# Size matters

01/10/2000

Japan's version of the Private Finance Initiative (PFI), the private/ public sector partnership scheme first devised in the UK, has continued to gather steam this year, spurred on by the publication of an official PFI policy document and two Ministry of Home Affairs PFI circulars. There are now about 10 Japanese PFI projects that have either been mandated or are currently being bid upon. In addition, market sources say as many as 80 more developments are being considered for PFI status.

The Kazusa waste disposal plant, signed in July and touted as the first PFI project financing will be succeeded by a wide variety of PFI projects.

Approaching financial close as Project Finance goes to press is the transaction to fund a co-generation plant being built at Tokyo Metropolitan Government Water Authority's Kanamachi water filtering center. The Kanamachi Energy Service deal is sponsored by Ishikawajema Harima Heavy Industries, Shimizu Corp and Electric Power Development and will cost about ¥1.1 billion ($10 million).

Other mandated PFI deals include the Kanagawa healthcare and medical university development project mandated to Obayashi Corp, projected to cost about ¥12 billion and expected to reach financial close by March 2001, the ¥7 billion Omuta recycling power station mandated to Electric Development Corp and also due to reach financial close in March next year, the Fukuoka Tobu Clean Center mandated to Kyushu Electric Power Corp at a cost of about ¥45 billion and scheduled to close at an unspecified time next year, a container terminal PFI project in Kitakyushu city and a waste disposal project in Oodate-city, Akita prefecture.

Five PFI projects which are expected to be mandated to the private sector in the coming year are the ¥27 billion Hibiki Container Terminal project, the ¥8 billion Kanagawa Hygiene Laboratory development, the ¥6 billion Kanagawa Museum of Modern Art, the Kohto-Ku Youth Plaza in Tokyo and the ¥1 to ¥2 billion Chiba Consumer Center.

Financial advisor to the Tokyo Metropolitan Government for the Youth Plaza project is Dai-Ichi Kangyo Research Institute. According to Mitsutaka Mori, vice-president in DKB's project finance department, bidding for the project is expected in spring 2001. The eventual mandate will embrace design construction and financing.

Bankers will note with some disappointment that most of the mooted PFI developments are small by international standards. ?That's one of the reasons why we aren't likely to be heavily involved,? says a source at one of Asia's largest non-Japanese project finance banks.

Another significant negative for the foreign banking community, says the same banker, is the way in which local governments are influencing the financing arrangements. The banker explains his comment with the example of a PFI project financing which is already near to financial close.

During the financing negotiations the local government in question (the banker wouldn't reveal which government or project) took exception to the premium it was being asked to pay for the limited recourse tranche of the overall financing package. The local government's governor called on the president of one of the government's regional relationship banks (a bank which had no project finance experience at all but which acts as fiscal agent for the government) and asked the bank to join the transaction in order to put downward pressure on the financing margin. The regional bank duly did so at a much lower margin than was being asked for by the participating Japanese city banks.

?In general, as long as these PFI deals rely on off-take agreements from local governments it is going to be difficult for foreign banks to get involved. No foreign banks have relationship with Japanese regional governments,? laments the banker.

Despite the familiar emphasis on relationships, according to the banking houses who are most active in the nascent market, PFI deals do have important differences with those previous developments which involved both the public and private sector. The ¥15 billion Kasuza waste disposal plant development, which should be completed in April 2002, and which was named as one of a handful of model projects by the PFI Promotion Office, provides an interesting insight into these differences.

On July 19, Bank of Tokyo-Mitsubishi (BTM) and Development Bank of Japan (DBJ) signed a ¥10 billion project financing package for phase one of Nippon Steel's waste disposal plant. Also included in the financing is ¥1 billion of equity, and a ¥4 billion subsidy. According to Toshiya Yamamoto, head of infrastructure financing at BTM, DBJ and BTM, which is also financial adviser and arranger, will each extend 50% of the loan to the borrower.

The borrower is Kazusa Clean System, a joint venture of Nippon Steel (which owns 49%), Emuko (holding 8.9%), Ichikawa Environmental Engineering (6%) and the four municipal governments of Kisarazu-city, Kimitsu-city, Futtsu-city and Sodegaura-city (who hold a combined 36% of the venture). Trust bank is Tokyo Trust Limited. EPC contractor is Nippon Steel.

As Toshihiro Toyoshima, deputy director of Development Bank of Japan's project finance department notes, the bank loan is not recourse to either Nippon Steel or the municipal governments. ?There are,? he says, ?no guarantees of any sort.?

In contrast, traditional Japanese developments involving a public-private joint venture have almost without exception included a comfort letter (in essence a substantial guarantee agreement), from the public sector to the joint venture. Also, the majority of the project loan will be covered by the fixed payment component of Kazusa's annual service charge. Future revenue from the long term contract will be assigned to Tokyo Trust as part of security package to lenders. As such the deal, reveals Yamamoto, includes the first attempt to create an escrow trust in Japan.

