Off balance sheet public-private partnerships (PPPs) ESA

Coverage

Presented output reflects data reported by budgetary organizations, state funds, semi-budgetary organizations, public universities, public research institutions established by the Czech Republic, regions and municipalities, voluntary associations of municipalities and some other entities, included as a part of Local Government.

Data source

Since the year 2018 the data source is an accounting statement „Information on PPP projects“, based on the obligatory template stipulated as Annex No. 3 to Decree No. 272/2017 Coll., on the implementation of certain provisions of the law on the selected data collection for monitoring and management of public finances (Act No. 25/2017 Coll., as amended by Act No. 183/2017 Coll.).
In the 2014 – 2017 period the information source were accounting statements stipulated in the „accounting“ Decree No. 410/2009 Coll.

Periodicity

Data are published anually, for the preceding four years.

Date of publication

Data are published anually on the last working day of October.

Methodological description

Presented output reflects so called amended capital value, i. e. contractual evaluation of the asset stipulated in the contract, that is each year regularly reduced by relevant part of the availability payment referring to acquisition of the asset, in the cases not yet having been decided by Czech Statistical Office concerning their classification in the general government sector balance according to the European system of national accounts.

Manual on Government Deficit and Debt
IMPLEMENTATION OF ESA 2010 2019 edition

6.4 Public-Private Partnerships (PPPs)

6.4.1 Overview

1. The term **'Public-Private Partnerships' (PPPs)** is widely used for many different types of long-term contracts between government and corporations for the provision of public assets. In public-private partnerships, government agrees to buy services from a non-government unit (a partner) over a long period of time, resulting from the use of specific 'dedicated assets', which the non-government unit builds to supply the service. The asset is usually used for the provision of public services, such as in the domain of health (hospitals), education (schools and universities), and public security (prisons) or in the context of transport and communication structures. The services might be purchased by government also in order to meet its own needs, e.g. in the case of an office building used to host government officials carrying out general administration or other specialised services.

2. In the context of this chapter, the term 'PPPs' will be exclusively used to describe those long-term contracts in which government pays to a non-government partner all or a majority of the fees under a specific contractual arrangement, thus covering most of the total cost of the service provided (including the amortisation of the assets). In national accounts, this feature distinguishes PPPs from concessions. In a concession contract, government makes no regular payments to the partner, or such payments, if they exist, do not constitute a majority of fees received by the partner (see chapter 6.3 of this Manual). In a PPP contract, as covered by this chapter, the final 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 only for a minor part (and generally for some specific uses of the asset), for the use of the assets for which a service will be provided.

3. The key statistical issue is the classification of the assets involved in the PPP contract — either as government assets (thereby immediately influencing government net lending/borrowing (B.9) and debt) or as assets of the partner (spreading the impact on government net lending/borrowing (B.9) — and on imputed debt — over the duration of the contract). This is an issue which has some similarities with the one of distinguishing between operating leases and financial leases, as explained in ESA 2010 chapter 15.

4. As a result of the methodological framework, the assets involved in a PPP can be considered nongovernment assets, in national accounts, only if there is strong evidence that the partner bears simultaneously most of the risks and rewards attached to the assets (directly and linked to its use) involved in the specific partnership. Therefore, the analysis of the allocation of risk and rewards between government and the non-government partner must be considered as the core issue. Here, the notion of risk refers to the impact (on revenue or on profit) of explicit actions by one party (related to construction, maintenance operations and provision of services for which it has been given responsibility) and/or the consequences of the behaviour of other economic agents for which the aktivity is carried out (such as a change in the demand for the service, by a government unit or by an end-user). Bearing the risks implies to be entitled to take actions in order to prevent them or mitigate their impact.

5. In this context, guidance on how to assess the risks is, as a first step, based on three main categories of risk:

- **construction risk**: covering events like late delivery, respect of specifications and increased costs;
- **availability risk**: covering the volume and the quality of output (linked to the performance of the
partner);
- **demand risk**: covering the variability of demand (the effective use of the asset by end-users).

6. As far as risks are concerned, as a basic rule, the PPP assets are to be classified in the partner's balance sheet and not in the government balance sheet, if the following conditions are met:

- the partner bears the construction(215) risks;
- the partner bears at least one of either availability or demand risk, as designed in the contract and in some cases (see below in sub-section 6.4.3.2), at the same time both availability and demand risks.

It must be stressed that, in most contracts, only one kind of risk triggers the whole (or almost whole) payment from government to the partner; the payment is based either on availability indicators of the asset, or on use/attendance of the asset. The latter case is only observed when this depends on the final users and not on the government-paying unit;

- the risks are not incurred by government through other means, such as through (e.g.) government financing, government guarantees and early redemption clauses.

7. If the above conditions are met, it is also important to consider all other mechanisms in place specified in the contract, in order to check whether there could be an allocation of the risks to government via other means. If this would not be the case(216), the accounting treatment of the PPP would be similar to the treatment of an operating lease in national accounts; it would be classified as a purchase of services by government.

8. If the conditions in paragraph 6 are not met, if government assumes the risks through another mechanism, or if government benefits from most of the rewards, then the assets are to be recorded in the government's balance sheet. The treatment would be in this case similar to the treatment of a financial lease in national accounts, requiring the recording of government capital expenditure and of a financial liability.

6.4.2 Background

6.4.2.1 THE DEVELOPMENT OF PPPS

9. PPPs **imply a long-term relationship** in the framework of specific contracts, where the obligations and rights of each partner are clearly specified. In practice, most PPPs contracts cover at least 20 years. The duration of a PPP contract normally depends on the nature of the assets (on the length of their expected depreciation) but there might be cases with a duration below 15 years or, even, 10 years. In such cases, a specific analysis should be undertaken in order to assess whether such contracts could actually be considered as PPPs in the sense used in this chapter. A contract would not fit the definition of a PPP if the duration of the contract would be longer than the economic life of the asset to be maintained, which would be replaced once or more times during the duration of the contract.

10. In addition to the goal of using the partner skills and competence to improve the quality of public services and reduce their cost, PPPs may also be motivated by budget constraints, which push governments to look for alternative means and external resources for building or developing collectively used equipment. Usually, such contracts allow spreading the cost of new assets over the time in which they are used, thus avoiding a large initial government

capital expenditure and a corresponding cash disbursement that would have occurred if government had used a direct procurement procedure for the building of infrastructure.

11. It **results** from this feature, that the schedule of government payments must be considered. For instance, if the expenditure incurred by the partner for the construction of the asset (a substantial part or all of it), was repaid by government at the start of the exploitation phase, through a single or a small number of sizeable payments (lump sums), the contract could be considered as the provision of procurement services for an asset, to be included in government balance sheet, followed by a service contract for the remaining life time of the contract. In any case, such payments from government should always be considered as government expenditure (if the asset is recorded off government balance sheet) and not as the pre-payments of future availability fee.

