Financial Viability

The Water Industry Commission for Scotland (the Commission) has two key requirements for financial viability. Firstly, Scottish Water Business Stream (Business Stream) must have a funding structure in place that allows the business to be financially sustainable, even in a 'reasonable downside scenario.' Secondly, Business Stream must ensure that it pays a commercial rate on borrowings, so that a competitor cannot argue that 'state aid' (the ability to borrow at reduced rates) is being provided, creating an unfair competitive advantage.

Capital Structure and Cost of Capital
To ensure that the Commission's requirements are met, five advisors (Price Waterhouse Coopers, Goldman Sachs, Merrill Lynch, Rothschild and the Royal Bank of Scotland) were commissioned to provide independent proposals on an appropriate capital structure and commercial cost of capital for Business Stream.

In developing their proposals, they were required to satisfy the following criteria:

- To ensure that Business Stream's capital structure and cost of capital could be replicated by another company engaged in similar activities, with no benefit of any cross-subsidy from Scottish Water or the Scottish Government

- To ensure that Business Stream's capital structure is sufficiently robust to enable it to meet debt service requirements under reasonably foreseeable adverse business and financial conditions

Their recommendations, which were broadly consistent, were used to develop the proposals for the funding structure and cost of capital which are summarised below.

In order to address concerns regarding the separation and governance of SW's investment in Business Stream, SW has created a wholly owned subsidiary called Scottish Water Business Stream Holdings (SWBSH), which owns 100% of Business Stream. The Board of SWBSH will be responsible for managing the investment in Business Stream and for monitoring Business Stream's financial performance, in accordance with the Governance Code.

SWBSH will be established with a funding structure consistent with that allowed by the Commission in the Final Determination, but with a 65/35 split of debt to equity. This will create an opening Balance Sheet within SWBSH as follows:-

	£m
Debt (65%)	58.5
Equity – ordinary shares	11.5
Subordinated debt (35% less £11.5m)	20.0
Total funding requirement assumed in the Final Determination	90.0

Scottish Water will invest the equity and subordinated debt in SWBSH, and the senior debt will be provided by the Scottish Government at commercial rates.

Structuring part of the investment as convertible subordinated debt allows Business Stream increased flexibility to re-leverage its capital structure in future years as clarity on the competitive market develops and the business risk diminishes, i.e. if business performance allows, this debt could be repaid.

Business Stream will drawdown the £90.0m of funding on 19 November 2007, and will pay SWBSH interest at commercial rates, as follows:

- Senior debt – at LIBOR + 125bps
- Subordinated debt – at 14.0%. 7.0% will be paid each year in cash and the remaining 7.0% will be accrued, increasing the nominal value of the debt in the balance sheet.

This is consistent with the recommendations provided by the independent advisors.

In addition, Business Stream will be required to:

- maintain a Return On Equity of at least 12.0%; and,
- ensure that the EBITDA/Interest cover is no less than 3.0x; and,
- ensure that the Net debt/EBITDA is no greater than 3.5x.

The above ratios are comparable with the financial restrictions that would typically apply to another company engaged in similar activities, borrowing from the financial market.

Having taken independent advice, we are confident that the proposals for the funding structure and commercial cost of capital meet the Commission's requirements for financial viability, in that the funding structure and cost of capital could be replicated by another company engaged in similar activities, and that Business Stream would not benefit from any cross-subsidy from SW or the Scottish Government.

The financial projections have been modelled out to 2014, in order to test the long term financial sustainability of the business. Even in the worst case, severe downside scenario, Business Stream would still comply with the financial covenants set by the funding advisors and would therefore, be considered financially sustainable.

The Treasury Management Policy has been designed to manage cashflow daily, in order to ensure that the wholesale charge and CMA fees can be paid and all other financial commitments can be met, whilst also minimising borrowing requirements and reducing interest costs.

Business Stream
January 2008