EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

Luxembourg,
ESTAT/D-3/EBC/LA/ANR/

Ms Aija Žīgure
President
Central Statistical Bureau of Latvia
Lāčplēša Street 1
Riga, LV - 1301
LATVIA

Subject: Request for ex-ante advice on the Statistical treatment of the government investment in SJSC "*Latvijas Dzelzceļš*"

Ref.: 0601-10/677 from 5 June 2017

Dear Ms Aija Žīgure,

Following your letter of 5 June, and the discussion at the EDP visit from 7-9 June 2017, Eurostat would like to provide you with its opinion regarding the recording a planned equity increase in SJSC "*Latvijas Dzelzceļš*" (LDz) by the government for implementation of the Latvian railway network electrification project.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

Just prior to the EDP visit 7-9 June 2017, the Latvian authorities requested an ex-ante advice concerning the national accounts treatment of a planned equity increase in SJSC "*Latvijas Dzelzceļš*" (LDz). The capital increase shall be carried out in the context of the Latvian railway network electrification project allowing LDz to finance necessary investments.

Eurostat agreed to include the issue in the agenda of the EDP visit. For the discussion and presentation of the project, Latvia invited for the meeting two representatives of the Ministry of Transport and the responsible project manager from Ernst & Young.

Documentation provided

The Central Statistical Bureau of Latvia (CSB) provided to Eurostat a detailed excerpt and a presentation of the LDz business plan for the period 2017-2036 as well as a complete assessment of an independent expert regarding the credibility of the assumptions used in the business plan.

After the EDP visit, as agreed in the meeting, the Latvian authorities submitted to Eurostat in e-mails dated 13, 19 and 30 of June 2017, further information such as the consolidated 2016 annual accounts of LDz, the main financial indicators (e.g. net profit, total liquidity, total assets, equity etc.), as well as a breakdown of the net turnover by individual items, for the period 2007-2016.

Description of the case

LDz plans to electrify the main railway network to the ports of Riga and Ventspils, to replace the existing 3.3kV DC network with 2x25kV AC network for suburban railway network in Riga agglomeration and to electrify the Jelgava –Liepaja as well as Daugavpils –Indra (Latvia's border) sections.

LDz is a 100% state-owned public company and was founded in 1991. LDz has 6 subsidiaries each of them (including LDz infrastructure, LDz Cargo, LDz Logistica, LatRaiNet, etc.), though, functional unbundling to take independent decisions.

LDz is the beneficiary, owner and maintainer of the current railway infrastructure. LDz is responsible for the implementation of the electrification project and will also maintain newly constructed catenary infrastructure.

The Latvian railway network electrification project will be financed by three sources: the Cohesion Fund will provide funds in the amount of EUR 347 million, government will invest an amount of EUR 120 million, and credit institutions will provide a loan in the amount of EUR 52 million to LDz.[1]

The project is divided into two stages. Stage I is planned to be implemented from 2019 till 2023 and Stage II is planned to be implemented from 2023 till 2025. Within Stage I, the total investment expenditure sum up to approximately EUR 519 million to electrify 299.9 km of the railway infrastructure, extend Stirniene station sideway and build a new Depot.[2]

The network electrification project aims "*to raise the efficiency of transportation, promote the use of environmentally friendly technologies and increase the international competitiveness of the Latvian railway transit corridor*".[3] It would allow not only passengers transportation but also an increase of the freight transportation.

It is understood that there will not be a private investor participation in the capital injection and that after implementation of the electrification project, LDz will remain a state-owned company.

Even though LDz is profitable, the European Union fund support is crucial to implement the project, as LDz cannot finance the project without the support from the EU fund.[4] Also the government capital injection is essential for the project realisation, since the existing debt level would not allow to take up the additional liabilities as the bank covenants, such as net debt / EBITDA and DSCR, would be breached. In addition, without the capital increase, the leverage ratio would get below 30% which could also be considered as a breach of financial covenants.

[1] SJSC «LATVIJAS DZELZCEĻŠ» Business plan from 18.05.2017
[2] Ibid.
[3] Ibid.
[4] Ibid.

The business plan base scenario assumes no increase in output: the traffic volume is supposed to remain the same with or without electrification. In this scenario the network electrification achieves profitability due to cost savings (in fuel, maintenance and, personnel), mainly via a reduction in the number of trains needed. The business plan pessimistic scenario assumes freight volume drops that will remain constant throughout the forecast. In case of pessimistic scenario, the estimated rate of return for the EUR 120 million share capital injected is approximately 2.2 p.p. lower than in the base scenario.[5]

2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

Applicable accounting rules

- ESA 2010, Chapter 20, Capital injections (§20.197 to § 20.204), in particular, § 20.198 and § 20.199 refer to capital injections into public corporations.
- ESA 2010, Chapter 4, Capital transfers – Investment grants (§4.152 to §4.163).
- In addition to ESA 2010, the Manual on Government Deficit and Debt (MGDD) provides a section dedicated to capital injections into public corporations (section III.2).

