CHAPTER 3

PPP Legal Framework

Velia M. Leone

Abstract This chapter analyzes PPP under a legal perspective. Since there are several differences across jurisdictions in the legal treatment of PPP contracts, and there are no binding rules at international level, this chapter is focused on the European Union framework, which is one of the most advanced. It could provide a reference for emerging countries which are approaching PPP and are drafting national legislation on PPP contracts. The main focus of this chapter is on the development of legal provisions applying to PPCPs, and, in particular, on the EU Concessions Directive and the fundamental concept of operating risk, i.e. the risk that has to be transferred on the private partner in concession contracts.

Keywords EU Court case law • EU Concession Directive • Operating risk • EPEC • Procedural aspects

3.1 The Development of an EU Legal Framework on PPP

This chapter examines PPPs from a legal standpoint. Since legal systems vary from one national context to the other, and considering there are no binding rules at international level, the natural choice was to focus on EU
legislation, which is both comprehensive and binding on a number of countries. That said, as seen in previous chapters, originally, the notion and practice of PPPs do not stem from legal provisions. Rather, they are the result of a complex phenomenon which developed as a practice over time in connection with the progressive scarcity of public funds. Also, more strategically, it developed as a trend to reduce the State’s active role in the market, that is, from owner of infrastructure to service provider.

At international level, and especially in the financial and economic sectors, PPP contracts had been negotiated and signed long before entering the radar of lawmakers, at EU or national level. This is because PPP contracts are inherently a very flexible and multi-disciplinary response to the need for better infrastructure and services of higher quality. This ambitious result can be obtained through structured cooperation between public and private sectors, allowing the best results, beneficial to both parties, through a combination of different arrangements, with a distinctive financial purpose.

As PPPs increasingly spread across Europe, the EU institutions, especially the Commission, started to focus on them with a view to ensuring that such contracts complied with the EU rules on public contracts and concessions. The first time PPPs were analyzed with a more systematic EU law approach was in the Green Paper on public-private partnerships and Community law on public contracts and concessions, issued by the EU Commission in 2004 (the Green Paper). The purpose of the Green Paper was to examine PPPs from the perspective of EU legislation and principles in order to provide a survey of the different types of contract and identify an appropriate framework for its encasing into the EU legal provisions on public procurement and concessions.

As expressly stated in the Green Paper, this approach was based on the assumption that “any act, whether it be contractual or unilateral, whereby a public entity entrusts the provision of an economic activity to a third party must be examined in the light of the rules and principles resulting from the Treaty, particularly as regards the principles of freedom of establishment and freedom to provide services […], which encompass in particular the principles of transparency, equality of treatment, proportionality and mutual recognition.” The Green Paper describes PPP contracts as “forms of cooperation between public authorities and the world of

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1 Communication dated 30.4.2004 COM (2004) 327 final.
2 Section 1.2, point 8 of the Green Paper.
business which aim to ensure the funding, construction, renovation, management or maintenance of an infrastructure or the provision of a service” and provides first guidance on how they should be construed according to the EU legal framework on public contracts.

The Green Paper identifies the general characteristics of PPPs, as follows:

- relatively long duration of the relationship, involving cooperation between the public and the private partner on different aspects of a specific project;
- method of funding the project, involving a significant role played by the private sector, sometimes by means of complex arrangements including various players, with different expertise and competencies. Nonetheless, public funds—in some cases even rather substantial—may be added to the private funds;
- important role of the economic operator (EO), participating at different levels and stages in the project (design, completion, implementation, funding). Conversely, the public partner concentrates primarily on defining the objectives to be achieved in terms of public interest, quality of services provided, and pricing policy. The public sector takes responsibility for monitoring compliance with these objectives;
- appropriate allocation of risks between the public and the private partner, to whom the risks generally borne by the public sector are transferred. However, PPP contracts do not necessarily mean that the private partner assumes all the risks, or even the major share of the risks linked to a specific project. The precise distribution of all risks involved in a particular project is, finally, identified on a case-by-case basis, according to the respective ability of the concerned parties to assess, control, and cope with each individual risk.

Bearing in mind the above-mentioned features, the Green Paper draws a fundamental distinction between:

- PPPs of a purely contractual nature, that is, when the partnership between the public and the private sector is based solely on contractual links; and
- PPPs of an institutional nature, that is, involving cooperation between the public and the private sector within an ad hoc entity.

\(^3\)Section 1.1, point 1 of the Green Paper.
Notwithstanding the different models used, throughout the EU and worldwide, the Green Paper concluded the scope of PPP contracts is aimed at the provision of services or works to contracting authorities (CAs), for a consideration, and, therefore, they qualify as “public contracts,” according to the interpretation of EU Court of Justice (Court) (see Box 3.1).

Therefore, as PPPs are public contracts used by the CAs for the acquisition of services, including works, they involve the expenditure of public money. This specific nature of PPP contracts requires that the selection of the private partner falls within the realm of application of EU Internal Market rules and applicable principles, in particular, to public procurement and concessions. Moreover, they are encompassed by the public procurement directives, which are “essentially aimed at protecting the interests of traders established in a Member State who wish to offer goods or services to contracting authorities established in another Member State and, to that end, to avoid both the risk of preference being given to national tenderers or applicants whenever a contract is awarded by the contracting authorities and the possibility that a body governed by public law may choose to be guided by considerations other than economic ones.”

In brief, according to the Green Paper, the rules applicable to the selection of the EOs are a consequence of the definition of the contractual relationship which that party enters into with CAs.

Having established the “public contract” nature of PPPs, then, it is important to assess whether this type of contract should be qualified as “public procurement” or “concession” contracts in order to determine their applicable rules. The Green Paper does not encase PPPs into a single specific contractual model, leaving such qualification open for a case-by-case analysis.

In this context, it should be stressed that, under EU law, the only two types of public contracts—that is, those aimed at the acquisition of works, goods, and services by CAs—are procurement and concession contracts. Therefore, all PPPs must fall within one of these two categories. The EU Directive on Concessions 2014/23/EU (Concessions Directive) clarifies

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4 It should be noted that when the Green Paper was issued, there was no specific directive on concessions. In those days, the public procurement directives provided a minimum set of rules on works concessions only.

