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Ms Genovefa Ružić  
Director General  
Statistical Office of the Republic of Slovenia  
Litostrojska 54, SI – 1000 Ljubljana

**Subject: Ex ante consultation of the sector classification of the DSU company**

Ref.: Your letter 542-57/2017/1 and its annexes sent by e-mail on 22 February 2017

Dear Ms Ružić,

Eurostat has analysed the documentation regarding the DSU company (*Property Management and Consultancy - družba za svetovanje in upravljanje, d.o.o. hereinafter DSU*) that was provided in your letter dated 22 February 2017, drawing the attention to the policy changes in the company's activities ("*new modus operandi*"). Eurostat is in a position to provide an opinion on the appropriate sector classification of the DSU company in the light of ESA 2010.

## 1. THE ACCOUNTING ISSUE

The accounting issue under discussion is the sector classification of the DSU company, a public limited liabilities company classified in government accounts since 2009.

### 1.1 Documentation provided by SORS, other related documents and correspondence

- 2014 emails correspondence on same issue;
- *SORS letter no. 96002-1/2015/24* sent by email on 5 May 2015 requesting the review of the institutional sector of public corporation DSU;
- *Final findings of the 2015 EDP dialogue visit*, carried out in September 2015, published on Eurostat website (see action point 20)<sup>1</sup>;
- *SORS new letter no. 542-57/2017/1* including a description of the case that highlights the *new modus operandi* of the DSU, the actual and proposed sector classification and annexes including data on 2012-2015 revenues, expenditures and debt, together with the profit and loss account, the balance sheet and the annuity plan for loans repayment for the 2008-2032 period.

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<sup>1</sup> <http://ec.europa.eu/eurostat/documents/1015035/6940197/Final-findings-EDP-dialogue-visit-SI-7-8-Sept-2015.pdf>

## 1.2 Description of the case

### 1.2.1 Background

DSU is an independent commercial company established in 2001, 100% owned by the state, to take over the Slovenian Development Company activities – including closing on the transformation of the ownership of social property. By 2007, its activities were expanded to manage real estates. It is organized as a limited liability company.

At the moment, the main source of the DSU income is rentals (95% of all revenues in 2015), with a large majority paid by general government units (94% of rentals in 2015). DSU rents buildings which were acquired, built or bought by DSU and financed by loans taken by DSU without government guaranties. From 2009 on, DSU has been classified in the general government sector (S.1311) based on the analysis that the majority of its activities was non-market. Considering the qualitative criteria set out in ESA 2010, in the past, SORS recognised the DSU activities as non-market, since the majority of services were provided to the government and since DSU had entered into transactions with the state through direct contracts or preliminary contracts.

As mentioned, the majority of DSU activities relates to sales of goods and services. The main activity is real estate management, including the leasing of commercial premises, the purchase or construction of real estate for letting or resale, and the management and maintenance of commercial buildings.

References about activities on DSU website (<http://www.dsu.si/en-gb/about-us/activity>):

*DSU carries out two core activities: implements investments in real estate, including the management of management of real estate property, and public authorisations related to the transformation of ownership of social property.*

*DSU was established in 2001 within the scope of the transformation and dissolution of Slovenska razvojna družba, d.d. (Slovenian Development Company, hereinafter: SDC). Pursuant to the Transfer of the Powers, Rights and Liabilities of the SDC and on the Dissolution of Agency of the Republic of Slovenia for Restructuring and Privatisation Act (hereinafter: the ZPPSRD), DSU, as a single-owner enterprise 100% owned by the Republic of Slovenia, as of 7 May 2004, assumed all authorisations, rights and obligations of SDC (in liquidation) deriving from the transformation of ownership of social property, privatisation and denationalisation. This involves a number of tasks and assets that DSU manages on its own behalf as well as for the account of the Republic of Slovenia. Pursuant to the ZPPSRD it therefore continues the extensive and complex service of resolving issues related to ownership and the conclusion of procedures relating to the transformation of ownership of social property which were previously carried out by the Company's legal predecessors, i.e. the Slovenian Development Fund, SDC and the Agency of the Republic of Slovenia for Restructuring and Privatisation.*

