

# Classification of Network Rail under European System of Accounts 2010

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## Abstract

This article explains the decision by the Office for National Statistics (ONS) to classify Network Rail as a Central Government body in the UK National Accounts and Public Sector Finances. This results from new guidance in the 2010 European System of Accounts (ESA10).

## Executive Summary

In January 2013, Eurostat officials visited the UK for one of their biennial Dialogue Visits under the Maastricht Excessive Deficit Procedure (EDP). The UK agreed a number of actions with Eurostat following the visit, one of which was a review by the ONS of the classification of Network Rail (NR) on the basis of updated guidance provided within the 2010 European System of Accounts (ESA10) the revised, ESA10 compliant, Eurostat Manual on Government Deficit and Debt (MGDD).

In conducting its review, ONS identified areas of relevant new guidance which appeared for the first time in ESA10 and MGDD manuals. In general terms, the main changes in the manuals that impact on the classification of Network Rail relate to determining government control over non-profit institutions (NPIs), and the determination of whether a body is either a 'market' or a 'non-market' producer.

The former aspect – 'Is the body controlled by government?' - is important in that it determines whether the body under consideration is included in the calculation of statistics for the General Government sector (comprising mainly, the Central Government and Local Government sectors) such as those on Public Sector Net Borrowing (PSNB) and Public Sector Net Debt (PSND).

The latter aspect – 'Is the body market or non-market?' - is important because if the body is found to be controlled by government, this second aspect determines whether the body is included within General Government statistics or within statistics for the Public Corporations (PC) sector. This matters because, while PCs are included in statistics for the public sector as a whole, they are not included in statistics for the General Government sector and so are not included in the main statistics produced for Excessive Deficit Procedure purposes.

Having considered the latest international guidance available in ESA10 and the MGDD, ONS has concluded that Network Rail should be reclassified as a Central Government body, applying this

reclassification in all periods from April 2004 when Network Rail became a non market body under the new guidelines. Regulation (EU) No 549/2013 of the European Parliament and of the Council requires that all European member states are compliant with ESA10 in the recording and reporting of their national accounts by 23 September 2014.

This classification will be implemented within National Accounts, Public Sector Finances and EDP statistics, from 1 September 2014 when ESA 10 comes into force. Until then, ONS is legally required to continue delivering statistics that are compliant with the European System of Accounts 1995.

## **Context of National Accounts Classification Decisions**

The National Accounts provide a framework for describing what is happening in national economies. These are compiled using internationally agreed definitions and standards, and in accordance with guidance issued by Eurostat (the statistical body of the European Union).

All institutional units (such as businesses, Government departments, or charities) operating within an economy are grouped together with other similar units into a number of 'institutional sectors'. Additionally, all transactions between the sectors of the economy are categorised as part of the National Accounts framework. This includes classifications of bodies to the public or private sector.

It is a legal requirement for European Union Member States to compile specified statistical returns on the basis of the European System of Accounts (ESA). The United Kingdom National Accounts are produced by the ONS on this basis. From September 1<sup>st</sup> 2014, European member states are required to produce National Accounts on the basis of the latest standards, codified in the ESA, the latest version being ESA10. The updated ESA10 is consistent with the 2008 revision of the System of National Accounts 2008 (SNA08) which is produced by the International Monetary Fund in partnership with the Organisation for Economic Co-operation and Development (OECD) and the European Union and is accompanied by an ESA10 compliant Manual on Government Deficit and Debt.

Since 1997, the UK fiscal policy frameworks have been based on the National Accounts. Fiscal policy objectives are described in terms of statistics based on National Accounts aggregates; as a result key, fiscal targets are dependent on National Accounts definitions and classifications.

Classification decisions for National Accounts purposes are taken by the National Accounts Classification Committee (NACC) within ONS. This is supported by a small secretariat and makes recommendations for consideration by the ONS Director of Collection and Production who may choose to accept the recommendation and approve the proposed classification, or refer the issue back to the NACC for further work.

## **Background**

### **About Network Rail Ltd**

Network Rail Ltd was incorporated in 2002 as a company limited by guarantee, effectively a not for profit institution (NPI). It was set up to replace Railtrack plc. Since its privatisation following floatation on the London Stock Exchange in 1996, Railtrack plc owned the majority of the UK

railway infrastructure. Following a number of railway accidents, most notably the Hatfield crash in 2000, Railtrack plc was criticised for its safety record, leading to its placement into 'Railway Administration', under the Railways Act 1993, on 7 October 2001.