5 Green Paper, quoting the Court on Judgement in joint cases C-285/99 and C-286/99, Impresa Lombardini v. ANAS (November 27, 2001).
Box 3.1 The notion of public contract under EU rules

The Court held that the concept of public works contracts (or public service contracts) within the meaning of the public procurement directives requires that:

- the contractor undertakes to carry out the works/service—that is, the scope of the contract—for a consideration and the obligations under the contract are legally binding, meaning that their execution must be legally enforceable;
- these works or services are carried out for the CA’s immediate economic benefit, so that they qualify as contract “for a pecuniary interest”\(^6\) on both sides;
- the scope of public works or service contracts is the realization of works or services “corresponding to the requirements specified by the contracting authority.” To verify if a CA has specified its requirements within the meaning of that provision, the CA must have taken measures to define the type of the work/service required or, at the very least, have had a decisive influence on its outline (Judgment of the Court, March 25, 2010, C-451/08, Helmut Müller GmbH).

The 2014 Directives enlist the notion of public contract, as developed by the Court. In particular, Directive 2014/24/EU on public contracts provides that:

- EU rules on public procurement “are not intended to cover all forms of disbursement of public funds, but only those aimed at the acquisition of works, supplies or services for consideration by means of a public contract. It should be clarified that such acquisitions of works, supplies or services should be subject to this Directive whether they are implemented through purchase, leasing, or other contractual forms” (recital 4, emphasis added);
- “The notion of acquisition should be understood broadly in the sense of obtaining the benefits of the works, supplies or services in question, not necessarily requiring a transfer of ownership to the contracting authorities” (recital 4. emphasis added):

\(^6\) Such interest is to be identified in any form of economic consideration received by EOs, leaving aside the legal definitions.

(continued)
the fundamental distinction between public procurement and concession contracts: namely, the latter requires EOs to bear the so-called operating risk, connected to the exploitation of the works or service, encompassed in the contract scope.

Consequently, within PPPs having contractual nature, the Green Paper identifies two general models, namely:

- the “concession model,” where there is a direct link between private operators and end-users. In other words, EOs provide services to the public, “in place of”—yet under the control of—the public partner. The remuneration consists of charges levied on the end-users of the services and, if necessary—for example, when they are not sufficient from a business perspective—supplemented by subsidies from public authorities.

- the so-called PFI model, whereby EOs carry out and operate infrastructure on behalf of the public authority and the remuneration is executed through regular payments by the CAs. These payments may be fixed or variable, on the basis, for example, of the availability of the works or their ancillary services, or even the level of use of the infrastructure.

That said, nowadays, the above-mentioned difference between these two models is no longer useful to distinguish between public procurement and concessions, as both types must encompass the proper allocation of operating risk to EOs in order to be considered PPP contracts. Such
further developments were envisaged already in the Green Paper itself, which paved the way for them, when establishing that—irrespective of the contractual model chosen—the success of a PPP depends, to a large extent, on a “comprehensive contractual framework for the project, and on the optimum definition of the elements which will govern its implementation,” such as:

- the “appropriate assessment and optimum distribution of the risks between the public and the private sectors, according to their respective ability to assume these risks” (emphasis added);
- the “mechanisms to evaluate the performance” of the EO.

Finally, the Green Paper stressed another important element, that is, the “economic and financial stability of a project,” which implies:

- on the one hand, the duration of the PPP contracts must be set so that it does not limit open competition beyond what is required to ensure that the investment is paid off and there is a reasonable return for EOs; and
- on the other hand, PPP contracts must be able to evolve in line with changes in the macro-economic or technological environment, and with general interest requirements, as long as such possibility is provided for in compliance with the principles of equality of treatment and transparency. Thus, the awarding procedure documents may provide for automatic adjustment clauses or stipulate re-negotiation clauses. The latter must identify precisely the circumstances and conditions under which adjustments could be made to the contract, in a sufficiently clear way, so as to allow the EOs participating in the awarding procedure to interpret them unequivocally and submit their tenders accordingly.

In light of the essential elements of PPPs, as identified in the Green Paper and the following case law and legislation, it is to be concluded that, nowadays, PPP contracts—in order to comply with the qualifying features

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7 Section 2.3.1., point 45 of the Green Paper.
8 Section 2.3.1., point 45 of the Green Paper.
9 Section 2.3.1., point 45 of the Green Paper.
10 Section 2.3.1., point 46 of the Green Paper.
that make them a useful and effective tool to achieve best results through cooperation between EOs and CAs—must be construed as a concession. Therefore, the following paragraphs concentrate on the identification and assessment of the operating risk since the distinctive character of concession contracts is a well-balanced and effective transfer of it to EOs.

3.2 Court Case Law on Concessions and the Concessions Directive: No More Ambiguities and False Myths

A pivotal role in fostering the evolution of EU law is played by the Court’s case law in relation to the interpretation and evolution of primary and secondary legislation. This is because the Court not only interpreted and clarified, but also developed and even created principles applicable in the field of public procurement—to both public procurement contracts and concessions—often paving the way to further developments. This osmotic relationship gives rise to a virtual circle thanks to which the EU legislator has progressively included the Court’s findings and guidelines in legislative reforms. If this is the case in all areas of EU legislation, it is even truer in the field of procurement and concessions. It is a field where the Court’s law-generating function has led, for example, to the creation of different new legal arrangements—by case law and, only later, also legislation—such as, in house contracting, the possibility of using third parties’ capacities, and so on. Additionally, it has led to the shaping of general principles which are to be considered immanent in the rules themselves and, therefore, must guide the parties—on the public and private side—both in the interpretation of the legislative provisions and in the conduct to be followed during awarding procedures and the execution of contracts, even in areas which were not specifically regulated by legal rules.

The evolution of EU regulation on concessions is no exception to this general backdrop.

Indeed, in terms of legal qualification, the Concessions Directive codified and clarified the principles and guidance on operating risk already laid down by the Court. Among other outcomes, these findings also overcame the distinction—in terms of applicable rules—between the awarding of works and service concessions. The concept of operating risk has been interpreted by the Court, on several occasions, progressing with the identification of its main features through subsequent refinements. The
ultimate result of the case law of the Court is the possibility of using con-
cession contracts, even in the context of highly regulated sectors, subject
to null or just negligible market fluctuations. By so doing, the Court
denied any relevance to the actual quantification of the operating risk.

