

NACC decisions – NACC case 2001/05

20 February 2006



**National Accounts Classifications**  
*London & Continental Railways Ltd.*

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## 1. Summary conclusions

- 1.1 This article explains the decision of the Office for National Statistics (ONS) on the National Accounts sector classification of London & Continental Railways Ltd (LCR). LCR is the company that is constructing the high speed Channel Tunnel Rail Link (CTRL) and owns the UK operator of the international Eurostar passenger train service. From February 1999 LCR will be reclassified from the private sector to the public sector. Previously LCR was classified as a private non-financial corporation; it will now be classified as a public non-financial corporation.
- 1.2 The decision is based on the judgement that government has the power to control LCR's general corporate policy through its rights in LCR's Articles of Association, particularly deriving from the Government's Special Share, and contractual agreements between LCR and the Government. These include the Government's:
- right to force the sale or flotation of LCR at any time, with a claw-back arrangement giving the Government at least 90 per cent of the proceeds;
  - requirement to provide consent for any declaration or distribution of dividend before 2021 (whilst the Access Charge Loan facility is in place);
  - right of veto over sale or purchase of LCR shares before 2011 (consent rights over transfer of shares or change of control of ownership or any listing of the company);
  - requirement to provide consent for any substantial acquisition of shares by a new shareholder after 2010;
  - right of veto over the voluntary winding up of the company;
  - requirement to provide consent for any material transfers or disposals within the LCR group not already covered by other agreements (e.g. by the Development Agreement);
  - appointment rights for a non-executive director;
  - rights to 35 per cent of LCR's cash-flow from 2021; and
  - rights to approve LCR's budget.
- 1.3 For National Accounts it is the existence of these powers rather than their actual exercise which determines classification.
- 1.4 This classification decision is consistent with international guidelines on National Accounts and has been authorised by the National Statistician.
- 1.5 The reclassification has been implemented in the Public Sector Finances dataset released on 20 February 2006. Revised data will be introduced into the National Accounts at the earliest possible opportunity.

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### 3. ONS's role

#### 3.1 The National Accounts

- 3.1.1 ONS produces the United Kingdom's National Accounts. The National Accounts are an internationally comparable accounting framework that describes the activities in a national economy, including the transactions that take place between sectors of that economy. The United Kingdom National Accounts are compiled on a legal basis following a 1996 regulation from the Council of the European Union. The relevant international manuals are the European System of Accounts 1995 (ESA95) and the System of National Accounts 1993 (SNA93).
- 3.1.2 For the purposes of producing the National Accounts ONS has an established and transparent classification process. Classification decisions are taken by the National Accounts Classification Committee (NACC), an ONS committee of experts in national accounting. The NACC considers the classification of entities and transactions. An article about NACC is available on the National Statistics website at [www.statistics.gov.uk/psa](http://www.statistics.gov.uk/psa). The NACC is referred to hereafter in this article as 'the classification committee'.
- 3.1.3 The ONS role in the production of the National Accounts is of particular importance when defining the institutions that belong within the public sector. The importance here is because both the United Kingdom Government and the European Union base their fiscal policy frameworks on the National Accounts.
- 3.1.4 The domestic sectors of the National Accounts can be aggregated into the private sector and the public sector, as shown in Table A.
- 3.1.5 The United Kingdom public sector features three sub-sectors: central government, local government and public corporations. Together the central government and local government sub-sectors comprise the general government sector.

**TABLE A: UK National Accounts Sectors and Sub-Sectors**

<b>Sectors</b>	Non-financial Corporations		Financial Corporations		General Government		Households & Non-profit Institutions serving Households	Rest of the World
<b>Sub-sectors</b>	Private	Public	Private	Public	Central Govt.	Local Govt.	Private	
<b>Colour Code</b>	Public Sector		Private Sector					

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## 3.2 Fiscal measures and National Accounts

- 3.2.1 In its fiscal policy framework (see HM Treasury's June 1998 *Economic and Fiscal Strategy Report*), the United Kingdom Government uses key statistical indicators for the public sector. As a result whenever the Government has an active role in the creation or funding of an institution, ONS will consider the appropriate National Accounts classifications.
- 3.2.2 This reclassification of LCR from the private to the public sector will impact on the main fiscal statistics used to monitor the Government's fiscal rules and position (*Public Sector Current Budget*, *Public Sector Net Debt* and *Public Sector Net Borrowing*).
- 3.2.3 The Public Sector Current Budget (broadly current revenue less current expenditure) will be revised down by between £0.1 billion and £0.4 billion a year. For the period from reclassification until end-2004 the cumulative effect on the current budget surplus is minus £1.4 billion. The cumulative effect, from 1998/9 to 2005/6, of the current budget revisions when expressed as a percentage of Gross Domestic Product for each year, is estimated to be -0.18.
- 3.2.4 Public Sector Net Borrowing is revised up by between £0.6 billion and £1.0 billion a year between 2001 and 2004, the period when capital expenditure is higher, and by smaller amounts before that.
- 3.2.5 Public Sector Net Debt at end-January 2006 will rise by about £5 billion as a result of the reclassification. This comprises £2.65 billion of bonds issued in 1999, a further £1.1 billion of bonds issued in 2002 with the remainder mainly in loans. At end-January 2006 this adds 0.4 to Public Sector Net Debt as a percentage of Gross Domestic Product. The £1.25 billion of LCR securitised bonds issued in 2003 are already included in Public Sector Net Debt.
- 3.2.6 The European Union's fiscal policy framework also uses key National Accounts based statistical indicators, this time using the general government sector. The 1992 Maastricht Treaty on European Union and the 1997 Stability and Growth Pact oblige member states to avoid excessive budgetary deficits. The Excessive Deficit Procedure defines reference values for General Government Deficit and Debt as ratios of Gross Domestic Product. ONS produces the statistical estimates of these measures for the European Commission. These statistics will not be affected, since LCR is a public corporation and not part of general government sector.
- 3.2.7 There will be no impact on Gross Domestic Product, since the reclassification simply moves the company from one sector of the economy to another; it does not add to or subtract from the amount of economic activity that is taking place.

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## 4. National Accounts classification

### 4.1 Approach to sector classification

- 4.1.1 UK National Accounts classification decisions are consistent with the principles of the international statistical manuals, the *European System of Accounts 1995* (ESA95) and the *System of National Accounts 1993* (SNA93), and supporting manuals and case law.
- 4.1.2 National Accounts explain the economy based on the activities of groups of institutions or entities within it, these groupings being called sectors. Paragraph 2.18 of ESA95, reproduced below, explains this.

