

THE PUBLIC-PRIVATE
PARTNERSHIP
LAW REVIEW

THIRD EDITION

Editors

Bruno Werneck and Mário Saadi

THE LAWREVIEWS

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LAW REVIEW

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PREFACE

We are very pleased to present the third edition of *The Public-Private Partnership Law Review*. Notwithstanding the number of articles in various law reviews on topics involving public-private partnerships (PPPs) and private finance initiatives (in areas such as projects and construction, real estate, mergers, transfers of concessionaires' corporate control, special purpose vehicles and government procurement, to name a few), we identified the need for a deeper understanding of the specific issues in this topic in different countries. The first and second editions of this book were the initial effort to fulfil this need.

In 2014, Brazil marked the 10th year of the publication of its first Public-Private Partnership Law (Federal Law No. 11,079/2004). Our experience with this law is still developing, especially in comparison with other countries where discussions on PPP models and the need to attract private investment into large projects dates from the 1980s and 1990s.

This is the case for countries such as the United Kingdom and the United States. PPPs have been used in the United States across a wide range of sectors in various forms for more than 30 years. From 1986 to 2012, approximately 700 PPP projects reached financial closure. The UK is widely known as one of the pioneers of the PPP model; Margaret Thatcher's governments in the 1980s embarked on an extensive privatisation programme of publicly owned utilities, including telecoms, gas, electricity, water and waste, airports and railways. The Private Finance Initiative was launched in the UK in 1992 aiming to boost design-build-finance-operate projects.

In certain developing countries, PPP laws are more recent than the Brazilian PPP law. Argentina was the first country in Latin America to enact a PPP Law (Decree No. 1,299/2000, ratified by Law No. 25,414/2000). The Argentinian PPP Law was designed to promote private investment in public infrastructure projects that could not be afforded exclusively by the state, especially in the areas of health, education, justice, transportation, construction of airport facilities, highways and investments in local security. In Mozambique, Law No. 15/2011 and Decree No. 16/2012 govern the Public-Private Partnerships (PPP) Law and other related PPP regulations, which establish procedures for contracting, implementing and monitoring PPP projects. In Paraguay, a regulation establishing the PPP regime has been enacted (Law No. 5,102) to promote public infrastructure and the expansion and improvement of services provided by the state; this law has been in force since late 2013.

In view of the foregoing, we hope a comparative study covering practical aspects and different perspectives regarding PPP issues will become an important tool for the strengthening of this model worldwide. We are certain this study will bring about a better dissemination of best practices implemented by private professionals and government authorities working on PPP projects around the world.

With respect to Brazil, the experience evidenced abroad may lead to the strengthening of this model in our country. In our last preface, we called your attention to one specific feature of the PPP law in Brazil: state guarantees. This feature permits that the obligation of the public party to pay a concessionaire be guaranteed by, among other mechanisms authorised by law: (1) a pledge of revenues; (2) creation or use of special funds; (3) purchase of a guarantee from insurance companies that are not under public control; (4) guarantees by international organisations or financial institutions not controlled by any government authority; or (5) guarantees by guarantor funds or state-owned companies created especially for that purpose.

The state guarantee pursuant to PPP agreements is an important innovation in administrative agreements in Brazil; it assures payment obligations by the public partner and serves as a guarantee in the event of lawsuits and claims against the government. This tool is one of the main factors distinguishing the legal regimen of PPP agreements from ordinary administrative agreements or concessions – one that is viewed as crucial for the success of PPPs, especially from private investors' standpoint.

Nevertheless, the difficulty in implementing state guarantees on PPP projects has been one of the main issues in the execution of new PPP projects in the country. This point is made worse due to the history of government default in administrative contracts.

In other jurisdictions, however, state guarantees are not a rule. Unlike PPP projects in developing countries, government solvency has not historically been a serious consideration in other jurisdictions. That is the case in countries such as Australia, France, Ireland, Japan, the United Kingdom and the United States.

We expect that the consolidation of PPPs and the strengthening of the government in Brazil may lead to a similar model, enabling private investments in areas where the country lacks the most.

Brazil must adopt cutting-edge models for awarding PPP agreements. The winner is usually chosen based solely on the price criterion (offering of lower prices or highest offers), which sometimes leads to projects lacking advanced or tailor-made solutions. Despite the legal provisions on the role of technical evaluation of offers, they are becoming less relevant. However, some ongoing discussions regarding amendments to the Brazilian procurement legislation and new criteria, which are based on the international experience, could (fortunately) be approved.

In this field, we highlight the current discussions regarding the amendment to the Federal Procurement Law (Federal Law No. 8,666/1993), which is expected to expedite public procurement in Brazil. One of the main innovations proposed in this debate is the competitive dialogue, a type of bid in which the authority engages with bidders to discuss and develop one or more solutions for the tendered project. After the conclusion of the dialogue phase, the authority will establish a term for the submission of bids.