Bearing in mind the pivotal role of the operating risk, for a contract to
qualify as concession, the Court has specified:11

- it is necessary to establish whether the service provider takes the risk
  of operating the service. Even where, at the outset, that risk is very
  limited, by reason of the public law arrangements governing the
  organization of the service—that is, controlled prices—it is necessary
  CAs transfer to EOs all or at least a significant share of the risk;
- the operational risk must be understood as the risk of exposure to the
  vagaries of the market, which may, among others, consist in:

  - competition from other operators
  - supply of the services not matching the demand
  - end-users’ inability to pay for the services provided
  - costs of operating the services not being met by revenue
  - liability for harm or damage resulting from an inadequacy of the
    service;

- risks such as those linked to inadequate management or errors of
  previous judgment by EOs are not decisive for the purposes of clas-
sification as a public service contract or a service concession, since
those risks may incur in any type of contract, whether it be a public
contract or a concession.

Conversely, the Court’s case law has not yet reached a consistent and
unambiguous position on the need for concessions to be based on a three-
party relationship, that is, whereby concessionaires may only recoup their
investments through tariffs paid by end-users. The Court went as far as
stating that such three-party relationship represents one form of remunera-
tion for concessions, without, however expanding on other possible types.
This step forward by the Court may have paved the way to the evolution

11 See, among others, Eurawasser, C-206/08, 10 September 2009; Privater Rettungsdienst,
C-274/09, 10 March 2011; Norma-A SIA, C-348/10, 10 November 2011.
of the concept of availability risk. Concessions based on supply/availability risk only require two counterparts, namely CAs—representing the public interest and paying on behalf of the end-user or, in any case, without their direct involvement in the remuneration—and EOs. This point was clarified only with the publication of the Concessions Directive, which took good note of previous case law of the Court as, in recital 18, it identifies the essential features of a concession, as follows: “The main feature of a concession, the right to exploit the works or services, always implies the transfer to the concessionaire of an operating risk of economic nature involving the possibility that it will not recoup the investments made and the costs incurred in operating the works or services awarded under normal operating conditions even if a part of the risk remains with the contracting authority or contracting entity” (emphasis added).

Moreover, to clarify the concept of concession contracts, so as to allow its wider use, the Concessions Directive further elaborates on the concept of “operating risk” to dispel many “false myths” often associated with it.

### 3.2.1 The First Myth: “Operating Risk Must be Quantified So As to Reach a Certain Minimum Amount”

Article 5 of the Concessions Directive states that: “The award of a works or services concession shall involve the transfer to the concessionaire of an operating risk in exploiting those works or services encompassing demand or supply risk or both. The concessionaire shall be deemed to assume operating risk where, under normal operating conditions, it is not guaranteed to recoup the investments made or the costs incurred in operating the works or the services which are the subject-matter of the concession. The part of the risk transferred to the concessionaire shall involve real exposure to the vagaries of the market, such that any potential estimated loss incurred by the concessionaire shall not be merely nominal or negligible” (emphasis added).

Consequently, pursuant to the Concessions Directive, operating risk must:

- be excluded in all those cases where CAs relieve EOs of any potential loss by ensuring a guaranteed minimum income equal to or greater than the investments made and the costs incurred for the performance of the contract;
- not be reduced to the risk of incurring a purely nominal or negligible potential loss.
However, it should be noted that the above requirements do not extend to impose that the operating risk reaches a pre-determined minimum amount, or that it necessarily has to be very high. In other words: *there is no minimum threshold for operating risk, provided it is not negligible.*

The Concessions Directive—following the same line of reasoning already developed by the Court in the above-mentioned case law\(^\text{12}\)—specifies that the extent of the risk can be limited by the market structure itself, reiterating that (recital 19): “The fact that the risk is limited from the outset should not preclude the qualification of the contract as a concession. This can be the case for instance in sectors with regulated tariffs or where the operating risk is limited by means of contractual arrangements providing for partial compensation including compensation in the event of early termination of the concession for reasons attributable to the contracting authority or contracting entity or for reasons of force majeure,” provided there are no “sector-specific regulation[s]” or contractual arrangements totally eliminating the concessionaire’s risk “by providing for a guarantee to the concessionaire on breaking even on investments and costs incurred for operating the contract.”

Bearing this in mind, it is still advisable, whenever possible, to quantify the economic impact of operational risk on EOs in the specific concession contract. This exercise must necessarily be related to the number of investments and costs whose recovery would be jeopardized should the expected risks occur. As methodologic guidance, Recital 20 of the Concessions Directive provides that “for the purpose of assessment of the operating risk the net present value of all the investment, costs and revenues of the concessionaire should be taken into account in a consistent and uniform manner.”

To conclude, the assessment of the amount of operating risk taken on by the concessionaire is, in fact, useful for ensuring contract maintenance. This is because the transfer of an operating risk which is only apparent, or, conversely, of an excessive operating risk could, respectively, modify the nature of the contract (from the original concession to public procurement\(^\text{13}\)) or undermine the economic sustainability of the concession itself overtime.

\(^{12}\)See footnote no. 11.

\(^{13}\)As regards such modification in the nature of the contract, initially qualified as concession, see Judgment of the Court of 13 November 2008—Commission v Italy, C-437/07.
3.2.2  The Second Myth: “Operating Risk may Only be Based on Demand”

The Concessions Directive departs from the traditional approach to concessions—focused on infrastructures and services of economic nature, meaning they can be exploited on the basis of actual demand from end-users—by providing a wider and clearer scope for the definition of operating risk. Recital 20 and Article 5 of the Concessions Directive make it clear that operating risk may be based on demand, supply risk, or both. Consequently, demand risk is to be understood as “the risk on actual demand for the works or services which are the object of the contract,” while supply risk is “the risk on the provision of the works or services which are the object of the contract, in particular the risk that the provision of the services will not match demand.”

Both risks imply that “under normal operating conditions”, the concessionaire is “not guaranteed to recoup the investments made or the costs incurred in operating the works or the services which are the subject-matter of the concession.”