*Each of the sectors and sub-sectors groups together the institutional units which have a similar type of economic behaviour.*

*The institutional units are grouped into sectors on the basis of the type of producer they are and depending on of their principal activity and function, which are considered to be indicative of their economic behaviour. A sector is divided into sub-sectors according to the criteria relevant to that sector; this permits a more precise description of the economic behaviour of the units.*

*The accounts for sectors and sub-sectors record all the activities, whether principal or secondary, of the institutional units covered.*

*Each institutional unit belongs to only one sector or sub-sector.*

- 4.1.3 In order to allocate a unit to the appropriate institutional sector the first decision to make is to whether the entity is in the public or private sector, as defined in the international statistical manuals. However, care should be taken here with the terminology as the term public sector is often used elsewhere in different contexts, for example ‘public’ schools and ‘public’ transport. Any references to public or private in this article refer to National Accounts definitions.
- 4.1.4 Chapter 2 of ESA95 defines the institutional sectors in the National Accounting system and clarifies the difference between the public and private sectors. It concentrates on control rather than ownership. For example, paragraph 2.28, which defines public non-financial corporations, states:

*The sub-sector public non-financial corporations consists of all non-financial corporations and quasi-corporations that are subject to control (see paragraph 2.26) by government units.*

- 4.1.5 The key paragraph in ESA95 for determining control is 2.26. Although this refers to corporations, it sets out the general standards to follow. It is reproduced below:

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*Control over a corporation is defined as the ability to determine general corporate policy by choosing appropriate directors, if necessary.*

*A single institutional unit (another corporation, a household or a government unit) secures control over a corporation by owning more than half the voting shares or otherwise controlling more than half the shareholders' voting power. In addition, government secures control over a corporation as a result of special legislation decree or regulation which empowers the government to determine corporate policy or to appoint the directors.*

4.1.6 Thus, having decided whether an entity is part of the public or private sectors, the second important aspect for classification is to determine whether it is a market or non-market entity. Public sector market entities are classified as public corporations (for example Royal Mail and Manchester Airport Group); public sector non-market entities in the general government sector (for example government departments and the BBC). General government is then sub-divided into sub-sectors, including central government, state government and local government. Private sector market entities are classified as private corporations, and private sector non-market entities are classified to a sector known as Non Profit Institutions Serving Households.

4.1.7 The borderline between market and non-market classification is defined in ESA95 by whether more than fifty per cent of production costs are covered by sales (ESA95 paragraph 3.32). An analysis of LCR's accounts shows that, in all relevant years, it meets comfortably the criteria to be a market entity.

## **4.2 Testing for public sector control using ESA95 principles**

4.2.1 The classification committee's approach to classification cases involving the public sector is to consider whether government, or any other part of the public sector, can exercise control or influence over an entity's directors through the appointment process.

4.2.2 In addition to securing control through power of appointment, ESA95 also recognises that control over a corporation can result from legislation, decree or regulation. The classification committee examines the situation to see whether there are any special factors that enable any part of the public sector to determine general corporate policy, either individually or collectively. In addition to this, the classification committee recognises that government, or other sectors, may also control a unit through contractual arrangements.

4.2.3 Chapter six examines the various government rights over LCR and the classification committee's views on them. However, before examining the classification it is first necessary to understand the history of the CTRL project and the restructurings of LCR.

## 5. The history of the CTRL project and LCR

### 5.1 Establishing the CTRL project and LCR

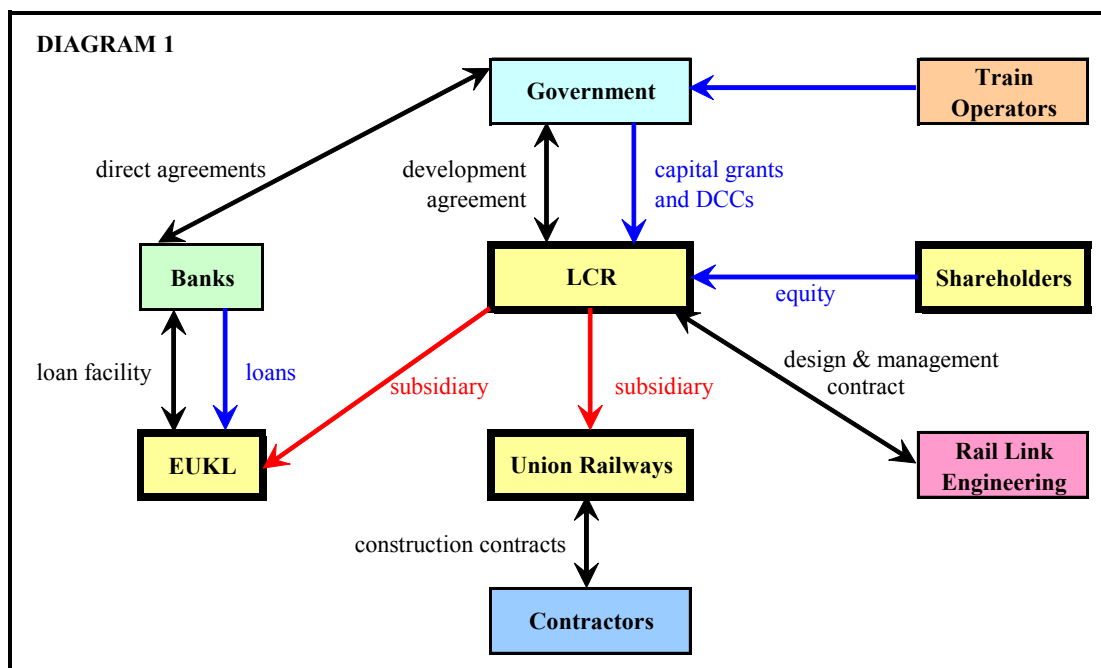
- 5.1.1 In 1987 the British Railways Board began a study for a Channel Tunnel rail service. In 1991 the route was chosen, from the Channel Tunnel to St. Pancras in London, and the Government decided there should be a substantial private sector involvement. In 1992 the British Rail project team was formed into a company, Union Railways Ltd. Union Railways was classified in the National Accounts as a public corporation (initially as a subsidiary of the British Railways Board public corporation and then as a stand-alone public corporation when British Rail was separated into different units prior to its privatisation).
- 5.1.2 In March 1994 the Government invited competitive tenders for the concession to design, build, finance and operate a new high-speed rail link between the Channel Tunnel and St Pancras station. The concession was a Private Finance Initiative (PFI) deal, so the Government was looking for a private sector partner.
- 5.1.3 LCR was formed to bid for the concession. It is an unquoted company (e.g. not listed on a stock exchange) owned by mainly private sector shareholders, which include among others Bechtel Ltd, UBS, National Express Group plc, EDF Energy plc (formerly London Electricity plc) and subsidiaries of the French railway company SNCF.
- 5.1.4 LCR won the bid and signed a contract, the Development Agreement, with the Government in February 1996.
- 5.1.5 The contract was a concession agreement in line with the principles of PFI. LCR would finance, build and operate the link, drawing on revenues primarily from the Eurostar service and additionally from use of the link by domestic train operators. As part of the deal LCR acquired Union Railways Ltd and became owner and operator of the UK arm of the Eurostar<sup>1</sup> train operator. This was a relatively new and recently privatised service with routes between London and Paris and London and Brussels.
- 5.1.6 In common with a number of PFI concessions there are claw-back arrangements in place. These allow the Government to recover any excess value created in LCR. The Government is entitled to a 50 per cent share in any profit over development costs for LCR's development land interests. However, the Government is not entitled to trigger these claw-back arrangements.
- 5.1.7 The legal title to the rail link is held by the Government, which originally signed a 999-year lease with LCR. When the project was restructured in 1998, the length of the lease was reduced to 90 years, ending in 2086.