12. It is not the role of statisticians to examine the reasons, rationale and efficiency (good value for money) of these partnerships, or to express an opinion about the economic and financial viability of the underlying projects, notably by comparing them with other kinds of investment approaches. The role of statisticians is just to provide clear guidance on the treatment of PPP projects in national accounts and, in the context of the Excessive Deficit Procedure, on their impact on general government net lending/borrowing (B.9) and debt. It is important, therefore, to properly implement the general national accounts principles in this domain in order to ensure the respect of rules and the homogeneity of government statistics in all EU Member States, such that net lending/borrowing (B.9) and debt figures would be fully comparable among countries.

13. In a similar way, it is not up to statisticians to provide a very detailed definition of PPPs, as the expression can be widely used to describe different various arrangements, whereas a definition, which would be too restrictive could also not be appropriate in a context of complexity and innovation. Instead, a set of basic criteria should be properly specified in order to easily allow national accountants to analyse the contracts, making a distinction among different arrangements that may be observed in practice and applying the rules specified in ESA 2010.

6.4.2.2 CHARACTERISTICS OF PPPS

14. PPPs refer more specifically to the forms of partnerships designed to provide public services, when government payments constitute a majority of the fees received by the partner under the contract.

15. In practice, PPPs occur in areas of activity where government usually has a strong involvement (e.g. transport, education, health, security, etc.). Government would normally enter into a contract with one or several experienced commercial partners, directly or through a special purpose entity set up for the specific purpose of the PPP, for the delivery of services derived from a specific asset. These services must include by definition the maintenance of buildings and structures (including which major repairs) but cover also other activities, which allow a certain degree of actual functioning for the services (heating, security services, etc.) On one side, some services can be implemented by other agents than the staff of the partner (such as medical or educational staff in hospitals or schools), thus, not under the direct responsibility of the partner. On the other side, the partner may provide itself or sub-contract some services which are undertaken in a building or structure but which do not constitute the core use of the asset.

16. This type of contracts mentions specifically designed assets, which either needs a significant initial capital expenditure or a major renovation or refurbishment, and the delivery of agreed services, requiring the use of these assets, although the contract may also

cover services not directly linked to them, according to determined quality and volume standards, which are specifically defined in the contract. The service component makes PPP contracts differ from leases.

17. The contract may refer either to a new asset or to a significant refurbishment, modernisation or upgrading of existing assets, previously owned and operated by government. If the contract does not involve the construction of a new asset but the renovation/refurbishment of an asset, which already existed, the work undertaken in this context must represent the major part of the value of the asset after completion. If it does not, (in cases where it would represent less than 50 % of the value of the asset), the contract is not to be considered as a PPP, as defined in this chapter, and, instead, it must be split into an asset procurement contract and a services contract, with the remaining asset recorded in the balance sheet of the government unit.

18. For some assets, there is no observed market price, as transactions do not exist or the assets are too specific to allow a method of valuation based on comparison. In this case, the value must be based on the 're-valued acquisition costs less accumulated write-downs'. In addition, this value must take into account the exact condition of the assets, which can result in a relatively low value if the asset must be substantially renovated. Another problem is that it may happen that the refurbishment/renovation expenditure will increase the value of the whole asset, even for the parts not renovated, above the expenditure incurred. This effect could be difficult to measure. A practical rule would be to check whether the foreseen capital expenditure exceeds at least the current value of the assets before renovation.

19. As a consequence of the above, if an existing and running PPP contract would be stopped, for various reasons, and a new contract would be later established with a new partner (through a new tendering procedure), the new contract would not be considered anymore as a PPP if signed during the operating phase of the old contract, as the new partner will not incur any construction risk. As a matter of principle, a contract can be considered as a PPP only if there is an asset to be built or renewed and a construction risk is clearly identifiable.

20. If the contract is stopped in the construction phase, it must be analysed whether most of the construction has already taken place or not. If a new partner (chosen by tendering procedure) will not have to incur any construction, the contract must simply be considered as a contract for the provision of services linked to an already existing asset, and the asset would be automatically reclassified in the government balance sheet at the moment in which the previous contract will be stopped and the old partner will not be anymore the economic owner of the assets. In some cases, although this could take some time after the formal termination of the previous contract, government may organise a new auction and a new partner may agree to take over the maintenance tasks for the remaining duration of the contract, i.e. the management of the assets with the associated services for an asset already built. In such cases, the payments to government should be recorded as a financial advance to government, which would be progressively amortised by the payment of future regular (unitary) payments to the partner (taking into account its effective performance). However, it may also happen that the initial partner would simply transfer the PPP contract to another partner, in general with government's approval, or that there would be some restructuring in the equity holding of the partner, so that a new contract will have to be signed. In this case, it should be closely examined whether the allocation of risks and rewards has changed in the new contract.

21. A key feature of PPPs is that government is the main purchaser of the services from the partner. In this respect, PPPs differ from 'concessions', as defined for national accounts purposes, where the main risk depends on the 'willingness to pay' of final users. In PPPs, government purchases the service by way of making regular payments once the assets are supplied by the partner, irrespective of whether the demand originates directly from government itself or from third party users (as for health and education services, and for some types of transport infrastructures). There is no need to specify a given threshold between government and third party payments on this point. Although it only needs to be just above 50 %, in reality it is usually much higher, generally above 90 %, because most contracts refer to 'typed' economic models. The expression 'shadow tolls' is frequently used, notably in the case of transport infrastructure assets, and refers to remuneration by government for a given volume usage of the asset by third parties.

22. The use of the assets would normally be specifically defined in the contract, possibly through a 'dialogue process', and there would be limitations in the way in which the assets could be used by the partner. For example, the partner could not dispose of them at will, and, where applicable, would have to give priority to government users over other possible users. It is to be underlined that many contracts do not rule out payments by 'third parties', when applicable, but these are likely to represent a minor (sometimes even negligible) part of the partner's revenue and frequently result from a secondary activity associated with the dedicated assets (for instance, an ad-hoc 'private' use of some sportive, educational or cultural infrastructure in some circumstances or fees collected for laying telephone cables along or under a motorway).

23. In addition, it must be stressed that in this context, 'government' refers to the whole general government sector (S.13) as defined in ESA 2010. Different government units, even classified in different subsectors of government, may take part in the contract according to various degrees.

6.4.2.3 THE KEY ISSUE IN NATIONAL ACCOUNTS

24. In national accounts, long-term contracts such as PPPs raise the issue in which sector's balance sheet the related assets are to be included in. This refers to the initial recording of the assets involved, either in the government's balance sheet or in the partner's balance sheet. A recording in the government's balance sheet may have important consequences for government statistics, both for government net lending/borrowing (B.9) (the capital expenditure is to be recorded as government gross fixed capital formation (GFCF) in the non-financial account (P.51g)), and government debt (the financial account would match the capital expenditure by an imputed government liability, which would increase government gross debt when recorded as an imputed loan (AF.4)).

