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PROJECT FINANCE IN JAPAN

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"The domestic project finance market is limited in scale, and many Japanese banks are also actively participating in offshore project finance transactions."

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GTDT: What have been the trends over the past year or so in terms of deal activity in the project finance sector in your jurisdiction?

Naoaki Eguchi, Gavin Raftery & Yasuhisa Takatori: In 2013, the Private Finance Initiative (PFI) Promotion Office of the Cabinet Office announced an action plan for the fundamental reform of private finance initiative/public-private partnerships (PFI/PPP), setting a target amount for domestic PFI/PPP projects of between ¥10 trillion and ¥12 trillion (including concession-style projects (ie, projects in which the operating rights of government-owned facilities are assigned to a private company and the private company recoups its investment through service fees charged) in the amount of between ¥2 trillion and ¥3 trillion) for the 10-year period from 2013. This is a significant increase, considering that the total amount of such projects during the previous 14 years, from 1999 to 2013, was ¥4.1 trillion. The action plan stresses the importance of addressing aging infrastructure and disaster prevention or mitigation, and leveraging standalone-type PFI/PPP projects not reliant on tax as a source of funding.

With regard to projects outside the area of PFI/PPP, electrical power projects such as renewable energy projects play an important role in the domestic project finance market. The proliferation of renewable energy sources such as solar power and wind power as alternatives to nuclear power and fossil fuels is also valued in Japan, and a feed-in tariff (FIT) scheme for

the purchase of power generated by renewable energy sources was introduced in 2012. As the introduction of this scheme has secured the prospects of recouping investments in renewable energy power generation projects, the number of such projects, particularly photovoltaic (PV) power generation projects, has increased dramatically (as of December 2014, certified capacity under the scheme amounts to approximately 67,450 megawatts), and project financing for these kinds of projects has also increased accordingly. Furthermore, as part of the liberalisation of the electrical power market, Tokyo Electric Power Co, Inc and other regional utilities (which essentially had a monopoly over power production and transmission) have been encouraged to outsource newly planned thermal power generation projects. This move is expected to increase the number of thermal power generation 'independent power producer' (IPP) projects operated by the private sector, which will also require substantial project financing.

The demand for project finance is expected to continue particularly for PFI/PPP projects and electrical power generation projects. However, the majority of social infrastructure developments and renewable energy projects are small to medium in scale, and the concession and standalone-type projects for which large-scale projects are anticipated are limited in number. Given this situation, the domestic project finance market is limited in scale, and many Japanese banks are also actively participating in offshore project finance transactions. Along with

the Japanese government's policy to enhance assistance through ODA loans and ECA financing – adopted in the 2013 Cabinet Decision 'Strategy for the Revitalisation of Japan', and aiming to achieve infrastructure exports of approximately ¥30 trillion in 2020 (compared with ¥10 trillion in 2010) – project finance transactions for infrastructure projects in developing countries, particularly throughout the ASEAN community, are on the increase. Traditionally, major banks such as The Bank of Tokyo-Mitsubishi UFJ, Ltd, Sumitomo Mitsui Banking Corporation and Mizuho Bank, Ltd have been the major Japanese players participating in overseas project finance markets. However, recently we have also seen multiple regional banks participating in major overseas project finance transactions, such as the financing of the Nghi Son Refinery project in Vietnam in 2013. Furthermore, Resona Bank, Ltd, which has made steady progress in repaying injected public funds, is now resuming its overseas operations.

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GTDT: In terms of project finance transactions, which industry sectors have been the most active and what have been the most significant deals to close in your jurisdiction?

NE, GR & YT: With respect to PFI/PPP projects, the majority have been service payment-type social infrastructure development projects (primarily for educational and cultural facilities, medical facilities, government offices and rehabilitation facilities, etc), ranging from a few hundred million to a few billion yen. It has been said that many PFI-type social facility development projects merely defer the payment of infrastructure development costs by the government using tax as a source of funding, and PFI/PPP's original purpose of utilising private sector know-how to efficiently develop social infrastructure, and to provide less expensive and better quality services to the public, are not being sufficiently achieved.