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<sup>1</sup> Then known as European Passenger Services Ltd, now Eurostar (UK) Ltd [EUKL]

- 5.1.8 LCR was granted the train operating franchise for the link until 2086, although for the 17 years following completion of the link the Government purchased, at pre-agreed prices, some slots from LCR, with the intention of sub-leasing them to other domestic train operating companies. The rentals LCR receive for this are referred to as Domestic Capacity Charges (DCCs).
- 5.1.9 LCR was initially capitalised with £70 million of equity contributions from its founder shareholders and £430 million of bank facilities secured on EUKL revenues. As LCR did not have the commercial strength to raise these loans the Government supported them through a Direct Agreement with the banks. This specified that if the agreement with LCR was terminated the Government would take over and operate EUKL. If EUKL reverted to another operator and could not meet its debt servicing and operating costs the Government would cover these operating costs and the term of the debt would be extended.

5.1.10 Diagram 1 shows the original contractual structure of the deal and the financing.



5.1.11 From the start of the project it was known that private finance would be insufficient by itself, but the Government was willing to partially fund it due to the wider policy benefits. Under the contractual agreement the Government agreed to pay LCR £1.7 billion<sup>2</sup> in the future. The payments were a combination of capital grants (£1.4 billion<sup>2</sup>) and DCCs (£0.3 billion<sup>2</sup>) and were dependent upon financing dates and completion milestones. LCR was also given the leasehold on St. Pancras station and other railway

<sup>2</sup> The values quoted are in 1995 prices but the actual payments are discounted to net present value at an annual rate of six per cent.

lands. Part of the agreement was that LCR would pay land rents to the Government in later years.

- 5.1.12 LCR's original financing plan to fund construction of the CTRL and the trading activities of EUKL envisaged that it would raise £0.8 billion of equity through an initial public offering of shares in the company, accompanied by raising debt of £3 billion to £4 billion. However, by August 1997 it had become apparent from the due diligence programme for the initial public offering that Eurostar forecast revenues were not achievable. LCR's attempts to raise private finance would thus have faced difficulties because of the markets' view of the potential risks and the projections of passenger revenue.
- 5.1.13 To develop alternative funding arrangements, LCR entered into discussions with the Government in early 1998. To keep LCR solvent while these discussions progressed, the Government agreed to LCR conducting a sale and leaseback of some of the Eurostar train fleet.

