Recent developments in public-private partnerships in Japan

Masanori Sato and Shigeki Okatani of Mori Hamada & Matsumoto in Tokyo report on the latest changes to Japan’s PPP (public-private partnership) environment

In 2015, there were significant developments in public-private partnerships (PPP) in Japan. The concession agreement for Sendai Airport was signed on December 1, 2015, and the concession agreement for Kansai International Airport (Kanju) and Osaka International Airport (Itami) was signed on December 15, 2015. These projects are the first cases of airport privatisations in Japan where there were substantial uses of PPP frameworks, and the management of the airports was assigned to entities established exclusively with private capital.

Another recent development was the introduction of special legislation, passed into law by parliament in July 2015, enabling a local government to implement a toll road concession, the bidding process for which commenced in November 2015. The government is actively promoting PPP in light of socio-economic changes and fiscal conditions. It has set numerical targets, and has implemented a variety of measures to promote PPP projects. However, hurdles to implementing PPPs, especially in regard to concessions in certain sectors, including water and sewage, still remain.

This article discusses the government’s recent efforts to promote PPPs and the latest developments in certain types of infrastructure development.

A new era for PPPs in Japan

In the Abe administration’s basic growth strategy, the Japan Revitalisation Strategy, which was revised in 2015, central government calls upon local governments to offer more opportunities to the private sector to operate public facilities.

The reason the government strongly supports PPPs is not only because of the expectation it will create new business opportunities, but also the circumstances of infrastructure in Japan: although demand for new infrastructure is decreasing in Japan due to an aging and declining population, the country needs to maintain and renovate existing infrastructure, especially developments constructed in the country’s era of rapid economic growth in the latter half of the twentieth century, under difficult fiscal conditions.

Action plan

The Council for the Promotion of Private Finance Initiatives of the Cabinet Office launched the Action Plan for Fundamental Reform of PPPs/PFIs on June 6, 2013. This action plan aims to intensively promote PPP/PFI projects to achieve a more efficient operation or renovation of infrastructure, enhance the level of services and reduce government fiscal burdens.

The action plan establishes targets on a deal value basis, totaling around ¥10-12 trillion between 2013 and 2022 in four areas.

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(i) Concessions: ¥2–3 trillion

Relevant authorities will actively promote concessions in airport, water and sewage projects. The concession here is a scheme introduced by a revision of the Act on the Promotion of Private Finance Initiative (the PFI Act) in 2011 (the PFI Act concession). Under the PFI Act concession, a public authority confers on a private entity (the concessionaire) the right to operate those facilities (the concession right) for a certain period (the concession period). The PFI Act concession is designed mainly for user-pay type projects in which private entities operate and maintain existing infrastructure by financially relying on users’ fees rather than service fees or availability payments from the government.

(ii) Public facilities with income-producing facilities: ¥3–4 trillion

PFIs for the construction, renovation, maintenance or operation of public facilities, which, together with income-producing facilities attached to them, may generate sufficient revenues to cover the costs associated with those projects. Relevant authorities will study the use of PPPs for the maintenance
and renewal of public facilities such as expressways (especially the Shutoke Metropolitan Expressway, which requires major repairs).

(ii) PPP projects based on private proposals: ¥2 trillion
PPP projects that adopt proposals from the private sector, for example, for the effective utilisation of unused or underused public real estate.

(iii) Other project types: ¥3 trillion
Other conventional types of PPP projects in which measures to reduce government fiscal burdens are to be pursued, such as structuring facility management fees based on revenues generated from the project (i.e., as opposed to availability-based fee arrangement) or combining the renovation and maintenance of multiple facilities.

Intensive enhancement period
The council announced its policy to accelerate the implementation of the PPP Act concessions under its action plan on June 16, 2014 by adopting the following measures:

(i) Implementing an intensive enhancement period between April 2014 and March 2017;
(ii) Prioritising sectors in which PPP Act concessions are intensively promoted: airports, water facilities, sewage facilities and toll roads;
(iii) Setting numerical targets for the intensive enhancement period: six projects each in airports, water and sewage, and one toll road; and ¥2–3 trillion for the total transaction value (which is measured by the total revenue of a concessionaire during the concession period).

The need for more efficient management of infrastructure, challenging fiscal conditions, and the expectation PPPs will create new business opportunities are driving the government to intensively promote PPP Act concessions.

The council is discussing policy revisions which will include numerical targets for PPP projects in education and public housing, and measures to further enhance the promotion of PPP Act concessions.

