Utilizing Private Capital: Opportunities for Public Private Partnerships (PPPs) and Private Finance Initiatives (PFIs) in Japan

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November 7, 2011

Abstract

In this paper, we summarize the background, outline, and future outlook of the Private Finance Initiative (PFI) Act Amendment which passed the Japanese Diet at the end of May 2011. The motivation to amend the PFI Act was to utilize private sector expertise and capital instead of government expenditures in order to deliver public infrastructure and public services under the burden of Japan's enormous fiscal deficit and public debt outstanding and also to facilitate the restoration of public infrastructure and services after the Tohoku earthquake. Although the PFI Act was originally enacted in 1999, the Public Properties Administration Laws constrained the use of PFIs in economic infrastructure sectors such as airports, toll roads, seaports, and water and sewerage systems. The amendment now gives governments the ability to offer "concession contracts," the first new "real right" in Japan's civil code in 55 years, and allows private companies and investors to manage various public facilities including economic infrastructure. Currently, the Government of Japan has started creating model cases using the new PFI method, including a project involving all 29 airports managed by the national government and projects involving water and sewerage systems owned and operated by local governments. Additionally, projects for the restoration of the Sendai airport and water and sewerage systems in the Tohoku region utilizing the PFI are also being planned. From the viewpoint of financial markets, Japanese institutional investors are showing a high interest in investing in domestic infrastructure. Consequently, in Japan in the near future, money flow should be generated from the private sector to public infrastructure.

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1. Introduction

At the plenary session of the House of Representatives held on May 24, 2011, an amendment to the PFI Act (Act on Promotion of Private Finance Initiative) was passed. Since the 1990s, private finance initiatives have increasingly been utilized in major countries around the world, including the UK, Australia, and Republic of Korea. In Japan, the PFI Act was originally passed in 1999 as legislation submitted by House members, and the system has been in use since then.

This was not the first amendment to the Act; in fact, it had undergone several revisions since its enactment in 1999. The amendment this time, however, was so wide-ranging and far-reaching, that it constituted a fundamental change from its enactment. In addition to improvements to address the issues that had been pointed out, several schemes were newly incorporated into the Act that were drastically different in spirit from the existing PFI schemes.

In this paper, we discuss the background of and events leading to the amendment, as well as specific details and expected effects of the amendment.

2. Background of the 2011 Amendment to the PFI Act

2.1. Discussions at Growth Strategy Council of the Ministry of Land, Infrastructure, Transport and Tourism (MLIT)

The work towards the 2011 amendment of the PFI Act was initiated by the issues raised at the Growth Strategy Council which was established in October 2009 by Seiji Maehara, then Minister of Land, Infrastructure, Transport and Tourism (MLIT), and chaired by Yasuchika Hasegawa, President and Representative Director of Takeda Pharmaceutical Company, Ltd.

The meetings of the Council were held 13 times between October 26, 2009 and May 17, 2010. In principle, the Minister, Vice Ministers, and the Parliamentary Secretaries attended all the sessions and positive discussions were held over the direction of the Council. It is worth noting that the clear indication of direction put forward by the ministers made it possible for the whole Ministry to move towards reforms, which had been considered difficult in the past, and for discussions to be conducted even on details.

2.2. Substantial Increase in Replacement Investment of Social Capital, and Fiscal Problems

The discussions at the Council mentioned above had, as their underlying assumption, the financial resource problems of public works, which are briefly described below.

Figure 1 shows the estimates presented in the *White Paper on Land, Infrastructure, Transport and Tourism in Japan, 2009,* which was published in 2010.