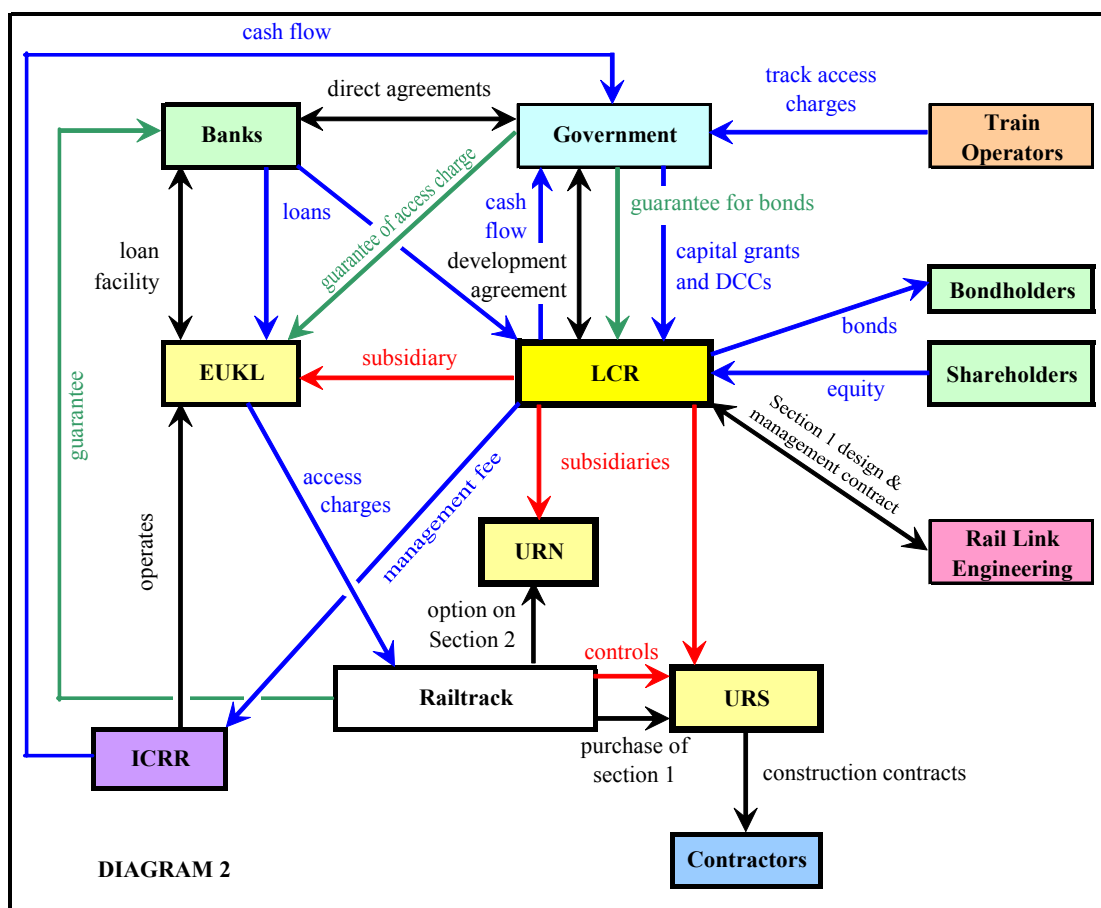
## **5.2 The 1998 restructuring**

- 5.2.1 Revised financing and risk-sharing arrangements were agreed in 1998 and these are referred to in this article as 'the 1998 restructuring'. Under these arrangements:
- there were no increases to the amount of government grants and DCCs payable under the previous agreements;
  - construction of the link was split into two sections;
  - the construction risk and EUKL revenue risk were separated;
  - the Government agreed to guarantee £3.75 billion of LCR debt and to provide a capped loan facility (the Access Charge Loan facility); and
  - Railtrack was brought into the project as the intended future owner of the CTRL, with the Government guaranteeing the track access charge revenue stream from EUKL to Railtrack.
- 5.2.2 In return for its assistance the Government obtained Special Share rights in LCR.
- 5.2.3 The 1998 restructuring split the construction of the Link into two sections: Section 1 (the southern part, from the Channel Tunnel to near Ebbsfleet on the outskirts of London) and Section 2 (the northern part, from near Ebbsfleet to St. Pancras). For contractual purposes the construction of the sections were undertaken in separate LCR subsidiaries: Section 1 by Union Railways (South) Ltd and Section 2 by Union Railways (North) Ltd.
- 5.2.4 The private sector Railtrack group, which included the Railtrack plc subsidiary that held the licence to own and operate British rail infrastructure, was brought in to assume the CTRL construction risk. Railtrack agreed to guarantee an additional £0.7 billion of LCR debt with banks and assumed the CTRL construction and operating risks for Section 1, taking control of Union Railways (South) Ltd. Railtrack agreed to purchase Section 1 of the link from LCR on its completion, for the actual cost of constructing and financing the section less grant payments. Railtrack also secured an option to enter into a similar

arrangement to purchase Section 2. In return, LCR assigned to Railtrack the DCCs allocated for Section 1 and the equivalent track access charges from EUKL. The EUKL payments were guaranteed by the Government for a period of 50 years from the opening of Section 1.

- 5.2.5 The government-guaranteed bonds were to be issued in two main tranches. The first tranche of £2.65 billion were issued in February 1999. The second tranche of £1.1 billion were for later issue, when funding was required for construction of Section 2.
- 5.2.6 The Government also guaranteed the tunnel access payments to Eurotunnel. The tunnel itself is jointly owned by the UK and French governments, which have leased it to Eurotunnel, a joint venture between British and French companies. The tunnel access agreements are between British Railways Board and Eurotunnel, with British Railways Board reimbursed by EUKL.
- 5.2.7 The Access Charge Loan facility was designed to fund EUKL's payments of track access charges if LCR had insufficient funds to make these payments. It also provided a buffer against the government guarantees to Railtrack being called.
- 5.2.8 Inter-Capital and Regional Railways Ltd (ICRR), a consortium of National Express, SNCF, SNCB and British Airways, was awarded a contract for the management of EUKL. Under this contract LCR paid ICRR a management fee and ICRR took the revenue rewards and risks on EUKL performance until 2010. Although the Government is not a party to the contract it has a Special Share in ICRR to protect its interests and this entitles it to receive five per cent of any profits.
- 5.2.9 In providing the guarantees for LCR's bonds and EUKL's track access charge payments the Government faced a contingent but potentially large liability if significant problems emerged in the construction project or in EUKL's business. The Government was also concerned that LCR's shareholders should not profit excessively from their investment if LCR became highly profitable on the back of the financial support that the Government had provided. Therefore, the Government sought to protect its interests and claw-back any windfall gains that the 1998 restructuring might have created.
- 5.2.10 Accordingly the Government took some rights over LCR. These included:
- a first-ranking charge over all LCR's assets as security for the guarantees;
  - controls and restrictions over LCR and its shareholders; and
  - claw-back mechanisms.
- 5.2.11 Included within the rights contained in the Government's Special Share in LCR was the right to appoint a non-executive director of LCR. LCR's shareholders continued to appoint the other directors.

5.2.12 Diagram 2 shows the updated situation after the 1998 restructuring.



5.2.13 Although the restructuring was agreed in principle in June 1998, it first needed State Aid clearance from the European Commission. As a result, the 1998 restructuring was implemented on 18 February 1999. This is the National Accounts reclassification date.

5.2.14 The LCR shareholders converted 95 per cent of their ordinary share equity into preference shares in Union Railways (South) Limited. 50 per cent of the preference share capital would be redeemed, together with associated rolled-up interest, upon the opening of each section.

### 5.3 The 2001 and 2002 restructurings

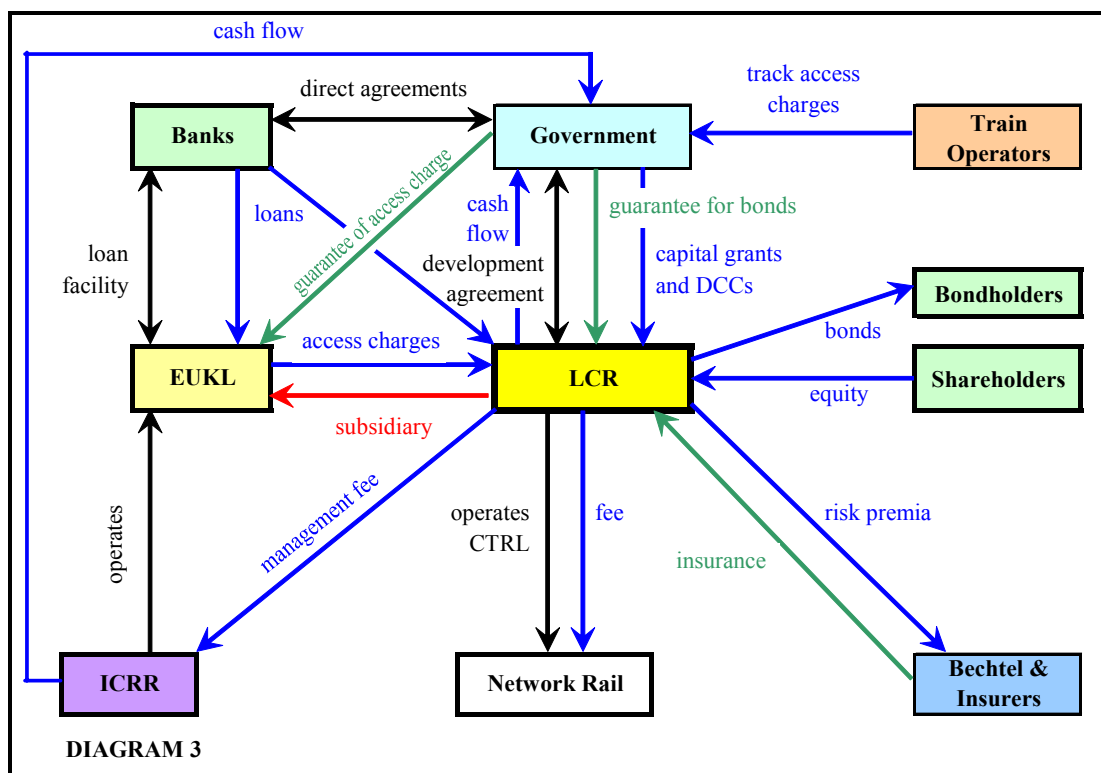
5.3.1 In 2001 construction of Section 2 was due to begin. Railtrack indicated that it was unwilling to exercise its option on Section 2 as the option was no longer economically attractive. However, Railtrack continued to manage the construction of Section 1 with the intention of purchasing that section on completion but alternative arrangements were needed for Section 2. Railtrack entered into new contracts to provide construction services for Section 2. LCR transferred some risk on this section by entering into a Cost