The competitive dialogue is a reality in many jurisdictions (e.g., Australia, Belgium, China, France, Ireland, Japan, and the United Kingdom). In Japan, for example, some projects are procured through the competitive dialogue process. This process may be adopted if a relevant authority is unable to prepare a proper service requirement, in which case it proposes a dialogue with multiple bidders simultaneously to learn more about the specific service it seeks to implement. As another example, in France a dialogue will be conducted with each bidder to define solutions on the basis of the functional programme. At the end of the dialogue period, the procuring authority will invite the candidates to submit a tender based on the considered solutions. After analysis of the tenders, a partnership contract will

be awarded to the bidder with the best price in accordance with the criteria established in the contract notice or in the tender procedure.

We hope the importance of this tool is recognised in Brazil and reflected in our legislation.

In the second edition of this book, our contributors were drawn from the most renowned firms working in the PPP field in their jurisdictions, including Argentina (M&M Bomchil), Australia (Allens), Belgium (Liedekerke), China (Zhong Lun), Denmark (LETT), France (White & Case), India (Seth Dua), Ireland (Maples and Calder), Japan (Mori Hamada & Matsumoto), Mozambique (TPLA), Nigeria (G Elias), Paraguay (Parquet & Asociados), Philippines (SyCip Salazar Hernandez & Gatmaitan), Portugal (Vieira de Almeida), Tanzania (Velma), the United Kingdom (Herbert Smith Freehills) and the United States (Kilpatrick Townsend & Stockton). We would like to thank all of them and our new contributors for their support in producing *The Public-Private Partnership Law Review* and in helping in the collective construction of a broad study on the main aspects of PPP projects.

We strongly believe that PPPs are an important tool for generating investments (and development) in infrastructure projects and creating efficiency not only in infrastructure, but also in the provision of public services, such as education and health, as well as public lighting services and prisons. PPPs are also an important means of combating corruption, which is common in the old and inefficient model of direct state procurement of projects.

We hope you enjoy this third edition of *The Public-Private Partnership Law Review* and we sincerely hope that this book will consolidate a comprehensive international guide to the anatomy of PPPs.

We also look forward to hearing your thoughts on this edition and particularly your comments and suggestions for improving future editions of this work.

Bruno Werneck and Mário Saadi

Mattos Filho, Veiga Filho, Marrey Jr e Quiroga Advogados

São Paulo

March 2017

JAPAN

Masanori Sato, Shigeki Okatani and Yusuke Suehiro¹

I OVERVIEW

In recent years, the government has presented a very positive attitude towards the promotion of public-private partnerships (PPPs) and more investors have become interested in investing in infrastructure. The national government is intensively promoting PPPs, which offer new business opportunities to the private sector, as a part of its economic strategy.² In addition, public authorities operating under severe fiscal constraints have recognised the importance of, and the role of PPPs in, maintaining and improving existing infrastructure. The national government has been particularly promoting concessions of certain infrastructure such as airports, water supplies, sewage and toll roads. Against this backdrop, in 2016, two airport concession projects and one concession project for toll roads started operation.

II THE YEAR IN REVIEW

In Japan, the Act on the Promotion of Private Finance Initiatives (the PFI Act), enacted in 1999, governs most PPP projects, referred to as private finance initiatives (PFIs). Since its enactment, the PFI Act has brought in 527 projects totalling approximately ¥4.9 trillion as of 31 March 2016.³

In 2011, this law was revised to allow the use of concessions and expand ‘user pays’ projects in which the national or a local governmental authority (as applicable, the ‘relevant authority’) grants to a private entity (the concessionaire) the right to operate existing infrastructure and earn income by charging user fees, in contrast to most PFIs in Japan, which are structured under the traditional PFI model in which project companies receive availability payments from the relevant authorities. Subsequently, the national government issued several guidelines providing detailed guidance on practical matters and interpretation of affected laws. In 2015, the PFI Act was further revised to enable governmental authorities to second public officers with expertise to private concessionaires.

In May 2016, the Council for the Promotion of Private Finance Initiatives of the Cabinet Office revised the Action Plan for Promotion of PPPs/PFIs, which highlights (1) the promotion of concessions, particularly those of airports, water supplies, sewage and toll roads as well as cultural and educational facilities and public housing; (2) the preferential

1 Masanori Sato and Shigeki Okatani are partners and Yusuke Suehiro is a senior associate at Mori Hamada & Matsumoto.

2 Revision of ‘Japanese Revitalisation Strategy 2016 – For the Fourth Industrial Revolution’, dated 2 June 2016 (published by the government of Japan), Part II, pp. 21–22 and 163–166.