Exact pricing details have not been revealed but Toyoshima says PFI project finance transactions bear a 100 to 200 basis point spread over Yen Libor with upfront fees of between 50 and 100 basis points.

The subsidy, direct from the Ministry of Welfare, represents another first: the first government infrastructure subsidy to a company with private stock holders. In the past, such subsidies were only possible for public bodies. From the perspective of the local government, the central government subsidy is still crucial. ?Without the subsidy the private waste treatment plant would not be viewed by the municipalities as financially competitive compared to a purely public plant,? says Toyoshima.

In place of a guarantee the financing does feature a generous off-take agreement. The municipal government customers are committed to use the waste disposal's facilities for 20 years compared to a loan term of 15 years. Long-term-budgeting for the contract has already been approved in the respective local assembly. Moreover, the Kazusa Clean System has been given exclusivity in the provision of waste treatment services to the four cities, for the duration of the off-take agreement. In addition, the project's lenders are protected from force majeure issues by local government funds.

Lawyers note that the local governments have also entered into a direct agreement with the debt providers, in which a whole host of issues including termination procedures and step in procedures have been agreed and in which the governments consent that the waste facility's revenues be turned over to a trust account as collateral. In the past, and as key principal of local government law, local government were prohibited from getting into long-term contracts with a specific company. It is because the Kazusa deal has been named as one of the PFI model projects that this long-standing legal principal has been waived.

To deal with daily operational issues, participants say an operation committee will be created for the Kasuza joint venture. In addition to the sponsors, Chiba prefectural government will take a seat on the committee. The waste treatment plant's capacity will be increased in a second construction phase from 200 tons of waste per day, eventually to 500 tons. This second phase is expected to cost about ¥25 billion.

Although the Kasuza project does feature several PFI innovations it is still centered on a traditional public/ private sector joint venture company. The ¥1.1 million financing for the Kanamachi power generating project, which will supply about half of the required electricity to operate Kanamachi Water Filtering Center (a facility owned by the Tokyo Metropolitan Government), goes one step further. The special purpose company which will run the power plant, Kanamachi Water Filtering Center Energy Service Co, is purely owned by private sector entities: Ishikawajema Harima Heavy Industries which will own 60%, Shimizu Corp which will own 20% and Electric Power Development Corp which will hold the remaining 20%. As a matter of record the construction of the plant was completed on October 3.

A lawyer involved in the financing points out the fundamental importance of the Kanamachi transaction. ?In the past the company at the center of these sorts of transactions has been part owned by the public sector because it was thought that this was the best way to protect the public's interest. Under the Kanamachi PFI deal, on the other hand, contractual arrangements and the law are relied on to protect the public,? he says.

What though of the interests of the private sector and their creditors now that the private sector is the counterparty to the government? Financiers say that the banking community has been nervous about participating in such deals because the public interest is generally regarded as taking precedent over private interests under Japanese common law. Therefore in any dispute between the contracted parties the legal system can be expected to lean in favour of the public rather than private sector. However, Toyoshima says analysis of the PFI Law has given sufficient comfort to the banking community that their interests will be protected as long as the project comprehensively complies with PFI guidelines.

Foreign participation

Of the PFI projects still to be financed foreign banks may be most interested in deals like the Hibiki container terminal project simply because foreign companies are amongst the short listed bidders. The project, says a Tokyo banker, involves the construction and operation of a terminal which can accept container carriers of a capacity up to 5000 to 6000 TEU. The terminal will be built on a 43 hectare site owned by the city of Kitakyushu.

The same banker says the terminal will have a cost no greater than ¥20 billion and is to be completed by the start of the 2003 financial year (the Japanese financial year begins on April 1). The city of Kitakyushu plans to own approximately 10% of the company which operates the terminal and which will run the facility for a concession period of 25 years. A total of ¥4 to 6 billion is expected as equity for the project.

In late July seven groups passed the pre-qualification requirements to bid for the concession and have until November to submit proposals on project design, operating structure, financing and other issues. The preferred bidder will then be selected in December. The seven companies are ICTSI International Holdings from the Philippines, PSA from Singapore, Mitsubishi together with SSA International of the U.S, Nippon Tsuun, Kami Gumi, Marubeni, and Nissho Iwai teamed up with Hitachi Zosen.

A set of new PFI guidelines are expected out as Project Finance goes to press which will add more detail to the PFI guideline legislation released in March. So far the PFI committee which is compiling the guidelines has revealed little of their content. But lawyers in Tokyo say the guidelines are expected to introduce more subjective non-monetary evaluation criteria like quality issues into the decision making process to encourage more flexible proposals from the private sector. Also, the guidelines are expected to encourage local governments to appoint independent experts to carry out the bid evaluation and concession awarding process. The additional PFI guidelines, whatever their content, will not be legally binding for local governments. However it is widely expected that local governments will follow the lead shown by the central government and closely follow the spirit of the new PFI recommendations.