Overrun Protection Programme with Bechtel Ltd and a group of insurers. Under this programme, LCR paid Bechtel Ltd and insurers to bear £315 million of the risks of cost overruns spread over the first £600 million of cost overruns. LCR and the Government, through its exposure to LCR from the guarantees, shared the risks for amounts beyond this limit.

- 5.3.2 LCR needed to replace the bank loan guarantee that Railtrack had previously provided. As a result, the Government made the first four instalments of the deferred investment grants unconditional. This gave security to the lenders.
- 5.3.3 In June 2002 LCR issued a further £1.1 billion of government-guaranteed bonds.
- 5.3.4 The Railtrack Group had run into financial difficulties and its subsidiary Railtrack plc had been placed in Railway Administration. In October 2002 Railtrack Group sold Railtrack (UK) Ltd, the holding company for its interests in the CTRL, to LCR. This included the contractual commitment to purchase Section 1 on completion and the subsidiary that benefited from the government guarantee of EUKL's track access charges payments. Therefore, the Government agreed to transfer to LCR the EUKL track access charge guarantee that it had given to Railtrack Group in the 1998 restructuring.

#### **5.4 Post-2002 events**

- 5.4.1 In 2003 LCR sold the rights to operate the completed CTRL and the concession to manage St Pancras station to Network Rail, the successor company to Railtrack plc as infrastructure licence holder. Network Rail's role is thus less than that of Railtrack, which was expected to own and operate the CTRL. Network Rail will only operate it. In September 2003 Section 1 of the link was opened on time. The forecast completion date for Section 2 is 2007.
- 5.4.2 In November 2003 LCR issued bonds securitised on future flows from government and EUKL. These are effectively guaranteed by government. The securitisation raised £1.25 billion. The resulting debt was classified as government borrowing by ONS. This is the subject of a separate classification article, dated 2 August 2005, at [www.statistics.gov.uk/lcr](http://www.statistics.gov.uk/lcr). This is summarised in section seven.
- 5.4.3 Diagram 3 shows the current structure of the project and financing.



## 6 National Accounts sector classification of LCR

### 6.1 Background

6.1.1 This section examines the relevant government rights as they were introduced and explains the National Accounts analysis of these rights.

### 6.2 Pre-1998

6.2.1 The 1996 Development Agreement set out the terms of the contractual relationship between the Government and LCR. It gave the Government the right to receive information on the project and its financing and also provided some additional powers:

- (i) if LCR fails without good reason to provide adequate track access for a specified time, the Development Agreement allows the Government the powers to bring in a third party to provide the necessary access;
- (ii) if LCR fails to maintain and repair the assets or to carry out required safety work then, if the contractually specified course of action is not met, the Government has rights to arrange for a third party to carry out the work.

6.2.2 There are also separate ring-fenced provisions relating to EUKL. The Government wanted to ensure that if LCR defaulted they would be able to take back EUKL as a viable stand-alone business for nil consideration. As a result there are extensive and detailed

restrictions on EUKL and LCR for the period of the concession. These are designed to maintain the EUKL business and its core assets, management and personnel. The Government also has approval rights over the appointment of the non-executive directors to the EUKL board; half the EUKL board of directors are non-executives.

6.2.3 For National Accounts classification purposes the rights at this time under the Development Agreement and the ring-fenced provisions relating to EUKL are judged as insufficient for government to be considered as controlling LCR.

### 6.3 The 1998 restructuring

6.3.1 The Government was involved in the 1998 restructuring of LCR. In return for providing the guarantees and loan facility, the Government was granted a restrictive Special Share in LCR and obtained a 35 per cent share of LCR cash-flow from 2021. The 1998 *LCR annual report and accounts* provides the following description:

"In return for the Government's guarantee of the Group's bond issues and additional financial support in downside trading scenarios for Eurostar UK the Government has been granted a Special Share. This Share enables the Government to participate in a number of Company matters including; the right to appoint a Director; to control certain changes to the Company's Articles; to control certain changes to the Company's share ownership; to force the Company's other shareholders to sell or seek a listing of their shares; and to control distributions and dividend declarations prior to 2021. The Company must also pay guarantee fees to Government from 2021 amounting to 35% of the Group's pre-tax net operating cash flow."

6.3.2 Special Shares, or Golden Shares, have been a common feature in British privatisations. They typically give the owner of these Special Shares the right of veto over a company's charter. For National Accounts classification purposes powers under Golden Shares, such as a veto to protect the company from takeover or step-in rights in event of national emergency, are usually considered as contingent or remote and thus ignored unless the powers are utilised. However, the rights associated with the Special Share in LCR go beyond those common in privatisations.