3 See the Cabinet Office website: www8.cao.go.jp/pfi/pfi_genjyou.html.

study of PFIs/PPPs as will be discussed below; and (3) the development of local platforms for PPPs/PFIs.

Airport concessions lead the way, as they are largely enhanced by new legislation which has made it easier to privatise airports owned and operated by the national or local governments. On 1 April 2016, a concessionaire established by a consortium led by ORIX Corporation and VINCI Airports started operating Kansai International Airport and Osaka (Itami) International Airport. On 1 July 2016, a consortium led by Tokyu Corporation initiated the operation of Sendai Airport through a concession. Aside from commencing the bidding processes for the concession projects for Takamatsu Airport and Kobe Airport in 2016, the relevant authorities have also started looking into several other airport concessions.

Concessions for toll roads, another important area, marked another turning point in 2016. Following the enactment of new legislation which removed obstacles to toll road concessions, the Aichi Prefecture Road Public Corporation offered a toll road concession covering eight toll roads in 2015, which was won by a concessionaire established by a consortium led by Maeda Corporation. Operations started on 1 October 2016.

Water supplies and sewage concessions are expected to follow suit. Hamamatsu City issued a request for proposal for a sewage concession in the Seien area in May 2016. Likewise, several cities have been working continuously towards privatising their water and sewage services through concessions.

In December 2015, to take advantage of private sector funds and expertise for PFIs, the Council for the Promotion of Private Finance Initiatives of the Cabinet Office established guidelines for the preferential consideration of PFIs/PPPs. Under the guidelines, the relevant authority should preferentially study PFIs/PPPs when planning a project for the construction, operation or maintenance of public facilities and the project meets certain requirements. Although the guidelines are not legally binding, the Cabinet Office has requested local governments with a population of 200,000 or more to establish their internal rules in accordance with the guidelines by no later than 31 March 2017.

III GENERAL FRAMEWORK

i Types of public-private partnership

Traditional arrangement

Until the introduction of concessions, more than two-thirds of traditional PFI projects have been undertaken using build–transfer–operate (BTO) arrangements where:

- a* a private entity as the contractor, usually a special purpose company formed by a consortium of project sponsors, constructs a facility (typically, social infrastructure such as governmental buildings and local public facilities);
- b* after completing the work, the contractor transfers the facility to the relevant authority and subsequently operates it for a specified period; and
- c* the contractor earns its revenues through the availability fees that the relevant authority pays in exchange for the construction and services.

While traditional PFIs feature BTO arrangements, the PFI Act permits other structures. For example, the international passenger terminal and the international air cargo terminal at Haneda Airport were constructed in 2010 and are operated under a build–operate–transfer (BOT) arrangement.

Concessions

As discussed above, the national government introduced the concession system in 2011 to (1) give the private sector a wider range of rights (including the right to determine user fees and earn them as its own revenue) along with more risks and responsibilities; (2) develop the Japanese PFI market; and (3) attract financiers.⁴

In a concession project:

- a* the relevant authority administering an existing facility grants a concessionaire the right to maintain and operate the facility for a specified period (the concession right);⁵
- b* the relevant authority continues to own the facility. The concessionaire may determine and collect user fees or tolls as its own income;⁶ and
- c* the relevant authority may charge the concessionaire concession fees for the concession right. The concession fees, which are usually calculated through the discontinued cash flow method but ultimately decided through bidding processes, are paid up front or in instalments depending on the concession agreement.

ii The authorities

All PFI projects are governed by the PFI Act but are procured by the national government, local governments or government-related organisations.⁷ Generally, a project would be overseen by a particular division within the relevant authority responsible for the target facility.

PFI is promoted by the PFI Promotion Office within the national government's Cabinet Office. The PFI Promotion Office has issued its basic policy and the following guidelines regarding practical aspects of PFIs:

- a* the Procurement Process Guidelines;
- b* the Value-for-money (VFM) Guidelines;
- c* the Risk Allocation Guidelines;
- d* the Contract Guidelines;
- e* the Monitoring Guidelines; and
- f* the Concession Guidelines.

The PFI Promotion Office has also standardised the project agreements for traditional BTO projects for social infrastructure and released the 'Model Project Agreement' on its website. These guidelines and the Model Project Agreement, which parties are not legally obliged to use, significantly affect PFI practice.

Other divisions in the national government as well as some local governments have also developed their own PFI policies and guidelines to utilise PFIs for specific areas such as water supply and sewage infrastructure.

4 Yasuyuki Kurano and Masatomo Miyazawa, *Kaisei PFI Hono Gaiyou (3 kai)* ('Overview of the Revised PFI Act (III)'), *Kinyu Homu Jijo*, Vol. 1927, pp.122–126.

