

Japanese PFI: Land of the Rising Sun

01/02/2000

Another big step forward along the road to a formal PFI market in Japan is expected this month with the release of the government's basic PFI policy document. Although the draft should put more flesh on the bones of the 1999 PFI Law, Japanese lawyers expect important legal and procedural questions to remain unresolved.

Nevertheless, more than a dozen PFI-styled projects are already being negotiated, indicating a quasi-PFI market can exist in Japan, even without a full legislative framework.

The deal likely to be hailed as the forerunner to PFI in Japan is the Tokyo Metropolitan Government water authority's scheme for a new co-generation power plant. The project will not officially be classed as a PFI deal (local governments have not yet nominated specific projects for PFI treatment) but the Tokyo Metropolitan Government is understood to have awarded the contract after an open, PFI style-bidding process, and is said by bankers involved to be handling talks according to PFI legislation already introduced.

Under the terms of a deal with Tokyo Metropolitan Government, Toshihiro Toyoshima, deputy director of the Development Bank of Japan's (DBJ) project finance department, says three sponsors – Ishikawajima-Harima Heavy Industries (IHI), Electric Power Development Co. and Shimizu Corp. – are to build and operate a new 10MW co-generation power plant at the Tokyo government-owned Kanamachi water treatment plant. IHI & Shimizu hold the EPC agreements. The local government has already signed a 20-year offtake deal with the private companies – DBJ and Dai-ichi Kangyo Bank are lead arrangers.

In terms of deal size, these are small beginnings. The project is only expected to cost about ¥1.1 billion (\$10 million), of which the project finance amount is estimated at between just ¥500 million and ¥600 million. At present, the exact project finance amount is unknown as the plant is eligible for large subsidies from the Energy Agency of the Ministry of International Trade and Industry (MITI). The amount of equity put in the project special purpose company (SPC) is approximately ¥240 million, says Toyoshima, but further financial details are still under negotiation.

DBJ is also involved as co-arranger, alongside Bank of Tokyo Mitsubishi, to fund a second quasi-PFI deal, a waste treatment plant being developed in Chiba costing \$100 million-plus. Nippon Steel is one of three Japanese sponsors with no less than four municipal Japanese governments involved – the cities of Kimitsu, Kisarazu, Futsu and Sodegaura. Because it is a waste treatment scheme, the project is also eligible for substantial subsidies, this time from the Ministry of Welfare. As with the Tokyo Metropolitan deal, the subsidy level is still under discussion and the size of the project finance portion has not yet been finalized. – Since PFI-like deals have already been given the go-ahead it is unlikely either the basic policy or further legal adjustments will be make or break for the market, – says one Japanese banking source keeping a close eye on the introduction of PFI in Japan.

Legal experts in Japan also say the new PFI Law, officially titled the PFI Promotion Law, is more the embodiment of the spirit of PFI than a series of concrete PFI-friendly measures. – The basic framework law [still only officially available in Japanese] runs only to 23 Articles, – notes Naoaki Eguchi, lawyer at Baker & McKenzie. Eguchi says the most important

specifics in the PFI law are that long-term commitments to a privately run project (such as purchase deals) should be extended beyond the current 10-year ceiling to 30 years, and that interest free loans from the DBJ should be available for PFI schemes.

But a number of important issues still need to be addressed to encourage the Japanese PFI market, although they may be tackled in the final policy document. One particular obstacle is the system of licensing that currently only allows public sector firms to take up public works contracts.

Although legal agreements dealing with license allocation, allowing private firms to be involved in major public sector projects, are not unheard of in Japan, they are specific to individual projects. For example, one had to be included in the Tokyo Bay Cross Highway development. It would be very cumbersome to have to introduce these special legal clauses in each and every PFI deal, says Eguchi.

As well as solving the licensing problem, lawyers hope that either including it in the policy document or announcing it this year would be a more useful set of guidelines to define standards under which central and local governments select PFI project proposals. Details of what tax exemptions and other financial support are available for the private sector should also be clarified so that private companies will be given more encouragement to enter the PFI market, says Takashi Akahane at law firm Anderson Mori in Tokyo.

Unfortunately, with the PFI policy document still being finalized, its exact content remains a closely guarded secret.

One source involved in drafting the policy document does reveal that it will lay out government policy in five different areas, including; the selection of PFI proposals from private corporations; the invitation and screening of private corporations; the definition of responsibilities borne by private corporations entrusted with projects; and legal and fiscal measures. However, no more details have yet been released .

The role of government

Eguchi says that despite PFI Law stipulations, local governments remain reluctant to extend the time committed to procurement agreements. Extending commitment terms is also permissible under local law, says Eguchi. But so far, local diets have been reluctant to endorse such pledges except for electricity and gas supply deals.

The fact provisions in the PFI Law relating to the extension of purchase deal terms fail to settle the issue highlights the weakness of the PFI bill. Because, as Hiroshi Maeda, a leading advisor to the Japanese government on PFI and a partner at Mitsui, Yasuda, Wani & Maeda, explains: The [PFI] Law has absolutely no power to supersede existing public law.

