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Directorate D: Government Finance Statistics (GFS) and quality

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Subject: Request for ex-ante advice
Sector-classification of "BVG-Fahrzeugfinanzierungsgesellschaft"

Ref.: Your Email of 20 January 2017 (your reference: D204/38131100-BVG-FFG)

Dear Mr Braakmann,

Thank you for your email dated 20 January 2017 and the attached documentation including the analysis by the Statistische Bundesamt (DESTATIS) of the sector-classification of *BVG Fahrzeugfinanzierungsgesellschaft* as well as the legal documents concerning the operations of *BVG Fahrzeugfinanzierungsgesellschaft*. After having closely examined the documents provided, Eurostat is now in a position to express a view on this matter.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

The issue to be analysed is the sector-classification of *BVG Fahrzeugfinanzierungsgesellschaft* (hereinafter, BVG FFG), a new subsidiary of *Berliner Verkehrsgesellschaft* (BVG) established to provide financial resources for the acquisition of rolling stock by BVG, as well as the accounting implications of the transactions carried out by BVG FFG. The statistical authorities of Germany have asked Eurostat to assess the issue at stake and express its opinion.

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Documentation provided

The statistical institute of Germany provided to Eurostat (1) its analysis of the sector-classification of BVG FFG, together with (2) several legal documents concerning the unit. The documents were the following:

- the articles of association of BVG FFG ("Gesellschaftsvertrag")
- the procedural rules for the executive directors of BVG FFG ("Geschäftsordnung für die Geschäftsführung")
- the management service agreement between BVG and BVG FFG ("Geschäftsbesorgungsvertrag")
- a domination agreement between BVG and BVG FFG ("Beherrschungs- und Gewinnabführungsvertrag")

Description of the case

BVG is the main provider of local public transportation services in Berlin. It has the monopoly position regarding the provision of tram and underground services, and, in addition, provides other services, including bus services, in competition with other corporations (although BVG is, by far, the main provider for this latter activity).

A service contract exists between BVG and the Land of Berlin, which will expire in August 2020. Both parties have already agreed, in 2015 in a letter of intent signed 7 January 2016, to renew the contract beyond that date. The next contract shall cover the years from 2020 to 2035. The letter also states major conditions for the extension; one of these conditions being the acquisition of new rolling stock by BVG to replace the existing fleet and increase its capacity. The acquisition is envisaged to include 700 large-profile and 500-small profile metro train sets and 200 trams. The investment into the rolling stock is planned to amount to up to EUR 3.1bn, a major investment for BVG given that – at end-2015 – the value of fixed assets on BVG's balance sheet amounted to EUR 4.64bn.

The acquisition of the new rolling stock shall be financed by incurring new debt on the capital market, rather than through loans (and investments grants) by the Land of Berlin, as was past practice. To implement this new financing model, a new unit has been established in January 2016, *BVG Fahrzeugfinanzierungsgesellschaft* (BVG FFG). BVG FFG is established as a private limited company with BVG being sole shareholder. The relation between the two companies is stipulated in various legal documents.

The Land of Berlin will however remain deeply involved with providing investments grants to BVG for the special purpose of allowing BVG to refund BVG FFG for the spending incurred. To this effect, the letter of intent between BVG and the Land of Berlin states additional details with regard to the financing model. BVG FFG will take out loans in its own name, however the Land of Berlin commits to covering the costs of the investments, i.e. the Land of Berlin will provide dedicated grants designed and calibrated to service the financing costs of BVG FFG (redemption of the principal and interest). The financing plan is set up to be in line with the scheduled depreciation of the procured vehicles (35 years; which extends the maturity of the financing commitment up to 2069, as the last procured vehicles are expected to take up service in 2035). The payment of the investment grants by the Land of Berlin to BVG will start in 2020, when the new service contract between BVG and the Land of Berlin will take effect. Therefore, the servicing of the loans is divided into two parts:

- 2016-2019 the BVG will cover the financing expenditure
- 2020-2069 the Land of Berlin will carry out the payments to BVG

Although the payments by the Land of Berlin will only start in 2020, they will cover the financing costs for the entire financing period, i.e. covering 2016-2069.