*In addition to the implementation of public authorisations which are tied to a number of court proceedings conducted by DSU, the Government of the Republic of Slovenia adopted a decision in July 2007 on the expansion of DSU's activity to the management of material assets (real estate) and the securing of spatial conditions for the functioning of public administration bodies and the public sector. DSU thereby began investing available funds in real estate projects.*

### **1.2.2 SORS requests on same issue in 2015 and 2014**

Following a SORS letter sent by email to Eurostat in May 2015, including an analysis based on national accounts concepts, the company statute, the financial statements for the period 2011-2014, and the revenues by activities and by clients (public/private), the sector classification of the DSU was discussed in the 2015 EDP dialogue visit on 7-8 September 2015. At that time, Eurostat and SORS agreed on the sector classification of DSU in the general government.

Eurostat's main arguments were the following. The unit was a government controlled unit, fully owned by the State. The Supervisory Board comprised three members – one representative of the employees, but the other two members were appointed by Government. A prior agreement of the supervisory board was needed in case of sale of shares and financing of projects that involved amounts bigger than 1 mill euro. Actually, more than 92% of the company's activities (in terms of revenues) were with government. In Eurostat's view this unit was seen as a kind of ancillary unit (a sort of "*captive rental company*") borrowing on the market, but constructing buildings to be rented to the government.

Considering the email correspondences on the same issue in previous years and given that SORS informed that a new statute, concerning changes in the company's activities in the future, was being drafted and not yet signed, it was agreed that Eurostat would be consulted on any further changes considered as a significant for sector classification review by a formal ex-ante request for advice.

### **1.2.3 SORS letter in 2017 on the DSU sector classification**

According to the letter from SORS, in the last three years, DSU has changed its activities and there is evidence that DSU is involved in market activities. SORS, thus, proposes to reclassify DSU into the public non-financial sector.

SORS has asked Eurostat if the proposal to reclassify DSU, together with proposed statistical treatment rerouting of debt, is in line with ESA rules. If the proposal for reclassification is supported by Eurostat, SORS will reclassify DSU starting from 2017, but SORS will closely monitor DSU activities and, if a non-market behaviour is noticed, DSU will be reclassified into the general government sector immediately.

## **2. METHODOLOGICAL ANALYSIS**

### **2.1 Applicable accounting rules**

- ESA2010 chapter 1 *General features and basic principles* section *Characteristics of the ESA 2010 concepts* paragraph 1.31;
- ESA2010 chapter 2 *Units and grouping of units* section *Artificial subsidiaries* paragraphs 2.24-2.26;
- ESA2010 chapter 20 *The government accounts* section *Market/non-market delineation* paragraphs 20.06, 20.08-20.12, 20.19, 20.24-20.28;
- MGDD 2016 chapter I.2.4 *Concept of a market or non-market institutional unit*.

## 2.2 Availability of national accounting analysis – SORS' analysis

According to the new letter from SORS, the basic argument in favour of the DSU "*market orientation*" is based on the main strategic documents of the company. The strategic plan of the company for the 2015-2017 period refers to a gradual transition from the implementation of its statutory powers towards a specialized investor and operator of real estates, while ensuring high profitable investments. Other strategic objectives are rational management of liabilities and assets, investment according to the principle of good liquidity and the acceptance of only minimum or medium risks, seeking new business opportunities and improving profitability. The primary interest pursued by the company is to achieve a target return on invested capital. The objectives mentioned were incorporated into the constitutional document (Akt o ustanovitvi DSU) adopted in May 2016 (the development and realization of the real estate projects and investment management of the real estate).