Availability of national accounting analysis

Central Statistical Bureau of Latvia (CSB) analysis

The Latvian authorities have provided an analysis of the case. According to the CSB analysis, the government is acting similarly to a private investor increasing the value of the company. Therefore, the capital injection in the total amount of EUR 120 million (40 million euros in 2019, 40 million euros in 2010 and 40 million euros in 2021) should be recorded as an acquisition of equity (F.5) in national accounts.

CSB's opinion is based on the fact that LDz has not accumulated any net losses. In fact, the corporation (holding company) makes profits on a regular basis and the profit is both distributed and reinvested. According to the Business Plan for 2017-2036 submitted by LDz, the company plans to make profits also in the future (i.e. in the period 2017-2036). The profit will be redirected to finance the implementation of the investment project (no dividend payments to the state are foreseen), and thus any return created by the project will manifest itself in the form of capital gains.

In their analysis, CSB stressed that in the business plan under the base scenario the return on the share capital invested will amount to approximately 7,25% after the implementation of the project. In the pessimistic scenario, the return will drop by approximately 2.2 pp. Accordingly, CSB concluded that a sufficient rate of return is ensured in comparison to 10-year state bond rates (based on data from the last 10-year bond issuance, the yield was 0,456%[6]). In addition, the ratios provided by LDz on comparable companies support the fulfilment of criteria for a sufficient rate of return.

[5] SJSC «LATVIJAS DZELZCEĻŠ» Business plan from 18.05.2017

[6] Link – http://www.kase.gov.lv/l/latvia-locks-in-historically-lowest-level-for-a-new-10-year-bond/9056

The business plan has been drawn up on the basis of the Cost-Benefit Analysis, in close cooperation with JASPERS. In this context, CSB mentioned that there are a "number of assumptions, which are related to significant uncertainty and risks and that the actual results may differ from the assumptions." During the discussions with KPMG, CSB was informed that these risks are not unusual for such a long planning period and are subject to economic/political/legislative/business developments. In addition, in the media there have been confronting views on the possible future developments of freight turnover, but they did not impact the CSB's opinion. The CSB does not have sound evidence that the performance could be worse than foreseen, at least in the pessimistic scenario.

Methodological analysis and clarification by Eurostat

Sector classification of LDz

Even if the sector classification of LDz was not subject of the request for advice, it is reasonable to review briefly its current classification, in particular, regarding the criteria established in ESA 2010, §20.19 to §20.31 and specifically to check the criteria from §20.29, c).

Independently of the result of the quantitative market/non-market test, which LDz has passed, there is a need to analyse the company under the qualitative criteria, since there may be cases where the producer "by its nature" is not considered a market producer and that require specific analysis.

LDz holds the rail infrastructure that is then used and "rented" by *Pasazieru Vilciens* (PV) – the passenger rail company. In the context of a sale of the "Passenger Train" shares to the Latvian Ministry of Transport in 2008, the sector classification of the passenger rail company was re-examined and, following the outcome of the analysis, the unit was reclassified inside the general government sector. Thus, a substantial part of the sale revenue of LDz are realised with the government, which requires to check not only the 50% criteria but also the qualitative criteria mentioned in ESA 2010 § 20.29 c). Taking this into account, in the LDz case it is now relevant to analyse whether government is the sole or major client of the company or whether it realizes the majority of its revenues with other customers (qualitative criteria).

According to the breakdown of the net turnover by individual items for the period 2007-2016, around 70% of the revenues of LDz are generated from the Cargo transportation business. In addition, the LDz consolidated annual report 2016 shows that transportation of oil/oil products and coal traditionally constitutes the largest proportion of all cargoes, up to more than two thirds. They are followed by mineral fertilisers, metals, chemicals and other types of commodities. Furthermore, most of the freight carried by LDz comes from the main cooperation partners of the company in Russia and Belarus, as well as Lithuania, Ukraine and Estonia.

Eurostat understands that most of the company's revenue is coming from domestic or foreign private clients and not from the government and concludes that if this is the case, LDz is correctly classified in sector S.11.

Equity increase in SJSC "Latvijas Dzelzceļš" (LDz)

When determining the classification of a transaction, it is required to consider the role government is playing in the transaction and to focus on the underlying economic substance of the transaction. The latter concerns in particular the circumstances of the provision of funds by the Latvian government.