Therefore, the possibility of relying on the sole supply risk is expressly provided for in the Concessions Directive. It is worth stressing that, according to the Concessions Directive, the two types of risk are absolutely equivalent and do not necessarily have to be both present: one of the two being present is sufficient to qualify a specific contract as a concession. Moreover, it should be highlighted that—as interpreted by the Court in the above referred case law, and further clarified by Recital 20 of the Concessions Directive—operating risk “should stem from factors which are outside the control of the parties. Risks such as those linked to bad management, contractual defaults by the economic operator or to instances of force majeure are not decisive for the purpose of classification as a concession, since those risks are inherent in every contract, whether it be a public procurement contract or a concession.”

For infrastructure, supply risk can be declined as “availability risk”—according to Eurostat terminology—that is, the risk of guaranteeing continued functioning and use of the structures and the services connected to them, in order to meet, according to certain qualitative and quantitative standards, the needs—that is, the demand—of CAs, even when these needs change over time and involve higher costs for the concessionaire. The expression “availability risk”, which initially appeared in the proposal for a directive on concessions submitted by the Commission—COM (2011) 897 final—was subsequently replaced by “supply risk” to give it a wider scope to concession contracts than just infrastructure.

See footnote no. 11.
particularly relevant when concessions are based on supply/availability risk since, in such cases, operating risk could be confused with a simple risk of default (see par. 3.3). Therefore, this specific recital of the Concessions Directive provides the most enlightening evidence of the absolute equivalence of the two types of concession, namely those based on demand risk and those based on supply/availability risk.

3.2.3  *The Third Myth: “Concessions are Based on a Three-Party Relationship, Whereby the Concessionaire Recoups its Investments and Costs Through Tariffs (Actually or Virtually\(^{16}\)) Paid by Users”*

The Concessions Directive finally clarifies residual ambiguities deriving from the Court’s case law as regards the need for a “three-party relationship” in concession contracts.

Recital 18 of the Concessions Directive specifies that remuneration may not stem from payments by end-users since “it should be made clear that certain arrangements which are exclusively remunerated by a contracting authority or a contracting entity should qualify as concessions where the recoupment of the investments and costs incurred by the operator for executing the work or providing the service depends on the actual demand for or the supply of the service or asset.”

In other words, operating risk consists in the lack of guarantees (for EOs) on the recovery of its investments and costs, regardless of the presence, or not, of a direct relationship with end-users. This is providing the risk of not recouping is related to events that, while being foreseeable and manageable by the concessionaire, are not directly attributable to it or its contractual performance, during the operational and management phase. As a result, the Concessions Directive expressly provides that, in addition to the “classic” types of concession contracts—where EOs are remunerated only or mainly by tariffs paid by end-users of the services and according to the (individual) demand for the service itself—the notion of concession also encompasses those contracts which are paid for—exclusively or mainly—by CAs, provided they entail an operating risk for the concessionaire.\(^{17}\)

\(^{16}\)For example, a virtual three-party relationship can be established when the so-called shadow tolls are paid to EOs, that is, when the concessionaire is remunerated through a fee based on individual use by end-users, but, in fact, the fee itself is paid by CAs.

\(^{17}\)According to Eurostat’s accounting rules, these concessions are defined PPP contracts (see par. 3.5).
These types of contracts—whereby EOs are paid by CAs—may include:

a. contracts where EOs are remunerated by CAs based on actual demand (although end-users do not directly pay tariffs to EOs)—for example, in the case of health services based on individual demand and paid accordingly;

b. contracts whose remuneration depends only on the supply of the work—that is, availability thereof—or the service, according to pre-defined qualitative and quantitative levels. This entails the risk of having to bear higher costs to guarantee the achievement of the aforementioned levels, such as, the efficient management and maintenance services of a non-economic infrastructure (school, prison, hospital) or certain equipment; as well as

c. contracts providing for both of the above mechanisms of payment.

### 3.3 The EPEC Guidance Note

Further clarification of the real scope of concessions, as defined by the Concessions Directive, was provided by the authoritative interpretation in the European PPP Expertise Centre’s (EPEC) guidance note on “PPPs and Procurement Impact of the new EU Directives” of April 2016 (Guidance Note on Directives). The Guidance Note on Directives was meant to examine the possibilities afforded to CAs by the new directives, and, in particular, to verify their impact on the legal qualification and use of PPPs.

After summarizing the key issues arising from the new directives in those areas where they are expected to have a specific impact on PPPs, the Guidance Note on Directives focuses on the Concessions Directive by verifying whether PPPs may be included in the more sophisticated notion of concession as defined therein. The distinctive features of the Concessions Directive, in terms of procedural rules, may offer CAs more flexibility in the awarding of particular types of (often complex) contracts as PPPs. Moving from the above remark, the Guidance Note on Directives considers that while user-paid (demand-based) PPPs would almost always be concessions, most government-paid (availability-based) PPPs were not traditionally, or at least immediately, seen as concessions. However, the Concessions Directive, although not encompassing a legal definition of PPP, represents a remarkable break-through by fostering the notion of
“supply risk” as a possible basis for operating risk. By so doing, it opens the possibility of procuring availability-based PPPs using the Concessions Directive. In any event, such qualification is conditional upon the actual transfer of operating risk—that is, economic risk foreseeable, but uncertain—to EOs.

In this context, the Guidance Note on Directives identifies key indicators useful for establishing whether:

- **the risk is transferred to EOs.** For instance, where a project benefits from guarantees from CAs, so as to make sure EOs are certain to at least break even on original investment costs, the risk is not transferred;
- **the risk may qualify as operating risk within the meaning of the Concessions Directive.** This is a specific type of risk, different than risks inherent in all public contracts. The following are examples of risks that cannot qualify as operating risk:
  - force majeure—the transfer of a risk materializing from something that is not foreseeable, often identified as an act of God, is not sufficient to give rise to a concession, as other public contracts also have to deal with such risks;
  - contractual default—that is, if a concessionaire bears the risk that it may default and consequently lose its investment, this is not sufficient to indicate that risk has been transferred, as this can happen in any public contract;
  - bad management—that is, just because a concessionaire might not realize its expected profits because of its inefficient internal management, this does not mean that operating risk has been transferred, as public contracts also have to deal with these risks. However, it is not always easy to distinguish contracted-for risks from supply risks.