5 PFI Act, Article 2, Paragraphs 6 and 7.

6 Id., Article 23.

7 Id., Article 2, Paragraph 3.

iii General requirements for PFI contracts

Class of facilities

PFI contracts are available for the construction, management and operation of public facilities and infrastructure listed in the PFI Act,⁸ such as:

- a roads, railways, ports, airports, rivers, parks, water supplies, sewage systems and other public infrastructure;
- b government buildings, housing for government workers and other official facilities;
- c public housing, social facilities such as educational and cultural facilities, hospitals, social welfare facilities, prisons and other social infrastructure;
- d information and communications facilities, heat supply facilities, new energy facilities, recycling facilities (excluding waste treatment facilities), tourist facilities, and research facilities; and
- e vessels, aircraft and other transportation vehicles, and satellites (including the facilities required to operate these vehicles).

Some public laws, however, restrict the ability of the private sector to manage and operate specific classes of public facilities, including airports and roads.⁹ Since the PFI Act does not *per se* override these laws, further legislation is required to enable concessionaires to undertake the management or operation of those 'restricted' public facilities. Since the introduction of concessions in 2011, the government has enacted special laws enabling concessions, or has expressed its administrative interpretation of the relevant public laws to the effect that those laws do not hinder concessions, for major infrastructure, including airports, water supplies and sewage systems. Today, roads are the last major infrastructure subject to such restrictions. However, the government enacted special legislation to specifically enable Aichi Prefecture to grant concessions for eight toll road routes, as mentioned above.

Scope of concession rights

Concession rights are subject to certain limitations. Generally, a concessionaire may make expansions or renovations that are necessary to operate the facilities¹⁰ though the exact scope of permissible expansions or renovations in a project needs to be clarified by the relevant authority. In contrast, the construction of new facilities and the complete removal and redevelopment of existing facilities are clearly outside the scope of concessions.¹¹ Nevertheless, it does not mean that the PFI Act prevents greenfield projects, or major renovation projects outside the scope of concessions, from being conducted through a combination of traditional arrangements (for construction or major renovation) and concessions (for operation).

VFM analysis

If a potential project falls within the scope of permitted facilities and services, the relevant authority must conduct a VFM analysis to confirm whether the project is appropriate for PFIs and whether it may go ahead.¹² This analysis may be a burden for the relevant authority

8 Id., Article 2, paragraphs 1 and 2.

9 Basic Policy for the Implementation of PFI Projects, Chapter 4, Section 1(3).

10 Concession Guidelines, Section 11.

11 Id.

12 VFM Guidelines.

but the applicable guidelines suggest a shorter process for traditional projects, such as construction of governmental buildings, by using precedents.¹³

Term

Projects under traditional arrangements usually have contract terms of between 15 and 30 years. Traditional PFIs with the national government are limited to 30 years due to the Public Finance Act limit on the terms of contracts under which the national government is obliged to pay for more than one fiscal year.¹⁴ PFIs with local governments and government related organisations do not have term limits. In addition, some laws restrict the period during which a private entity may use assets owned by a relevant authority. In most cases of land with a building on it, the maximum period of use is 30 years.¹⁵

There are no restrictions on concession terms, and the PFI Act does not mandate a maximum concession term. Accordingly, a relevant authority may decide the term on a project-specific basis.¹⁶ For example, the relevant authority suggests that airport concessions will basically have terms of between 30 and 50 years.¹⁷ In addition, a concession term may be extended, subject to the conditions in the concession agreement.¹⁸

IV BIDDING AND AWARD PROCEDURE

The general process for procuring PFI projects, whether using traditional arrangements or concessions, is as follows:¹⁹

- a* the relevant authority draws up an implementation policy, which outlines the project and the bidding process;²⁰
- b* it conducts a VFM analysis and identifies the project scope;²¹ and
- c* finally, it conducts a bidding process and awards the project to the selected project sponsor.

The Procurement Process Guidelines provide the general guidance for the bidding process to ensure the transparency, fairness and competitiveness of the process.

The Agreement on Government Procurement (GPA) under the WTO framework applies to certain types of PFI projects above certain thresholds procured by the national government, prefectures, certain major cities and certain government-affiliated organisations. For example, the GPA applies to PFI projects whose main purpose is construction service worth ¥740 million (4.5 million SDR) or more procured by national government agencies or ¥2.47 billion (15 million SDR) or more by local governments. However, concessions in Japan are currently exempted from the application of the GPA.

13 Revision of the Procurement Process Guidelines and the VFM Guidelines.

14 Strictly speaking, the Public Finance Act provides five years but the PFI Act extended the term to 30 years (PFI Act, Article 68).

15 National Property Act, Article 21, Paragraph 1, Item (iii).

16 Concession Guidelines, Section 15(2)2.(1).

17 Minister of Land, Infrastructure, Transport and Tourism, 'Basic Policy for Airport Concession of National Airports', 2013 (Basic policy for Airport Concessions), Section 2.