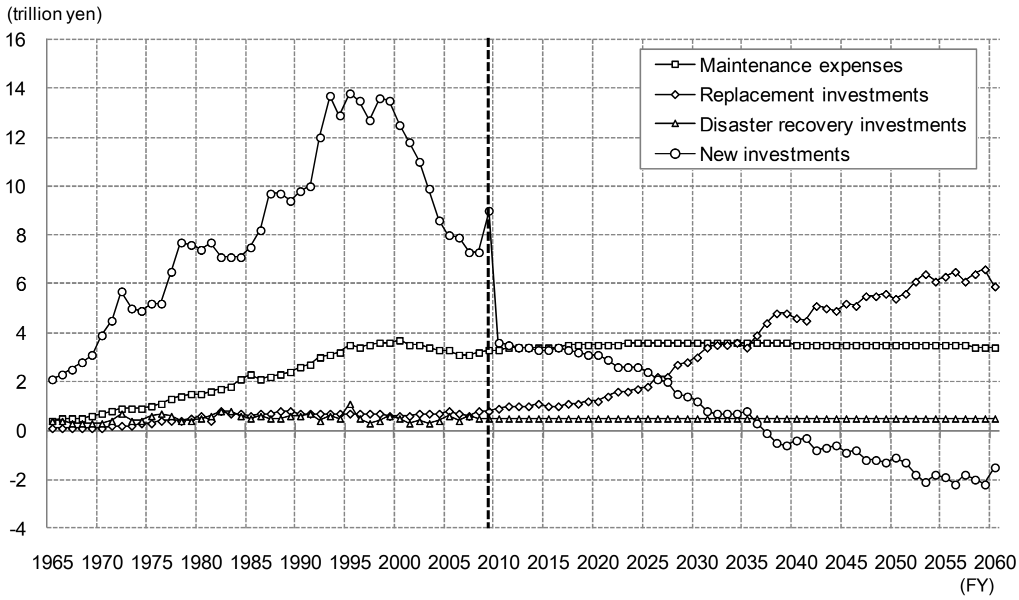

Figure 1: Estimated Replacement Investments in Social Capital

Note 1: Estimates for eight areas of infrastructure stock, including roads, ports, airports, public rental accommodations, urban parks, sewerage systems, flood control, and coastal protection.

Note2: The amount of new investment, which is allocable to new facilities, is total investable amount less maintenance, replacement, and disaster recovery investment.

Source: Prepared from *White Paper on Land, Infrastructure, Transport and Tourism in Japan, 2009*.

The assumptions underlying the above data are that Japan's public works budget will remain flat in the future, and that the amount allocable for new facilities will be the budget amount less obligatory expenses including maintenance, replacement, and disaster recovery investment. Accordingly, the sharp increase in replacement investment from around 2020 will reduce the budget available for new facilities, and by the mid-2030s, the latter will be negative. The data conveys a sense of pending crisis that the current budget level will soon be insufficient to maintain and replace the country's social capital. Furthermore, Japan will have to allocate more and more of its budget to social welfare, in view of its rapidly aging society and low birthrate. The situation is therefore all the more serious, as the budget for infrastructure will have to compete with such social expenses for a limited budget. The premise behind the discussions of the Growth Strategy Council was therefore to identify means to maintain and operate essential social capital of Japan given these conditions.

Naturally, there were varied discussions at the Council meetings. For example, one of the measures now in place is to carry out well-planned maintenance on social capital to prolong its life and defer replacement investment. Together with such measures, the private financial initiative (PFI) scheme came to attract attention. This is because, unlike the traditional taxpayer-funded public works, PFI can be used where social capital has identifiable beneficiaries who can be positively made to bear the cost of such capital. Such projects are carried out with private funds and not with taxpayer money, thus solving the issue of limited fiscal resources.

2.3. Problems with Traditional PFI Schemes

According to the Cabinet Office, 366 PFI projects have been implemented in Japan from 1999 when the original PFI Act came into effect to the end of 2010, for a sum of about 4.7 trillion yen. As the schemes grew more popular, their problems also became evident. The biggest problem was that the PFI projects were heavily skewed towards certain types of schemes and certain areas of business.

For example, some 70 percent of PFI projects in Japan were of the service-purchasing type, and some 70 percent were of the build-transfer-operate (BTO) type. This combination of spending and asset ownership is in principle very similar to an installment sale in the private sector. The government, as buyer, is obliged to pay in installments the whole development cost to the operator. Although projects utilizing this scheme may be run more efficiently than as purely public projects, from a financial perspective, the government still carries the burden of their financial risk. This is why PFI projects have been sarcastically called 'the hidden debt of the government.'