The above-mentioned issues are thoroughly analyzed in the Guidance Note on Directives, in particular, as regards supply/availability-based PPPs.

In these kinds of PPPs, EOs are not subject to the vagaries of the market as there is minimal competition for use, that is, demand is basically stable. However, even in these instances EOs are exposed to the vagaries of the market in relation to pricing of materials, supplies, and labor costs. Therefore, the key issue is to determine whether losses EOs might incur are due to the transfer of a supply risk rather than mismanagement.
According to the Guidance Note on Directives, in typical PPP, unlike conventional public contracts, significant risk transfer occurs because:

- the revenue stream does not match the cost liability being incurred. EOs, therefore, incur significant costs in building the asset in advance, but are not reimbursed or compensated for these costs until that asset is operating properly, together with the associated services;
- when EOs are faced with deductions through the payment mechanism (due to unavailability), they are expected to remedy the alleged defect from their own resources. This would reduce shareholders’ returns and potentially involve making a call for contributions from equity participants.

Considering the above, the Guidance Note on Directives remarks that one of the main reasons for choosing a PPP structure is the contractual guarantee the asset will be carried out “on time” and “on budget,”$^{18}$ as well as in compliance with the expected quality standards. These guarantees are effective and efficient insofar as EOs are penalized financially—in a significant, not purely “cosmetic,” or merely potential, way—if they fail to provide the initial asset and ancillary services, according to the agreed contractual terms. Consequently, the Guidance Note on Directives highlights the type of risks that—in PPP contracts based on supply/availability risk—EOs must assume and represent their operating risk, pursuant to the Concessions Directive. Furthermore, the impact of operating risk is different during the different execution phases of the PPP contract, namely:

- in the initial phase of the contract—EOs must design and deliver assets (which may consist of works or other fixed investments, for example machinery not easily removable) having a value which is retained throughout the contract duration and beyond. These assets are instrumental to the delivery of services by EOs. This is a fundamental transfer of supply risk. It requires EOs to make product and design choices at the outset, incurring the related investment costs. However, EOs’ initial decisions and investments are rewarded only

$^{18}$That is on the basis of the time schedule and predetermined costs.
through the stream of availability payments, achievable over the contract’s complete and appropriate execution.\(^{19}\)

- **during the operational phase of the contract**—Additional risks must be managed by EOs to ensure that assets, and associated services, remain in use and continue to function, in compliance with the agreed quality standards and the quantitative requirements set in the contract. These risks include many relief event risks (such as failure by a third-party utility provider or industry-wide industrial action and strikes), risk of failure of sub-contractors, some utility risks, insurance cost risks, maintenance costs, and so on. It is fundamentally important to manage these risks correctly for the proper functioning of the contract. If EOs are unable to do so—regardless of the circumstance of having, otherwise, fulfilled contractual obligations—they can be penalized through deductions from the availability payment, in addition to the classic contractual provisions relating to contractual breach, such as traditional penalties. Deductions are generally made by applying a predefined formula, progressively increasing the level of financial deductions as the duration of the sub-standard performance persists. In the worst-case scenario, persistent failure to perform according to the standards can lead EOs to forfeit the contract (through an event of default). In the event of unavailability of the asset and/or the service, CAs may step in to perform the services for a period of time while the issues leading to the service failures are addressed. Even in this hypothesis, the risk is transferred to EOs since the costs

\(^{19}\)The fact that remuneration cannot take place before the assets involved in the investment come into operation does not prevent CAs—in order to ensure the initial balance of the contract—from providing an initial partial contribution—during the investment phase, and possibly also according to the progress of the works aimed at mitigating the debt exposure of EOs in the primary contractual phase. The aforementioned contribution does not constitute an availability payment—subject to operating risk—but a co-financing of the initial investment. Clearly, the value of this possible contribution must not be such as to eliminate construction risk for EOs and, therefore, in accordance with Eurostat rules, the same must be below 50% of the investment. Also it should be noted that the EPEC Guidance on statistical treatment of PPP of 2016 (the EPEC-PPP Guidance on Manual)—providing guidance on the interpretation of Eurostat’s Manual on Government Deficit and Debt (implementation of ESA 2010)—clearly states that ways and timing of disbursement of the public contribution are considered irrelevant with respect to the transfer of construction risk (cf. Theme 2 and Theme 14.4 of the EPEC-PPP Guidance on Manual).
incurred by CAs for the replacements will be charged to the former, thereby reducing their chances to fully recover their own investments and costs. Moreover, senior lenders to EOs may also take action and apply coercive pressure for performance standards to be corrected, by stepping in and replacing the private counterpart. This opportunity to intervene is preemptive of any final decisive action by the CA to terminate the contract. In any event, in each risk-management scenario, CAs are reimbursed for any costs incurred and these costs are ultimately borne by EOs. In these cases, there is an additional element of supply risk on EOs having to ensure that the revenue/income stream matches their liabilities over the contract period. This supply risk is transferred to EOs, and it is often managed by the use of provisioning, preemptive maintenance planning, resource scheduling, product choices, seeking and maintenance of warranties, supply chain management, and so on. These management strategies are all aimed at managing many of the increased costs associated with the supply of the contract services (e.g. labor, raw materials) to ensure the supply of the asset and services—in quantity and quality—according to CAs’ demand; • at the end of the contract (be it because of the end of its agreed duration or because of early termination)—EOs retain significant supply risk until the end of the contract period with regard to returning the asset to CAs in the required state of maintenance and functionality, according to the contract, which may entail additional costs in order to restore assets, equipment, or other goods to the agreed state and conditions.