Apparently BVG FFG is not yet operational. In 2016, the first loans were taken out directly by BVG, however, in the name of its subsidiary BVG FFG.

2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

Applicable accounting rules

- ESA 2010, Chapter 1, paragraph 1.78, recognising the principal party of a transaction.
- ESA 2010, Chapter 2, in particular, paragraph 2.12 dealing with the issue of the definition of an institutional unit. As well as, paragraphs 2.35 to 2.38 concerning the issue of control of an institutional unit. In addition, ESA 2010, Chapter 20, especially paragraphs 20.27 to 20.29 providing rules for the market distinction and 20.309 dealing with public sector control.
- ESA 2010, Chapter 4, 4.152-4.163 dealing with investment grants.
- The Manual on Government Deficit and Debt (MGDD), implementation of ESA 2010, 2016 edition:
  Part I.2 “Criteria for classifying units to the general government sector”

Availability of national accounting analysis

The national statistical institute of Germany (DESTATIS) has provided an analysis of the case. It concludes that BVG FFG is not an institutional unit and therefore it has to be classified with its controlling unit. According to the analysis, the controlling unit of BVG FFG is BVG. BVG itself is controlled by government. However, since BVG is currently considered by DESTATIS to be a market producer, the BVG FFG would be classified with BVG in the non-financial corporations sector (S.11).

Methodological analysis and clarification by Eurostat

BVG FFG as institutional unit

From a legal perspective, BVG FFG would appear to be an institutional unit. A priori, the unit seems to comply with all the criteria set out in ESA 2010 2.12. Because of its legal form ("Gesellschaft mit beschränkter Haftung", private limited company), it is in principle:

a) entitled to own goods and assets in its own right,
b) able to take economic decisions and engage in economic activities for which it is responsible and accountable at law,
c) able to incur liabilities on its own behalf,
d) able to draw up a complete set of accounts

The legal documents provided by the national statistical authorities of Germany indicate, however, that BVG FFG is restricted in its decision making ability in such a way that it would lack autonomy of decision, in the ESA 2010 meaning, and therefore would not be seen as being an institutional unit.

The provisions in the procedural rules clearly state that the two executive directors of BVG FFG have to be executive staff members of BVG. The rules also stipulate that all transactions concerning the main function of the unit, which is, according to the articles of association, the provision of financial resources to BVG, surpassing a certain threshold in EUR need the approval of the shareholders – in this case, the BVG, since it is the sole shareholder. The threshold is set in such a way (i.e. very low) that, in practice, the executive directors of BVG FFG cannot enter in any material contract in the name of the company without the consent of the shareholders. Furthermore, in the event that shareholders' approval cannot be obtained in time, the executive directors may directly take a decision for urgent matters in agreement with the chair of the board of BVG (not acting in its capacity as shareholder). The shareholders' meeting is obligated to approve the decision taken by BVG afterwards. This provision is rather theoretical by nature, since BVG is the sole shareholder.

BVG FFG is also only allowed to act for BVG. It must not act in the name of others, or provide services to other units than BVG. The domination agreement, in particular, restricts the decision making autonomy of BVG FFG. It stipulates that BVG has the right to issue directives of any kind to the management of BVG FFG. Any directive issued by BVG has to be followed by the executive directors of BVG FFG if it does not contradict established law.

Beyond these provisions, BVG is also allowed to inspect the books and documents of BVG FFG at any time, and BVG FFG has the obligation to monthly inform BVG about all actions taken with regards to the financing of the acquisition of rolling stock for BVG.

Furthermore, any operating profit has to be forwarded to BVG, while BVG has to guarantee the liquidity of BVG FFG.

<u>*Parent of BVG FFG*</u>

Once it is established that BVG FFG seems to be an entity lacking autonomy of decision in the meaning of ESA2010, one needs to clarify which institutional unit is its "parent", i.e. the unit with which BVG FFG accounts will be aggregated for the purpose of statistical reporting. This step of establishing which institutional unit is the parent of an entity that is not an institutional unit is often described as amounting to determining which unit is controlling that entity (see Diagram 20.1 of ESA 2010 Chapter 20).

