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EUROPEAN COMMISSION

Directorate C: National and European Accounts

Luxembourg, 18 SEP. 2008
ESTAT/C-3/MHF/LA/KW/mg D (2008) 30212

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Subjects: 1. Methodological treatment of the € 1.4 bn capital injection of ÖBB in 2004
2. Progress on new EDP Tables 2B-D
3. Sales of housing loans
4. Public Hospitals

Ref.: Our letter ESTAT/C-3/LN/LA/KW/mg D(2008) 30042, dated 14 March 2008 Final findings of the EDP dialogue visit on 10-11 September 2007, dated 31 January 2008, and various notes from Statistics Austria (STAT) on relevant topics June 2008

Dear Mr Schwarzl,

Following the discussion during the EDP dialogue visit in Vienna on 10-11 September 2007 and following exchange of information, we are in a position to provide you with the preliminary view of Eurostat on the appropriate ESA95 accounting treatment of accounting issues.

Documentation pertaining to all issues

- Final findings from EDP mission to Austria, Vienna 10-11 September 2007

1. The € 1.4 billion capital injection in 2004 into ÖBB

The accounting issue

Documentation

- Eurostat minutes from the meeting between Eurostat and an Austrian delegation on 25 June 2003.

- Mission minutes from EDP mission to Austria, Vienna 13-14 September 2004, ESTAT/C-0/BM/LP/gr D(2005) 30006

- Eurostat letter to Statistics Austria, ESTAT/C-0/BM/LP/gr D(2005) 30006, following up issues from the EDP mission in 2004

- Letter from Statistics Austria; EDP mission to Austria (13-14 September 2004) – Follow up items, with answers to Eurostat letter ESTAT/C-0/BM/LP/gr D(2005) 30006, including attachment from Austrian Ministry of Finance containing details concerning the government capital injection and debt assumption/cancellation of ÖBBB and a business plan for the new ÖBB.

- Note from STATIS of June 2008 on "ÖBB restructuring 2005 Addition in equity (€1.4 bio)".

- Letter of 21 December 2004 by from the "Bundesministerium für Verkehr, Innovation und Technologie was forwarded to Eurostat summer 2008.

Description of the case

The issue for which opinion is being sought is the determination of the correct EDP accounting treatment of the 2004 government capital injection into ÖBB.

To summarize, the Austrian government undertook a capital injection of € 1.4 bn in 2004 into Austrian railways ÖBB. New information available at Eurostat on the injection in cash (profitability depending on government transfers, as underlined by the corporation itself and by its auditors) radically changes the way Eurostat perceives this operation and put a question mark on whether Eurostat can support the current recording.

ÖBB restructuring

The Austrian Railway ÖBB was reorganized with effect from 2004. The reform aimed at creating a system to make the new company ÖBB more sustainable and competitive by reuniting the rail operation company (OIAG) and the rail infrastructure company (SCHIG) under one new holding company, ÖBB-Holding AG.

As part of this restructuring, two transactions were carried out:

- a capital injection in cash of €1.4 billion in 2004, recorded as addition to equity in national accounts, without impact on the 2004 deficit.
- a debt assumption/cancellation of €6.3 billion in 2004, recorded in the other changes in volume account, on the explicit argument that the debt of the railways was already accounted for in general government via the mechanism of *Rechststrägerfinanzierung*, without impact on the 2004 deficit.

These two events were discussed in some detail during the last EDP dialogue visit on 10-11 September 2007. Meanwhile, Eurostat has also been able to consider some further documentation, such as the ÖBB Annual Report 2006 provided during the visit.

The issue of the recording of the debt assumption/cancellation was agreed on between STATIS and Eurostat during the April 2008 EDP notification.

The remaining issue of the ÖBB restructuring is whether the current recording of the capital injection is appropriate, i.e. whether the capital injection in cash in 2004 should impact the deficit (EDP B.9), or not.

In a letter of 21 December 2004 from the "Bundesministerium für Verkehr, Innovation und Technologie forwarded to Eurostat summer 2008, it seems that the ministry expects ÖBB to be profitable in the future based on ÖBB's business plan. On this argument STAT finds it reasonable that the capital injection is to be recorded as an acquisition in equity. In the above mentioned letter it is stated:

Der Bund, vertreten durch den Bundesminister für Verkehr, Innovation und Technologie hat den ÖBB für das Jahr 2004 im Einvernehmen mit dem Bundesminister für Finanzen einen Kapitalzuschuß in der Höhe von 1,4 Mrd Euro gewährt. Die Wirtschaftsprüfer der ÖBB bestätigten, dass der Kapitalzuschuß in dieser Höhe für die neugegründeten Gesellschaften der ÖBB eine angemessene Eigenmittelausstattung darstellt.