Not only the types of schemes used, but also the concentration of PFI projects in certain fields is problematic. At the top of the list of permitted fields spelled out in the PFI Act are "public facilities including roads, railways, ports, airports, rivers, parks, water supply systems, sewerage systems, and water systems for industrial use."

However, with the exception of very few projects such as the Haneda Airport International Terminal Development Project, there has been no project in any of these fields. Instead, implemented projects are primarily in the fields of educational and cultural facilities as well as government buildings and staff housing buildings. As a result, the PFI Act has been criticized as a tool to develop public buildings.

The underlying problem is the incoherence of the PFI Act with existing laws and regulations. In 2002, MLIT published a notice clarifying the position of PFI operators with regard to the Public Properties Administration Laws. This notice addressed the relationship of the PFI Act with the Public Properties Administration Laws such as the Road Act and Sewage Service Act, which regulate various types of public infrastructure. The notice stated that the Public Properties Administration Laws did not preclude commissioning of the routine works with strict specifications of public property administration to private bodies. In other words, private bodies were only allowed to accept commissioning of the routine works with strict specifications. This means that these laws were not coherent with the expectations for the utilization of private bodies; it was not possible for private companies to act with discretion and take responsibility for the management of the operations. This is one reason for the skewed concentration in building projects, particularly in the construction of buildings.

As stated above, during the nearly ten-year history of Japan's PFI Act, the successes and limitations of PFI have started to become evident. In particular, from the perspective of expectations for PFI as a tool to overcome fiscal constraints, the service-purchasing type PFIs have only limited utility, as the financial burden of these PFIs continues to be ultimately borne by the government. The big issue that needed addressing was solving the institutional problems causing the skewed project schemes and business fields and broadening the applicable fields.

2.4. Development of Discussions

Although the discussions were started at MLIT with background and awareness of issues as described above, it was the Cabinet Office that was actually responsible for the PFI Act.

Accordingly, MLIT Minister Maehara and Keisuke Tsumura, the then Parliamentary Secretary in charge at the Cabinet Office, coordinated with each other, and determined that the PFI Project Promotion Committee (chaired by Fumiaki Watari, Senior Executive Advisor, JX Holdings, Inc.) of the Cabinet Office would also start discussion. The meetings of the Committee were attended by Takashi Nagayasu, the then Parliamentary Secretary in charge at MLIT, who provided feedback to the Committee on discussions at the International Expansion and Public-Private Partnership Sector Working Group of the Growth Strategy Council. Thus, the Cabinet Office and MLIT established a structure through which they were able to work jointly on the issue.

Finally, on May 17, 2010, the Growth Strategy Council of MLIT issued its proposal, and on May 18th, the PFI Project Promotion Committee of the Cabinet Office published their interim summary. In the end, these proposals made their way to the New Growth Strategy of the DPJ government which the Cabinet adopted in June 2010. The New Growth Strategy designated the amendment of the PFI Act as one of the 21 national strategic projects.

The business integration of Kansai International and Osaka International (Itami) Airports emerged as one promising project to utilize the revised PFI Act. It was agreed upon between MLIT Minister Maehara and Toru Hashimoto, Governor of Osaka Prefecture, in April 2009. The framework of the project was determined based on the discussions at the Aviation Sector Working Group of the Growth Strategy Council, and eventually included in the New Growth Strategy.

3. Turning the Proposals into a Bill and Summary of the Amended PFI Act

3.1. Discussions Leading to Amendment Bill

In response to the Cabinet decision on the New Growth Strategy, work commenced on drafting the bill to put the strategy into effect. The work itself was mainly performed by the Cabinet Office, which was responsible for the Act, but many ministries came to be also involved, including MLIT, Ministry of Internal Affairs and Communications, Ministry of Justice, Ministry of Finance, Ministry of Health, Labor, and Welfare, Ministry of Agriculture, Forestry and Fisheries, and Ministry of Economy, Trade and Industry. One reason for the wide ministerial involvement was the PFI Act’s objective to create across-the-board exceptions to the Public Property Administration Laws under the responsibility of a broad range of ministries. In addition, other ministries and agencies in charge of the various procedures related to the Public Accounting Act, Local Autonomy Act, Civil Code, etc. had to be also involved, making it an extremely arduous task.

