

# WATER INDUSTRY (SCOTLAND) ACT 2002

## The Scottish Water Governance Directions 2009

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## **Section 1 – Corporate Governance**

In section 1, the Scottish Ministers in exercise of the powers conferred on them by section 56(1)(a) and (b) of the Water Industry (Scotland) Act 2002 after having consulted Scottish Water in terms of section 56(4) of the said Act hereby give the following directions:–

### **Part I - Corporate Governance and Procedures**

#### **General**

1. Scottish Water shall ensure at all times:-

(1) it provides strategic direction to and focus for the exercise of its functions;

(2) it complies with any directions, guidance, procedure and requirements notified by the Scottish Ministers; so far as such matters relate to the functions of Scottish Water.

(3) it complies with any standards of integrity or propriety provided for in these Directions or in any guidance, procedures or requirements notified to it by the Scottish Ministers so far as such matters relate to the functions of Scottish Water.

#### **Governance**

2. (1) Scottish Water shall operate its corporate governance arrangements in line with the principles and best practice contained in the Combined Code on Corporate Governance so far as relevant and applicable, except:

- (a) where Schedule 3 of the Act requires it to do otherwise;
- (b) where any other enactment requires it to do otherwise; or
- (c) where notified to it by the Scottish Ministers in the form of guidance, procedures or directions.

(2) Scottish Water shall inform Ministers as to the administrative arrangements that it will put in place as a result of its corporate governance arrangements.

3. Scottish Water shall also, in as far as they are appropriate, meet the requirements of the Companies Act 1985 and 2006.

### **Part II - The Business Plan & The Retail Plan**

4. (1) Scottish Water shall prepare a Delivery Plan at a date to be specified by the Scottish Ministers for each regulatory period and submit it to them for their approval. This key planning document shall set out how Scottish Water plan to deliver the Regulatory Settlement through the period. In addition the Board is responsible for presenting a wider Business Plan.

- (2) The Business Plan shall set out:
- the overarching business strategy for Scottish Water and its subsidiaries (excluding Business Stream Holdings and Business Stream);
  - the Delivery Plan for delivering the Regulatory Settlement;
  - how it shall exercise its non-core functions through its subsidiaries or otherwise;
  - the value created (assessed on several levels including financial and delivery of public policy) for the Owner and the risks associated with this.
- (3) Scottish Water shall direct Business Stream Holdings to prepare a plan (the “Retail Plan”) for Business Stream Holdings that is consistent with the governance code and submit this directly to the Scottish Government. This plan shall set out the strategy for Business Stream Holdings together with key financial targets.
- (4) Scottish Water shall provide an update to the Business Plan annually, or more frequently if required, and submit it to the Scottish Ministers for approval at a date to be specified by the Scottish Ministers. Scottish Water will also direct Business Stream Holdings to provide the Scottish Ministers with an update to the Retail Plan annually, or more frequently if required, for approval at a date to be specified by the Scottish Ministers.
- (5) The Scottish Ministers may:
- (a) approve the Business Plan and/or the Retail Plan in their entirety;
  - (b) approve parts of the Business Plan or Retail Plan and seek such modification as they deem appropriate to the remaining parts;
  - (c) reject the Business Plan or Retail Plan in its entirety and require a revised plan to be drawn up.

### **Part III – General Powers and Delegated Limits**

5. (1) Scottish Water may carry out any activity, exercise any powers involved in carrying out any activity (including its general powers under section 25 of the Act) or incur any expenditure in connection with any activity, if the activity is necessary or ancillary to the delivery of its core functions provided the activity:-
- (a) is consistent with the approved Business Plan or its approved annual update; and
  - (b) is not novel or contentious;
- (2) Scottish Water may carry out any activity, exercise any power involved in carrying out any activity, or incur any expenditure in connection with any activity, if the activity is necessary or ancillary to the delivery of its non-core functions, providing that the activity:-
- (a) is exercised as set out in the approved Business Plan or its approved annual update; and
  - (b) is not novel or contentious;
- (3) Scottish Water may carry out any activity, exercise any power involved in carrying out any activity or incur any expenditure in connection with any activity, which does not fall within Articles 5.(1)-(2) providing that:

- (a) the activity is not novel or contentious; and
- (b) the activity is closely aligned to existing business competencies; and
- (c) the maximum financial exposure to Scottish Water is less than £0.5m.