18 Id.

19 Procurement Process Guidelines.

20 PFI Act, Article 5.

21 Id., Article 7.

i Expressions of interest

Under the Procurement Process Guidelines, authorities are encouraged to invite and assess expressions of interest, proposals and requests for information from the private sector.²² These proposals may influence the implementation policy as the pertinent relevant authority identifies the project scope and initiates the bidding process.

ii Requests for proposals and unsolicited proposals

Requests for proposals

Generally, a project sponsor is selected through a competitive procedure. Following the VFM analysis and the decision to initiate a project, the relevant authority starts the bidding process by issuing a request for proposals and a tender package (including the requirements for services and specifications, the criteria for awarding the project, and the drafts of the project agreement and other relevant contracts). Although bidders may be required to post deposits to ensure that they honour the bids, deposits have been exempted in many past projects.²³

Unsolicited proposals

In 2011, the revised PFI Act introduced the unsolicited proposal system through which the private sector may propose a PFI project.²⁴ Competitive bidding is still required even if the unsolicited proposal induces the relevant authority to start a PFI procedure. Thus, the proponent must participate in the bidding process, although the relevant authority is required to protect the proponent's intellectual property that is contained in the proposal.²⁵ The revised Procurement Process Guidelines allow the relevant authority, in the bidding process, to consider in the favour of the proponent bidder, how its proposal contributes to the project with attention to fairness, transparency and competitiveness.²⁶

iii Evaluation and grant

Qualification

A relevant authority sets qualifications for bidders in the request for proposal. A bidder may be either a single corporation or a consortium (which is typical in most major projects). The relevant authority also sets qualifications for the consortium or for each member of the consortium, or for both.

A relevant authority may adopt a pre-qualification process or multi-phase selection process if a sizeable number of bidders are expected to participate.²⁷ In a typical competitive dialogue procedure (see 'Bidding process', *infra*), before the competitive dialogues start, the bidders are shortlisted to around three based on documentary submissions.²⁸

The PFI Act and other laws enumerate the grounds for disqualification.²⁹ A relevant authority may also set additional qualifications for specific projects. In many past cases,

22 Procurement Process Guidelines, Section 1-2.

23 See the PFI Promotion Office website: www8.cao.go.jp/pfi/tebiki/jitsumu/jitsumu04.html, (question 4.7).

24 PFI Act, Article 6.

25 Procurement Process Guidelines. Section 1-2(1).

26 Id. Section 4-1(13)–(16).

27 Id. Section 4-1(11)(i)-2-1 and (ii)-1-2.

28 Id. Section 4-1(11)(i)-2-1.

29 PFI Act, Article 9.

authorities required certain financial capacity and capability for long-term risk management and project management.³⁰ Although the PFI Act does not restrict foreign sponsors' entry, the relevant authority may set additional qualifications, such as the bidder's experience or knowledge of business in Japan, which some foreign sponsors may find hard to meet. The bidders may also be subject to governmental scrutiny concerning national security, crisis management and contribution to local economy.³¹

Bidding process

Most PFI projects are procured through either the competitive dialogue procedure or the open and competitive bidding procedure.³² In the competitive dialogue procedure, which may be adopted if a relevant authority has difficulties setting out the proper service requirements and specifications, the relevant authority may have dialogues concurrently with multiple bidders.³³ Taking the dialogues into account, the relevant authority finalises the service requirements and specifications before the bidders submit their final proposals.³⁴ In contrast, the open and competitive bidding procedure is less flexible because the requirements cannot be modified or revised once the bidding process has begun; however, the relevant authority is allowed to communicate with bidders to clarify the requirements as long as the transparency and fairness of the process are maintained.³⁵

Awarding contracts

In determining the winning bidder, the relevant authority takes into consideration not only the bid price but also other factors such as the consortium members, the contents and feasibility of business plans and safety and security measures. The weight of each factor is described in the criteria for awarding the project included in the tender package. The authority usually sets up a selection committee consisting of experts with expertise and experience in the pertinent fields and evaluates the bid proposals in consultation with that committee. In general, once the winning bidder is selected, it may not negotiate with the relevant authority to modify the terms and conditions of the project.

The relevant authority and the selected sponsor enter into a basic agreement, which contains the sponsor's obligations regarding preparations for the project. Afterward, the contractor or the concessionaire and the relevant authority execute a project agreement (or a concession agreement for concessions), the main document containing their rights and obligations regarding the project.