While it is indisputable that BVG FFG is publicly controlled, one may wonder whether the parent is the Land of Berlin itself (trough financing) or BVG (trough ownership).

ESA 2010 2.36 stipulates that "*a single institutional unit […] secures control over a corporation or quasi-corporation by owning more than half the voting shares or otherwise controlling more than half the shareholders' voting power.*" In the case of BVG FFG, BVG is the only shareholder in the company, and therefore the owner of the majority of voting interest.

The control criteria stated in ESA 2010 20.309 include the following:

"(a) rights to appoint, veto or remove a majority of officers, board of directors etc. […]"
"(c) rights to appoint, veto or remove a majority of appointments for key committees of the entity. […]"
"(d) ownership of the majority of the voting interest. […]"
"(f) rights to control via contractual agreements. […]"

BVG satisfies the criteria mentioned above. The executive directors of BVG FFG have to be chosen from the ranks of the executive members of staff of BVG. BVG is the sole shareholder in the company and also the sole client, as BVG FFG is prohibited to act for other clients than BVG.

At the same time, financing is also a criterion of control (ESA 20.309(g)), and as such the Land of Berlin may be seen as the parent of BVG FFG, rather than BVG.

Given that BVG FFG is a mere financial vehicle with limited autonomy (as analysed by DESTATIS), and given the statistical treatment envisaged for the BVG FFG borrowing (see below), Eurostat sees no objection to concur with DESTATIS' decision that the parent of BVG FFG is BVG.

Statistical treatment of the loans

According to the financing model already described, BVG FFG takes out in its own name loans to fund the acquisition of rolling stock. These funds are forwarded in the form of loans provided by BVG FFG to BVG. The funds are solely used to finance the acquisition of the rolling stock.

However, because of the mutual agreement between the Land of Berlin and BVG (letter of intent) stating that Berlin will take over full responsibility of the servicing of the loans (payment of the capital costs, which are defined in the agreement as repayment of the principal and payment of interest) the loans may not merely be seen as loans taken out by BVG FFG but as liabilities of the Land of Berlin.

In line with ESA 2010 1.78, the Land of Berlin can be seen as the principal party in the borrowing transactions, that is, in this case, as the obligated party of the financial transactions, although indirectly. This is because the loans incurred by BVG FFG are solely funded by government through the contractual agreement between the Land of Berlin and BVG. Thus, although BVG FFG would be taking out the loans from a legal perspective, government *de facto* assumes the responsibilities of the debtor. It is, therefore, the only party fully exposed to the obligations of the borrowing. As a consequence, the loans incurred by BVG FFG should be directly recorded in the accounts of the Land of Berlin.

The loans taken out by BVG FFG are only incurred to finance the investment in fixed capital of BVG. Due to this predefined use of funds, and in combination with the contractual commitment of the Land of Berlin, it has to be assumed that government provides an investment grant. Eurostat also considers that the time of recording of such investment grants, in this case, would be the time at which each individual loan is drawn down. The reason for this is that it is already predefined that the loans will only be used for the acquisition of rolling stock and that the Land of Berlin has already entered into the obligation for the loans. Consequently, as no material element of contingency exists, the investment grants can already by recorded at this time, rather than at time of investment (which is the usual time of recording of investment grants).

It should be noted that the recording approach outlined herewith, i.e. consisting in recognising the principal of the borrowing along with a counterpart as investment grant, would yield the same result as if Land of Berlin was considered the parent of BVG FFG (and if the latter was accordingly classified within general government).

The profile of the cash flows, with the Land of Berlin only starting the grant payments in 2020, which are also not directly in line with the actual debt payments but based on average values, does not provide a reason to avoid this treatment. This is because ESA 2010 records the substance over form and applies the accrual principle. In the case in question, in substance the

Land of Berlin incurs an obligation when debts are issued by BVG FFG. The matching investment grant should be recorded at that time, and not at the time the payments are made, according to the accrual principle.

Sector-classification of BVG

Another issue concerns the sector classification of BVG itself.

BVG is established as an "Anstalt öffentlichen Rechts" (institution under public law). It seems to fulfil the "autonomy of decision" criteria under ESA 2010 2.12 and can therefore be considered to be an institutional unit. It is furthermore controlled by government.