The owner, i.e. the Slovenian Sovereign Holding, treats DSU as a market investment and regularly monitors the operations of the company in terms of implementation of the Strategic Plan and achievement of business and financial goals. In accordance with the management plan, DSU manages the company's assets in its own name and on its own account.

DSU has clearly defined criteria for the purchase, construction and letting of the commercial premises, when pursuing the objective of making a profit. The minimum rates of return are calculated on the basis of a DSU methodology to assess the economic viability of investments and are approved by the Supervisory Council Board.

DSU finances investments that prove to be economically viable by its own funds and by long-term loans from commercial banks incurred under market conditions. SORS has indicated that no guarantees have been provided by government, i.e. creditors can solely draw on the DSU capital or pledged assets.

In accordance with current practice, government units now conclude lessee contracts with DSU in accordance with the applicable legislation, including inter alia their obligation to verify and to obtain competitive bids on the basis of the Decree on Physical Assets of the State and Local Governments (last dated 2016). In accordance with Article 50 of this Decree, the operators of tangible assets have to check the supply on the external market and to carry out negotiations with the best bidders and then conclude contracts with the most favourable bidders. Consequently, DSU now competes with all other providers of real estate or business premises and concludes deals with government units only when DSU offers the most favourable conditions for the lessee.

DSU is a public producer that sells the majority of its output to government. But there are several competitive producers and the DSU contracting process with government, at least in recent years, has taken place in an open competition. Therefore, SORS has proposed to reclassify the unit from the general government sector into the public non-financial corporations sector. SORS proposes:

- to reclassify DSU into S.11001 public non-financial corporations sector, starting from 2017;
- DSU's present debt is to remain within the general government debt (until the total repayment in 2031). Annual interest and payments of the principal, which is imputed, will be matched by a D.9 capital transfer from DSU to general government: the impact on B.9 of the general government will be equal to annual repayments of the principal.

SORS has asks Eurostat if the proposal to reclassify DSU, together with the proposed statistical treatment rerouting of debt, is in line with ESA rules. If the proposal for reclassification is supported by Eurostat, SORS will reclassify DSU starting from 2017, but SORS will closely monitor DSU activities and, if a non-market behaviour is noticed, DSU will be reclassified into the general government sector immediately.

### **2.3 Eurostat's analysis**

Eurostat does not support the statistical treatment proposed by SORS to reclassify DSU from the sector S.13 to the sector S.11. In Eurostat's view, arguments still favour maintaining the classification in the government sector.

Eurostat understands that DSU still conducts residual operations related to the SDC, which implies the exercise of governmental powers. In this respect DSU acts as an agency of government, which would merit the classification inside general government, as a 'government unit', in application of ESA 2010 paragraphs 20.06 and 20.08-20.12.

Aside from this, the key issue is to determine whether the establishing of the DSU entity is merely a way for government to organise itself concerning the mentioned activities, or whether the DSU is an institutional unit genuinely engaged in renting assets on the market, on a commercial basis, with government units being one of its clients, being attracted to it only by the economic advantage of the contract provided.

In this respect there are reasons to consider DSU as an 'artificial subsidiary', as described in ESA 2010 2.24-2.26 or, even, as a unit carrying out 'ancillary activities' as described in ESA 2010 20.24 as well as in ESA 2010 paragraphs 1.31 and 13.23.

Eurostat observes significant assets in the financial statements of DSU. According to ESA 2010 2.24-2.25, artificial subsidiaries are entities created to artificially host either the assets, or the employees, or the liabilities, or a combination thereof, in legally separated structures, whereas these various parts of the enterprise in fact constitute a unique whole, from an economic point of view, and should be recognised as one unique institutional unit. In a sense, each legal entity cannot meaningfully or effectively operate without the others: each entity can be seen as sole (or predominant) client or supplier to the others. As such, substance over form does require recognising one institutional unit, which is what ESA paragraphs 2.24 and 2.25 recommend.