25. Moreover, according to national accounts rules (see ESA 2010 paragraph 3.148 (b) (3)), when the assets (in the form of buildings or other structures) are considered as government assets, the capital expenditure is recorded on an accrual basis as the works proceed, and not at the end of the construction/refurbishment period. For practical reasons, the existence of phased payments (instalments) received by the constructor or manufacturer, may sometimes be used as a proxy for indicating the appropriate time of recording. This is by definition applicable for GFCF under PPP contracts, (see ESA 2010 paragraph 3.55 related to the case of construction of other structure).

26. There are also consequences as regards the recording of the flows that are observed between government and the partner during the lifetime of the contract. If an imputed loan has been recorded in the government's balance sheet, the redemption of the corresponding

principal must be spread over the entire period with no impact on government net lending/borrowing (B.9), while imputed interest must also be calculated and included in government expenditure together with the costs of the services charged to government in the context of the contract, with both expenditure impacting government net lending/borrowing (B.9).

27. It is to be underlined that the criteria developed in the following section, leading to the decision to classify the asset in the balance sheet of government or of the partner, should not be considered in isolation, criteria by criteria, but according to a principle of additivity. For instance, the fact that government would hold a minority share in the equity of the partner would not be enough, by itself, to reclassify the assets in the government balance sheet, but, if at the same time, the rewards for government would go beyond its rights as a shareholder, the assets should be considered as belonging to government. Similarly, if government would hold specific rights (such as a veto right for major decisions), the partner could be reclassified in government (and thus the assets).

28. Moreover, concerning the issue of the amount of risks and rewards taken back by government through different ways, in some cases one single criterion would be enough to reclassify the asset in the balance sheet of government (construction risk, availability/demand risk, financing (including refinancing), early termination, '*force majeure*'). However, in some complex cases, a specific analysis, through an additive global approach, should be used when more features or specific clauses in the contract, as such not individually sufficient, on the basis of the current methodological provisions, to classify the asset in the balance sheet of government, would result in an insufficient transfer of economic ownership to the partner.

6.4.3 Treatment in national accounts

6.4.3.1 SECTOR CLASSIFICATION OF THE PARTNER

29. The partners involved in long-term contracts with government can belong either to the public or to the private sector. If it is a public unit, it means that, according to national accounts rules, government or another public unit determines the general corporate policy of this unit.

30. The public partner should be classified as a non-financial corporation as long as it acts as a market unit (meeting the 50 % criterion), fulfils the qualitative criteria specified in ESA 2010 and if payments by government may be considered as sales (as a counterpart for the provision of services).

31. However, specific attention should be given to cases of a public corporation (which would meet the qualitative/quantitative criteria for market production and would be classified under normal circumstances outside the government sector), or when government would be a minority shareholder but in a position to exert a significant influence in the contract negotiation and on important decisions to be taken in the course of its implementation(225). In cases where payments by government under this contract would be a predominant part of the partner's revenue, these payments should be analysed to determine if they can be classified as sales, particularly if this contract alone results in a significant change in the size or nature of the partner activities. Following the application of the rules described in Part 1 Delimitation of general government sector, this corporation could be reclassified as a government unit if payments from government would not be considered as sales.

32. As regards PPP contracts where the partner is a special unit, created on purpose (frequently referred to as 'project company' or a special purpose entity — SPE) for a single

PPP contract, it must be considered to what extent it is controlled by government. Even when government holds a minority stake, it can exert a predominant influence in the contract negotiation and on important decisions. Government could, for instance, hold veto rights on final approval for important decisions in the context of the drafting the contract and/or in the course of its execution (for instance, choice of sub-contractors, annexed activities, significant repairs, extension of capacity, etc.). If this is the case, the assets should be reclassified in the balance sheet of government. Moreover, the presence of government in an SPE or the fact that the partner could be a public unit, are factors that have to be taken into account in the context of the final sharing of the rewards between government and the partner.

33. Finally, whenever government deliberately provides support to a partner classified outside the government sector as compensation for events that were not mentioned as clear commitments when the contract was signed, this support must be recorded as a transfer affecting government net lending/borrowing (B.9) at the time the decision to provide the support is taken or implemented, unless it would fall under the restrictive list of events which can be considered '*force majeure*'. Support from government to the partner can also affect the allocation of risks. For instance, government could provide refinancing so that the liability to government would cover a major part of the value of the fixed asset. Another example could be the provision of some subsidies, which would result in a market/non-market test value below 50 %.

34. A reclassification of the assets in the government's balance sheet will result from the reclassification of the public partner in general government. This may occur, for example, if a recurrent support would result in a shift (of a public unit) from a market entity to a non-market entity (i.e. no longer satisfying the criteria as to be considered engaged in market activity) or for other reasons.

6.4.3.2 ASSESSMENT OF THE RISKS AND REWARDS BORNE BY EACH CONTRACTING PARTY

35. In national accounts, the assets involved in a long-term contract between a government unit and a nongovernment partner can be considered as non-government assets only if the non-government partner bears most of the risks attached to the asset during the whole duration of the contract and is also entitled to receive most of the current benefits from the assets.

36. ESA 2010 paragraph 20.283 states that a majority of the risks and rewards must be transferred and not 'all' of them. As a matter of fact, some sharing of risks between government and the partner is usually observed in partnerships. As mentioned further, it may be seen as acceptable that some risks might be taken by government, for instance in the case of exceptional events (*force majeure*), in the context of a government action which would change the conditions of activity that were contractually agreed, or for specific risks, notably in relation with archaeology, land register, environment, public security, enforcement of legal decisions, etc., for which government behaviour may have a decisive influence. However, normal risks associated to the economic ownership of the asset should be taken by the partner if the asset is going to be classified in its balance sheet, and the risks incurred by the partner must have a significant impact on its profitability (and possibly, in some cases, also on its solvency), It would not matter whether it would be the contracting government unit the one owning the shares or another government unit, which could even be in another government subsector.

37. It has also to be noted that these arrangements deal with a single asset or with a set of assets that are not contractually divisible. Because of the features of the contracts, PPP assets should not be split in national accounts. The assets should be recorded in the balance sheet of just one of the parties involved (the economic owner), for their total value.

38. For the purpose of classifying PPPs in national accounts, in order to simplify the analysis, three main categories of risks have been selected.

39. The **Construction risk** covers events related to possible difficulties faced during the construction phase and to the state of the involved asset(s) at the moment in which the services start to be provided. In practice, it is related to events such as late delivery, non-respect of specified standards, significant additional costs, legal and environmental issues, technical deficiency and external negative effects (including environmental risk) triggering compensation payments to third parties.

40. The **Availability risk** covers cases where, during the operation of the asset, the responsibility of the partner is called upon, because of faulty management ('bad performance'), resulting in a volume of services lower than the one which was contractually agreed, or in services not meeting the quality standards specified in the contract.