6.3.3 The Government, as holder of the Special Share, obtained the following rights, which were added to LCR's Articles of Association:

- (i) the right to appoint a non-executive director of LCR;
- (ii) a requirement for LCR to obtain consent to any declaration or distribution of dividend before 2021 (while the Access Charge Loan facility is in place);
- (iii) the right of veto over sale or purchase of LCR shares before 2011 (consent rights over transfer of shares or change of control of ownership or any listing of the company);
- (iv) a requirement for LCR to obtain consent to any substantial acquisition of shares by a new shareholder after 2010;

- (v) the right to force the sale or flotation of LCR at any time, with a claw-back arrangement giving the Government at least 90 per cent of the proceeds;
  - (vi) a veto over the voluntary winding up of the company;
  - (vii) a requirement for LCR to obtain consent for any material transfers or disposals within the LCR group not already covered by other agreements (e.g. by the Development Agreement); and
  - (viii) a requirement for LCR to obtain consent to the alteration of the Special Share rights in the LCR Articles of Association.
- 6.3.4 Additionally, secured through the Special Share but included within the updated Development Agreement rather than the Articles of Association, LCR agreed to pay the Government a fee equal to 35 per cent of pre-tax<sup>3</sup> cash-flow from 2021. This cash-flow is first used to ensure the repayment of any loans outstanding under the Access Charge Loan facility and thereafter is effectively a dividend payable to the Government.
- 6.3.5 The Government has the ability to prevent Union Railways (North) Ltd undertaking any activity other than the construction of Section 2. This is achieved largely through a Special Share which government holds in Union Railways (North) Limited that allows the Government veto involvement in any other business.
- 6.3.6 The Accounts Agreement governs the approval of LCR's budgeted expenditure and places restrictions on the application of LCR's cash resources, ensuring that both the budget and expenditure are applied solely to the CTRL project. Every six months, LCR submits a budget and cash forecast to the Government. In 1998 the Accounts Agreement was amended to give the Government the right to approve the budgets. A dispute resolution process is in place if the Government and LCR disagree.
- 6.3.7 The restated Accounts Agreement also contained a restriction that "the types of financial instrument used for investment purposes must be approved in advance by the Board and the Secretary of State, which also sets down limits, both in terms of capital invested and market price risk, for this activity".
- 6.3.8 The Government has the right to intervene if either EUKL or the LCR subsidiary owning Section 1 served a suspension or termination notice on the other in relation to EUKL's access rights to Section 1. This was introduced as part of the 1998 restructuring.
- 6.3.9 The Government only appoints one director of LCR and has no right to attend or vote at meetings of any other class of shareholder in the company. However, it is possible to exercise control without having appointment rights over the directors.
- 6.3.10 It is a matter of judgement as to the extent of the influence that the Government has over LCR, for example through control of dividend policy, the powers to force flotation or sale and the rights to approve budgets. However, ONS concluded that the rights conferred by the Special Share alone provided government with the effective ability to control the corporate policy of the LCR Group.

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<sup>3</sup> Profits before tax and interest.

- 6.3.11 LCR has confirmed that, while the controls that the Secretary of State (for the Department for Transport) has in place over LCR are extensive, he and his officials do not seek to exploit the controls and rights in his agreements with LCR to interfere in management decision making. However, for National Accounts classification it is the existence of the powers to control that matter - that is the ability to determine general corporate policy - not whether they are actually utilised.
- 6.3.12 As a result, and without the need to examine any other controls over LCR, the LCR Group will be reclassified to the public sector from 18 February 1999.
- 6.3.13 It may be noted that the LCR arrangements and controls have similarities with the controls that banks might typically require over a borrower where the banks face significant exposure risk. In such similar cases ONS would conclude that control has moved from one part of the private sector (the shareholders) to another (the bank) and so the company would remain classified in the private sector. When government takes the place of the bank, the control moves from a private sector entity to a public sector entity, resulting in public sector classification.

#### **6.4 The 2001 and 2002 restructurings**

- 6.4.1 In 2001 the relevant Articles of Association were amended to add government rights to appoint its LCR director to the boards of two subsidiary companies, Union Railways (North) Ltd and LCR Finance plc. In addition, the Government has the right to veto LCR's appointment of the managing director of Union Railways (North) Ltd. The appointment and veto rights cover a minority of the directors of these subsidiaries.
- 6.4.2 This apart, ONS is not aware of any material change to government rights over LCR as a result of the 2001 and 2002 restructuring, for example the rights of the Special Shareholder remain, so there was no impact for the National Accounts classification.

### **7 Previous ONS classification decisions on LCR**

#### **7.1 Previous classification decisions**

- 7.1.1 ONS had previously examined the classification issues relating to LCR and the Channel Tunnel Rail Link. These examinations focused mainly on the government support for the link.
- 7.1.2 ONS's re-examination of the public sector controls over LCR began during the classification case on the 2003 LCR securitisation<sup>4</sup>. During the research for the securitisation case ONS reconsidered the sector classification of LCR and investigated

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<sup>4</sup> The LCR securitisation took place in 2003 and the ONS announced the decision to classify the securitised bonds as government debt in August 2005.

the full extent of the public sector powers over LCR, in particular the extent of the rights through the Special Share.

- 7.1.3 Over recent years there has been an increase in public-private partnership arrangements and the complexity of associated financial transactions, both in the UK and abroad. As a result both ONS and Eurostat have further developed their approaches to, and rules for, classification. ONS case law has evolved as the cases have become more sophisticated and Eurostat has a growing and evolving body of guidance on classification. ONS and HM Treasury have worked together to improve the classification process, in particular ensuring the supply of information and time available allows sufficient consideration of the cases, ensuring robust decision making. The ONS classification process for high-profile cases now routinely involves the detailed examination of the legal contracts for the case. So, the rules and best practice have changed. As a result of these changes ONS were in the position to apply this more developed approach to the LCR case.

## 7.2 Pre-1998

- 7.2.1 For National Accounts classification purposes the rights at this time under the Development Agreement and the ring-fenced provisions relating to EUKL were judged as insufficient for government to be considered as controlling LCR. LCR was classified in the private sector as a private non-financial corporation. This situation remains unchanged.

## 7.3 The 1998 restructuring

- 7.3.1 In May 1998 ONS was asked by HM Treasury to consider the classification of the government support. ONS considered:
- the government-guaranteed bonds;
  - the government loan facility to ensure that EUKL's track access charges could be paid; and
  - LCR's agreement to pay cash flow to government.
- 7.3.2 When considering the government support, ESA95 paragraph 5.05, which defines contingent assets and includes lines of credit, was relevant. It is reproduced below. Contingent assets and liabilities are excluded from the National Accounts because their focus is on the economic transactions that take place in the economy at the time they take place and the resulting matched assets and liabilities that arise from them.

*Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities (NIFs) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is tradable or*

*can be offset on the market. Otherwise, a contingent asset is not recorded in the system.*

- 7.3.3 As a result, while the government guarantees remained as contingent liabilities of the Government, the bonds were classified as LCR's borrowing rather than government borrowing and on-lending to LCR. If the guarantees were called, then the National Accounts would record a central government liability to LCR. This would be achieved by imputing a capital transfer from central government to LCR, which would be balanced by an imputed sale of the debt by LCR to central government, known as debt assumption.
- 7.3.4 Similarly, the Access Charge Loan facility was a contingent liability of government. Any amounts drawn on the facility would be classified as government lending to LCR (F.4 lending in the financial account).
- 7.3.5 The LCR situation is similar to that which occurred later with Network Rail, where government support enabled the company to borrow at a lower rate of interest than would otherwise have been available. ONS recognises that there is an economic effect resulting from the government support and imputes subsidies in the National Accounts to reflect this benefit; this imputation remains. The economic reality of the imputed subsidy is similar to a direct government subsidy, which improves a company's financial position and allows it to borrow on more favourable terms. This is explained further in the article 'PSCC decision – Guarantee for Network Rail's borrowing' at [www.statistics.gov.uk/nrail](http://www.statistics.gov.uk/nrail).
- 7.3.6 LCR's agreement to pay cash flow to government was considered not to affect the sector classification of LCR. This is an indication that the Government holds a type of 'other equity' (National Accounts category F.513 in the financial account) in LCR. The levels of this 'other equity' could be viewed as being substantially greater than the relatively small ordinary share equity risk provided by LCR's shareholders. However, this is indicative of ownership rather than control and it is control that is the basis of National Accounts classification decisions.
- 7.3.7 At the time of the May 1998 ONS decision on the government support, ONS judged that the Government's relationship with LCR did not amount to control.
- 7.3.8 In November 1998 HM Treasury supplied some further information on government powers, including the rights to require LCR shareholders to dispose of their shares on the market. The economic effect was considered as similar to imposing a claw-back on the grant.

#### **7.4 The 2001 and 2002 restructurings**

- 7.4.1 In 2001 HM Treasury requested ONS classification advice on some further restructuring proposals. The main factors for the proposal eventually adopted were the transfer of a significant proportion of the CTRL construction risk from LCR and the Government's agreement to guarantee the payment of track access charges by EUKL.

- 7.4.2 The sector classification was considered in 2001. ONS judged that there were no material changes present in the 2001 restructuring that would affect the previous classification judgement.
- 7.4.3 Since then, we have identified that, at the time of this restructuring, the Government gained an additional control over LCR through the rights to appoint or veto the appointment of some directors in LCR subsidiaries. However, this additional control was limited to a minority of directors in these subsidiaries. As the private sector retained a clear majority of appointment rights on each of these boards, this would not have changed the 2001 judgement.
- 7.4.4 Similarly the government support for the LCR bonds and the Access Charge Loan facility remained as previously classified as there was nothing material added that would have changed the earlier ONS decision. Therefore the bond guarantees remained as contingent liabilities of government and would not be recorded as government borrowing in the National Accounts. The debt remained the private sector debt of LCR.

## **7.5 The 2003 securitised bonds**

- 7.5.1 In November 2003, LCR issued £1.25 billion of bonds securitised on future income. When ONS was later informed of this development, it decided that the bonds should be classified as government borrowing.
- 7.5.2 The income stream that was securitised is future track rentals: track access charges paid by EUKL and DCCs paid by the Government. The income streams are payable to the LCR subsidiary that owns Section 1.
- 7.5.3 The track access charges are guaranteed by government; if EUKL is unable to pay them in full, then the Government guarantees to pay the difference. The Department for Transport has judged that the likelihood of the guarantee being called is remote. In practice LCR would first draw on the Access Charge Loan facility to meet its cash deficit.
- 7.5.4 The securitised flow of DCCs were ‘derisked’ by the Government, which means that they refer only to those charges that are payable in all circumstances, thus excluding any payments that are conditional.
- 7.5.5 The bonds received AAA ratings because they were backed by direct obligations of the Government and by obligations of EUKL guaranteed by the Government.
- 7.5.6 Eurostat’s *Manual on Government Deficit and Debt* (MGDD) gives guidance on the classification of securitisation deals that involve governments. The judgement required is whether the bondholders are at risk. If the bondholders are not at risk, because of a formal guarantee or an indirect equivalent, then government is viewed as the risk holder. Although the debt raised by the securitisation is not directly guaranteed, the details of the

arrangements are such that government is judged to be holding the risk rather than the bondholders.

- 7.5.7 The classification rules for securitised borrowing differ from the classification of more straightforward government-guaranteed borrowing. A conventional government guarantee judged as a contingent liability will have no impact on government borrowing unless the guarantee is actually called because, until that point the financial liability will have been borne by the original holder of the debt. However, securitisation arrangements are more complex and as a result the rules on the risk transfer are very specific.
- 7.5.8 The government-guaranteed bonds remain the borrowing of LCR and not government, the reclassification of LCR makes them public corporation bonds and hence public sector debt. This has the same effect on the UK fiscal debt measure as if the bonds had been classified as government debt.

## **7.6 Summary of updated position**

- 7.6.1 LCR remains classified as a private non-financial corporation prior to 18 February 1999. From 18 February 1999 it has been reclassified as a public non-financial corporation.
- 7.6.2 The 2003 securitised bonds continue to be re-routed as if issued by central government with the proceeds lent on to LCR. Now, as a result of the sector reclassification of LCR, the on-lending is to the public sector and not to the private sector.

## **8 Comparison with classification of Network Rail**

- 8.1 Although both Network Rail and LCR receive government support for their borrowing this does not define their classification. Classification depends on who controls the general corporate policy.
- 8.2 Although ownership is not relevant to National Accounts classification, it is worth noting that LCR and Network Rail are different types of corporation in that respect. LCR is a conventional limited company, owned by shareholders. Network Rail is a company limited by guarantee and does not have shareholders. In a company limited by guarantee the function of holding the directors to account, which would be the role of shareholders in a conventional limited company, is instead performed by its members. Companies limited by guarantee usually have constitutions that prevent the distribution of profits, whereas conventional companies pay dividends to their shareholders.
- 8.3 In respect to the governance arrangements for the two companies there are significant differences. The main differences between the two are Government's powers over LCR concerning the forced sale of the company, the veto over winding-up, control of dividend policy and rights to profits, which do not exist in the case of Network Rail.

## 9. National Accounts, GAAP accounting and Whole of Government Accounts

### 9.1 Accounting systems

- 9.1.1 ESA95 is designed as an integrated system of economic statistics for the whole economy. Unlike GAAP (Generally Accepted Accounting Practice) it is not used to produce financial statements for individual entities.
- 9.1.2 Where the sector classification for National Accounts purposes and the treatment under Generally Accepted Accounting Practice appear to be contradictory, this can be a matter of public interest and lead to confusion. In its report on the classification of Network Rail<sup>5</sup>, the Treasury Committee recommended that where the (National Accounts) statistical and (departmental accounts) accountancy practice differed, “the onus is on the parties concerned to align their different positions and explain the rationale for them to the public”.
- 9.1.3 In its response<sup>6</sup>, the Government said that it agreed that “where these two processes produce apparently contradictory results as regards sector classification, it is appropriate that the parties concerned should explain to the public the rationale for their views. ... However, once this has been done, and the issues fully explained, it is inappropriate for the Government to attempt to ‘align’ the different positions.”
- 9.1.4 So, consistent with the Government response to the Treasury Committee, this chapter records the position on LCR’s treatment in the departmental accounts.
- 9.1.5 ONS asked the Department for Transport to provide its views on the departmental accounting treatment of LCR.