In October 2002, Network Rail Ltd acquired Railtrack plc for £500 million and renamed it Network Rail Infrastructure Ltd. Although Network Rail Ltd has a number of limited company subsidiaries, it is a not-for-profit group of companies. Network Rail obtains its income from two main sources – track access charges receivable from train operating companies and government grants mainly from the Department for Transport and Transport for Scotland.

In this article, references to Network Rail refer to Network Rail Ltd and include all its subsidiaries.

## **Relationship with government**

Network Rail Ltd has a close relationship with government. It was set up by government through the Strategic Rail Authority (SRA) which was a non-departmental public body. The SRA was itself set up under the Transport Act 2000 to provide strategic direction for the railway industry.

Following the passage of the Railways Act 2005, the SRA was abolished and its functions were transferred to the Department for Transport (DfT). Currently, Network Rail's relationship with government has two main aspects:

- via regulation of Network Rail through the Office of Rail Regulation and the conditions of the Network Licence. This licence contains a set of conditions under which Network Rail must operate and is a tool which government uses to hold Network Rail to account
- via government acting as a significant funder and as guarantor of Network Rail's debt issuance programme

## **Previous classification**

Network Rail has been classified as a private non-financial corporation by ONS since June 2002. This decision was based on the 1995 European System of Accounts (ESA95) rules. ESA95 and the accompanying MGDD included relatively little guidance on identifying government control over institutional units. ONS's approach to the National Rail classification considered whether:

- there was control or influence over the directors through the appointment process
- there were any special factors that enabled any part of public sector (including the DfT, the SRA and the ORR) to determine general corporate policy

## **Appointment of Directors**

The board of directors was appointed by the members, with the exception of the special director. Control of the other directors was dependent on whether the members were majority private or public sector. In assessing whether the board was public sector controlled or not, ONS went beyond a simple arithmetic test and considered whether key directors were government controlled. This was important because an influential minority could sometimes control general corporate policy. ONS was satisfied that, provided the members remained majority private sector, the board of directors was not controlled by the public sector.

## Reserve Powers

Government, through the SRA, had a number of 'step in' powers similar to a 'golden share' arrangement in a conventional privatisation. This is where government retains the power to take control in certain circumstances. At the time, ONS considered the likelihood of these circumstances occurring to be remote. As such, these were taken to be 'reserve powers' not affecting control of general corporate policy. It was noted, however, that should government utilise them this would trigger an immediate reclassification to public sector through government control.

## Other issues considered

- The Office of the Rail Regulator (ORR) could influence Network Rail's business plan through its regulatory powers associated with the licence. This situation was similar to previous arrangements with Railtrack plc. ONS considered these powers as regulation rather than government control.
- Government, through the SRA, had some rights associated with direct lending or support for lending. These were similar to the rights associated with standard commercial lending. ONS considered them reasonable, taking into account the nature of the company and industry.
- Network Rail receives income directly and indirectly from government. The direct income is from investment grants to pay for infrastructure. Network Rail also receives rentals for use of its track, known as Track Access Charges, from the operating companies. The ORR sets the Track Access Charges. Most of the train operating companies receive subsidies from government. ONS considered that these arrangements were not government control.
- The control of Network Rail's Remuneration Committee was important, since having control of directors' pay can be interpreted as having the ability to influence director's behaviour. Although the SRA director had the right to sit on this committee, the public sector was a minority on it.
- While each potential area of control was assessed individually, ONS also looked at the totality of the situation to consider if the economic reality of the total powers amounted to public sector control. ONS decided that Network Rail was a private sector company though it operated within certain boundaries set by government via regulation. If those boundaries were breached (such as in times of financial failure) triggering the reserve powers and the SRA exercised control, then Network Rail would be reclassified as public sector at that point.

Further information on the classification of Network Rail under the 1995 European System of Accounts can be found [on the ONS National Accounts Classifications web page](#).

Subsequently, ONS developed a set of indicators<sup>1</sup> that were used to supplement ESA95 guidance in identifying public sector control in classification decisions. This set has largely been embedded into ESA10 and MGDD guidance.

## Notes

1. The set of indicators was developed gradually and used to supplement ESA95 guidance. For a full list of indicators in the set see the '[ONS National Accounts Classification Process](#)' on the ONS website.