The market/non-market delineation is, in a first step, assessed along the so-called **qualitative criteria**, notably in accordance with ESA 2010 20.27, for the services provided under the monopoly of BVG, and ESA 2010 20.28, for the services provided in competition with private corporations. For the areas in which BVG competes with private service providers, contracts are awarded on the basis of a tendering procedure, seemingly satisfying ESA 2010 20.28. Concerning the monopolistic output, it is sold to both, households and government, where the share of output sold to government consists of reductions in ticket prices based on social criteria. As the share of sales to non-government units greatly exceeds 50% of total sales, the quantitative criterion is additionally used to determine the sector classification of BVG.

With regard to the **quantitative criterion**, the sales figures used for the computation of the test include neither any of the significant current or capital transfers made by the Land of Berlin to BVG nor the amortisation of investment grants also received from the Land of Berlin (and booked as revenue in the profit and loss accounts of BVG). However, included in the sales component are revenues stemming from advertising and other revenues (e.g. revenues from renting operations). An important component of the test is the "output sold to government", i.e. the reductions in ticket prices based on social criteria. Approximately one eighth of total sales originate from these reductions. These payments are directly linked to the social purpose and are classified by DESTATIS as social transfers in kind (D.632). Because any operator of public transportation services in Berlin may benefit from such payments provided by the Land of Berlin, this choice made by DESTATIS appears legitimate. If this was, in fact, not the case, these payments would need to be excluded from the test. In view of the near monopolistic status of BVG in the public transportation sector in Berlin, it may be nonetheless difficult to genuinely assess this condition. Concerning the cost component of the test, consumption of fixed capital is approximated by using depreciation of fixed assets observed in the financial statement of BVG, weighted by using a multiplier of 1.5, as is common practice of the Statistische Bundesamt. It is also believed that the fixed assets financed through investment grants appear in the balance sheet as both an asset and a matching liability provision, and that the amortisation of both appear in the profit and loss accounts as, respectively, an expense and a revenue.

The sales to production costs ratio of BVG remained for the years 2012-2015 somewhat above 50%. Based on the results of the market/non-market test, BVG is currently classified in the non-financial corporations sector (S.11).

This said, Eurostat draws the attention of DESTATIS to the fact that BVG meets the 50% criterion but hardly by a large margin, which, coupled with the fact that BVG can fund its investments only based on a long term contract with the Land of Berlin (allowing BVG to finance its needs through tapping the Land of Berlin’s borrowing capacity), may seem to be pointing to a borderline case. The increasing intertwining between BVG and the Land of Berlin together with BVG quasi-monopoly position may put a question mark on its market character, in the meaning of ESA 2010, if not on its autonomy of decision (although the wording of certain conditions in the letter of intent might raise doubts in this respect). Accordingly, Eurostat encourages DESTATIS to closely monitor future developments in this respect.

3. Conclusion

The combined provisions in the legal documents clearly constrict the BVG FFG in a way that it cannot be considered to have any autonomy of decision regarding its main function. The main function of BVG FFG is the provision of funds to BVG, which, not only has to agree to all operations, but has the right to issue obligatory directives. Therefore, BVG FFG is not an institutional unit and has to be classified with its controlling unit.

Based on the legal documents provided and the fact that BVG is the sole shareholder in BVG FFG, BVG seems to be the plausible parent of BVG FFG (although the State of Berlin could also be seen as an alternative parent based on a financing criterion).

Since BVG FFG cannot be seen as an institutional unit and BVG is its parent, BVG FFG has to be classified with its parent institution, BVG, which is currently classified in the sector S.11.

Given the agreement between the Land of Berlin and BVG (letter of intent) stating that the Land of Berlin will take over full responsibility of the servicing of the loans incurred by BVG FFG, the latter have to be considered as liabilities of the Land of Berlin at inception (i.e. at time of loan drawdowns). The corresponding transactions in the non-financial accounts have to be recorded, in national accounts, as investment grants expenditure by the Land of Berlin, at that time.

4. Procedure

This preliminary view of Eurostat is based on the information provided by the German authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

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 Council Regulation 479/2009 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site.

Yours sincerely,

(e-Signed)

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