

Is Japanese PPP/PFI set to take off?

Recent policy initiatives are expected to lead to a pipeline of new Japanese PPP/PFI projects. A concession for the operation of Sendai Airport will be launched within the next few months and the procuring authority has recently released the basic policy and the draft outline of the basic scheme. This briefing note discusses the Sendai Airport project and the government's current thinking, as well as further opportunities in the Japanese PPP/PFI market.

Introduction

In June 2013, the Abe government released the "Japan Revitalisation Strategy – Japan is Back" (the **Strategy**) and expressed the intention to implement its action plan in respect of Public Private Partnerships (**PPP**) and Private Finance Initiatives (**PFI**). The Strategy stated that the aggregate investment requirement for PPP/PFI projects would be JPY 12 trillion (approximately USD 120 billion) over the next 10 years.

Historically, the private sector's role in Japanese infrastructure projects has been limited mainly to the construction and financing of public assets, with a limited scope of service provision. The PFI Act¹ was amended in June 2011 to allow the government to grant concession rights to private operators for them to manage facilities and collect service fees from users (**Concession Type PFI**). However, despite more than two years having passed, no Concession Type PFI projects have been launched so far.

In an effort to stimulate this market, the government has implemented the following measures:

- New legislation has been enacted to allow private players to operate government-owned airports².
- New guidelines (the **New Guidelines**) for Concession Type PFI were released in June 2013³ to clarify the bidding process and design of such projects.
- In order to secure sufficient funds for infrastructure projects, a new infrastructure fund (Private Finance Initiative Promotion Corporation of Japan⁴) was established in October 2013 by the government together with Japanese financial institutions. The new fund has JPY 20 billion⁵ (approximately USD 200 million) at its disposal and is expected to provide mezzanine facilities for infrastructure projects.

¹ Act on Promotion of Private Finance Initiatives (Act No.117 of 1999)

² Without the following new legislation, Concession Type PFI would not be possible for airports: (i) Act on Operation etc. of State Owned Airports etc. by Utilisation of Private Abilities (Act No. 67 of 2013); and (ii) Act on Integrated and Efficient Installation and Operation of Kansai International Airport and Osaka International Airport (Act No. 54 of 2011).

³ http://www8.cao.go.jp/pfi/uneiken_guideline.pdf (Japanese only)

⁴ <http://www.pfipci.co.jp/> (Japanese only)

⁵ As of 17 December 2013

Sendai Airport – The First Concession?

Sendai Airport (a regional airport) looks set to become the first Concession Type PFI project under the Strategy. The Ministry of Land, Infrastructure, Transport and Tourism (**MLIT**) conducted market soundings in respect of the privatisation of Sendai Airport in November 2013⁶. On 13 November 2013, MLIT released the draft outline of the basic scheme⁷ (the **Outline**) which set out the outline of the project, basic principles regarding the terms and conditions of the concession, the requirements for bidders and the selection process for an operator. According to the Outline, the selection process will commence in April 2014 and the deadline for bids will be August 2014. The second stage of the process will be held in March 2015, with operation by the private operator expected to commence in September 2016.

According to the requirements for bidders, international investors are not excluded. However, given that the Outline has only been released in Japanese and a bidder would need to communicate with local governments and stakeholders, foreign investors would most likely wish to form a consortium with one or more Japanese companies to participate in the bid process.

The scope of the Sendai Airport Project includes the terminal and a parking business. The business of the current state-owned operator will be transferred to the new operator⁸. All employees are expected to be transferred to the new operator on employment terms no less favourable to the employees. Furthermore, certain technical experts and engineers such as air traffic control operators will be seconded by the government.

Although it is unclear what terms and conditions MLIT will suggest in the actual selection process, certain bankability issues are immediately apparent from the Outline.

- In case of a change of law for example, the Outline suggests that the government and the operator should 'discuss' issues, but does not clearly provide for the operator to have the right to an extension of the term of the project or revised terms of the relevant agreements.
- Another example is force majeure events such as earthquakes, floods and wars. Firstly, the Outline does not distinguish between natural disasters and political risks despite the fact that risk allocation would customarily be different – in particular, due to the limited availability/high cost of insurance for political risks. Also, upon the occurrence of a force majeure event, the Outline provides that the government will decide – based on discussions with the operator – how to deal with the project. The government has the option to (i) take over the project without paying any termination compensation if the damage cannot be remedied through insurance proceeds or (ii) extend the project period or revise the project agreement if the operation is disrupted for a certain period of time or the cost is increased due to the force majeure event. Otherwise, the operator must repair and reconstruct the facilities itself and continue the project within the existing timeframe.
- The Outline provides that the government can terminate the concession agreement with 6 months' prior written notice without cause. The government will indemnify the operator for its loss in accordance with the PFI Act. However, it is far from certain that such indemnification would be enough to repay the debt and to recover lost profits in respect of the remaining concession period. In non-concession type PFI projects, it is not uncommon for the government to agree to indemnify for loss incurred by the operator due to termination by the government without cause so that the operator can repay the debt.

The New Guidelines suggest that risks should be allocated to the party that can best manage the relevant risk and that risk allocation should be clearly documented. We expect that the detailed risk allocation and termination mechanics will be heavily negotiated and properly documented during the course of the actual bidding process in order to address these and any other bankability issues.

⁶ http://www.mlit.go.jp/koku/koku_tk5_000006.html (Japanese only)

⁷ <http://www.mlit.go.jp/common/001018629.pdf> (Japanese only)

⁸ Although an option for share transfer is also being discussed, for market sounding purposes the Outline assumes that a business transfer will take place.

Other Opportunities

The government authorities have also been discussing the possibility of a Concession Type PFI project for the Kansai International Airport and Osaka International Airport. These two airports are currently operated by one operating company⁹ and the authorities intend to grant a concession for a combined project. Press reports suggest that the bid process will be launched in summer 2014 with commencement of a concession during 2015. The size of the airports with their combined annual gross revenue of approximately JPY 120 billion (USD 1.2 billion) is much greater than Sendai Airport. However, the size of their current debt (approximately JPY 1.3 trillion) is an issue, which the government is trying to address. The current state-owned operating company has been making efforts to increase its revenue by inviting new low cost carriers and becoming a hub airport for international courier services with a view to maximising the concession price to pay off the entire amount of the debt through the proceeds of the concession.

Takamatsu Airport and Hiroshima Airport (both regional airports) have also been named as potential targets for privatisation while the Strategy also mentioned water PPP/PFI projects as a target for Concession Type PFI. The aggregate value of airport PPP/PFI and water PPP/PFI projects contemplated by the Strategy is estimated at JPY 2 – 3 trillion (approximately USD 200 – 300 billion).

There is significant need for investment in transportation infrastructure, both for renovations - of the Metropolitan Expressway for instance - and new developments, mainly targeted towards the Tokyo Olympics in 2020. The overall construction costs for the Olympic games, together with the infrastructure investments, are estimated at JPY 900 billion (approximately USD 9 billion). Such projects are also candidates for PPP/PFI projects.

Conclusion

Sendai Airport may be the bellwether for Concession Type PFI in Japan and the achievability of the JPY 12 trillion target set by the Abe government, and if so, the manner in which various risk issues are settled on the Sendai deal will inform future projects. How the Japanese risk-allocation model for infrastructure will develop and the extent to which it forges an independent path or borrows from other developed markets such as Europe or Australia remains an open question.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

⁹ New Kansai International Airport Company, Ltd. <http://www.nkiac.co.jp/en/>

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