Gleichzeitig wird entsprechend den vorliegenden Businessplänen der ÖBB von einer Werthaltigkeit der zugeführten Eigenmittel und einer nachhaltigen Eigenfinanzierungskraft dieser Gesellschaft ausgegangen, d.h. es ist davon auszugehen, dass die neugegründeten Kapitalgesellschaften in Zukunft rentabel sein werden.

Diese Kapitalerhöhung stellt bzw. die einzelnen Kapitalerhöhungen stellen nach bisheriger Übung und nach der bisherigen Anwendung gemäß EU-Beihilfenrecht keine unzulässige Beihilfe. Dieser Umstand wurde durch das Verkehrsressort, gemeinsam mit dem Finanzressort, den Wirtschaftsprüfern der ÖBB und einer Anwaltskanzlei abgestimmt.

Methodological analysis and clarification by Eurostat

After an examination of the documentation provided, Eurostat has reached the following preliminary views.

Applicable accounting rules

Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA 95) in Community Legislation in its entirety and directly applicable in all Member States.

For the capital injection, ESA95 paragraph 4.152 applies. In addition, the Eurostat ESA95 Manual on government deficit and debt (MGDD) chapter II.3 on capital injections, and chapter II.1.2 on application to ESA95 transactions are relevant.

Availability of national accounting analysis

The Austrian statistical authorities considered appropriate to record the capital injection for the amount of € 1.4 bn in 2004 as a financial transaction, under the heading *"Shares and other equity" (F5)*, without impact on the government deficit.

Analysis - classification of the capital injection

During the September 2007 dialogue visit, Eurostat took note of information and clarifications provided by the ÖBB staff (Chief Financial Officer): actual results show significantly better profitability than planned, with ÖBB showing an overall profit, though relatively small. ÖBB accounts are not yet reported in compliance with IFRSs (International Financial Reporting Standards), but the implementation in 2007 of the IFRSs is not expected to significantly impact these yearly results.

However, Eurostat has also noticed that the ÖBB result is obtained after taking into account the yearly government transfers of € 1.6 bn (on € 5.4 bn total revenue of ÖBB in 2006). This notably includes € 1 bn transferred annually to the infrastructure maintenance unit *ÖBB-Infrastruktur Betrieb* for compensating costs related to the operation, maintenance, inspection, and repair of the railway infrastructure, pursuant to §42 BBG (the law regulating Austrian railways). Contrary to the other transfers, subsidies to cover ticket rebates for social purposes which would have the nature of sales, these yearly €1 billion transfers cannot have such a nature. Eurostat notes that the sales/costs ratio of *Infrastruktur Betrieb* seems even close to 50%.

No dividends have been paid out to the government owner by the group since 2005, which raises an issue of how or to what extent "*there is clear evidence that government will benefit from its investment*" as originally indicted on the second page of a note of the Federal Ministry of Finance attached to the Statistics Austria's letter dated 24 January 2005. In addition, the return on equity was, during the EDP visit of September 2007, explicitly recognized by ÖBB staff to be very low, noticeably below market rates of return.

In addition, Eurostat observes that the ÖBB Annual Report 2006 (page 85 of the English version) seems to cast a doubt on the actual profitability of the operations of the group, with the explicit indication that the expectation of subsidies allows avoiding recording provisions otherwise required: "*Since current market conditions only provide insufficient cost coverage of infrastructure investments through earnings, ÖBB-Infrastruktur Bau assumes that on the basis of the relevant statutory provisions (§47(1) BBG) the Republic of Austria will provide sufficient funds so as to reduce capital charges arising out of depreciations and interest to a level acceptable to the company, and that it is therefore not necessary to set up provisions of whatsoever kind for infrastructure investments not covered by earnings*".

Furthermore, the ÖBB auditors also explicitly state, in the Audit Certificate in the ÖBB Annual Report 2006 (page 49), that "*Without any restrictions of the Audit Certificate we state that in the basis of the master plan 2007-2012 approved by the Federal Ministry for Transport, Innovation and Technology and the Ministry of Finance, the group had initiated a considerable number of infrastructure projects with an overall volume of about 9.2 billion EUR at the end of 2006 and/or is carrying out these projects over a period of several years.*" and that "*Since only a small part of infrastructural capital expenditure may be earned by ÖBB-Infrastruktur Bau given the present market situation, the Republic of Austria is obliged to provide necessary funding (§§43 and 47) so ÖBB-Infrastruktur Bau is enabled to be in a position to comply with its tasks and to maintain its liquidity and equity to carry out the master plan*". Finally: "*nevertheless, we emphasize that the consolidated financial statements as of December 31, 2006 were drawn up on the assumption that the Republic of Austria will grant subsidies pursuant to § 43 par.2 BBG*".