41. The **Demand risk** covers the variability of demand (higher or lower than expected at the moment in which the contract was signed) irrespective of the performance of the partner. In other words, a shift of demand cannot be directly and totally linked to an insufficient quality of the services provided by the partner, although quantitative and qualitative shortfalls in this matter are likely to have an impact on the effective use of the service and, in some cases, exert an eviction effect. Instead, the demand risk may also result from other factors, such as the business cycle, new market trends, a change in final users' preferences or technological obsolescence. This must be seen as part of the usual 'economic risk' borne by private entities in a market economy.

42. Normally, the demand risk would not be applicable for contracts where the final user has no free choice as regards the asset-dependent service provided to them by the partner (thus, excluding 'secondary' services falling under the 'third parties' revenue category). For example, a demand risk should not apply to assets such as prisons. It may also be the case for hospitals or schools under certain conditions and, in some cases, sporting and cultural infrastructure assets. The non-applicability of the demand risk would reinforce the fact that the construction and availability risks should be unquestionably transferred in such cases.

43. In addition, some contracts may be designed in a way so that government payments would be mainly linked to the effective use of the assets (volume indicators), whatever the extent of final user's own initiative and in spite of the fact that the volume would be frequently closely correlated with the performance of the partner related to the availability and the quality of the asset.

44. Some contracts may combine regular (unitary) payments related to the availability of the assets with other regular (unitary) payments linked to the actual use of the assets (demand), both being identifiable. The partner may be seen here as bearing several risks. Where neither of the separate types of payments would exceed two thirds of the total government unitary payments, both availability and demand risks must be assessed separately; they would have to be jointly transferred (in addition to the transfer of the construction risk which is, as such, an imperative condition) in order to classify the asset off government's balance sheet. If it appears that one type of payment is the predominant part, higher than two thirds of the total, the analysis should rather focus in priority on the corresponding risk.

However, the other component paid by government should also not be neglected and it should be checked to what extent it could mitigate the impact of the occurrence of the predominant risk on the income/profits of the partner.

45. In all cases, the analysis of the risks borne by each party must assess which party is bearing the majority of the risk in each of the different categories, under the conditions mentioned above, and taking into account the other contractual features mentioned below.

46. However, this assessment does not consider risks that are not closely related to the asset(s) and that can be separated from the main contract, as it is the case when part of the contract might be periodically renegotiated, and where there are performance or penalty payments that do not significantly depend on the actual condition of the main assets or on the quality of the service.

47. The assets involved in such PPPs would be recorded in the partner's balance sheet, and therefore recorded 'off-balance sheet' of government, only if both of the following conditions are met:

- the partner bears the construction risk, and
- the partner bears at least one of either availability or demand risk, as designed in the contract.

48. Therefore, if the construction risk is borne by government, or if the partner bears only the construction risk and no other risks, the assets are to be recorded in the government's balance sheet.

49. A key criterion, which must be taken into account, is the possibility for government to apply penalties in cases when the partner is defaulting on its service obligations. Application of the penalties should be automatic (i.e. clearly stated in the contract and not subject to bargaining or to a decision by government on whether to apply them or not) and should also have a significant effect on the partner's revenue/profit and, therefore, must not be purely symbolic. Should the asset not be available for a non-negligible period of time, the government payments, as determined by the contractual formula, would be expected to fall to zero for that period, according to a fundamental principle 'zero availability — zero payment'.

50. However, it must be stressed that there might also be some lump sum payments due by the partner (for instance as specific penalties related to some events, insufficient quality of the asset, lack of information or insufficient provision of documentation, bad performance, etc.), which should be paid by the partner in any case as a result of other occurrences, independently from the application of the penalties systém due to the non-availability of the asset mentioned above. This could result in net payments from the partner to government, which, as a matter of principle, should not be brought back to zero. Conversely, if the partner is in a position to perform its obligations, according to the contractual provisions, better than expected (through higher productivity, lower costs of input, better financial conditions, etc.), it should be entitled to keep the resulting entire and higher than expected profit.

51. Furthermore, any other mechanisms by which government would re-assume the majority of risks of the project (e.g. via termination clauses, government majority financing or the provision of guarantees by government (see below sub-sections 6.4.3.3 to 6.4.3.5)) would determine the recording of the asset on government's balance sheet, independently from the analysis of the risks mentioned above. In other words, the assets will be classified as government assets if one of the provisions below related to guarantees, financing or early termination would not be met.

52. As far as the rewards derived from the project are concerned, if the PPP contract foresees that, at a given level of profitability for the partner, whatever the way in which it would be expressed (monetary terms, ratio of return on equity, etc.), the government unit would be entitled to take any part of the profit, the PPP assets should be considered as government assets, independently from the precise definition and amount of the profits captured by government. All things being equal, the fact that a unit receives the rewards from an asset is an indication that the asset should be classified on its balance sheet, However, in case government would hold a minority stake in the PPP partner, government could still indirectly be entitled to its normal share of profit which could be distributed to the partner, i.e. under the same conditions as the other shareholders, by way of payment of dividend. It is to be underlined, nevertheless, that government can be entitled to receive all or part of the additional previously unforeseen profits realised by the partner if they, by evidence, result from a deliberate action or decision of government with an impact on the use of the specific asset and/or the costs of their availability, such as an increase in demand fees resulting from an explicit government decision/policy, etc. This should not include, however, general measures taken by government with a large impact in the economy.

53. It is possible that an important aim of government's long-term partnerships with non-government units would be to spread the recording of capital expenditure and related financing over a long period of time.

54. I this framework, it may be the case that government itself takes part in the financing of the partner. Frequently, a partner is not able to borrow at the same rate of interest as government, thus increasing the cost of the project. Therefore, government may offer a certain level of financing to the partner in the context of a PPP project, to attract greater interest by private sector entities in the project, to reduce the total cost of financing, and/or simply to ensure the viability of the project.

55. If the majority of the financing of the capital expenditure would be provided by government (in various forms to be jointly considered, e.g. investment grants, loans, guarantees, equity in the partner, etc.), government would be deemed to bear the majority of risks and the asset must be classified on its balance sheet. If this situation is foreseen in the initial contract, any capital expenditure will be recorded as government GFCF. The financing by government may also take place at different points of time. It may be from inception, covering the construction phase, but also at the end of the latter when the debt incurred during the construction phase (financed by partner's own funds and/or short time banking facilities) could need to be 'consolidated' at long term. It may happen that government would pay a significant amount at the end of the construction phase which should be considered as an investment grant (and not as pre-payments of the future unitary availability or demand payments) and, as mentioned above, it should be taken into account in the assessment of the share of government in the total financing. Moreover, if the financing provided by government would be at first a minor part of the total financing needs (with the assets therefore, ceteris paribus, being classified in the balance sheet of the partner) but then would become predominant in the course of the construction phase for various reasons, this would trigger a reclassification of the assets into the government's balance sheet at the time when this would occur.