Save for the Haneda Airport development project, there are hardly any standalone-type PFI projects where the operator bears market risks, such as demand risk and price fluctuation risk, without using tax as a source of funding. On the other hand, with respect to projects based on the concession scheme introduced in 2011, the government has set (in addition to the target figure we mentioned earlier) a specific numeric target to advance six airport projects, six water or sewage system projects, and one road project by the end of financial year (FY) 2016. In fact, the bidding procedure for the Kansai International Airport/Itami Airport project has commenced, and several other airport projects have also been running since last year. Among the concession-type projects, the Kansai/Itami project stands out in scale, as the Ministry of Land, Infrastructure and Transport envisages a concession price exceeding ¥2 trillion (however, the bidding deadline, originally scheduled for February 2015, was extended for three months because of a lack of bids).

In addition to the sectors described above, the PFI Act lists a wide variety of sectors as targets for PFI projects, such as railways, ports, rivers, parks, rental housing, waste treatment facilities, information and communications facilities, tourist facilities, research facilities, vessels, aircraft and satellites, and in the future, the PFI/PPP method may be employed in a wider range of fields.

Moreover, while the number is still limited, there have been cases of project financing for infrastructure projects executed outside the scheme of the PFI Act, such as tourist facilities, including Universal Studios Japan (1999) and the public-private cooperation for the reconstruction of Nakano Sun Plaza (2004).

In the field of power generation, project finance transactions for PV power producers

are increasing under the FIT scheme. However, the government is currently reviewing the FIT price and related schemes to address over-concentration in the PV power generation market and to promote offshore wind power, biomass energy, geothermal energy and other renewable sources. The utilisation of project financing is anticipated in these non-PV renewable energy fields. However, as they are relatively new in Japan, there are several issues that need to be addressed to establish a market. As for land-based wind power projects, a number of project financings, ranging from a few hundred million yen to a few billion yen, were successfully syndicated even before the introduction of the FIT scheme. One example is the Hibikinada wind power project. However, because of factors such as an increasing difficulty in securing suitable project sites for wind power generation projects, a significant increase in the number of projects is not expected in the future.

Furthermore, with progress being made in the liberalisation of Japan's domestic power market, including the separation of power production and transmission, an increase in thermal power generation IPP projects that rely on project financing is expected. These IPP projects are expected to be on an availability payment basis with electricity companies as off-takers.

It is worth noting that project financing in Japan has traditionally been used primarily for infrastructure development projects. While there has recently been a discussion on the mining of methane hydrate around the Sea of Japan, it is still at the surveying stage and commercialisation is expected to take a number of years.

GTDT: Which project sponsors have been most active in driving activity? Which banks have been most active in providing debt finance?

NE, GR & YT: Primary sponsors of PFI/PPP projects have been domestic construction companies, trading companies and real estate companies. However, overseas airport operators are also showing strong interest in large-scale projects such as the Kansai/Itami project, exemplified by the fact that 11 foreign enterprises, including the Macquarie Group, and overseas airport operators such as the operator of the Changi Airport in Singapore and Heathrow Airport in the UK have passed the bid screening.

Among renewable energy projects, because of the high FIT price, overseas renewable energy companies are actively involved as sponsors, in addition to domestic sponsors such as the trading companies, SoftBank Corp and Orix Corp. In the future, these entities are expected to engage in next-generation renewable energy projects, such as offshore wind power and biomass energy, as alternative investments to solar power. As for



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thermal power IPP projects, the existing electricity utilities, gas companies, trading companies, new power producers and suppliers are expected to act as sponsors.

For non-Japanese sponsors involved in Japan's infrastructure projects, the Macquarie Group has been active in this field and is already engaged in various infrastructure development projects, such as the Haneda Airport development project and toll road projects. Infrastructure projects in fields such as power generation, passenger transportation, railways and water systems are regulated under the Foreign Exchange and Foreign Trade Act of Japan, and prior notification is required for foreign sponsors to invest in these businesses. Japan does not have particularly strict foreign investment regulations. However, in the past, there have been discussions about strengthening regulations on foreign investments, for example when the Macquarie Group increased its equity holding in the operating company of Haneda Airport, and when The Children's Investment Fund tried to increase its shareholding in J-Power Systems Corp. In the latter case, the Ministry of Economy, Trade and Industry actually requested that the proposed increase be reconsidered. Save for these exceptions, there have been no particular moves to regulate foreign investments, and foreign investments are normally allowed, without any problems, after the

THE INSIDE TRACK

What three things should a client consider when choosing counsel for a complex project financing?

1. Knowledge and long-standing experience of working in the local market.
2. Government connections, which bring first-hand knowledge of front-of-line market issues
3. A well-balanced mix of local and international experts with first-hand experience dealing with complex matters on a dual-language basis.

