial basis.

Approach
Using the information available in:

- Business Stream's action plan;
- the transfer scheme Scottish Water effected when setting up Business Stream; and
- the underlying section 11 directions and standard licence conditions and other regulatory documents currently in place (such as the operational code and wholesale services agreement);

S+W and LECG proposed to the Commission some general questions in relation to each of the three tests noted above which the Commission then sent on to Scottish Water and Business Stream.

Commission sent questions to Scottish Water/Business Stream. These questions formed the basis of interviews with key members of staff from both Business Stream and Scottish Water. The questions were sent to the members of staff prior to the interviews, which were conducted by representatives of S+W and LECG.

Timescale – exercise conducted between February and March 2007

Week commencing 19 February – S+W, LECG and the Commission agreed high-level interview questions and issue to Scottish Water and Business Stream.

List of questions compiled by S+W/LECG against the three tests

List of questions compiled by S+W/LECG against the three tests formulated by Commission.

S+W compiled questions in relation to:

- robust and demonstrable separation between the wholesale and retail businesses; and
- governance arrangements that ensure independent decision-making for the two businesses.
  LECG compiled questions re a retail business that is fully financed on a commercial basis.

Questions agreed with the Commission.

Letters sent to Scottish Water/Business Stream re audits

Initial letters sent to Scottish Water and to Business Stream regarding proposed audit; which:

- confirmed a pre-meeting would be held with Scottish Water and Business Stream before commencing the individual meetings with staff; and
- identified staff to be interviewed and requesting suggested timings for meetings with each.

Further letters sent to Scottish Water and to Business Stream regarding proposed audit; which:

- contained some supplemental questions which would require some form of documentary submission in response; and
- indicated areas expected to be discussed with each individual (recognising that not all members of staff will be able to respond to all questions, in particular financeability).

Interviews conducted with Scottish Water and, separately, Business Stream

Notes of each interview completed and requests for “missing” documentary evidence issued, e.g. SLAs, action plans etc.

Reports issued to Scottish Water and, separately, Business Stream

A report was issued to Scottish Water and Business Stream by the Commission on 20 March 2007 outlining the findings of the review of progress made towards business separation by Scottish Water and Business Stream respectively.

Underlying verification reports produced by S+W/LECG

- These were not disclosed to the Commission;
- These provided the supporting evidence for the observations contained within the reports issued to Scottish Water and to Business Stream; and
- These verification reports also contained the following useful Summary of Review Process:

"The Commission agreed with Scottish Water that it would be useful to conduct an informal review of the progress that it (and, separately, Business Stream) has made towards meeting the three tests set by the Commission for the issue of a permanent Licence to Business Stream. To recap, the tests are as follows:-

- *Functional separation – robust and demonstrable separation between the wholesale and retail businesses;*

- *Managerial separation – governance arrangements that ensure independent decision-making for the two businesses; and*

- *Financial separation – a retail business that is fully financed on a commercial basis.*

In order to assess the extent of the progress that has been made in respect of each of the three tests and to identify any areas where additional efforts could be made, it was agreed that the Commission advisers' could usefully interview key members of staff from both Scottish Water and Business Stream.

To this end, the Commission, together with its advisers, compiled a list of indicative interview questions. These questions were structured in order to elicit information relevant to each of the three "separate" tests, i.e. functional separation, managerial separation and financial separation. It was recognised that documentary evidence would be required or could usefully be provided in relation to certain matters and so a separate list of questions which required documentary support was also compiled. These questionnaires were sent to Scottish Water and Business Stream in advance to enable adequate preparation to be undertaken.

In addition to these questionnaires, there was a supplemental list of questions which was also released to Scottish Water and Business Stream in advance. These questions were to enable our advisers to drill down for further more detailed information as necessary. Finally, there was a simplified questionnaire for staff acting below management level or where their level of involvement in the business separation project did not merit use of the full questionnaire. The simplified questionnaire was not passed to Scottish Water and Business Stream.