56. This would apply only to cases of financing from national government units, therefore excluding any financing from international entities resulting from inter-governmental agreements, such as from EU funds (ESIFs, Cohesion Fund) that are granted to non-government units. In this context, it is to be underlined that, for instance, if the EU finances

30 % by way of grants, the private partner 36 % and government 34 % (of the total), the PPP project would be deemed to be financed in majority by the private sector as its funding would be 36/70=51.4 % of the total. The assessment of the contribution of government and of the partner in the financing of the capital cost must exclude the EU grants, which reduce the need to finance the capital expenditure on a domestic basis, possibly with government participation. The assets could be recorded as government assets even if government would not cover more than 50 % of the capital expenditure, depending on the share of EU grants. It would simply depend, in fact, on whether the share of government financing would be above or below the share of the financing provided by the private sector. The external EU financing in the form of grants would be excluded from the analysis and from the assessment of the balance of risks between government and the partner. An assessment will still need to be undertaken on whether government incurs more risk than the partner or whether it would be the other way around.

57. When government would be taking part in the financing of the PPP project for less than 50 % of the total, as mentioned above, it would be important to examine the nature of the debt incurred by the partner vis-à-vis government (which would not necessarily be the same unit involved in the contract). This is because financial instruments may involve different degrees of risks, in the sense that a debtor default would be imputed to creditors according to a given order of priority. In this context, in order to It may happen, in this respect, that the financing arrangement is not agreed at the time of the signature of the contract between government and the partner. In this case, the compliance of the PPP with the specific rules related to financing and guarantees in this chapter can be assessed only at the time when the financing arrangements will be agreed upon and properly examined. When it would be agreed that the EU funds would be allocated directly to government in view of covering part of the future payments by government to be made in the context of a PPP contract, the funds should be recorded as a financial advance when transferred from the EU, with no impact on government net lending/borrowing (B.9). When the funds would be used, under regular unitary payments by government, they shall be recorded as government revenue, neutralising the impact of the expenditure on government net lending/borrowing (B.9), until the complete depletion of the EU funds earmarked for the PPP contract. The financing from the EIB through loans, must not be considered as government financing, but simply as any financing from the private sector for the purpose of the application of these national accounts rules (unless the EIB would benefit from a guarantee of government). Obviously such grants will simply decrease the capital cost of the project and would not be reflected in the availability or demand unitary payment which government will make to the partner.

58. In some contracts, government may take a firm commitment to ensure all or part of the financing of the partner in case this could not be in a position to get the financial resources when needed.

59. For instance, in some cases, which should be rather exceptional, the financial agreement signed at inception would not cover the whole duration of the contract (such as in the case of a long term syndicated bank lending) or problems could be incurred at the end of the construction phase. The latter is generally financed by short term facilities (drawn according to the progress in the works) 'consolidated', when the construction is completed (and accepted by the counterpart), by long term financing means (including the issuance of long-term securities). This could happen, for instance, when some banks or underwriters have no firm obligation to ensure this consolidation and, for various reasons, could decide not to participate. In this case, if government has taken the commitment to finance more than 50 %

of the capital expenditure, the assets should be classified as government assets at the start of the implementation of the PPP contract (with the GFCF being progressively recorded following the completion of the works), as the PPP assessment needs to be undertaken over the global financing risk of the partner on both the construction and the exploitation phases, i.e. all along the lifetime of the contract and not only at the moment of its signature. Such a contingent commitment of government would strongly mitigate the risk of the partner.

60. Another case could be when the long term financing would not cover the PPP contract until its final maturity for various reasons (market conditions at the time of the financial, agreement, risk aversion, uncertainties on the arrangement viability, etc.) and there would be uncertainty on the capacity of the partner to get all the needed financial resources as well as on their cost. The assets should be reclassified as government assets at the time government would actually refinance the debt, if its commitment covers more than 50 % of the expected value of the asset at the time of this refinancing, on the basis of the contractual provisions related to the capital expenditure (in some cases the realised expenditure could be however higher). However, in both cases mentioned above, if the government (re)financing would take place in a context of market disruptions (this could be the case, for instance, at the time the financial agreement is signed), such as a credit crunch or inactive financial markets, which could be considered as a case of '*force majeure*', the intervention of government might not result in a reclassification of the asset, provided that the government financing would cover only a small part of the remaining duration of the contract and that the stepping out of government should be envisaged as soon as the market conditions would come back to relatively 'normal' conditions.

61. Finally, a refinancing may be implemented, either because the financial instruments reach their maturity before the end of the PPP contract, or in order to benefit from favourable market trends (such as a general decline in the interest rate) or due to a better appreciation of the partner's risk on the market). The assets should be at inception considered as government assets if government is entitled in the contract to a specific share of the possible refinancing gain. However, there would be an exception, when it may be evidenced that a better appreciation of the partner's risk is due to a specific action of government (for instance due to a lower use of the assets, or a creation due to government of better conditions for their use, etc.) which has increased the partner's profitability. In this case, the refinancing gain could be allocated to government. In some cases, it may be difficult to isolate the predominant cause of the refinancing gain, which, in practice, may result from the conjunction of various factors, not easily and precisely weighted. Under these conditions, if government was entitled to capture no more than one third of the gain, the assets should not be reclassified in government at inception of the PPP. This level has been derived from default probability matrices set up by rating agencies. For instance if a subordinated debt equal to 30 % of the total is held by government, and the 70 % senior debt is held by other investors. The subordinated debt would be weighted 75 and the share of government in total financing would be 75/145 = 51.7 %. The subordinated debt could also be held by other investors: for instance, government subordinated debt 20 %, other subordinated debt 10 %, senior debt 7 %; the share of government in total financing would be in this case 50/145 = 34.5 %. This may also be linked to the appreciation of the risks of the 'sponsors' of the partner (for instance in the case of building companies which have set up a specific PPP unit) which could have to support it in case of difficulties (such support would be compulsory if their stake take the form of an unlimited liability).