It is generally not convincing to have the assets required to conduct an activity separated from the underlying producing unit, on the presumption that the holder of these assets would be engaged in renting services. When institutional arrangements create separate entities hosting a significant part of the assets, it must be proved that the latter are genuinely engaged in the activity of renting assets on the market. The fact that DSU was established by government and is mostly holding leases on buildings with government units established without competitive process, does suggest that DSU is an artificial subsidiary. The other DSU contracts with non-government units are too marginal yet to materially change this analysis.

The sales to non-government are indeed sufficiently marginal such that DSU output could be considered to be received only from government, so that the provisions set in ESA 2010 paragraphs 20.24-20.26 would prevail.

Another, largely similar, approach to the 'artificial subsidiary' is to consider that DSU is, *de facto*, a unit engaged in providing 'ancillary services' to government units, as explicitly

referred to in ESA 2010 para 20.24. Although renting of building is not explicitly mentioned in the ancillary activity list in ESA 2010, renting equipment is explicitly cited in ESA 2010 9.24), and renting of offices may be seen as meeting the ancillary activity general definition: ESA 2010 paragraph 3.31 "*An ancillary activity is an activity whose output is intended for use within an enterprise*" and ESA 2010 paragraph 2.26 "*Ancillary activities are limited in scope to the type of service functions that virtually all enterprises need to some extent or another*".

Whereas ancillary activities are most often not recognised in the accounts (i.e. not seen as production delivered with a KAU), ESA 2010 explicitly foresees circumstances where ancillary activities are recognised as production: when the information exists and it is analytically useful to do so, or when the activity is carried out in a different locality than the unit benefiting from the activity (ESA 2010 paragraphs 1.31 and 9.48b).

Similarly to the artificial unit, the entity providing ancillary services is not considered as an institutional unit, mostly based on the fact that the monopolistic or quasi-monopolistic arrangement prevents genuine autonomy of decision (DSU largely holds buildings and rents them mostly to government units), as well as prevents pricing at economically significant prices.

ESA 2010 paragraphs 20.25 to 20.26 indicate that when sales are exclusively delivered to government, it is considered that sales are not market, unless the contracts have been through public tender. ESA 2010 paragraphs 20.27 and 20.28 indicate that when sales are partly delivered to government, a public producer can be considered as a market producer if more than the majority of sale is to non-public entities or fulfils the tendering condition. The MGDD 2016 chapter 1.2 paragraph 29 recalls that the quantitative criteria also has to be fulfilled.

Renting is a production activity. The rationale for using the tendering criteria is that the market/non-market criterion is referring to the notion of economically significant prices (ESA paragraph 20.19). This means that contracted prices must "*have a substantial influence on the amounts of products producers are willing to supply and on the amounts of products that purchasers wish to acquire*". This cannot be established when a public entity contracts with a government entity outside of competition (*see MGDD 2016 section I.2.4 Concept of a market or non-market institutional unit*).

Although it is well understood that DSU management is intending to act more commercially in the future and to contract by way of tenders, Eurostat notes that past contracts (which constitute the main activity) were not subject to such tendering. As a result, given that these contracts are very long term, it is not expected that, in the near future, less than half of the sales will originate from contracts contracted from non-commercial contracts with Government.

### **3. CONCLUSION**

Based on all the elements above, and, in particular, taking into account the available data, Eurostat does not support the statistical treatment proposed by SORS to reclassify the DSU company from sector S.13 to the sector S.11 and to reroute the debt of DSU to government.

During the phone conference on 3 March 2017 with the representatives of the Slovenian Statistical Authorities, Eurostat expressed its opinion to maintain the actual sector classification of DSU in the government sector.

#### **4. PROCEDURE**

This view of Eurostat is based on the information provided by the SORS. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information currently available and the assumptions made above, Eurostat reserves the right to reconsider its view.

In this context, we would like to remind you that Eurostat is committed to adopt 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. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

*(e-Signed)*

Eduardo Barredo Capelot  
Director