Unless more forceful PFI legislation is enacted in Japan, implementation of PFI will depend greatly on individual local governments interpreting existing laws in a pro-PFI manner; either that or changing the law at a local level. And since legal change in Japan is slow, the prospects for new PFI legislation look dim. The trouble, say observers, is that local governments in Japan have traditionally been suspicious of the private sector and have been slow to introduce new administrative measures. Since local government officials may also lose subsidies from central government and perhaps even their jobs if a great deal of projects are handled by the private sector, a clear conflict of interest exists.

Be that as it may, Akahane, Maeda, and others believe local governments are having to accept economic reality and press forward with PFI reforms. Local governments have been confronted by falling revenues, both in central government subsidies and in tax receipts because of Japan's continuing recession. At the same time, expenditure commitments have grown, partly because of the need to spend just to stimulate the economy and to replace old infrastructure assets.

Sure enough, Toyoshima says local governments have shown differing levels of support for PFI depending partly on the state of their budgets. Kaneda prefecture, one of the front-runners, has even prepared its own policy, unwilling to wait

for a lead from central government.

From PFI to project finance

PFI and project finance are, of course, not interchangeable labels. PFI project status will not always mean project finance mandates, particularly in Japan where a project finance market is only just beginning to emerge.

In the past, development schemes involving Japanese corporations in Japan have been funded on a corporate basis. Foreign banks and law firms in Japan have also questioned, off the record, if more recent deals, touted as Japan's first project financing, can be classed as true project finance transactions (a slippery term given that there is no hard and fast definition). This is principally because the relationships between a particular project's sponsors, contractors and even financiers are often the relationships of companies within the same Keiretsu (business conglomerate) grouping.

The Nakayama Kyodo Hatsuden financing, involving the building of a 150MW gas-fired peaking plant in Osaka, has been hailed as a project finance transaction. But three of the institutions holding central roles within the \$128 million project, Nakayama Steel and Tomen as sponsors, and Tokai Bank, belong to the same business conglomerate. Without their inter-relationships the deal would have fallen apart, comments one Tokyo-based lawyer.

One could debate forever if the Nakayama deal is a true project financing, but, says Hiroshi Maeda: Deals like this are certainly not comparable to project finance transactions done in Europe or the US, where almost every part of the transaction is open to scrutiny.

Foreign commentators have also questioned if true project finance is possible given the deficiencies in the Japanese legal system, particularly the lack of floating charges. Doubts about the legal system recently led to some financial institutions suggesting the introduction of an equivalent to the English floating charge in Japan.

Japanese players don't, however, regard the holes in the legal system as insurmountable hurdles. Akahane points out that a floating charge on specific assets (such as factory assets) is available in Japan. Moreover, mortgages on real estate can be registered, he says. One Japanese banker adds that lenders in the recently concluded Universal Studios Japan (USJ) financing were able to take a first mortgage on the security interest over the Tourist Facilities Foundation under which all the properties, assets and rights associated with the theme park are registered. Assignments of contracts and pledges are also a feature of the USJ deal, similar to standard international project finance.

However, in this highly precedent-driven market some fears remain that funding arrangements for recent projects in Japan may form the precedent for all future deals. Because of the need to hammer out private and public sector responsibilities, says one lawyer, some of these quasi-PFI deals have been proving a nightmare to negotiate. It seems therefore that the documentation in the deals may not be as good as they could be. Private companies who have been given development mandates for public sector works are towing government's line just to get deals signed.

In the Nakayama Kyodo financing this is thought to have led to a thin and unsophisticated power purchase deal with the Kansai government. I think the PPA must have been difficult to bank on a project basis, says the legal source. The Nakayama transaction is also thought to have lacked a force majeure provision due to government objections.

Nevertheless, there are also more promising signs of change in the way in which development schemes are funded. In the Universal Studios deal which featured a ¥125 billion syndicated project finance loan plus ¥45 billion in equity and ¥15 billion of corporate loans it is much harder to find the sort of hidden corporate guarantees that allegedly underpinned the Nakayama deal.

Toyoshima admits substantial sponsor support is embedded in the funding arrangement but this is due to the revenue volatility common to all theme parks. Other sources say the Osaka government has agreed to subordinate some

payments expected on municipal properties (such as land lease payments) to the project to loan payment.

However, nothing that amounts to anything like a financial guarantee has yet emerged. It has also been revealed that equity shares of private sponsors are pledged and all the major contracts are assigned to lenders as a part of the security package. "We are hopeful," says one bank involved in the project, that the Universal deal will become the template for future PFI project financings."

The USJ deal does, of course, centre on a non-Japanese corporate with a different attitude to financing in Japan than domestic corporations. PFI is also expected to bring other non-Japanese corporates to the domestic market. One portent could lie in French multinational Vivendi's teaming up last year with Marubeni, precisely to target PFI opportunities in the Japan market.

Even if foreign corporates don't become heavily involved in Japanese PFI, Toyoshima sees another reason to be hopeful about the prospects for project finance. Says Toyoshima: "Japanese companies are more concerned about controlling risk. Companies once loathe to the extra interest for a funding minus the corporate guarantee are now willing to pay more interest if they can finance the project on a limited recourse basis."

If Toyoshima is right, Japanese banks, at long last, will be able to draw on project finance experience gained in the international arena in their own backyard.

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