6.4.3.4 GOVERNMENT GUARANTEES

62. Government may also provide directly an explicit guarantee, partially or fully covering the projectrelated borrowing of the partner, whatever the nature of the creditors (including possibly international financial organisations). Generally, this helps the partner to raise funds at a lower cost on markets and to improve its credit rating.
63. In this context, the existence of legal provisions transferring to government all or part of the debt service would trigger a classification of the partner's debt as government debt.
64. Moreover, because guarantees have an impact on the distribution of risks between the parties, guarantees should be used in the analyses of risks in PPPs, especially where the majority of the value of the PPP assets (including any refurbishment cost) would result from a transfer of the assets from government.
65. The scope of a guarantee, (including cases where it covers not only a specific project-related debt instrument), may influence the recording of the PPP assets. It may result in the re-assumption by government of some of the risks analysed above in this chapter.
66. In PPPs, government guarantees can be granted to the partner to cover the repayment of the debt, but they may also ensure a given return on equity, whatever the performance of the partner. This would indicate an insufficient transfer of risks to the partner. Similarly, in some cases where 'shadow-tolls' would be set up depending of the use by end users, government could ensure minimum revenue under the form of a guaranteed level of demand, independently of the actual use of the asset. This would also be considered as an insufficient transfer of risks.
67. If, at inception or during the construction phase, government guarantees cover a majority of the capital expenditure of the PPP project, the asset is normally to be recorded in the government's balance sheet, except in the case of a guarantee very limited in time and applicable only to strict circumstances of market disruption. The same should apply if a given or a minimal rate of return is assured for the partner under all circumstances
68. In addition to the straightforward case of an explicit debt guarantee, the guarantees to consider when analysing the risk distribution between government and the partner would also include those provided to the creditors or to the partner, under various forms (such as through insurance or derivatives), or under any other arrangements with similar effects.
69. For the evaluation of the risk distribution between government and the partner, both tests for majority financing and guarantees in relation to the capital expenditure of the PPP project must be undertaken jointly. It might well be the case, in PPP contracts, that government would provide a minority of the total capital expenditure, but would then guarantee a major part of the remaining project finance (related to the partner loan liabilities directly or indirectly, e.g. through guaranteed availability payments). In this case, if the combined effect of government support would represent more than a majority of capital expenditure, this would lead to the conclusion that a majority of risks would be incurred with government. Additionally, in the cases where a PPP is in majority financed by equity, a special analysis needs to be undertaken assessing the impact on the risk distribution between government and the partner from the contract provisions on the equity stake.
70. Finally, when a guarantee is effectively called, this might result in a change in the economic ownership of the assets and in their reclassification (at their remaining value), whenever this would change the share of risks borne by the parties. It means that it would be directly enforceable, in most cases unconditionally and at first demand, by the debt holders, as soon as a default is observed or, in some cases, following the assessment of some bodies (such as International Swaps and Derivatives Association (ISDA)).

6.4.3.5 TERMINATION CLAUSES AND CHANGE IN THE NATURE OF THE CONTRACT

71. PPP contracts include termination clauses in the event that government or the partner cannot fulfil the contract or if they persistently fail to meet their contractual obligations. In addition, government may use its exceptional sovereign rights. There may be different causes for the termination before the maturity of the contract. Special attention must be given to the case where the termination is triggered by a default of the partner (or by an independent decision of the partner to withdraw from the contract), for instance because of recurrent bad performance or because no longer being in a position to provide services at the agreed contractual conditions. This is generally submitted to some conditions and procedures in the contract. When the partner defaults, the assets are generally transferred to government (see the conditions below) at the time of the termination, except in the case where there would be an immediate transfer to a new partner. Any new contract, in this respect, would require a new analysis.

72. Termination clauses will often require the government to acquire the asset and take on board part or all of the partner's PPP-related debt, and pay the partner a compensation. This is because the PPP asset is often a 'dedicated asset' with limited resale value on the market for the partner and because government usually wants to retain a major influence on the conditions in which services are provided from the asset. As a matter of principle, any compensation in the context of an early termination due to a default by the partner must take into account the insufficient performance of the partner and, therefore, must be different to a compensation payment resulting from an early termination at the initiative of government.

- If the termination is due to the partner's default during or at the end of the construction phase, generally the contract should require just a refund by government based on the capital expenditure incurred. In addition, in the absence of penalties charged to the partner for any possible negative consequences of the default (delays, cost overruns), the construction risk is deemed to be borne by government.
- If the default takes place during the operating phase, the contract should explicitly mention that the compensation owed to the partner, if any, at the time government takes over the asset from the partner, should not exceed the current market value (as indicated in ESA 2010, chapter 7 Balance sheets) of the asset (taking into account the likely cost required to bring the asset to an adequate condition), as determined by a retendering process or reliably estimated by independent experts.

If the conditions are not met (first and foremost whenever the compensation is only based on the present value of future flows for the partner as foreseen in the contract, without taking into account the exact state of the asset), or on some other amount not reflecting the current value of the asset), the transfer of (availability or demand) risks to the partner is deemed to be insufficient.

73. When assets are reclassified in the government's balance sheet at the time of the termination of the contract, the GFCF of government is recorded at that time, at the exact market value of the assets. Government should usually take over an equivalent amount of debt but it may also happen that government would assume a higher amount of debt than the value of the assets. Any excess is to be recorded as a capital transfer, with an impact on government net lending/ borrowing (B.9).

74. Significant amendments to contracts or renegotiations have been observed in the course of the life of many PPP contracts. In most cases, they should be considered as the cancellation of a previous contract and the creation of a new one, when changes introduced in the contract are not negligible and whenever they alter the distribution of risks and

rewards between government and the partner. Notably, a compensation clause may be added in order to maintain the economic equilibrium of the contract (the profitability of the partner) when it appears that the outcome is diverging from the initial expectations. Thus, the reasons for the revision to the contract must be closely considered by statisticians. Only if such revision results from a change in the environment of the contract clearly beyond the responsibility of the partner, (and only in the case when government takes specific actions or decisions affecting the contract implementation) the revision might be considered as being neutral on the analysis of the transfer of risks. As a matter of principle, however, in such cases, the compensation to the partner should be strictly in proportion to the impact of the action of government on the partner's revenue.

75. As a specific case of contract amendments, it may be foreseen that the final users will start paying directly or indirectly government for the use of the asset (such as in the case of road tolls), whereas government will continue to pay regular fees to the partner. Even if these contracts are still in current terminology referred to as PPPs contracts, they should no longer be considered as PPPs in national accounts if the final users would pay for the use of the assets and this would become the major source of revenue. In this context, the assets should be reclassified as government assets if these payments (recorded on a gross basis, i.e. including any collection fees kept by the partner) by final users are higher than 50 % of the total cost for the use of the assets (consumption of fixed capital, expenditure for maintenance and repair, etc.) which are mainly covered by the unitary payments made by government to the partner.

76. If the amended contract foresees that the 50 % ratio of payments by final users on the cost of use of the assets should be reached in a relatively short period (defined as less than two years), the transfer of the assets must take place at the time the new contract enters into force.

77. If the amended contract foresees a progressive change in the relative amount of payments between government and final users (for instance, involving successive stretches of transportation infrastructure), the transfer should take place as soon as the 50 % threshold will be reached. Similar clauses related to payments by final users could also be envisaged in contracts at inception for new projects but, in this case, the assets should be classified as government assets at the start of the construction phase in any case, independently of the progressing towards the 50 % threshold.