Accordingly, in addition to coordination work performed by the PFI Project

Promotion Office of the Cabinet Office, which was the responsible section of the government, the Growth Strategy and Economic Measures Project Team of the ruling Democratic Party of Japan (chaired by lower house member Masayuki Naoshima) assumed the role of urging ministries and agencies to draft the bills based on the New Growth Strategy.

With such urging from both the political and administrative sides, the bill was decided upon at the Cabinet meeting on March 11, 2011 (the day of the Great East Japan Earthquake), and presented to the House of Councilors on April 1 to be passed on April 20. It was passed by the House of Representatives on May 24, and was finally promulgated on June 1.

3.2. Summary of the Concession System

With such background, the amendment to the Act introduced the concession system (right to operate public facilities), which is summarized in figure 2. Private operators to whom the right to operate public facilities is granted are now able to set fees within a certain range, collect the fees directly from the users, and manage the infrastructure in most fields, with a few exceptions such as toll roads that will be described later.

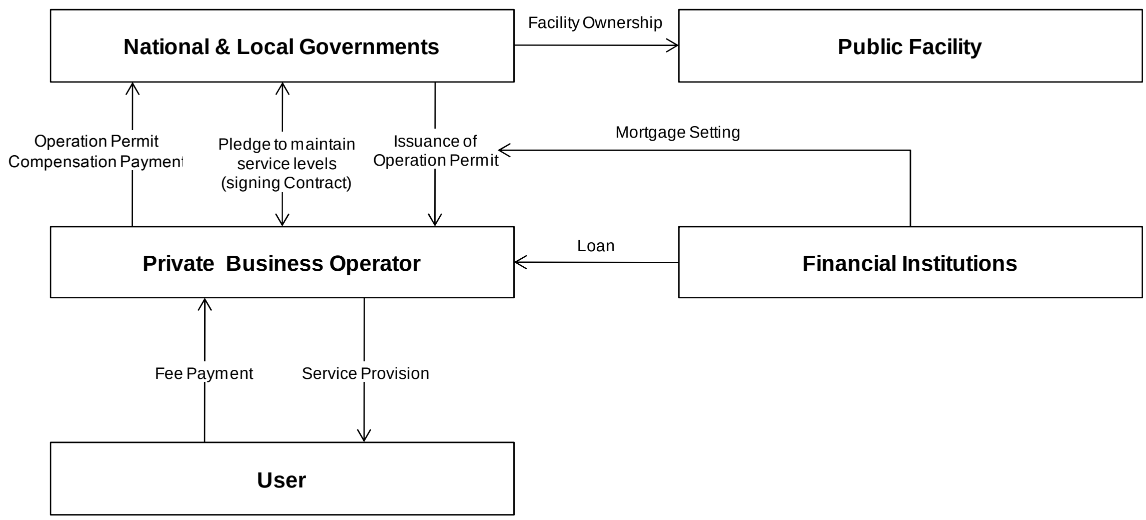

Figure 2: Summary of Concession System

The right to operate the public facilities is given as an intangible asset, and the private entity owning the right is able to obtain exemption from the municipal tax on real estate and real estate acquisition tax, putting it on equal business footing with governments and government bodies that are not subject to these taxes.

Legally, the public facilities operation right is designated as a ‘real right’, which is possible to be mortgaged. In terms of tax accounting, the right may be amortized equally over the contract period, which makes it easier for the operator to obtain funds from financial institutions.

In addition, as the public facilities operation right is only a right to run the facilities and does not involve the transfer of assets to the private sector, the operator of the facilities enjoys the benefit of not having to face the issue of repayment of subsidies, which would be the case if the facilities were built with subsidies and then sold.