30 PFI Procurement Process Guidelines, Section 4-1(11)(ii)-1-2.

31 Basic policy for Airport Concessions, Section 2-10.

32 PFI Procurement Process Guidelines, Id. Section 4-1(11).

33 Id.

34 Id.

35 Id.

V THE CONTRACT

i Payment

Traditional arrangement – availability fees

In traditional projects, the relevant authority pays availability fees for the services provided by the contractor.³⁶ The project agreement sets out the calculation mechanism, which is either unitary charges or charges made up of separate elements (such as costs of construction, finance, maintenance and operation).³⁷ Fees may be deducted or withheld if the services do not meet the agreed performance criteria and standards.³⁸ Payments are typically made on a semi-annual or a quarterly basis.³⁹

Concessions – user fees

In general, the concessionaire determines and charges user fees for the use of the public facilities and collects the fees as its own revenues.⁴⁰ The fee determination, however, may be subject to the concession agreement or to applicable laws and regulations on the pertinent infrastructure (e.g., the Airport Act, the Water Supply Act and the Sewage Service Act).

ii State guarantees

Generally, there is no state guarantee on a relevant authority's payment obligations to either the contractor or the concessionaire.

iii Distribution of risk

Several guidelines clarify that proper risk allocation should be accomplished through the principle that the party in the best position to manage a risk bears that risk.⁴¹

Force majeure

In traditional projects, the project agreement typically stipulates that if a force majeure event occurs:

- a the parties are relieved of their contractual obligations;
- b the handover date or service commencement date is postponed; and
- c if the force majeure lasts for a certain period of time, the agreement may, upon consultation between the parties, be terminated by the relevant authority or, if allowed in the agreement, the contractor.⁴²

To address financial consequences, typical project agreements require that the contractor purchases insurance that meets certain criteria.⁴³ In many traditional cases, relevant authorities have agreed to bear a substantial portion of uninsurable costs resulting from force majeure.⁴⁴

36 PFI Contract Guidelines, Section 4.

37 Id., Section 4-3.

38 Id.

39 Id., Section 4-4.

40 PFI Act, Article 23.

41 Risk Allocation Guidelines, Article 1, Section 2.

42 Contract Guidelines, Sections 2-2-9, 3-6, 5-3 and 6-9.

43 Risk Allocation Guidelines, Article 2, Section 6(1)(i)-3.

44 Contract Guidelines, Sections 3-6 and 6-9.

Under concession agreements, the relevant authorities typically bear the costs to repair physical damages to the facilities caused by force majeure except for insurable or relatively minor costs. Concession agreements may also provide for the extension of the concession term to compensate the concessionaire for increased costs or losses arising from force majeure.⁴⁵

Change in laws

In traditional projects, authorities are required to compensate the contractors for increased costs resulting from a change in specific law or governmental action which applies only to the project or similar projects.⁴⁶ In other words, the private sector bears the risk of a change in law that has general effect.⁴⁷ The agreement may, upon consultation between the parties, be terminated if a change in specific law makes it impossible to continue the project.⁴⁸ The range of the specific laws and governmental actions is determined on a project specific basis. Concession agreements generally provide for similar arrangements, although increased costs may be addressed by extending the concession term, instead of monetary compensation.⁴⁹

Demand risk

In most traditional projects, the private sector does not bear the demand risk because availability payments from the government remain unchanged irrespective of demand for the provided services.

In concession projects and some BOT projects, concessionaires or contractors generally bear the demand risk because the project revenues are generated mainly from user fees rather than availability payments. Nevertheless, risk sharing mechanisms may be appropriate in some specific areas. For example, the Concession Agreement for the Aichi Prefecture Toll Road Project adopted a risk sharing mechanism which passes on to the relevant authority any increase or decrease in toll revenues beyond 6 per cent from the projected revenues agreed by the authority and the concessionaire.⁵⁰

Latent defect of existing facilities

In concession projects where concessionaires will operate existing government-owned facilities, the parties need to consider the risk allocation for latent defects in those facilities. While authorities do not bear the risk of latent defects in principle, and the private sector should minimise this risk through intensive due diligence, some authorities have come to understand that authorities should, to a certain extent, bear the risk of latent defects that are difficult to discover even through due diligence.⁵¹ In the Sendai Airport project, for example, the relevant authority will compensate the concessionaire for losses from latent physical

45 Concession Agreement for Sendai Airport, Section 48.

46 Model Agreement, Section 45.

47 Contract Guidelines, Section 5-3, Paragraph 5.

48 Id., Paragraph 2.

49 Concession Agreement for Sendai Airport, Sections 45 and 73.

50 See the summary of the Concession Agreement for the Aichi Prefecture Toll Road Project, Section 9(3), which was released on the Aichi Prefecture Road Public Corporation website: www.aichi-dourokousha.or.jp/wp-content/uploads/2016/08/2-gaiyou-shuusei.pdf.