6.4.3.6 FORCE MAJEURE

78. In the course of the implementation of the contract, after the partner has started carrying out the capital expenditure or during the exploitation phase, it is important to make a clear distinction between different types of events or trends having an impact on the PPP arrangement. Some are unquestionably under the responsibility of the partner as they depend on the 'quality' of its performance, related to the asset or linked to the services performed by using the asset. This must be reflected by a downward adjustment of the unitary payments, notably when they involve 'availability fees' (see above) but also when these payments are linked to the effective use which would likely be affected. On the contrary, there are some government decisions which have a direct impact on the implementation of the contract and for which the partner should be entitled to receive compensation if they deviate from the original contractual clauses and government obligations. However, this should exclude any general policy decision (in various areas, such as economy, social, environment, public order, etc.) which does not specifically refer to the individual PPP contract.

79. There is, however, a third category of events for which there is no clear responsibility from one side or the other. These exceptional 'external' events are generally referred to as '*force majeure*' events in the contract. They may have a significant impact on the availability of the services and/or on the level of the demand. Such risks could be retained by government without necessarily requiring the classification of the asset on its balance sheet. They may also be referred in contracts to as 'relief events' or using another terminology, which exempt the partner to bear the financial consequences. However, they must be considered under restrictive conditions, with an exhaustive and precise list. Notably, the absence of responsibility of the partner in the event must be absolutely unquestionable, meaning that the partner could not reasonably have foreseen the occurrence or consequences of the event and could not reasonably have avoided its occurrence. In addition, any 'macro-economic' risk, borne by any economic agents in their activity (for instance, the impact of business cycle on costs and demands, contagion and spill over effects) cannot be taken over by government. Normally, the partner should take measures to protect itself against the negative effect on such events, notably through insurance policies when available on the market at a reasonable price (although the protection would be generally limited to a fixed amount or a maximum claim which could be out of proportion with the potential real costs of the damages). On the contrary, in the case of events which would normally be impossible to ensure (such as riots, wars, natural disasters, etc.) government could take over their risk, in totality or partially, without that this would necessarily result in an *ex-ante* classification of the assets in the balance sheet of the government. However, in case of occurrence of such events, a new analysis of the allocation of risks and rewards should be carried out.

6.4.3.7 ALLOCATION OF THE ASSETS AT THE END OF THE CONTRACT

80. An analysis of the clauses relating to the disposal of the PPP assets described at the end of the contract should be used as a supplementary criterion for determining the overall risk transfer, notably where the risk analysis mentioned above, should not give unequivocal conclusions (for instance if the risk distribution would be estimated as balanced or would be based on fragile hypotheses). The conditions in which the final allocation of the assets would be carried out might give, additional important insight into risks among the contract partners as such clauses might help to assess whether a significant risk remains with the partner. In the context of very long-term contracts, the economic value of assets at the end of the contract may be quite uncertain (due notably to unpredictable obsolescence), while any payment from government at this stage would be a minor part of the total payments made by government over the lifetime of the contract. As a result, this issue cannot by itself be considered as the unique and decisive criterion in deciding on the classification of the assets.

81. If the assets remain the property of the partner at the end of the project, whatever their economic value at that time (although frequently their future economic life remains quite significant, notably in cases of infrastructure that only slightly depreciates over time), then recording the assets in the partner's balance sheet would have an additional strong justification.

82. In some contracts, government holds an option to buy the asset at one or several points of time. If this option is to be exercised at the market value of the asset, properly assessed at the time of the purchase, the partner would bear the risks associated with the continued demand for the asset and its physical condition during the contract period. This would also reinforce the recording of the assets in the partner's balance sheet during the contract period.

83. In some contracts, government has the firm obligation to acquire the assets at the end of the contract at a pre-determined price, usually set where the contract is signed.

84. The following cases would strongly reinforce the analysis of other characteristics of the contract and would point to a recording of the assets as government assets:

- the pre-determined price is fixed as a remaining part of the initial cost of capital, without any reference to the asset's expected market value at the end of the contract;
- the pre-determined price is obviously higher than the expected market value of the assets at the end of the contract;
- the pre-determined price is lower than an expected market value at time of the transfer or the assets revert back to government at no cost, but government effectively prepays for the acquisition of the assets throughout the contract by making regular payments that reached a total amount very close to the full market value of the assets;
- if it is not specified in the contract that there should be a thorough check by an independent body of the exact condition of the assets ('rendezvous' clauses) a few years before final termination, such that government is entitled to ask for supplementary expenditure and/or reducing the pre-determined price where necessary.

85. In some cases, at the end of the contract, the partner is wound up or absorbed by government. In such cases, the assets would enter the government's balance sheet at the end of the contract through other changes in volume (changes in sector classification and institutional unit structure (K.61)).

6.4.3.8 CLASSIFICATION OF SOME TRANSACTIONS BETWEEN A CORPORATION AND GOVERNMENT

86. When government makes regular payments to the partner, the treatment of these transactions would depend on whether the asset is recorded in the balance sheet of government or of the partner.

87. If the asset is included in the partner's balance sheet, the corporation provides a service to government that constitutes government intermediate consumption expenditure, valued by the payments done to the corporation.

88. If the asset is included in the government balance sheet, the service to the community is provided using government asset. The acquisition of the asset by government is recorded as in a 'standard' financial leasing contract. Government payments to the partner over the whole life of the contract are split between redemption of principal (F.4), payment of interest (D.41) and, possibly, purchase of services for the tasks performed by the corporation and purchased by government (P.2).

6.4.4 Rationale of the treatment

6.4.4.1 SECTOR CLASSIFICATION OF THE PARTNER

89. The special case of a PPP between government and a public corporation should fulfil certain conditions.

90. The public corporation should show the usual required competence in the area of activity covered by the PPP (directly or, in the case of creation, by the unit(s) controlling it), and the PPP contract with government should be one among several commercial activities of the public corporation.

91. In the case of a public entity in which the contracts with government are almost exclusively the source of its revenue, a reclassification as government unit is not necessarily required if there is evidence that market-oriented payments (meaning of a similar kind to those observed between other market units) are made to the corporation, and if government bears only risks that a commercial entity would not normally be expected to

bear (very high political or security risks, for instance). Otherwise, this will indicate an ancillary activity of the public entity to government.

92. In some contracts, the execution of the contract takes place under the legal umbrella of a special purpose entity (SPE). Normally, such a legal entity has a pre-defined life limited to the length of the PPP contract, or just to the construction period. It can be expected to have been created solely for legal purposes.

93. If one or several partners that are the operational contracting parties collectively control this unit, it should be classified as a non-government unit. This may be observed in the case of the construction of innovative and complex assets that need the close cooperation of firms specialised in different technical areas. The SPE would be the organisation created to represent them as a consortium. The SPE may also take the form of a pooling of banks where the financing requirements are quite significant. Therefore, an SPE generally does not play an operational part in the execution of the contract, neither as a project manager, nor as the builder or operator of the PPP asset.