Furthermore, various new measures that had not been available have been incorporated into the Amendment. It is now possible to second to the private operator government employees who have been engaged in the operation of the subject PFI facility and have operational expertise. A proposal system for private operators has also been newly established.

3.3. Projects to Which the Concession System can be Applied

The amended PFI Act stipulates that the concession system is applicable to all public facilities that collect fees from users.

In practice, however, coherence with the above-mentioned Public Properties Administration Laws can always be an issue. In this regard, answers by the ministers in charge, etc. to questions in the Diet have made the picture fairly clear. In principle, the concession scheme can be applied to any field other than toll roads and airports. Specifically, material prepared by the Cabinet Office and presented to the Democratic Party of Japan in February lists 14 applicable fields (although detailed conditions are attached to each): water supply services, medical facilities, social welfare facilities, fishing harbors, central wholesale markets, industrial water services, heat supply facilities, parking lots, urban parks, sewerage systems, rental accommodations, railways (including track), harbors, and waste water treatment systems. In addition, a report published in July 2011 by the Committee on the Airport Operation, an expert committee on airports established by MLIT, proposes to enable the utilization of the concession system in airport operation, including local airports. This is expected to become possible after the amendment of relevant laws.

4. Future Development

4.1. Project Formation

With regard to future project formation, airports are the field where the utilization of public facilities operation rights under the amended PFI Act progressed furthest. In addition to the aforementioned business integration project of Kansai International and Osaka International (Itami) Airports already under study for some time, the Committee on the Direction of Airport Management proposed in July 2011 to utilize the public facilities operation rights at 27 airports managed by the central government, including some type I airports, such as Haneda, New Chitose, Fukuoka, Sendai, and Hiroshima Airports, and all type II-A airports.

In parallel with the government's efforts, the local governments are also working on project formation. Specifically, it will be important to watch the applications submitted in response to the invitation for ideas that MLIT floated in May 2011. This invitation was to determine how the Ministry would use some 700 million yen to support project formation that it had secured in the original FY 2011 budget. By the closing date in June, some 150 proposals had been filed, most notably for water supply services, sewerage systems, public rental accommodations, and housing corporations, including over 20 for implementation of businesses utilizing the public facility operating rights. In August, eleven proposals were selected from as model projects, and studies on their implementation are now underway.

Although no official statistics are available, according to our calculations the book value of the stock of fee-charging infrastructure projects owned by the central and local governments amounts to well over 100 trillion yen **(**table 1**)**. Although the projects now being studied cover only a tiny portion of these facilities, in view of Japan's expected fiscal situation it will be unavoidable over the medium-term to utilize these facilities as a source of revenue and to manage them more efficiently. The concession system aims to utilize private sector vitality to generate various advantages thereby contributing to the improvement of the fiscal situation and offering better services for users. It is hoped that the introduction of this system will trigger efforts by private entities towards that purpose.

Table 1: Major Fee-Charging Domestic Infrastructure Projects

(Unit: Trillion Yen)

Type		Assets	Liabilities	Fee Receipts
Airport	Nationally managed	1.32	0.91	0.11
	Narita, KIX, Chubu	3.52	2.62	0.34
	Local govt. managed	N/A		
	Terminal buildings			
Toll Road	NEXCO	41.4	34.3	2.3
	Local public corporations	5.3	4.2	0.23
Sewerage Service		31.7	12.7	1.29
Water Service		31.1	9.7	2.80
Maritime Port & Harbor	Piers owned by public corporation	0.28	0.21	0.04
	Ports & harbors managed by public corporation	0.49	0.66	0.03
Public Subway		6.7	3.1	0.58
Total		121.81	68.4	7.72

Source: Prepared from the Council of Transport Policy, Financial Reports of Individual Airport Companies, Japan Expressway Holding and Debt Repayment Agency, Akai and DIR (2007), Annual Reports of Local Public Corporation, and Port Public Corporations.