51 Sewage Concession Guidelines, Section 3.6.4(1).

defects discovered in certain facilities within a year from the commencement of the project, subject to limitations on the scope of defects and compensation.⁵²

iv Adjustment and revision

In traditional projects, availability fees may be adjusted as set out in the project agreement. Typically, adjustment is limited to indexation to deal with inflation, although many project agreements do not even contain such indexation, partly because of the stable prices in Japan since the 1990s.⁵³

In concessions where concessionaires may set the user fees, a concessionaire may adjust the user fees at its discretion unless otherwise limited by the concession agreement or by applicable laws or regulations.

v Ownership of underlying assets

Traditional arrangement

In traditional projects using a BTO arrangement, the relevant authority owns the underlying assets, such as land. On completing the construction of the facility on land leased from the relevant authority, the contractor transfers the ownership of the facility to the relevant authority.⁵⁴

Concessions

Likewise, relevant authorities own the underlying facilities in concessions, while a concessionaire is granted concession right in respect of such facilities.

A concessionaire's concession right is assignable subject to the consent of the relevant authority.⁵⁵ The PFI Act also allows a concessionaire to mortgage its concession right to its lenders, although the consent of the relevant authority for the assignment of the concession right is necessary when the lenders foreclose the mortgage.⁵⁶ To alleviate the lenders' concern on unpredictability in the foreclosure of mortgage over concession rights, the concession guidelines provide that if: (1) the transferee would not have been disqualified as a bidder for the project; and (2) the transfer is appropriate in light of the implementation policy, then the relevant authority must approve the transfer.⁵⁷

The grant, transfer and mortgage of a concession right are registered in a manner similar to real property registration.⁵⁸ Concessionaires may take advantage of these features to obtain third-party financing, as also set out below.

For tax accounting purposes, a concession right may be depreciated equally over the concession term.⁵⁹

52 Concession Agreement for Sendai Airport, Section 16.

53 Contract Guidelines, Section 4-4.

54 Contract Guidelines, Section 2-4-1.

55 PFI Act, Article 24 and Article 26.

56 Id., Article 25.

57 Concession Guidelines, Section 13(1)2.(2).

58 PFI Act, Article 27.

59 Order for Enforcement of the Corporation Tax Act, Articles 13(viii)(k) and 48-2.

Airport projects

Airport projects may require special arrangements because in many airports in Japan, private or third sector entities own and manage non-aeronautical facilities such as terminal buildings and parking lots, while the national or local governments own and manage the runways and other aeronautical facilities. To integrate aeronautical and non-aeronautical operations, the national government intends to have concessionaires acquire the terminal buildings or shares in entities holding terminal buildings.⁶⁰ Under such a scheme, concessionaires will operate the aeronautical facilities as concessionaires and the non-aeronautical facilities as owners, although a single integrated procurement process covers both types of facilities as a package.

vi Early termination

Early termination events

Traditional project agreements generally provide for several causes for early termination, including default, force majeure and a change in law⁶¹ and for the right of the relevant authority to terminate the agreement at any time.⁶² Concession agreements are generally the same. Although the PFI Act enumerates the termination events for concessions,⁶³ in practice, the parties agree on termination events similar to those under project agreements used for traditional arrangements and which are broader than those provided in the PFI Act.

Consequences of early termination

In traditional project agreements, the relevant authority agrees to pay the contractor the following costs and losses arising from early termination:

- a* (if termination occurs during the construction phase) the purchase price for the part of the building that the contractor has completed at the time of the termination; or
- b* (if termination occurs after the completion of the construction) the unpaid construction costs.

In either case, payment will be to the extent that the contractor's services meet the required specifications.⁶⁴

In cases of early termination owing to the relevant authority's default or voluntary termination, the compensation covers the contractor's costs and losses, such as financing costs and the availability fees for a certain period.⁶⁵ If the agreement is terminated due to force majeure or a change in law, the relevant authority will compensate for a reasonable amount of costs according to the risk allocation under the project agreement.⁶⁶

In many projects, if a project terminates upon the contractor's default, the contractor will pay a penalty and, additionally, actual damages if they exceed the amount of the penalty. The Contract Guidelines suggest that the project agreement may provide for either liquidated damages or penalty.⁶⁷

60 Basic policy for Airport Concessions, Section 3-2(1).

61 PFI Contract Guidelines, Section 5.

62 Id.

63 PFI Act, Article 29.

64 Contract Guidelines, Section 5-4.

65 Id.

66 Id., Section 5-3.

67 Id., Sections 5-4 and 5-5.

Concession projects generally adopt similar approaches although the parties do not pay damages to each other in cases of termination due to force majeure or a change in law. In addition, some new mechanisms may be anticipated. For example, in concession agreements where the concessionaire must pay the concession fee up front, the relevant authority would agree to refund the portion of the concession fee that corresponds to the remaining concession term.⁶⁸

VI FINANCE

i Project finance

Generally, the private sector finances PFI projects through project finance, which relies on the cash flow generated from the project.