Given the above, although ÖBB is technically formally in profit, Eurostat believes that it is not the spirit of the 2003 Decision to treat the 2004 capital injection in cash as addition to equity, given the dependence of the ÖBB net results on substantial government transfers (other than subsidies on products), a fact that is explicitly acknowledged by ÖBB management and auditors. This constitutes new information that radically changes the way Eurostat perceives the operation and that puts a question mark on whether Eurostat can support the current recording.

According to ESA95 rules, in order for a capital injection to be considered as a financial transaction, government should behave as a private investor. The present Part II.1.2 of the *ESA95 Manual on Government deficit and debt*, page 36, indicates that an expected "market rate of return" is a required criterion, notably for 100% owned public corporation. Eurostat believes that the calculation of the appropriate "market rate of return" should generally not include transfers and subventions undertaken by government. If such was not the case the rules could be easily circumvented by way of circular designs of cash flows. In addition, even when taking these subsidies into account, the small expected profits shown since the restructuring of the Austrian railways ÖBB do clearly not provide for a sufficient rate of return. In addition, the very small profit expected according to the business plan covering the period 2005-2010 seems not to ensure a "market rate of return".

Similar recent cases

I would like to draw your attention to the fact that, in a similar Spanish case RENFE (Red Nacional de los Ferrocarriles Espanõles) was divided into RENFE-Operadora and ADIF on 1 January 2005. In this case, the observation led to the advice to classify the government capital injections into RENFE-Operadora as government expenditure-capital transfers (D.9), likely in the form of an investment grant (D.92). The Eurostat advice is also published on the Eurostat web site.

Conclusion

Eurostat considers that the 2004 government capital injection into ÖBB should be classified as government expenditure-capital transfer (D.9), likely in the form of an investment grant (D92).

2. Progress on new EDP Tables 2B-D

As discussed during the September 2007 EDP mission, Eurostat suggested to the Austrian statistical authorities to change the way EDP tables 2B-D were compiled, by starting from real working balances. Eurostat would like to be informed on the efforts to improve on this issue, and expects noticeable progress in the upcoming notification, so that these tables will be reported as soon as possible in line with the intention of these tables, i.e., starting with published working balances based on public accounts.

3. Sales of housing loans

The accounting issue

Documentation

- Note from STAT of June 2008 on "Housing loans in Austria Conceptual issues".

Description of the case

State governments in Austria have sold housing loans, in particular in 2001, 2002 and 2007, for a price considerably below the face values of the loans. The total amount of the loans sold between 2001 and 2007 was € 7.4 bn, whilst the total face value was € 13.6 bn, i.e., a difference between transaction value and face value equal to € 6.2 bn or close to 46%. No capital transfer has been recorded in national accounts.

Eurostat will come back on this issue before the April 2009 EDP notification. Meanwhile, Eurostat wants to devote more time to reflect further on the issue as it has general interest, and Eurostat aims to present a general document for the next meeting in the Financial Accounts Working Group.

4. Public Hospitals

The accounting issue

Documentation

- Final findings from EDP mission to Austria, Vienna 10-11 September 2007

Description of the case

The two issues concerning public hospitals in Austria are the institutional sector classification of public hospitals and the government loans provided to the hospitals that are mainly recorded as capital transfers. Concerning the issue of sector classification, Eurostat has questioned the view of STAT that it is appropriate to classify public hospitals outside government. The reasons for Eurostat to question the classification of public hospitals, which are mostly loss making entities, as market producers, are that there does not seem to be an effective competition amongst hospitals, and that the so-called LKF system is a system of estimating the theoretical use of resources rather than a system working similarly to a price mechanism in a market. Eurostat will again ask STAT to reflect on their view, and provide a national accounts analysis on the sector classification issue.

As far as the issue of loans is concerned, and more specifically the question from STAT on what would be the definition of "profit making and loss making", Eurostat considers that four cases of recording of government loans to public quasi-corporations, could be envisaged:

1. Borrowing by government, independently from the quasi-corporations, forwarded to a profitable quasi-corporations = F.4 borrowing+F.5 (or F.4 loan)

2. Borrowing by government, independently from the quasi-corporations, forwarded to a non-profitable quasi-corporations =F.4 borrowing+D.9

3. Borrowing on behalf of a non-profitable quasi-corporations = F.4 borrowing+D.9

4. Borrowing on behalf of a profitable quasi-corporations = no entry in government accounts (direct quasi-corporations F.4 borrowing)

On the question of what is to be the definition in practice of the concept of profit making and loss making, ESA 95 does not provide an exact definition. However, what is usually understood by the concept of a profitable enterprise in a market economy is that after servicing all costs, the enterprise still have a surplus that will enable a market (or sufficient) rate of return to its owners on their investments.