Preferential consideration of PPP/PFI
The council established its guideline for preferential consideration of the introduction of various PPP/PFI methods on December 15, 2015. The cabinet Office requested government agencies and local governments establish their respective internal rules in accordance with the guidelines. Although the Cabinet Office’s request is not legally binding, the government aims to have all the prefectures and cities with a population of 200,000 or more to have established internal rules no later than March 31, 2017.

Under the guidelines, a public authority should preferentially consider PPPs/PPIs when they make certain decisions on construction, renovation, operation and maintenance of public facilities. If a project meets certain requirements, the public authority must choose an appropriate PPP/PFI method for the project, conduct a valuation by comparing the PPP/PFI method with a traditional method, and publish the results of the valuation on its website if it decides not to adopt the PPP/PFI method.

It is still unclear how many PPP/PFI projects will actually be adopted using this process because the guidelines do not suggest adopting PPP/PFI methods but suggest considering it first or, more precisely, establishing internal rules for a process that gives preferential consideration to PPP/PFI methods. In addition, public authorities may choose other relatively easy methods with limited private involvement because the guidelines do not instruct the public authorities on how to choose from the various PPP/PFI methods.

Nevertheless, the establishment of internal rules is expected to be the first step for a local government with no PPP experience to consider PPP/PFI as an option for construction, renovation, operation and maintenance of public facilities.

Development of PPP projects in Japan
Airports
The Act for the Operation of Government Controlled Airports by Private Sector Entities (the airport concession act) enacted in 2013 enabled the government and local governments to privatise airports through a PFI Act concession. Later, in November 2013, the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) promulgated the Basic Policy on the Operation of Government Controlled Airports by Private Sector Entities (the basic policy on airport concessions), which provides the basic framework for concessions of national airports.

The central government intends to sell 30 to 50 year concession rights for national airports, which it owns and manages, subject to the consent of the local government of the region where the airport is located.

The move towards privatisation is driven by increased demand for the efficient management of airports: the government needs to maintain airport facilities under severe fiscal conditions, and airlines face a severe competitive environment and are demanding more flexible airport services at lower costs from airports.

In addition, in many airports in Japan, the government owns basic aeronautical facilities, while private or third sector entities own and manage non-aeronautical facilities such as airport terminals and car parking facilities. That division is believed to hinder Japanese airports from taking strategic approaches. According to the basic policy on airport concessions, a concessionaire will manage both aeronautical and non-aeronautical operations by acquiring the ownership of airport terminals and car parking facilities from the existing owners as well as acquiring the concession right on basic aeronautical facilities from the government.

Sendai Airport became the first concession of a national airport. On December 1, 2015, the government and a concessionaire established by a consortium led by Tokyu Corporation signed the concession agreement.

The government has begun the process towards the concession of the Takamatsu Airport. Kagawa Prefecture, the local government of the area where the airport is located, desires to hold minority shares of up to 25% and send a full-time director to the board of directors of the concessionaire.

With regard to other national airports, the granting of the concession right to operate the Fukuoka Airport in order to finance the construction of an additional runway, and a concession for several airports in Hokkaido, including the New Chitose Airport, are also being discussed.

With regard to regional airports, concessions for Kobe Airport run by Kobe City, and Shizuoka Airport run by Shizuoka Prefecture, are being discussed.

As described above, the airport sector is a front runner for concessions. However, there is much room for improvement. For example, it is confusing for bidders that the closing conditions of the transaction and the due diligence process for aeronautical and non-aeronautical facilities are divided. This is partly due to the separation of ownership and management of these facilities, as described above; however, the government could improve on coordinating the entire bidding process. Another example is the compensation for the renovation or upgrade under the concession agreements. It is unclear whether the government will compensate the concessionaire for the renovation or upgrade of facilities; thus it may be more difficult for the concessionaire to decide to invest in the construction or major renovation of airport facilities toward the end of the concession period.

On December 15, 2015, the New Kansai International Airport Company and a concessionaire established by a consortium led by ORIX Corporation and VINCI Airports signed a concession agreement for the operation of Kansai International Airport (Kansu) and
Osaka International Airport (Itami). This project is also a PFI Act concession; however, it is not implemented under the airport concession act but under special legislation (the Kanku-Itami Act) because it was not run directly by the government, but by N-KIA (a corporation wholly-owned by the government) and the main purpose is to repay Kanku’s large debt. The total concession fee is approximately ¥2.2 trillion, and this is by far the largest PPP deal in Japan.

Roads
In principle, the current legal system regarding roads allows only certain limited types of entities such as local governments, local road public corporations founded by local governments, and certain highway companies to manage toll roads and collect tolls. With regard to national highways, highway companies were incorporated in 2005 under laws on highway privatisation, but they are still owned by the national government and local governments. Unlike airports, water and sewerage, special legislation is necessary to allow private entities to manage toll roads and collect tolls.