### 9.2 Departmental accounts

- 9.2.1 The financial statements of central government departments are prepared in accordance with the *Government Resources and Accounting Act 2000*, following UK GAAP adapted as necessary for the public sector. HM Treasury is responsible for developing accounting guidance for central government departments. This guidance is reviewed by the independent Financial Reporting Advisory Board, which reports annually to Parliament. The departmental accounts are audited by the National Audit Office, which is responsible for providing an independent and objective audit opinion on them.
- 9.2.2 The guidance developed for central government departments is contained in the Government’s *Financial Reporting Manual*. This states that departments “shall prepare an annual report and consolidated financial statements ... covering all entities within their consolidation boundary”. This boundary is different to the concept of group under GAAP as it is based on in-year budgetary control and not on strategic control as defined

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<sup>5</sup> House of Commons paper № 154.

<sup>6</sup> House of Commons paper № 550.

by GAAP. The consolidation boundary for a department is therefore limited to that department and its agencies. Public corporations, executive non-departmental public bodies and entities classified as private sector by the ONS fall outside this boundary. Public corporations are mentioned in notes to the accounts.

9.2.3 The Department for Transport did not consolidate LCR in its financial statements at the time that it was classified as private sector by ONS. Following reclassification as a public corporation, the Department for Transport “intends to continue to account for LCR on the established basis”; that is LCR will remain outside their consolidated boundary as per the *Financial Reporting Manual*.

9.2.4 The National Audit Office is in discussion with the Department for Transport regarding the Department’s response to the National Accounts reclassification of LCR to the public sector. Any change to the Department’s treatment of LCR in their 2005-06 Resource Account will be subject to audit by the National Audit Office and the Comptroller and Auditor General’s audit opinion in due course. The Department for Transport plans to publish its Resource Account before the summer Parliamentary recess in July 2006.

### **9.3 Existing treatment in Department for Transport’s Resource Accounts**

9.3.1 The Department for Transport concluded in 2005 that it should “account for the property of the CTRL Project as ‘off balance sheet’”, (i.e., not on the Government’s balance sheet and so, although not stated, implicitly<sup>7</sup> on LCR’s balance sheet). Some provisions for future payments to LCR are already included in the Department for Transport’s accounts. The Department for Transport considered the guarantee of the LCR bonds to be a contingent liability, which “should not be reflected on the Government’s balance sheet, but disclosed and explained as a note to the Government’s accounts.” Its view is that “the likelihood of the liability crystallising is remote as at the date of this report [2005]”. The Access Charge Loan facility and Access Charge guarantee are also considered as contingent liabilities in the Resource Account.

9.3.2 Regarding the rights to cash flow after 2021, the Department for Transport’s accounting advice states that “consideration should be given as to whether this may represent some form of equity investment in LCR”. However, it notes the opinion that, due to the financial position of LCR, it would be “highly imprudent” to recognise or disclose any asset at this time. The five per cent revenue share held by Government in ICRR is treated similarly, based on advice that the dividend is unlikely.

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<sup>7</sup> National Accounts and GAAP differ here. In National Accounts all relevant assets are recorded once and once only, reflecting that the asset exists in the economy and has to be accounted for. In GAAP they can be recorded in more than one entity’s balance sheet or in none depending on the accounting judgements regarding individual entities. Financial statements produced under UK GAAP and the *Financial Reporting Manual* consider only the individual entity to which they relate. As such the Department for Transport’s accounts do not state that the assets and liabilities of the project are on LCR’s balance sheet.

## 9.4 Whole of Government Accounts

- 9.4.1 HM Treasury is in the process of developing “Whole of Government Accounts”. These will be commercial-style accounts on an accruals basis covering the whole of the public sector. They are required by the *Government Resources and Accounts Act 2000* to use UK GAAP, adapted where necessary for government.
- 9.4.2 HM Treasury has developed a series of tests of control to assist in determining which bodies should be included in Whole of Government Accounts. These tests have been approved by the Financial Reporting Advisory Board and are considered by ONS to be broadly consistent with the approach taken in deciding sector classifications for National Accounts. The paper<sup>8</sup> describing them defines the boundary for the public sector used in Whole of Government Accounts consistently with that used by National Accounts. HM Treasury have yet to form a view on whether LCR should be included in Whole of Government Accounts. They will form their view in the light of the tests detailed in the paper and ONS’s National Accounts classification.

## 10. Release of information

- 10.1 Under the National Statistics Code of Practice, all important methodological decisions, and the reasons for them should be made publicly available in advance of the release of statistics based upon them. ONS places such sector classification committee decisions on the National Statistics website as soon as possible after any confidentiality implications have been cleared. To avoid unnecessary speculation regarding the impact of this classification on the market sensitive Public Sector Finances, the revised statistics have been released at the same time as the decision.

## 11. Contacts

- 11.1 If you have any questions on statistical classification please contact [psa@ons.gov.uk](mailto:psa@ons.gov.uk) . Any questions on the Government’s policy on the LCR Group and the CTRL should be referred to the Department for Transport. The ONS acknowledges the assistance of LCR, HM Treasury, the Department for Transport and the National Audit Office in producing this article.

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<sup>8</sup> HM Treasury CLASS(2000)1

## 12. Abbreviations used in the article

CTRL	Channel Tunnel Rail Link
DCCs	Domestic Capacity Charges
EDF	Electricité de France
ESA95	European System of Accounts (1995)
EUKL	Eurostar (UK) Ltd
FRS	Financial reporting standard
GAAP	Generally accepted accounting practice
GDP	Gross domestic product
HM	Her Majesty's
ICRR	Inter-Capital and Regional Railways Ltd
LCR	London and Continental Railways Ltd
Ltd	Limited
NACC	National Accounts Classification Committee
ONS	Office for National Statistics
PFI	Private Finance Initiative
Plc	Public limited company
SNA93	System of National Accounts (1993)
SNCB	Société Nationale des Chemins de fer Belges
SNCF	Société Nationale des Chemins de fer Français
St.	Saint
UBS	Union Bank of Switzerland
UK	United Kingdom
URN	Union Railways (North) Ltd
URS	Union Railways (South) Ltd