In the case of public hospitals in Austria, they seem to be making losses. The so-called capital injection test could also be useful in these elaborations. When the government, acting in the same capacity as a private shareholder, provides funds, while receiving contractually something (usually financial instruments) of equal value in exchange *and* expecting to earn a sufficient rate of return on its investment, mostly in the form of dividends and a higher value of the financial instrument which represents the government's property rights on the corporation, the capital injection is to be recorded as a financial transaction in shares and other equity. In national accounting terms, the financial transaction has no impact on the government net borrowing/net lending, as well as no impact on the net worth of government.

When, on the other hand, the government, acting for public policy purposes, provides funds to a corporation without receiving anything of equal value in exchange *or* without expecting a sufficient rate of return on investment *or* in case of past losses of the corporation, the capital injection is to be recorded as a capital transfer. A capital injection recorded as a non-financial transaction has an impact on the government net borrowing/net lending (B.9), as well as on the change in net worth due to transactions (B.10.1). The eventual/final change in net worth, will depend on whether the injection gives rise to a parallel revaluation in the equity assets of the beneficiary.

In the draft version (and still not approved) of the new MGDD chapter on capital injections a sufficient rate of return expected on funds invested is proposed to be at least equal to:

- risk adjusted rates of return expected by private investors on similar equity investments in the same sector of activity; or
- long-term government bonds rates, after due deduction of relevant transfer payments made by government.

Even if no precise definition of profit making/loss making is established, the above clearly indicates the philosophy of the thinking in terms of national accounts. Therefore, in your national accounts analysis of public hospitals, it would be advisable to reason also along the above described lines.

For public quasi-corporations, the proposal (but not yet formally approved) for a new chapter in MGDD suggests the following operational guidance (this was also presented at the last meeting of FAWG in June 2008):

i) When a public quasi-corporation is <u>making profits and expecting to make sufficient profits in future,</u> government transfers of a capital nature, such as for the purpose of acquiring assets or reducing liabilities, should be recorded as financial transactions, other equity F.513 – ESA95 §4.61 and §5.95e, otherwise a capital transfer should generally be recorded.

ii) When a public quasi-corporation receives transfers from government to cover <u>accumulated losses or expected future losses,</u> these should be recorded as non-financial transactions, other capital transfer D.99 – ESA95 §4.165b. However, any part of a capital injection in excess of accumulated losses, may be recorded as a financial transaction (F.513) when appropriately documented.

iii) When a public quasi-corporation is running a <u>persistent operating deficit,</u> regular government transfers should be recorded as non-financial transactions, subsidies D.3 – ESA95 §4.61.

iv) When the government owner <u>cancels financial claims against, or assumes liabilities from,</u> a quasi-corporation, this should lead to the recording of financial transactions, equity F.513 – ESA95 §4.165f and §5.16, unless the operation is intended to cover accumulated losses or expected future losses, or is in the context of persistent losses or an exceptionally large loss – ESA95 §4.165b and § 4.61.

v) When government transfers to quasi-corporations take the form of investment grants, these are to be recorded as financial transactions, equity F.513 – ESA95 §4.157 and §4.61, unless these payments are intended to cover accumulated losses or expected future losses, or in the context of persistent losses or an exceptional large loss, in case of which they are recorded as other capital transfers D.99 – ESA95 §4.165 b. However, any part of a capital injection in excess of losses, accumulated or expected, may be recorded as a financial transaction (F.513) when appropriately documented.

This means that government inflows, in cash or in kind, into non-profitable quasi-corporations should be recorded as non-financial transactions. Therefore, §4.165b would prevail over §4.165 f, §5.16 and §4.61 in these cases. However, government inflows in excess of losses, accumulated or expected, may be recorded as financial transactions when appropriately documented.

Conclusion: Eurostat have some doubts on whether the sector classification of public hospitals in Austria as market producers reflects the economic reality. It is also recalled from the final findings of the September 2007 EDP mission that the 50% sales/cost threshold seems to be at risk when including consumption of fixed capital. Even if not verified, there appears to be a pattern according to which hospitals are loss making and dependent on government transfers. Eurostat would welcome a more thorough analysis of both the sector classification of public hospitals and their dependency of government financing.

Procedure

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with the amended Council Regulation 3605/93. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not), we would like to receive an answer from you on the issue, no later than **27 September 2008.**

Yours sincerely,

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