Aichi prefecture had been requesting the national government to deregulate the current system in order for the prefecture to use a PFI Act concession to privatise its roads, which are currently maintained by its local road public corporation, Aichi Prefectural Road Public Corporation (APRPC). A special legislation which enables local governments to implement toll road concessions passed the parliament in July 2015, and the government decided to apply the legislation to Aichi Prefecture’s toll road concession. APRPC began the bidding process for the concession of its toll roads of 8 lines and 72.5 km in total, together with construction of two new exits, two rest areas, and certain facilities in November 2015.

Water
In principle, water supply services are provided by municipalities. The water supply section of a municipality is deemed a local public corporation (LPC) which has a separate account from the general account of the municipality.

Many parts of the operation, such as the operation of filtration plants, the checkup of pipes, meter reading and water charge collection, have been separately outsourced to different private companies and some PFI projects have been implemented for the construction of filtration plants. However, there has been no project involving the privatisation of the management of the whole water supply system involving private financing and the transfer of responsibility to establish a long-term business plan.

However, the municipalities are facing a decline in water demands in parallel with the decline in population. In addition, the number of public personnel in charge of water supply operations is decreasing due to severe fiscal conditions that local governments are facing. At the same time, demand to renovate aging facilities is rapidly growing. Not a few experts point out the need for municipalities to make their water supply business more efficient by combining their water supply services with those of neighboring municipalities, and by privatising through PPPs.

The government continues to promote the PFI Act concessions of water supply services. For example, the government supports local government considering concessions by providing financial aid for research and advice by experts. The government also amended its rule for subsidies so the concessionaire can receive certain subsidies that LPCs are currently receiving.

Osaka City, the third largest city in Japan with a population of 2.6 million, has been considering the privatisation of its water services by utilising a PFI Act concession. However, it has been struggling to pass a local ordinance for the concession at the city assembly.

Nara City has been considering a PFI Act concession of its water supply services, but the city assembly rejected a local ordinance for the concession in March 2016.

Setting aside PFI Act concessions, some arrangements involving the outsourcing of a relatively wide range of operations to a private company or a third sector company have been implemented recently. For example, Kanagawa prefecture comprehensively outsourced its water supply operation in Hakone area to a private company. Examples of third sector companies are Mizu Mirai Hiroshima Corporation, a joint venture of Swing Corporation and Hiroshima Prefecture, and Kitakyushu Water Service, a joint venture of Kitakyushu City and several public company led by Yaskawa Electric Corporation and Metawater.

Sewage
The municipalities also provide sewage services. Unlike water supply services, however, the sewage service divisions of many municipalities receive financial support from the relevant municipality’s general accounts and the central government’s subsidies. Although it is more common for segments of sewage services to be outsourced, the issues faced by municipalities regarding their water supply services also apply to sewage services.

On March 31, 2014, MLIT published the guidelines for sewage concession, which reflected discussions of a study group on the utilisation of PPP/ PFI in the operation of sewage facilities set up by MLIT in December 2012. The guidelines clarify the interpretation of laws and regulations related to the sewage business and local governments, and are expected to help local governments consider concessions as a possible answer to their problems in the management of sewage systems.

Hamamatsu City will start the bidding process for the PFI Act concession of the operation of sewage facilities in the Seien area in May 2016. The facilities are currently managed by Shizuoka Prefecture, but Hamamatsu City will receive them from Shizuoka Prefecture in 2016 when the city annexes that area. The city decided to implement the concession because it is difficult to secure additional human resources for the facilities in light of its policy to reduce expenditures. The concession covers the operation of one water treatment plant and two pump stations, and the concession period will be around 20 years.

Conclusion
The government has shown a positive attitude towards PPPs with the hope of reducing its fiscal deficit and stimulating the economy, and has actually revised existing laws and legislated new ones. Although there are still some hurdles, the government is continuing to try to address regulatory hurdles and incentivise governmental agencies and local governments to adopt PPP methods. Accordingly, the number of the PFI Act concessions and other PPP projects is actually increasing. These recent trends demonstrate encouraging and exciting times for PPP in Japan.
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Masanori is the head of MHM’s banking and structured financing practice group. He advises across the board on structured finance transactions, both internationally and domestically, including PFI, project finance, REIT and syndicated loans. He has led teams advising on a number of high profile transactions, including the first Japanese publicly offered CMBS transaction, the securitisation of public loans originated by the Japanese government and whole business securitisations in a number of sectors. Masanori was educated at the University of Tokyo and the University of Chicago Law School.

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