In particular, MGDD - section III.2 - Capital injections into public corporations, Box 1 – Recording transactions: straightforward cases and difficult areas, states that raises doubts on the nature of the transaction when it refers that "*in practice, compilers are confronted either with straightforward cases that lead to clear statistical treatments, or with borderline cases that require further inquiries and applying various tests",* giving as a first example of a straightforward case in the recording of capital injections, the case of investment grants (D.92).

In accordance with ESA 2010 §4.152, the MGDD provides that *"A capital injection that would consist of a capital transfer in cash or in kind made by government (...) to another resident (...) institutional unit to finance all or part of the costs of its acquiring of fixed assets is to be recorded as an investment grant (D.92).*" In general, if the provision of government funds is *de facto* earmarked to the acquisition of fixed assets, ESA 2010 forces to record a non-financial instead of a financial transaction.

Eurostat is in fact of the opinion that the intended provision of funds has the features of an investment grant to the extent that this injection is earmarked to the implementation of the Latvian railway network electrification project. In this context it is understood that the government capital injection is even essential for the project realisation, since the existing debt level does not permit to finance it in another manner.

In addition, the Government investment in the project could be seen as a national investment to ensure a public policy need, i.e., the improvement of a public-use railway infrastructure. which is a government responsibility. Acting this way the government may be just expecting an improvement of the corporation's wealth and above all the meeting of social needs. In such circumstances, a capital transfer expenditure (i.e. an investment grant) should be recorded in the Government accounts with negative impact on B9. In this context the fact that the LDz will not pay any dividends (it will retain its future profits) to government, raises also concerns and corroborates this argument, even if in the end this would result in an increased value of equity held by government.

The fact that the major part of the project is financed by the Cohesion Fund supports the view that there is a public policy issue first and not the intention to realize a profitable investment. One could also question whether the capital injection constitutes an increase of equity or is the national co-financing part of Latvia to the European Cohesion Fund financing, which would lead also to a recording of an investment grant in national accounts.

Furthermore, for a profitable investment to be recorded as an acquisition of equity MGDD, section III.2, Box 1, states for example that "*a capital injection given to a public corporation with the objective of increasing the government's future dividends should be recorded in F.5. This would be the case when the corporation is free to use the funds to maximise profits and the government expects a market return on its investment."*

Thus, for the recording of an acquisition of equity it is not only necessary that the government will receive in the future higher dividend payments or that the value of the corporation will increase (i.e. the value of its equity) but also that the corporation is free to use the funds to maximise its profits. In the present case the funds provided by the government are clearly earmarked to the electrification of the railway infrastructure (i.e. to the acquisition of the related assets) without there being any possibility for LDz to invest in a possible alternative project.

Eurostat is in fact of the opinion that in the present case the issue of losses and earning a sufficient rate of return are not decisive for the classification of the capital injection. The intended provision of funds is earmarked to the implementation of the Latvian railway network electrification project and therefore LDz is not free to decide on the best possible use of the funds. Therefore, the capital injection is, in substance, to be considered as a non-financial transaction, with a negative impact on net lending /borrowing (B.9).

3. CONCLUSION

LDz is a 100% state-owned profitable public company that plans to implement the Latvian railway network electrification project. The project is mainly financed by the European Cohesion Fund. The government capital injection is essential for the project realisation, since the existing debt level will not allow to take up additional liabilities of the project as the bank covenants, such as net debt / EBITDA and DSCR, will be breached.

A Business Plan was presented with scenarios that are based on reasonable assumptions where the consolidated profitability of the group significantly increases mainly due to cost reduction. The planned investment, presents a positive RoE that still meets a "sufficient rate of return".

CSB considers that the government is acting in its capacity as shareholder and expecting to earn a sufficient rate of return on its investment, as so, the capital injection in LDz is to be recorded as a financial transaction in shares and other equity, with no impact on the government net lending/borrowing

The issue is whether the intended provision of funds could be considered as a financial transaction since it seems to comply with the requirements of the capital injection test (i.e. no (accumulated) losses, sufficient rate of return) or, if it is to be seen as a straightforward case of the recording of a capital injection into a public corporation, where the provision of funds has the nature of an investment grant which would preclude the application of the capital injection test.

A key feature of an investment grant is that it is earmarked whereas equity is freely usable. Eurostat is of the opinion that the proposed capital injection has the features of an investment grant to the extent that is provided in the context of the Latvian railway network electrification project and LDz is not able to decide freely on the use of the funds. Hence, Eurostat concludes that this capital injection is, de facto, not distinguishable from an investment grant and is to be recorded as a non-financial transaction expenditure in capital transfers (D.9) - investment grants (D92), with an impact on the government net lending/borrowing (B.9).

In addition, the Government investment in the project could be seen as a national investment to ensure a public policy need, i.e., the electrification of a public-use railway infrastructure, which would be a government responsibility and should be reflected in the government accounts.

4. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the Latvian 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)

Eduardo Barredo Capelot
Director