The Guidance Note on Directives stresses that PPP contracts must (and typically do) establish what risks are foreseeable in order to qualify as concessions. Moreover, PPP contracts must identify who is responsible in the event of such risks materializing during the execution of the contract (providing for specific consequences in case of failure to supply the contracted services to the standard defined). To this end, it is essential to contractually identify the “foreseeable, but uncertain” risks, establishing which contractual party supports the relative cost, in the event that they occur, through the preparation of a so-called Risks Matrix. Such a matrix is an essential tool to evaluate—at the outset and during contract
performance—which specific risks have been transferred to EOs and whether such initial allocation remains throughout the whole contract duration, notwithstanding the possibility of changes in the contract provisions that may occur and are regulated for in the contract itself. In this perspective, a well-conceived availability-based PPP contract requires EOs running and exploiting works and/or services, where investments are executed and being remunerated by an availability payment, “which may be seen as a revenue stream to be exploited in the same way as a toll. In this situation it just so happens that the security for the recovery of revenue comes via a third party (i.e. the government on behalf of taxpayers), rather than directly from users (in the same way as with shadow-toll PPPs).”.

Having set out this overall picture, the Guidance Note on Directives highlights that in supply/availability-based PPPs qualifying as concessions, EOs must bear the risk of a mismatch between revenues and costs due to the increase in labor costs and raw materials, interest rates, and so on. In traditional public procurement contracts, these additional costs are taken on by CAs. Conversely, in PPP contracts, ultimately, if EOs fail to manage any of the above supply risks, they could lose—or rather, not recover—their up-front investments and costs, which is the key aspect of a concession. However, in general terms, it may be difficult to judge to what extent this is simply due to mismanagement, as described in the Concessions Directive, rather than the effect of a transfer of supply risk. The outcome of this analysis will depend on a detailed perusal of the facts in each individual case. Supply/availability risk must, in fact:

- depend on external factors to EOs’ organization, and
- be such as to involve, if not properly managed by EOs, the reduction of the due consideration, entailing the possibility their investments are not recouped during the execution of the contract.

In conclusion, according to the Guidance Note on Directives, the subtle and fundamental distinction between supply/availability risk and “poor management” must be analyzed and assessed on a case-by-case basis, taking into account the specific nature of the project, the characteristics of the performance required from EOs and the contractual consequences in cases of failure to reach the agreed qualitative and quantitative standards allocated to the latter.
3.4 Normal Operating Conditions and Operating Risk Versus Other Contract Risks

As mentioned, the Concessions Directive clarifies and emphasizes the notion of operating risk as the key feature of concession contracts, encompassing both the findings of the Court and further developments stemming from market practice. Therefore, the main characteristic of concession/PPP contracts—even when based on supply/availability risk—is the transfer to the concessionaire of an operating risk of an economic nature. In essence, assuming this risk, EOs, in “normal operating conditions,” accept the possibility of not being able—even when complying with contractual obligations—to recoup the initial investments made and the costs subsequently incurred for carrying out the works and/or services awarded to them.

The reference to “normal operating conditions” encapsulates the correct classification of risks taken on by the concessionaire at the outset. This forecast must be taken from a predetermined and established set of data and reliable estimates, based on foreseeable events. In other words, the concession/PPP contract, although characterized by the assumption of operating risk, must not be a gamble. It must remain a contract in which the relationship between performance, verifiable events, and level of remuneration is determined ex ante, in itinere and ex post, through different monitoring instruments.

In concession contracts—when supply/availability-based risks are allocated—EOs fully assume the risks related to any increase in costs—including financial ones—necessary for the execution of the contract, and to other factors that may reduce its revenues, provided they are potentially predictable and therefore manageable. This excludes those variations deriving from an action by CAs, or from other factors, expressly envisaged and contractually regulated, such as “acts of God”, which are outside the realm of “normal operating conditions.”

Uncertainty on the actual materializing of risks is required in order to qualify the contract as a concession, although risks should stem from a set of events identifiable, whilst not certain. The possible range of variables affecting concessionaires include both incurring lower costs than expected (therefore, raising the EO’s revenues) and also higher costs than expected, bringing about the opposite effect. Both cases should be part of the PPP/concessions spectrum of possibilities.
In this perspective, the analysis regarding the appropriate and well-balanced transfer of operating risk must be made ex ante and must maintain a certain level of uncertainty for the EO, relating to the possible fluctuations in operating costs during the execution phase. Therefore, the possibility of recouping the investments and costs through the revenues deriving from the concession must be assessed against a factual background based on reliable data. Conversely, an ex post evaluation would lead to conceptually erroneous and paradoxical effects since it would always exclude operating risk in all cases where risks do not materialize, and/or cause disadvantageous effects for the EO, even though the same risks could have reasonably been expected to occur, at the outset. Therefore, according to this mistaken approach, the risk would end up losing its distinctive feature—which can be found in the aforementioned variability of the events connected to it—if the possibility of adverse effects actually materializing is not adequately evaluated beforehand. This background explains why a careful evaluation of risks is necessary, bearing in mind that operating risk is different from mere entrepreneurial risk, as the latter always falls on EOs, even in case of public procurement contracts. Entrepreneurial risk may, in fact, be identified with “bad management”, within the meaning of the Concessions Directive and the Guidance Note on Directives because it calls on EOs’ responsibility to organize its own means of production and management of resources to deliver the expected performance.

As in any other contract, EOs are free to organize all their own means (including financial ones) and the provision of services in order to maximize efficiency and economy in performing contract obligations, based on an assessment of forecast of revenues. If such forecast proves unfounded, EOs will suffer the economic consequences of flawed evaluation, but this faulty estimation does not qualify as operating risk according to the Concession Directive.

In conclusion, if compared with classic procurement contracts, the assumptions underlying PPPs and concessions are more complex and sophisticated since the transfer of operating risk entails the EOs’ responsibility to ensure:

- timely execution of the works/investments, since the remuneration derives directly from the availability of the works/investment. This implies that any delay may slow down and jeopardize the prospects for recovery of the investments and costs incurred by OEs (the so-called on-time guarantee);
• quality in carrying out the works/procuring the assets, including fixed equipment and on their continued functioning according to the agreed qualitative and quantitative standards since any negligence during the investment phase may lead to higher maintenance costs, and therefore undermine the prospects of recovery for EOs (the so-called on-quality guarantee);
• management of costs, since the contractually agreed availability payment cannot be increased during contract execution, except in exceptional circumstances—which must be expressly regulated—outside the “normal operating conditions.” This makes CAs’ expenditure predictable and fixed (the so-called on-budget guarantee).