4.2. Needs of Financial Investors to Invest in Infrastructure

Financial investors in Japan have expressed high hopes for these new investment opportunities. In November 2010, the Ministry of Economy, Trade and Industry conducted a survey on investment in infrastructure funds among some 1,600 pension funds, insurance companies, and other financial investors in Japan (as many as 514 parties responded). Figure 3 shows the result of this survey.

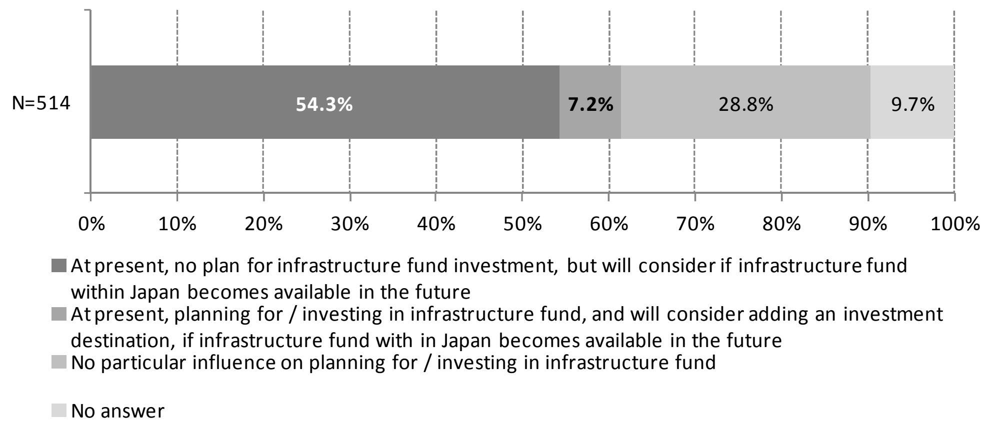

Figure 3: Intention to Invest in Infrastructure Projects in Japan

Source: Ministry of Economy, Trade and Industry (METI), Government of Japan

One question in the survey was whether investors would invest in infrastructure funds that invested in domestic infrastructure projects, if such funds were set up. As many as 54.3 percent of respondents said that, although they were not investing in infrastructure funds at the moment, they would consider doing so if such funds investing in projects in Japan were set up.

In addition, 7.2 percent of respondents said that they were currently investing in infrastructure funds or were considering doing so, and that they would also consider funds investing in projects in Japan as investment candidates, if such funds were set up. The survey results clearly show that the number of investors in infrastructure funds would increase drastically, if funds investing in domestic infrastructure projects were newly set up, in addition to the existing funds that mainly invest in overseas projects.

As indicated, financial investors are rapidly improving their understanding of such investment opportunities and their needs for such investments are also rising. If the government continues creating projects, a new financial system will emerge.

5. Conclusion

As described, the amended PFI Act has overcome the limitations of the original Act, and now offers a system that can help improve efficiency in managing a wide range of infrastructure projects owned by the central and local governments, and alleviate the hardship of restructuring its fiscal situation that Japan will very likely face in the near future. Furthermore, utilization of the new PFI scheme can generate a new industry and a new financial system, as discussed in the preceding section.

However, laws are just laws, and the issue is how to take advantage of the revised law effectively. It cannot be denied that for Japan’s administrative bodies that relied heavily on simple fund-raising means such as government bonds and municipal bonds, the new system will appear very complicated and hard to adopt. The proposal for the New Growth Strategy included the establishment of a PFI support organization to address this issue, calling for an expert organization to help especially local governments utilize the PFI system. But there is no sign that such a body is being planned at the moment.

If Japan finds itself really in a bind fiscally, there will be an avalanche of projects using this scheme. It goes without saying, however, that it is much better if the scheme is utilized in a voluntary reform effort and gradually gains in popularity. In order to achieve this, we hope to see a system established that makes maximum use of measures stipulated in the amended PFI Act, such as the Council for Promoting Projects Utilizing Private Funds, and also to see the PFI support organization set up as soon as possible.

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