(4) Activities undertaken under Article 5.(3) are subject to a cumulative limit of £1.0m. Activities initially undertaken under Article 5.(3) and which are subsequently included within an approved Business plan do not count towards the £1.0m cumulative limit.

(5) The Scottish Ministers may give consent to any activity not falling within Article 5.(1)-(3) in response to a specific written request made by the Board of Scottish Water. In approving any such request the Scottish Ministers may set such conditions as they consider appropriate.

6. (1) Scottish Water shall direct Business Stream Holdings that it may carry out any activity or incur any expenditure provided the activity:-
- (a) is contained with the approved Retail Plan or its approved annual update; and
  - (b) is not novel or contentious;

(2) Scottish Water shall direct Business Stream Holdings that it may carry out any activity or incur any expenditure which is not contained within the approved Retail Plan and which is not novel or contentious if:

- (a) the activity is closely aligned to existing business competencies; and
- (b) the maximum financial exposure to Business Stream Holdings is less than £0.5m.

(3) Activities undertaken under Article 6.(2) are subject to a cumulative limit of £1.0m. Activities initially undertaken under Article 6.(2) and which are subsequently included within an approved Retail plan do not count towards the £1.0m cumulative limit

(4) The Scottish Ministers may give consent to any activity not covered under Article 6.(1)-(2) in response to a specific written request made by the board of Business Stream Holdings. In approving any such request the Scottish Ministers may set such conditions as they consider appropriate.

### **Reporting Requirements**

7. Scottish Water shall, at the end of each financial year, make an itemised report to the Scottish Ministers of all expenditure it incurred which exceed the thresholds set out in Schedule 1.

### **Surplus Funds**

8. The investment of outperformance is covered in Section 2. This Article covers the investment of surplus funds other than outperformance.

- 1) Scottish Water shall not make or enter into any arrangements for the investment of funds, except with the prior written consent of the Scottish Ministers.
- 2) Scottish Water shall not release any invested funds except with the prior written consent of the Scottish Ministers.
- 3) Scottish Water is not permitted, without the prior written consent of the Scottish Ministers, to:-
  - (a) anticipate interest rate changes;
  - (b) undertake arbitrage between facilities open to them;
  - (c) write or purchase interest or currency swap rates, hedges, options, future contracts or other similar financial products; or
  - (d) borrow, other than by way of overdraft, from the financial markets;
- 4) The Scottish Ministers may give consent to the activities falling within Article 8. (1) to (3) subject to such conditions as they consider appropriate.
- 5) Notwithstanding Article 8.(3), Scottish Water may in the normal course of business and pursuant to the purchase or sale of any goods or services overseas determine any foreign currency exposure under a project but prior to determining any exposure for a sum in excess of £0.5 million shall inform the Scottish Ministers of the nature and extent of the proposed arrangements to do so.

### **Subsidiaries**

9. With the exception of its licensed retail subsidiary, Business Stream, these directions apply to any subsidiary formed or promoted by Scottish Water.