## New Guidance and Application to Network Rail

There are two areas, relevant to the classification of Network Rail, where new guidance has been added to ESA10 and MGDD which was not contained within either ESA95 or the previous ONS list of control indicators. This new guidance is in the following areas:

- Network Rail is a Non-Profit Institution. ESA10 includes new guidance relating specifically to government control of Non-Profit Institutions and in particular government's exposure to risk in relation to these bodies
- ESA10 includes more detailed methodology for conducting the market test. This test considers the relationship of a body's market output (i.e. sales) to its production costs. To be classified as a market producer, at least 50% of costs must be covered by revenue from sales over a sustained multi-year period. The new market test methodology under ESA10 includes consideration of net interest charges in the determination of production

### Control of Non-Profit Institutions

ESA10 includes 5 new indicators of government control over Non-Profit Institutions (NPIs), of which 'government's risk exposure relating to an NPI' and 'degree of financing' have not previously been considered specifically for Network Rail. The ESA10 guidance states that any of these indicators on its own may be sufficient to establish government control;

- a) Appointment of officers
- b) Provisions of enabling instruments
- c) Contractual agreements
- d) Degree of financing
- e) Degree of government risk exposure

As regards risk exposure, the latest MGDD advises that risk exposure might be evidenced by various types of government commitments to the body in question.

### The new indicators for NPIs in relation to Network Rail

Of the five indicators of control of a Not-for-Profit Institution, three, ('appointment of officers'; 'provision of enabling instruments'; and 'contractual agreements') were considered in the previous classification of Network Rail. It was decided then that while government was involved in appointing the original board when Network Rail was set up, subsequent membership was a private majority, therefore no control. 'Providing enabling instruments' and 'contractual agreements' (Network Licence) were considered part of government's regulatory responsibility and not control. There have been no significant changes in the governance of Network Rail nor in the guidance for ONS to change this view.

The remaining two indicators, 'degree of financing' and degree of 'risk exposure' were not specifically considered in the previous classification as they were not included in ESA95 or its

accompanying MGDD. They have now been considered under the ESA10 classification and are discussed in detail below;

### **Degree of Financing and Network Rail**

Under ESA10 and the accompanying MGDD, 'degree of financing' may also be an indicator of government control. To be in control, government must 'fully or close to fully' finance the body in question. A review of Network Rail's financial reports between 2004 and 2013 shows that government is a significant source of funding for Network Rail. This funding takes the form of direct support from the DfT and the Scottish and Welsh Governments. While government is the main funder (around £4bn annually since 2008), Network Rail has other sources of income including franchised track access charges (around £1.8bn in 2012-13) and 'other single till income' (around £700m in 2012-13, including income from non franchised rail companies, station property rental income etc). Grant funding has not made up more than 65% of Network Rail's total income since 2004/5. ONS did not therefore consider this to be 'fully or close to fully' financing by government. This indicator was therefore not considered as establishing government control.

### **Degree of government risk exposure**

The degree of government risk exposure was not considered explicitly in previous classification decisions relating to Network Rail as, at the time of previous decisions, neither ESA95, nor its accompanying MGDD, included a specific control indicator in this respect.

The guidance in ESA10 (paragraph 20.15) advises that government's risk exposure is an indicator of control. The current MGDD states that ESA10 is not explicit regarding the forms that government's risk exposure may take, but notes various possible commitments taken by government in order to ensure the continuity of the activity carried out by the NPI and judged essential for public policy purposes;

*This notion of control is also applicable to NPIs and similarly covers the ability to determine the general policy or programme of the NPI. ESA10 20.15 indicates that the following five criteria should be considered: a) appointment of officers, b) other provisions of the enabling instrument (such as the specific obligations in the statute of the NPI), c) contractual agreements, d) degree of financing and e) risk exposure<sup>1</sup>. In some cases, one indicator can be sufficient to establish control but it is most frequently necessary to consider collectively a number of indicators and would be frequently 'judgmental in nature' (2013 MGDD I.2.3 (12)).*

In relation to the degree of government's risk exposure, ONS has concluded that this factor is highly relevant for three reasons;

- Network Rail's debt is guaranteed explicitly by DfT<sup>2</sup>. Both DfT and HM Treasury have confirmed to ONS that they are guaranteeing this debt
- There is a statutory obligation on government to protect the interests of rail users, meaning government would be forced to step in to keep the railways operating were Network Rail to collapse<sup>3</sup>

- Nobody else bears any significant financial risk in relation to Network Rail (as Network Rail has no shareholders)<sup>4</sup>

ONS concluded that these facts establish control by government and therefore Network Rail should be classified in the public sector.