Scottish Water and Business Stream nominated those members of staff which they considered it most appropriate to interview. The Commission suggested a few alterations to this "cast list" where it believed other individuals could add value to the review process. A final list of interviewees was then agreed between the Commission and Scottish Water/Business Stream respectively. The relevant area(s) of questioning for each of these individuals (i.e. financial/managerial/functional) was also agreed beforehand.

The interviews were scheduled to take place from 5 – 7 March.

During the course of the interviews, it became apparent that there were additional documents that may be useful to have sight of in order to assess progress.

After the interviews had concluded, the folders of documentary responses were passed to the interview teams to form part of their assessment. A written record of all interviews was then prepared and used as the basis for the reports sent to Scottish Water and Business Stream, along with the documentary evidence.

After reviewing the documentary responses and the records of interviews, draft reports were prepared for the Commission outlining the advisers' observations. These observations were categorised under the relevant tests (functional, managerial or financial). The observations were then prioritised from 1-4, priority 1 being the highest priority down to priority 4 being the lowest".

Follow up de-brief meeting

A follow up de-brief meeting was held to discuss observations and update on progress on 29 May 2007.

Outcome of review

The Commission subsequently issued an information paper giving the outcome of the review.

From this review, it was apparent that Business Stream was unable to demonstrate operational separation on most measures, this included physical separation, information technology separation and the separation of internal systems and processes (for example, HR). As a result of the review, the Commission requested Business Stream to supply and maintain a monthly action plan that monitored Business Stream's progress. The Commission made a visit in September 2007 to assess progress against Business Stream's action plan. The result of this visit was that Business Stream appeared much better placed for a licence application than it did when the previous review was conducted in February.

Progress in operational separation did allow the Commission to grant permanent licences to Business Stream but with a number of issues outstanding. These outstanding issues included the compliance officer's attendance at meetings with Scottish Water, the need for confidentiality in the communal areas shared with Scottish Water and the concern that Business Stream had a cashflow advantage by being part of Scottish Water Group for VAT purposes.

Continued monitoring

Following a letter from the Commission to Business Stream on 9 March 2009 which updated previous correspondence in February, a further visit by the Commission took place on 11 March 2009, which did note that there had been significant improvements, including a more demonstrable identity for Business Stream.

In March of 2009 Business Stream had written to the Commission formally requesting the Commission's consent to the on-going use of Scottish Water's IT as Business Stream's supplier of IT infrastructure when they were to move to their new premises. Owing to the specialist nature of the work involved, Grant Thornton were commissioned to carry out a review of the IT systems of Business Stream and Scottish Water to determine the degree of separation between the two. Grant Thornton conducted a review of the controls and procedures that were currently in place which were designed to separate the IT systems. Grant Thornton also carried out a vulnerability assessment where their experts attempted to penetrate the Scottish Water IT systems from within Business Stream.

Grant Thornton found good practice had been established between the two companies, however areas were identified where separation could be tighter and more complete. These areas were:-

- the level of segregation between users (where separation is primarily based on passwords);
- the insufficiency of audit trails; and
- the fact that compliance checks (to prove assurance that users from either organisation are not accessing sensitive information) were not carried out in sufficient detail.

In summary, therefore, the Commission commented that the network still gave the appearance of being one company separated by logical controls rather than being two legally separate companies as required. Grant Thornton's recommendations were:

1. the network should be divided into separate "subnets" using firewalls, installed at appropriate network junctures, to enforce segregation;
2. the network audit logs within the Novell software should be permanently switched on for all shared servers;
3. processes to review the audit logs for any suspected unauthorised access should be implemented. This would allow accountability over data access; and
4. all servers that hold shared data or host shared applications should be updated with the latest vendor software patches and fixes, to ensure that any access vulnerabilities cannot be exploited.

In October 2009 Business Stream partially completed its IT application separation from Scottish Water and in 2010 physically separated from Scottish Water by moving into new premises.

Finally Business Stream wrote to the Commission confirming that full IT separation had been completed on 6 March 2012.

The monitoring process in many ways illustrates the Commission's view that business separation can be a demanding and technically difficult exercise which requires to be given sufficient resource and attention, appreciating that the newly formed business has its own priorities in terms of establishing itself in the market place.

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