## **Section 2 – Investment of Outperformance**

In section 2, the Scottish Ministers, in exercise of the powers conferred on them by section 44 (2) and 56 (1)(b) of the Water Industry (Scotland) Act 2002 and after having consulted Scottish Water in accordance with section 56(4) of the said Act hereby give Scottish Water the following directions:-

### **The Investment Policy**

1. Scottish Water shall develop an investment policy for the investment of outperformance and shall submit a copy of the investment policy to Scottish Ministers for approval. The investment policy should set out:-
  - (1) the most appropriate asset class(es) for achieving the investment aim. Index linked gilts should be one of the asset classes considered;
  - (2) an appropriate portfolio of assets from within the selected asset class(es);
  - (3) appropriate arrangements for handling income and other financial flows that may arise. As part of this, consideration should be given to any tax implications that may arise and how these can be mitigated;
  - (4) appropriate arrangements for the monitoring and management of the investment;
  - (5) the circumstances in, or times at which, the investment policy should be reviewed.
2. Scottish Water shall review the investment policy in accordance with Article 1 (v), or when Scottish Ministers direct it to do so. When Scottish Water makes changes to the investment policy, it shall first submit a copy of those changes to Scottish Ministers for their approval.

### **Investment**

3. Scottish Water shall:-
  - (1) invest the initial investment in accordance with the investment policy approved under Article 1 (and Article 2, if applicable);
  - (2) invest further outperformance in accordance with the investment policy approved under Article 1 (and Article 2, if applicable); and
  - (3) put in place arrangements so that the investment made under Article 3(1) (and Article 3(2), if applicable), and any income and other financial flows associated with the investment, may be clearly distinguished from Scottish Water's day to day income and expenditure flows.

### **Withdrawals**

4. Scottish Water may not withdraw funds from the financial reserve or the financial buffer without the prior approval of Scottish Ministers.
5. Scottish Water must make withdrawals from the financial reserve or the financial buffer if Scottish Ministers direct it to do so.

### **Section 3 – Accounts**

In section 3, the Scottish Ministers in exercise of the powers conferred on them by section 45(2) of the Water Industry (Scotland) Act 2002 hereby give the following directions:–

1. Scottish Water shall prepare in respect of each financial year an annual report and accounts. These shall comprise:
  - a foreword;
  - an income and expenditure account;
  - a statement of total recognised gains and losses;
  - a balance sheet; and
  - a cashflow statementtogether with such further information as may be necessary to comply with this Direction.
  
2. The Report and Accounts shall meet in, as far as they are appropriate:
  - 2.1 the accounting and disclosure requirements of the Companies Acts 1985 and 2006, and any regulations made under those acts;
  - 2.2 generally accepted accounting practice including financial reporting standards issued by the Accounting Standards Board;
  - 2.3 the accounts disclosure requirements of paragraph 43 of Chapter 12 of the Listing Rules issued by the Financial Services Authority (formerly the London Stock Exchange);
  - 2.4 the accounting and disclosure requirements given in ‘The Scottish Public Finance Manual’ as amended or augmented from time to time; and
  - 2.5 the accounting and disclosure requirements contained in other guidance and directions issued by the Scottish Ministers from time to time in respect of Accounts, which are required to give a true and fair view.
  
3. The foreword to the Report and Accounts shall contain, insofar as it is appropriate a statement confirming compliance by Scottish Water with any Directions, requirements and guidance issued by the Scottish Ministers insofar as such matters relate to the functions of Scottish Water.
  
4. The income and expenditure account shall be prepared for the financial year ending 31 March 2009 in accordance with profit and loss account format 1 set out in Schedule 4, Companies Act 1985 and for subsequent financial years in accordance with profit and loss account format 1 set out in Schedule 1 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. The balance sheet for the financial year ending 31 March 2009 shall be prepared in accordance with balance sheet format 1 set out in Schedule 4, Companies Act 1985 and for subsequent financial years in accordance with balance sheet account format 1 set out in Schedule 1 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

- 5 The balance sheet shall include indebtedness to the Scottish Ministers under the heading 'capital and reserves'. The notes thereto shall show separately any amounts falling due for payment within 12 months of the date of the balance sheet.
- 6 The Report and Accounts shall be audited and laid before the Parliament not later than 6 months after the end of the financial year.