3.5 Operating Risk: Between the Concessions Directive and Eurostat Principles

The advantages of PPP are manifold, as it ensures both economic and timing efficiency as well as EOs’ contribution to public services in terms of innovation and know-how, especially when it comes to the construction and management of infrastructure of a certain complexity or in case of services that need a series of interconnected skills and require substantial investments. However, especially in times of tight budgets, it is undeniable that CAs also appreciate being able to carry out a public project with a substantial injection of private resources as well as benefiting from the opportunity of not affecting their debt stock, even in case of infrastructure and services not paid by end-users.

Such opportunity stems from the principles set out by Eurostat, for statistical and accounting purposes, in order to obtain reliable and comparable statistics across the EU within the European system of national and regional accounts in the European Union—ESA 2010.

According to Eurostat principles—as set out in the Manual on Government Deficit and Debt (Manual)—assets involved in PPP projects can be considered non-government assets, in national accounts, and therefore “off balance-sheet”, only if there is strong evidence that the private partner bears simultaneously most of the risks and rewards attached to the assets themselves (directly and linked to its use). The Manual considers that bearing such risks implies “to be entitled to take actions in order to prevent them or mitigate their impact.”
As a general principle, the assets concerned are considered “off balance-sheet” for CAs if EOs bear:

- the construction risks, covering events like late delivery, respect of specifications, and increased costs;
- one of either availability—covering the volume and the quality of output (linked to the performance of the partner)—or demand risk—covering the variability of demand (the effective use of the asset by end-users)—as set in the contract, or both.

The above principles are remarkably similar to the concept of operating risk, stemming from the Court’s case law and, further, implemented in the Concessions Directive.

However, the two different set of regulations should not be confused, not only because they have a different rationale, but also because there are fundamental differences between these two different regulatory rules. These important nuances should not be underestimated when contemplating setting up a PPP. In particular:

- the notion of PPP used by Eurostat and the Manual only concerns contracts where end-users do not pay directly (i.e. in a way proportional to the use of the asset and clearly identified only for this use), or if they pay, it is only for a minor part, for the use of the assets and the related services. This implies the EOs’ remuneration is mainly paid for by CAs. Furthermore, for Eurostat, the concept of concession only includes contracts for the construction of assets whose use is paid directly by end-users. Conversely, as already explained, such distinction is irrelevant in the Concessions Directive;

- in the context of PPPs, Eurostat principles require the transfer of the construction risk. Conversely, the Concessions Directive does not distinguish between works and service concessions and does not consider the presence of works or assets as a qualifying element of these types of contracts. In fact, one of the major innovations of the Concessions Directive is the introduction of a single set of rules applying to both works and services concessions plus acknowledging equal standing to the different types of operating risk, that is, supply- and demand-based;
• contrary to Eurostat classifications, according to the Concessions Directive, the concept of operating risk covers all types of investments and costs that may be incurred by EOs, indistinctly, as it is linked to the concrete possibility—also known as risk—for EOs of not recovering them, or rather, the lack of any guarantee on their recovery. The Concessions Directive does not expressly mention availability risk, limiting itself to referring to a generic “supply” risk. As for the transfer of substantial operating risk, the latter may be linked to works and/or services, regardless of its qualification as construction, availability (supply), or demand, and independently from the subject matter of the contract or the amount of the related investment.

In light of the above, it should be concluded that the criteria developed by Eurostat for accounting purposes cannot be used, as such, for assessing the presence of an operating risk as required by the Concessions Directive. The Concessions Directive has a broader scope than the Manual, but, at the same time, is very strict in assessing the legal conditions evidencing the actual transfer of a substantial risk of suffering losses.

Nevertheless, some of the indications provided for in the Manual may prove useful in order to analyze individual PPP contracts with a view to assessing specific contractual arrangements and clauses from an accounting perspective, in order to verify potential issues that may prevent a proper transfer of risks to EOs (Box 3.2).20

Box 3.2 Assessment of PPPS from a policy perspective
From a policy perspective, apart from the European Union, at international level, other institutions have also been engaged in outlining the main features of PPPs.

For instance, the OECD, in the Recommendation of the Council on Principles for Public Governance of Public-Private Partnerships (May 2012), defines PPPs as “long-term contractual arrangements between the government and a private partner whereby the latter

(continued)

20 For a thorough examination of the implications of certain typical PPP contract clauses, refer to the EPEC-PPP Guidance on Manual.
Box 3.2  (continued)
delivers and funds public services using a capital asset, sharing the associated risks”. The Recommendation also stresses that in PPP contracts “the service delivery objectives of the government are intended to be aligned with the profit objectives of the private partner. The effectiveness of the alignment depends on a sufficient and appropriate transfer of risk to the private partners. In a PPP contract, the government specifies the quality and quantity of the service it requires from the private partner.” In return for the service, “The private partner will receive either a stream of payments from the government for services provided or at least made available, user charges levied directly on the end users, or a combination of both”.

The OECD Recommendation acknowledges that PPPs “are increasingly becoming a prominent method for delivering key public services, can deliver value for money transparently and prudently in so far as the right institutional capacities and processes are in place.” Therefore, OECD recommends that the “public governance framework for Public-Private Partnerships should be set and monitored at the highest political level, so that a whole of government approach ensures affordability, transparency and value for money”.

From an accounting perspective, Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013, setting up the revised European system of national and regional accounts in the European Union (ESA 2010), defines PPPs in chapter 15 as “long-term contracts between two units, whereby one unit acquires or builds an asset or set of assets, operates it for a period and then hands the asset over to a second unit. Such arrangements are usually between a private enterprise and government but other combinations are possible, with a public corporation as either party or a private NPI [‘non-profit institution’] as the second party”.

The ESA 2010 Regulation also describes the main reasons why CAs find it advantageous to engage in PPPs, such as: “the hope that private managements will lead to more efficient production and that access to a broader range of financial sources can be obtained and the wish to reduce government debt”. Regarding the accounting aspects, the same ESA 2010 Regulation specifies that “In the contract period the PPP contractor has the legal ownership. Once the contract period is over, the government has both economic and legal ownership”.