## Notes

1. MGDD states that this indicator is not explicit in ESA10. It seems to refer to various possible commitments taken by government in order to ensure the continuity of the activity carried out by the NPI and judged essential for public policy purpose. ONS has obtained confirmation from Eurostat that such commitments include government guarantees of the body's debt.
2. More information can be found on the Network Rail website. See <http://www.networkrail.co.uk/investor-relations/faq/>
3. The [Railways Act 2005](#) abolished the Strategic Railway Authority and transferred most of its functions and responsibilities to Office of Rail Regulation, Department for Trade and Scottish Ministers.
4. For more information see the [Network Rail Legal and Financial Structure](#).

## The new Market Test

Having established government's control over Network Rail, ONS needed to carry out the 'market test', which is used to determine whether a government-controlled body is a public corporation or part of central government. As explained earlier, in order for a government-controlled body to be classified as a market body (and thus to be classified as a public corporation rather than as part of central government) that body's sales of goods and services should account for more than 50 per cent of its production costs.

The ESA10 market test uses the same general methodology but is different to the ESA95 market test as it adds 'net interest charges' into the calculation of production costs. For institutional units with high debt levels, like Network Rail, which incur substantial interest costs (around £1.5bn annually for Network Rail between 2009-10 and 2012-13), this new guidance has a critical impact on the outcome of the market test.

In applying the market test to Network Rail, ONS concluded that the track access charges constituted sales and considered the following four major items from Network Rail's expenditure figures within its annual report and accounts;

- Employee costs - taken to be broadly equivalent to 'compensation of employees'
- Other external charges (including infrastructure maintenance costs) - taken to be broadly equivalent to 'intermediate consumption'

- Depreciation and other amounts written-off non-current assets - taken to be broadly equivalent to 'consumption of fixed capital' and
- Total Borrowing Costs - taken to be broadly equivalent to actual interest payable. Information on interest receivable is then deducted to arrive at 'net actual interest payments'

On this basis, the ESA10 market test indicates that Network Rail has not been a market body since its 2004-05 financial year. This means that, while under the ESA95 market test methodology, Network Rail continually had sales which accounted for more than 50 per cent of its production costs, under ESA10 it consistently has sales that are less than 50 per cent of production costs.

The ONS therefore concluded that Network Rail 'fails' the market test under ESA10 and is a non-market producer.

## Overall conclusion

Because of government's risk exposure in guaranteeing Network Rail's debt, ONS has concluded that, under ESA10 rules, Network Rail is a government controlled body and, as such, is within the public sector. Following the market test, ONS has concluded that, under ESA10 rules, Network Rail is a non-market body. Consequently, since the financial indemnity which guarantees Network Rail's debt is provided by Central Government, Network Rail is a central government controlled, non-market body classified as part of the Central Government sector.

This classification decision will be implemented on 1 September 2014 when ESA10 comes into force and will apply retroactively from April 2004 when Network Rail became a non market body under the new ESA10 guidelines.

## Are there any other bodies affected by these changes in guidance?

ONS has looked at other regulated industries in order to check whether the new guidance in ESA10 and the MGDD would apply to other UK bodies. Specifically, ONS considered water companies and energy companies.

Some of these companies are already classified to the Public Sector such as Scottish Water and Northern Ireland Water. The remainder of the energy and water companies are all limited by shares and therefore the new guidance would not apply. The exception is Dwr Cymru which is a Not-for-Profit Institution. However, Dwr Cymru is neither funded by Government nor does it receive any Government guarantees on its debt. From these industries we have therefore concluded that no other bodies in these areas need reclassification under ESA 2010.

## Implementation and impact on key statistics

The classification of Network Rail will be implemented alongside all other changes relating to ESA10 in September 2014.

The impacts on National Accounts are being determined at present and will be announced as part of a series of articles on the impact of ESA 2010 during 2014.



For the key aggregates in the Public Sector, Network Rail is estimated to increase Public Sector Net Debt by approximately £30bn and Public Sector Net Borrowing by approximately £2.5bn in 2012/13. These provisional estimates will be updated during 2014.

## Further Information

Further information on ONS classifications and the NACC can be found on the [National Statistics website](#).

## References and background

1. Regulation (EU) No 549/2013 of the European Parliament and of the Council <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:174:0001:0727:EN:PDF>
2. Sector Classification, HM Treasury (2013) [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/226420/PU1547\\_final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/226420/PU1547_final.pdf)
3. Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1996:310:0001:0469:EN:PDF>
4. Network Rail membership Policy, Network Rail, 2012 <http://www.networkrail.co.uk.aspx/5619.aspx>
5. System of National Accounts, 2008 <http://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf>

## Background notes

1. Details of the policy governing the release of new data are available by visiting [www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html](http://www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html) or from the Media Relations Office email: [media.relations@ons.gsi.gov.uk](mailto:media.relations@ons.gsi.gov.uk)

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