What are the most important factors for a client to consider and address to successfully implement a project in your country?

A clear understanding of local market practices and expectations, and how they differ from other markets, is crucial to successfully implementing a transaction in Japan.

What was the most noteworthy deal that you have worked on recently and what features were of key interest?

We are currently advising an international airport operator on its participation in the bid for the Kansai/Itami airport concession. This will be the largest domestic project finance transaction to date, with an estimated value in excess of ¥2 trillion. It will also be the largest concession-type privatisation project run by the Japanese government and is expected to establish local market precedent for risk allocation in large-scale infrastructure projects in Japan.

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passage of the ‘no action period’ of approximately two weeks following the submission of the prior notification under the Foreign Exchange and Foreign Trade Act.

As for lenders, in addition to major private sector financial institutions such as Mizuho Bank, Ltd, The Bank of Tokyo-Mitsubishi UFJ, Ltd, and Sumitomo Mitsui Banking Corporation, the Development Bank of Japan (DBJ), which is a public financial institution, is active in both PFI/PPP projects and power generation projects. Of these projects, major banks and the DBJ tend to play a central role in state and large-scale projects, and regional financial institutions tend to play a central role in regional projects. Except for certain limited cases, participation by overseas lenders in domestic PFI/PPP transactions has been limited. This may not necessarily be due to schematic hurdles but to the fact that sufficient debt liquidity is provided by domestic banks. However, recently, lending by foreign lenders, especially to international sponsors for PV power generation projects, has increased, along with the number of international sponsors.

GTDT: *What are the biggest challenges that your clients face when implementing projects in your jurisdiction?*

NE, GR & YT: Among PFI/PPP projects, facility development-type PFI projects have relatively low project risks, but also have low profitability. In addition, with regard to regional projects that constitute the vast majority of domestic PFI

projects, many municipalities are inexperienced with PFI. They also are not incentivised to use PFI for facility developments, as financing public projects through municipal bonds is less expensive and the structure is less complicated. Thus, PFI projects that are attractive as investment targets have been rare. From this standpoint, there is growing attention being given to concession-type projects. As noted, multiple airport concessions have already entered the bidding phase, and water and sewage system projects and toll road projects are also expected to be conducted. Also, to establish concession rights over toll roads, amendments to laws allowing operators to collect fees for the use of toll roads will be required (while there is a concession project on toll roads in progress, this is an exceptional case as this project is based on a special law).

Among renewable energy projects, a drop in the number of new PV power generation projects is anticipated, due mainly to increasing difficulty in securing land for large-scale PV projects, and a downward trend in the FIT price. In the future, an increase in alternative power sources such as offshore wind power, biomass energy and geothermal power is expected. However, for offshore wind power, issues such as the environmental impact assessment, the treatment of fishery rights and the installation of transmission wiring and submarine cables suitable for wind power generation remain. As for biomass energy and geothermal power, issues such as fuel procurement risks and development restrictions based on the Natural Parks Act and other laws

could also be a concern. These items require attention from a bankability standpoint.

Thermal power generation IPP projects to be outsourced by regional electricity utilities such as Tokyo Electric Power Co, Inc, will be on an availability payment basis, and while the sponsors will not bear any market risk, they will take the credit risk of the electricity utilities (which are structured as normal joint stock companies rather than public agencies) as off-takers.

Also, the development of power grids (wide-area interconnection and expansion of capacity) has been an issue for the domestic power industry as a whole. In particular, with the surge of PV power generation, certain electricity utilities with insufficient interconnection capacity (including Hokkaido Electric Power Co, Inc, Kyushu Electric Power Co, Inc, and Tohoku Electric Power Co, Inc) are permitted to enforce (limitless) output restrictions without compensation to operators for projects commencing after a certain date. While such output restrictions without compensation are currently only for PV power generation projects, the possibility of such restrictions being extended to other power source types and general utilities cannot be denied, and hence attention should be given to future developments.

GTDT: Are there any proposed legal or regulatory changes that may give rise to new opportunities in project development and finance? Do you believe these changes will open the market up to a broader range of participants?

NE, GR & YT: Regarding PFI/PPP projects, the guidelines were recently revised to simplify procedures applicable to facility development-type PFI projects, which may produce an increase in regional PFI projects. As to concessions, airport and water and sewage system concession projects commenced recently. New legislation to allow concessions for toll roads is also drawing attention.