In past projects, authorities have not allowed project companies to transfer, collateralise or dispose of project assets without their approval.⁶⁹ When granting security interests, the relevant authority will enter into a direct agreement with the lenders concerning: (1) the creation of security interests over project assets and some procedural matters related to the enforcement of the security interests; and (2) the lenders' step-in rights which allow them, following the contractor's default, to propose to replace the defaulting contractor with another private entity.⁷⁰ Apart from adding the concession right as a collateral, the foregoing basic practice is generally applied to concession projects.

Given that the contractor (or the concessionaire) is a special purpose company formed by the project sponsor, which is usually a consortium of private companies, lenders usually request the consortium members to pledge their shares in the contractor (or the concessionaire). In past projects, the transfers of those shares, including upon the enforcement of the pledge, require the relevant authority's approval but the current guidelines suggest that the relevant authority has more flexibility for such share transfers. For example, the relevant authority may adopt an arrangement in which share transfers are subject only to an *ex post* facto notification rather than an approval, as long as the transferee does not fall within a pre-agreed blacklist.⁷¹

ii Efforts to expand the PFI market

In traditional projects, a substantial portion of the financing consists of loans from Japanese banks, and equity investors usually come from members (such as a construction company) of the project sponsor consortium. The Japanese PFI market characteristically lacks financial investors and foreign investors.⁷² This is partly because traditional projects relying on the relevant authority's availability fees, which have constituted most of the deals executed in the Japanese PFI market, do not need much equity investment and the government has easily been able to finance its infrastructure projects at very low costs.

68 Concession Guidelines, Section 14(3)2(6).

69 Contract Guidelines, Section 6-1.

70 Id., Section 5-1.

71 Id., Section 6-2.

72 Japan External Trade Organisation, 'Public Private Partnerships in Australia and Japan; Facilitating Private Sector Participation', 2010, pp. 25–26.

However, future PFI projects in Japan will likely rely more on private sector investors, including financial investors and foreign investors for the construction and maintenance of infrastructure for two reasons: (1) the government has severe financial problems, and some future PFI projects may require a significant amount of investment by private sector investors; and (2) the 'user pays' projects, which the government intends to promote, may involve more subtle risk analysis in relation to demand risks and need to secure investments from new classes of investors who bear such risk. Both the government and the market are trying to create a supportive environment in this regard.

As already mentioned, the current guidelines allow more flexibility for the transfer of shares in project companies. The Contract Guidelines clearly acknowledge that the need to restrict share transfers depends on various factors such as the content and phase of the project, and clarify that conditions to a stock transfer by a consortium member must be kept to the minimum extent necessary to appropriately implement the project, in light of the role of each consortium member in the project.⁷³ Further, the guidelines suggest that relevant authorities allow investors to freely transfer non-voting shares.

In October 2013, the Private Finance Initiative Promotion Corporation of Japan (PFIPCJ), co-sponsored by the government and the private sector, including banks and insurance companies, was established.⁷⁴ To encourage investors to provide risk money for infrastructure, the PFIPCJ is supposed to financially support 'user pays' projects mainly by subordinated debts, preferred stocks or other mezzanine finance.⁷⁵ The PFIPCJ decided to finance 18 projects, including the Kansai-Osaka (Itami) International Airport project, the Sendai Airport project and the Aichi Prefecture Toll Road project, until the end of 2016.⁷⁶

In 2014, the national government revised the Financial Instruments and Exchange Act to allow investment corporations and investment trusts to invest in concession rights. In April 2015, the Tokyo Stock Exchange established the listed infrastructure market for funds that invest in infrastructure assets, which include concession rights.⁷⁷ An investment corporation, usually used in a Japanese REIT, is a tax-transparent vehicle that may, to the extent that it meets certain conditions, avail itself of tax deductions for dividends paid. As a vehicle investing in real property, it has gained broad acceptance among individual and institutional investors. In this regard, while the use of investment corporations may attract institutional investments in public infrastructure, current tax requirements limit an investment corporation's investments in concession rights to less than half of its total assets. It is also questionable whether the authorities will allow an investment corporation, which is seen as engaging in passive investments, to actively operate an infrastructure business as concessionaire. Further considerations are required for investment by an investment corporation in concession rights.

73 Contract Guidelines, Section 6-2.

74 PFI Act, Chapter 5.

75 Id., Article 53.

76 See the PFIPCJ website: www.pfipcj.co.jp/activity/support_list.html.

77 See the Tokyo Stock Exchange press release issued on 30 April 2015, www.jpx.co.jp/news/1070/20150430-01.html.

VII OUTLOOK

As the government continues to demonstrate a proactive and encouraging support of PPPs, address remaining regulatory hurdles and incentivise governmental agencies and local governments to adopt PPP methods, PFI Act concessions and other PPP projects will keep growing and expanding while project schemes and finance arrangements of PPP projects are expected to become more diversified.

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