3 PPP LEGAL FRAMEWORK
3.6 Brief Notes on Procedural Aspects

The correct qualification of PPPs as concession contracts is of particular relevance also because of its procedural consequences. Since a well-conceived PPP contract—that is, whereby the appropriate type of risk is transferred on the EO—qualifies as a concession, as a general rule, PPPs can be awarded through the more flexible procedures provided for by the Concessions Directive, contrary to the more stringent procedures envisaged by the Public Contracts Directive. The Concessions Directive defines a minimalistic procedural framework for the awarding of these contracts. In fact, with regard to award procedures, the Concessions Directive does not provide for, nor does it regulate, any specific procedure. This leaves ample room for maneuver for Member States—and for CAs, consequently—for organizing procedures in the most appropriate way, tailored to the specific contract contents.

Article 30 of the Concessions Directive expressly provides that “The contracting authority or contracting entity shall have the freedom to organise the procedure leading to the choice of concessionaire subject to compliance with this Directive”. This provision has a highly innovative scope since it is the first time that an EU directive on public contracts avoids prescriptive rules on procedural models. However, it should be noted that, on the one hand, procedural freedom must be exercised by CAs in compliance with the principles—as elaborated in the procurement and concessions sector, by the EU Court (see Box 3.3)—(Principles) and, on the other hand, that the Concessions Directive prescribes a core of minimum procedural guarantees, aimed at implementing the aforementioned Principles, to ensure transparency, equal treatment, proportionality and mutual recognition are always respected in the launching and conducting of awarding procedures as well as in the execution of the ensuing contracts.

To conclude the Concessions Directive affords CAs’ wide procedural freedom, allowing them to explore all forms of dialogue and negotiation compatible and in compliance with the Principles, with particular reference to the prescriptions set by Article 3 of the Concessions Directive, which specifically requires CAs:

- to treat EOs equally and without discrimination and act in a transparent and proportionate manner;
- not to conceive the concession award procedure, including the estimate of the value, with the intention of excluding it from the scope
Box 3.3 The principles

The Principles were developed by the Court in relation to public contracts. They are applicable to both public procurement contracts and concessions, as both contracts fall under the general EU Internal Market legislative framework, which aims at ensuring free movement of goods and services by removing any obstacles based on national protectionism and implementing the general principle of non-discrimination on the basis of nationality. The Principles are aimed at ensuring the achievement of the main objectives of EU procurement—and concessions—policy: the opening of national procurement markets to all products, services, and EOs without discrimination or limitations that could hinder the widest possible participation, on an equal footing, while ensuring effective competition, resulting in better and more convenient offers for CAs.

The main applicable Principles are:

- equal treatment—which translates into ensuring, in the context of awarding procedures, the same objective conditions for all EOs wishing to be awarded the contract, including those not participating in the procedures who may be interested should the specific conditions be different. During contract execution, the principle of equal treatment implies that terms and conditions of the contract, as well as its scope, cannot be modified substantially (see Chap. 4);
- transparency (corollary of equal treatment)—which means ensuring adequate, clear, and unambiguous publicity of all the relevant elements concerning the awarding of the contract, so as to allow informed participation and avoid any arbitrariness in the conduct of the procedures. Transparency is also required in relation to communications, reasoning, and access to documents, in order to allow interested parties to challenge adverse decisions before the competent judge;
- proportionality—that is the need not to restrict market access to a greater extent than is strictly necessary to achieve the expected result. This principle is expressed, above all, in the setting of requirements for selecting bidders and evaluating
Box 3.3 (continued)

offers, as well as concerning possible conditions upon the performance of contracts. All of those—though allowed—must be objective and proportionate *vis-à-vis* the subject matter and scope of the contract to be awarded;

- mutual recognition—that is the obligation to accept authorized products and services (technical specifications)—as well as professional qualifications obtained—in other Member States, without limiting their scope or questioning their validity.

The above Principles act as a boundary—but, at the same time, as a stimulus and instrument—to establish the correct synthesis of the opposite needs of CAs, on one hand, and EOs, on the other, not only when choosing the counterpart, but also when executing the contract.

To ensure compliance with the principles, correct ex ante planning of the operation—not only in its procedural performance, but also in the previous phase of collecting the needs, that is, appropriate identification of the scope of the contract—is the best guarantee to ensure that the principles and rules are complied with, during the awarding procedure and contract execution. Furthermore, in full compliance with the above principles, correct planning and structuring of the overall operation allow for the provision of the appropriate measures so as to ensure the correct execution of the contract over time, attempting to prevent the need to abort the project and/or re-negotiate the contract (see Chap. 4).

of the Concessions Directive or of unduly favoring or disadvantaging certain EOs or certain works, supplies, or services;

- to aim at ensuring the transparency of the award procedure and of the performance of the contract in compliance with the confidentiality requirements, pursuant to article 28 of the Concessions Directive.

Finally, it should be noted that procedural requirements—other than the Principles—must be seen as a tool to ensure appropriateness of the
contract: in other words, they are just functional to satisfy CAs’ needs. This approach has been further stressed by the EU Commission in the wake of the Covid-19 pandemic. The “Guidance from the European Commission on using the public procurement framework in the emergency situation related to the COVID-19 crisis”\textsuperscript{21} was issued by the Commission to implement operational guidelines in order to foster emergency-related procurement and, at the same time, to remind Member States and CAs of the importance of programming their procurement carefully so as to provide swiftly to their increasing needs.

The Commission highlights that EU public procurement framework provides all necessary flexibility to public buyers to purchase goods and services directly linked to the COVID-19 crisis as quickly as possible. This also involves more accomplished methodologies to engage in interaction with EOs, taking into account also strategic aspects, like environmental, innovative, and social requirements, including accessibility to any services procured, that can be integrated in public procurement processes. All in all, apart from the possibility to use emergency direct procedures—which must be justified by unforeseeable events not attributable to CAs, such as the pandemic—the Commission’s strategic message is that procedural rules contain the necessary flexibility so as to accommodate public needs, in the context of major and disastrous events, but also on a more stable basis. CAs should take advantage of such flexibility, so as to be more efficient and effective in their buying strategies. On a different level, this also means CAs should be aware of all tools available to them, including contract models different from traditional procurement—such as concessions/PPPs—and should not hesitate to use them, when appropriate, especially if they can guarantee better results.

\textsuperscript{21} Communication from the Commission (2020/C 108 I/01), published on OJEU C 108 I/01, 1.04.2020.