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Directorate C: National and European Accounts

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Subject: Methodological treatment of the capital injections into RENFE-Operadora in 2006

Dear Mr Gómez del Moral,

Following the exchange of information during the Request for clarification in the context of the October 2007 EDP notification, we are in a position to provide you with the preliminary view of Eurostat on the appropriate ESA95 accounting treatment of the capital injections of government into RENFE-Operadora in 2006.

The accounting issue

Documentation provided

The documentation provided is as follows:

- Description of the capital injections undertaken by the State into RENFE-Operadora in 2006, Request for clarification in the context of the October 2007 EDP notification (reference D/2007/30319)
- Business plan of RENFE-Operadora for the years 2006-2009 and supplementary information until 2014

Description of the case

The issue for which an opinion is being sought is the determination of the correct EDP accounting treatment of the capital injections of government into RENFE-Operadora in 2006.

RENFE restructuring

In 2004, a restructuring of the Spanish railway system took place. RENFE (Red Nacional de los Ferrocarriles Españoles) was divided into RENFE-Operadora and ADIF on 1 January 2005 (Ley 39/2003, of 17th November, del Sector Ferroviario). As regards the income of RENFE-Operadora, besides the sale of tickets, it is expected that the State will continue to finance this corporation, in particular the lines around suburbs of big cities.

Prior to the restructuring, RENFE was receiving each year subsidises and investment grants from government. RENFE had a considerable debt of about 7200 million euro. In the context of the railways restructuring, government assumed a large part of RENFE debt in 2004. The amounts were recorded as follows in national accounts: assumption of the historical debt of RENFE of 3659 million Euro as an "other capital transfer" (D99) and of the debt associated with the conventional railways of 1800 million Euro as "gross fixed capital formation" (P51), for a total impact on the government deficit of 5459 million EUR in 2004. The rest of the debt of RENFE (about 1600 million euro) was transferred to the new RENFE-Operadora.

RENFE-Operadora started operating on 1st January 2005. The "Aportaciones Patrimoniales" (contributions of government) to RENFE-Operadora own funds amounted to 1230 million euro. This amount is the difference between assets and liabilities assigned to the newly created company in the context of restructuring, and does not represent capital injection made in 2005 by government.

RENFE-Operadora

During the October 2007 EDP notification assessment, Eurostat noticed that government had made a capital injection to RENFE-Operadora for an amount of 404 million euro in 2006, which had been treated as a financial transaction (transaction in equity) by the Spanish statistical authorities (INE), thus without impact on the government deficit. On the basis of the publicly available 2005 accounts, Eurostat observed that the company received from government, as non-market income, 206 million euro in 2005 earmarked as "compensation for losses" (*compensacion de perdida*). According to the accounts, the loss of the exercise (*resultado de ejercicio*) of 201 million euro was transformed into an operational profit (*resultado de gestion*) of 4.4 million euro, due to this "compensation for losses".

Eurostat questioned the treatment of this capital injection as a financial transaction, and requested further information from the Spanish statistical authorities. The Spanish statistical authorities claimed that RENFE-Operadora is a profitable corporation without accumulated losses and explained the situation as follows.

In 2005 and 2006, the total amount of subsidies and transfers from government to RENFE-Operadora amounted to 623 and 716 million euro, respectively, which were recorded as government expenditure, with an impact on government deficit, as follows:

- 265 and 335 million euro of *subsidies* (recorded as a revenue in the profit and loss account of RENFE-Operadora);
- 206 and 227 million euro of "*compensation for covering losses*" (recorded in the own funds in the balance sheet of RENFE-Operadora);
- *assumption of RENFE debt* for amounts of 60 and 154 million euro;
- *investments on behalf of the State* for an amount of 92 million euro in 2005.

In 2005, government did not give to RENFE-Operadora any capital injection recorded as a financial transaction. But in 2006, government made, for the first time, a capital injection to RENFE-Operadora recorded as a financial transaction (*Shares and other equity – F5*) for an amount of 404 million of euro. The Spanish statistical authorities based their treatment on RENFE-Operadora's business plan, according to which the company will be profitable from 2010 onwards.

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.

ESA95 paragraph 4.152 applies in this case. 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 Spanish statistical authorities considered appropriate to record the capital injection for the amount of 404 million euro in 2006 as a financial transaction, under the heading "*Shares and other equity*" (F5), without impact on the government deficit.

Analysis

Classification of the transaction

RENFE-Operadora took over operations from a company, RENFE, that has a long history of bearing losses and will continue to require the assistance of government for a long time. According to the business plan, RENFE-Operadora will become profitable only in 2010. According to the publicly available "*Contrato Programa 2006-2010*", the company will be receiving the following subsidies until 2010:

- Subsidies - *Public service agreement (Aportaciones del estado para contratos)*
- Subsidies - *Human resources plan (Plan de Recursos Humanos)*
- *Compensation for losses (Compensation de perdidas)*

Secondly, 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% own 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 over 2006-2009 do clearly not provide for a sufficient rate of return. In addition, the very small profit expected in 2010 seems not to ensure a "market rate of return".

Thirdly, government will undertake capital injections into RENFE-Operadora in every single year between 2006 and 2010. It is suggested in the chapter II.3.1 of the *ESA95 Manual on government and deficit* that "*a pattern of repetitive payments would be an indication of unrequited transfers*".

Finally, according to the publicly available "*Contrato Programa 2006-2010*", the capital injections undertaken by government is clearly earmarked for investments (*Apportaciones estatal de capital para financiar inversiones*). This suggests recognising an investment grant (D.92). ESA 95 specifies that (§4.152) "*Investment grants (D.92) consist of capital transfers in cash or in kind*".

made by government or by the rest of the world to other residents or non-resident institutional units to finance all or part of the costs of their acquiring fixed assets". The ESA95 manual on government deficit and debt further indicate that "A capital injection that is conditional on the public corporation spending the funds on fixed capital formation, but does not commit the recipient any further, such as in making future payments should be recorded as a capital transfer – in this case an investment grant (D.92)".

Supplementary information to be provided

We have noticed that, in the "*Contrato Programa 2006-2010*", annual capital injections are foreseen until 2010 as follows:

- 404 million euro in 2006
- 404 million euro in 2007
- 449 million euro in 2008
- 479 million euro in 2009
- 404 million euro in 2010

In this context, we would like to know whether these amounts have been irrevocably agreed by government, or whether they remain conditional to future performance and might be subject to revisions, possibly depending also on the fulfilment of some conditions by RENFE-Operadora.

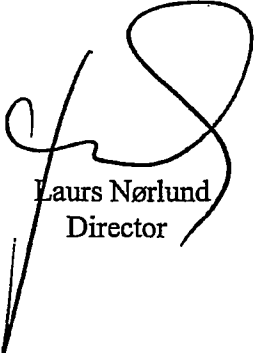
Conclusion

Eurostat considers that the capital injections of government into RENFE-Operadora should be classified as government expenditure – capital transfer (D.9), likely of the form of an investment grant (D.92).

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 15 April 2008.

Yours sincerely,



Laurs Nørlund
Director