## **Section 4 – Previous Directions, Citation and Interpretation**

In section 4, the Scottish Ministers in exercise of the powers conferred on them by section 44 (2), section 45(2), section 56(1)(a) and (b) of the Water Industry (Scotland) Act 2002 and after having consulted Scottish Water in terms of section 56(4) of the said Act hereby give the following directions:

1. The Directions contained in sections 1-5 together with the Schedule supersede The Scottish Water Governance Directions 2008.

2. The Directions contained in sections 1- 5 together with the Schedule may be cited as the Scottish Water Governance Directions 2009 and shall come into force on 30 March 2009.

3. In these Directions unless the context otherwise requires:–

“Board” means the Board of Scottish Water appointed in accordance with paragraph 2 of Schedule 3 to the Act;

“Business Plan”, “Delivery Plan” and “Retail Plan” means the plan prepared in accordance with Section 1, Part II, article 4 of this Direction;

“Business Stream” means Scottish Water Business Stream Limited incorporated under the Companies Act 1985 with the registered number SC294924;

“Business Stream Holdings ” means Scottish Water Business Stream Holdings Limited incorporated under the Companies Act 1985 with the registered number SC332622;

“Combined Code on Corporate Governance” means the Combined Code on corporate governance published by the Financial Reporting Council;

“core functions” shall have the same meanings as in section 70 (2) of the Act;

“executive member” and “non-executive member” shall have the same meanings as in paragraph 2 of Schedule 3 to the Act;

“financial buffer” means the fund comprised of the total financial reserve for the previous regulatory periods, together with any necessary adjustments, which is agreed by Scottish Ministers;

“financial exposure” means, in relation to any project, the sum of Scottish Water’s planned expenditure on the project over its period of operation, discounted back to current values, and the maximum potential value of any guarantees to be issued by Scottish Water to third parties, or other risks or contingent liabilities that could be incurred, in respect of the project;

“financial reserve” means the total amount invested under Section 2, Article 3 of this Direction during a regulatory period. It does not include the financial buffer;

“initial investment” means the sum of £27.4 million, being the amount of Scottish Water’s outperformance of the regulatory settlement up to the financial year 2006/07;

“investment aim” means the creation of a fund to protect customers from shocks outside the control of Scottish Water’s management;

“non-core functions” means the activities Scottish Water undertake which are not core functions;

“outperformance” means the amount of efficiency savings which are:-

- secured by Scottish Water, over and above those required by the Water Industry Commission for Scotland under Section 29B of the Water Industry (Scotland) Act 2002, in (or during) each year of the regulatory period; and
- approved for the purposes of this direction by Scottish Ministers

“Owner” means the Scottish Ministers;

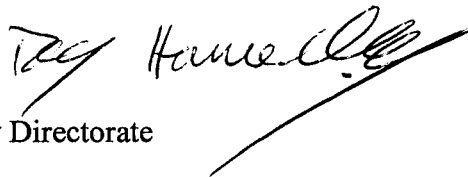
“regulatory period” means the period for the determination that Ministers have specified as under section 29B (2) of the Act;

“Regulatory Settlement” means the determination of maximum charges by the Water Industry Commission for Scotland under Section 29B of the Water Industry (Scotland) Act 2002;

“the Act” means the Water Industry (Scotland) Act 2002, as amended;

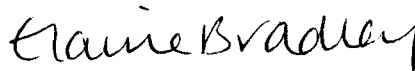
These Directions, together with the Schedules attached and signed as relative hereto, are subscribed as follows :-

They are signed by  
Water Industry Division  
Climate Change and Water Industry Directorate  
At Edinburgh on 31 March 2009



Tom Harvie-Clark

Before this witness:



A member of the staff of the Scottish Ministers  
Victoria Quay, Edinburgh EH6 6QQ

### Schedule 1 – Reporting Thresholds

Project Expenditure (per Project)	£ per Project
Capital Expenditure on major works (eg treatment works) including improvements to existing assets	10,000,000
Purchase of individual capital items, including land, with a life of more than one year	1,000,000
Advertising	1,000,000
Sponsorship	10,000
Gifts	100