Pursuant to the 2013 amendments to the PFI Act, a public-private infrastructure fund was established with the government's injection of ¥10 billion in 2013 to assist market risk-bearing PFI/PPP projects such as standalone-type PFI projects and concession-type projects. Contributions of risk money such as subordinated loans and investments are expected to be the catalyst for private sector funds in market risk-bearing PFI/PPP projects. In addition, the national government secured ¥300 billion in FY 2013 to provide government guarantees to the private sector by extending loans to the fund, and this amount is expected to increase in the future.

With respect to the power generation sector, the FIT price will be modified annually, and minor adjustments to the scheme for the establishment

of renewable energy power production projects will continue. For example, the Ministry of Environment is currently preparing rules for environmental impact assessments for the introduction of offshore wind power generation projects. In addition, with respect to the Hokkaido and Tohoku districts, where the expansion of wind power generation projects is expected because of their strong and stable winds, but where a lack of transmission capacity has been identified, the Ministry of Economy, Trade and Industry has designated these areas as specified wind power intensive development zones and has begun transmission grid developments. There has been a growing interest in the progress of these efforts.

Furthermore, electricity market reform, including the deregulation of the market and the separation of power production and transmission and distribution, is currently in progress, and an increase in grid management and power transmission and distribution businesses along with an increase in privately operated thermal power generation IPP projects is expected. Electricity company bonds were the main mode of financing for these businesses. However, these may be replaced with project financing by private banks and the DBJ in the future.

GTDT: What trends you have been seeing in terms of range of project participants? What factors have influenced negotiations on commercial terms and risk allocation? Are there any particularly innovative features?

NE, GR & YT: As noted, the main sponsors for project finance transactions in Japan are domestic enterprises, and the main lenders are domestic commercial banks and the DBJ. However, we have seen an increase in foreign investors in renewable energy projects and large-scale concession-type projects.

Facility-type PFI projects usually involve post-construction completion financing where the completion of construction is one of the conditions precedent to financing. After the completion of construction, debts may be collected from the purchase price to be paid by public authorities, and thus normally no sponsor support for ongoing business risks is required. Given the low risk profile, a debt-equity ratio of approximately 9:1 is seen in many of the cases. Force majeure risk is typically borne mostly by the public sector, with only a small portion being borne by private operators. The public sector will generally bear the risk of changes in specific laws and regulations directly related to the project, while the private sector bears the risk of other regulatory changes.

On the other hand, while there are not too many cases of stand-alone PFI projects in Japan, government support for revenue risks is generally not expected. For example, no government



"The Tokyo Stock Exchange is planning a market for listed infrastructure funds investing in renewable energy projects and concession projects."

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support for revenue risks has been given in the Haneda Airport development project or the airport concession projects for which the bidding process has begun. However, in such ongoing airport concession projects, force majeure risk not covered by insurance is borne by the government (in the case of the Kansai/Itami project, by a government-affiliated operating company), and an approach similar to that taken in facility-type PFI projects is adopted for regulatory change risk.

Most new thermal IPP projects are expected to operate on an availability payment basis with electricity companies as off-takers, and hence no revenue risk support is envisaged. However, depending on the creditworthiness of the EPC contractor, construction completion support may be required. Furthermore, although off-takers have strong relationships with the government, they are ordinary joint-stock companies, and their creditworthiness should be taken into account.

GTDT: What are the major changes in activity levels or new trends you anticipate over the next year or so?

NE, GR & YT: The first full-fledged airport concession project in Japan is expected to be implemented in FY 2015, and it is anticipated that this will trigger concession-type projects in water and sewage systems and toll roads. In the field of renewable energy, since the domestic PV market is already crowded and there are fewer prospects for new investments, a gradual shift towards wind, biomass and geothermal energy power production is anticipated. However, these sources have higher business risks than PV power production and it may take time to establish standard practices. While no dramatic increase in new investments for PV power generation is expected, we may see an increase in the acquisitions of existing PV power generation projects as investors look to capitalise on the stability provided by the FIT scheme.

In addition, the Tokyo Stock Exchange is planning a market for listed infrastructure funds investing in renewable energy projects and concession projects, and we hope the development of such markets will see more financial investors investing in infrastructure projects, as well as the development of a secondary market for domestic infrastructure. Furthermore, infrastructure investments as alternative investments by institutional investors such as the Government Pension Investment Fund, which manages approximately ¥137 trillion of public pension funds, and insurance companies are receiving increasing attention.