94. Complications arise when such a special unit partner is created by government or by a public corporation. In this case, it must be closely checked whether the unit can be considered an independent institutional unit according to national accounts, and whether the unit is a true market producer. The unit must, amongst other things, have the capacity to acquire assets and incur liabilities in its own right and to enter into contracts with non-government units. In some cases, the unit should be reclassified within the government sector (possibly as an unit undertaking ancillary activities (ESA 2010 paragraph 2.26) or according to rules for special purpose entities of general government (ESA 2010 paragraphs 2.27–28)), so that the fees paid by government would not be considered as the revenue of a 'real partner', but, instead, as transfers within the general government sector.

6.4.4.2 ASSESSMENT OF THE RISK

95. The core issue is the share of the risks which are inherent in the contract and which are directly related to the state of the assets involved or depend on some management tasks that must be carried out by the partner in the framework of its contractual obligations. This refers to the concept of 'economic ownership', which is clearly distinguished in national accounts from the one of 'legal ownership' and which is used in most accounting standards (both in national accounts and for business accounting purposes). The analysis of risk sharing must rely both on the potential effect on profits of the partner (lower income and/or higher costs) and on the probability (even roughly estimated) of occurrence of the risk, by analogy to the 'mathematical expectancy' concept (or the notions of 'probability of default' and 'loss given default' in financial risk models). Thus, it would not be acceptable that the partner would bear only risks with potentially high damageable effects but with a very low reasonable likelihood to occur.

96. As regards the **construction risk**, an obligation for government to start making regular payments to a partner without taking into account the effective condition of the assets that are delivered would be evidence that government bears the majority of the construction risk and is acting as the *de facto* owner of the assets since inception. This is also true where payments are made by government to cover systematically any additional cost, whatever their justification.

97. The magnitude of the different components of this risk can be estimated by the amount that each partner would be obliged to pay if a specific deficiency was to occur. This risk might be quite significant where the assets involve major research and development or technical innovation, whereas it could be more limited for conventional structures. An

important point is that government should not be obliged to pay for any event resulting from a default in the performance of the construction phase by the partner, either as a direct supplier or only as a coordinator/ supervisor.

98. The partner would not need to take the risks for unexpected exogenous events not normally covered by insurance companies, or that it was not reasonably possible to estimate before the beginning of the works. This risk must not be confused with the appropriateness of the 'design' of the assets, where the degree of initiative of the partner may be very limited. The main point here is that a partner would not normally agree to bear risks related to the construction, if government's requirements would be unusual, and would alter the commercial viability of the asset. In addition, the partner should not be held responsible in case of an explicit government action, such as modifying the specifications in the course of the construction or modifying some standards requirements. A specific case to be considered is when the partner receives an existing government asset as a necessary part of the project (either as an element of the whole or in the context of a significant refurbishment). The construction risk applies only to the new capital expenditure under the responsibility of the partner, whatever the conditions in which the asset has been transferred. The partner may also not be held responsible for over-costs and delays that could result from legal risks or assimilated risk (such as the expropriation risk), resulting explicitly from an inadequate regulation/legislation decided by government.

99. As regards the **availability risk**, government is assumed not to bear such a risk if it is entitled to reduce significantly its periodic payments, like any 'normal customer' would be entitled to, if certain performance criteria were not met. Under these conditions, government payments must depend on the effective degree of availability ensured by the partner during a given period of time. This would mainly apply when the partner does not meet the required quality standards, resulting from an insufficient performance and reflected in the non-availability of the service, in a low level of effective demand by final users, or a low level of user satisfaction. This would be reflected in the performance indicators mentioned in the contract, for instance, concerning the available number of beds in a hospital, of classrooms, of cells in a prison, of lanes of a highway opened to traffic, etc. Normally, the partner is assumed to be in a position to avoid the occurrence of the availability risk. In some cases, the partner could invoke an 'external cause', such as a major policy change of government, additional specifications requested by government, or '*force majeure*' events. However, such exceptions should be accepted only under very restrictive conditions, be explicitly stated in the contract and cover a large number of factors having an impact on the costs incurred by the partner and/or on its ability to meet the contractual requirements.

100. The application of the penalties when the partner is defaulting on its service obligations must be automatic and must also have a significant effect on the revenue/profit of the partner. They must affect significantly the operating margin of the partner and could even exceed it in some cases, so that the partner would be financially strongly penalised for its inadequate performance. It may also take the form of an automatic renegotiation of the contract and even in the cancellation of the contract.

101. It is important to make sure that penalties for inadequate performance are not purely 'cosmetic' or symbolic. The existence of inadequate penalties would be evidenced by a reduction in government payment far less than proportional to the amount of services not provided, and this event would be contrary to the basic concept that risk must be significantly transferred to the partner. Furthermore, the existence of a maximum ceiling or

percentage of penalties that could be applicable in the event of defaulting performance, would also suggest that this risk has not been significantly transferred to the partner. In the case of no availability of the asset during a certain period, it would be expected that the government's payments would fall to zero.

102. As regards the **demand risk**, government is assumed to bear this risk where it would be contractually obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final users, making irrelevant the fluctuations in the level of demand on the partner’s profitability. The variability of demand however would not be due to the performance of the partner, which is already covered by the provisions above (in other words, the availability standards stated in the contract would be fulfilled). Therefore, the demand risk would cover a direct change in final users’ behaviour due to factors such as the business cycle, new market trends, direct competition or technological obsolescence. In other words, the bearing of such economic risks would be a normal feature of the partner’s activity.

103. For the asset to be recorded in the partner’s balance sheet, when there is an unexpected decrease in the partner’s revenue, the partner must be able to manage the situation through various actions under its own responsibility, such as increasing promotion, diversification, redesign, etc. In this respect, the partner would be carrying out its activity according to a commercial manner. Thus, the existence of contractual clauses allowing the partner to use the assets for purposes other than those that have been agreed with government would frequently be an indication that the partner would effectively be bearing the demand risk, as defined here.

104. Where the shift in demand results from an obvious government action, such as decisions by government (and thus not necessarily only by the government unit(s) directly involved in the contract) which would represent a significant policy change, or such as the development of directly competing infrastructure built under government mandate, an adjustment in the regular payments or even a compensation payment to the partner would not imply the recording (or the reclassification) of the assets in the government’s balance sheet if it would be recognised that a decrease in the profitability of the partner was the direct result of a deliberate government action.

105. As regards other mechanisms by which government may assume the risk of the project, the presence of government financing and guarantees in the private sector financing should be analysed. It could be argued that this ‘financing risk’ would be an integral part of ‘construction risk’, since the absence of suitable financing could mean that the asset either cannot be built, or cannot be built according to required standards. In addition, as the financing risk would depend on the performance of the partner, which could result in some circumstances in less revenue from government, such guarantees would finally decrease the risks borne by the partner.

106. In those cases where government would finance a part of the PPP and would also guarantee all or part of the partner's equity and/or debts, these actions should be seen as cumulative from the point of view of risk analysis. This analysis should be made in relation to the capital expenditure of the project, to see if government would be covering a majority of the capital expenditure through such mechanisms.