



# Financial Risks in PFI Project

## A Case Study of Bankrupt Projects in Japan

World Bank / KDI Conference  
Seoul, Korea  
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# *History of PFI in Japan*

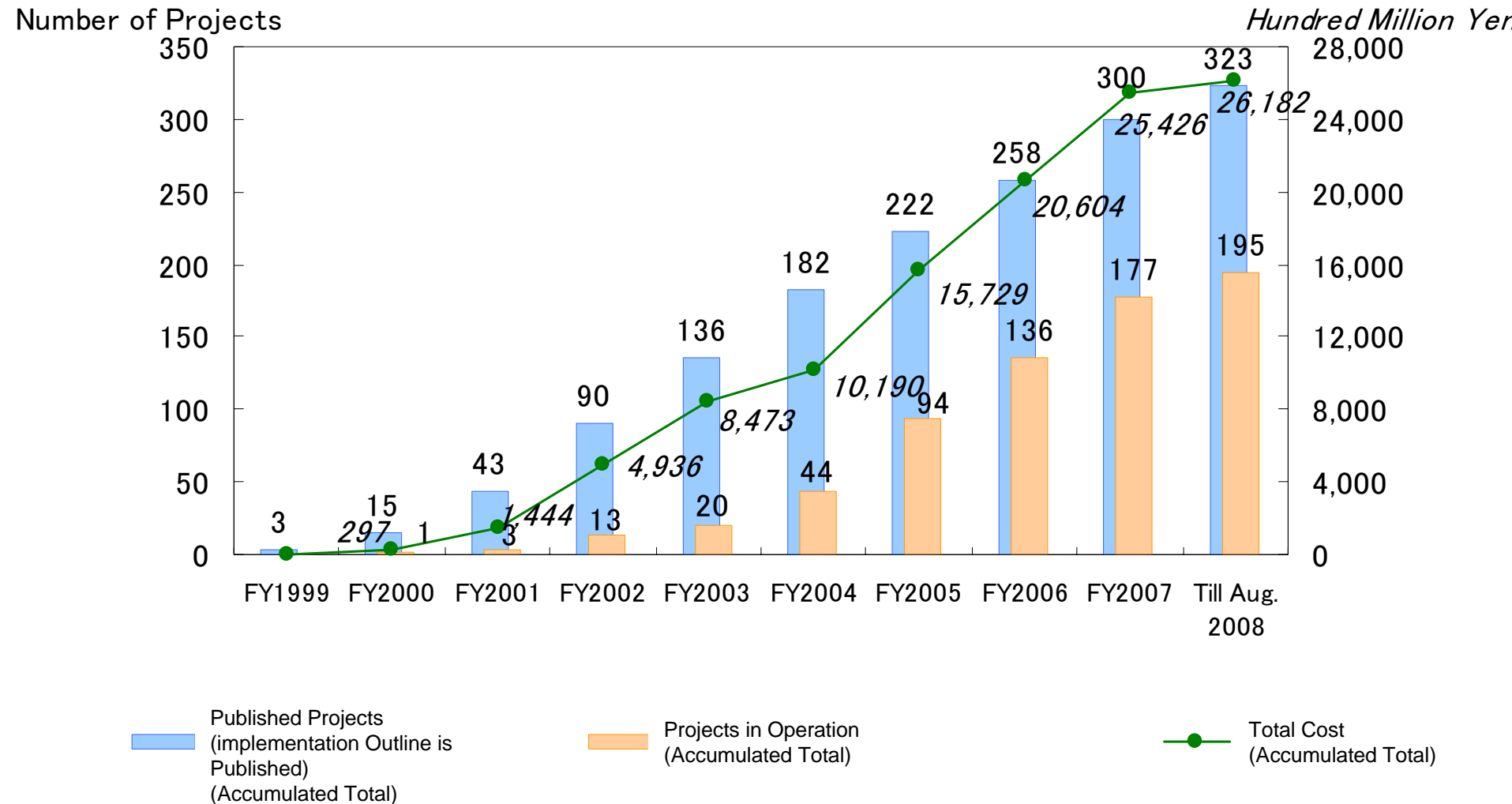
## **History Chart**

- Jul. 1999 Enactment of “PFI Law”
- Oct. 1999 Creation of “The Committee for Promotion of PFI” in the Prime Minister’s Office
- Mar. 2000 Drawing up “Policy Framework”
- Jan. 2001 Release of “Process Guideline” and “Risk Sharing Guideline”
- Jul. 2001 Release of “VFM Guideline”
- Dec. 2001 Revision of “PFI Law”
- Jun. 2003 Release of “Contract Guideline” and “Monitoring Guideline”
- Jun. 2004 Release of “Interim Report of the committee for promotion of PFI”
- Aug. 2005 Revision of “PFI Law”
- Nov. 2006 “Procedures for Selection of and Agreements with Private Companies for PFI Projects,” an arrangement paper by the directors of the PFI Liaison Committee of Relevant Ministries and Agencies
- Dec. 2006 Issue of Annual Report 2005(the 1st Annual Report)
- Jun. 2007 Revision of “VFM Guideline” and “Process Guideline”
- Nov. 2007 Release of “Report of the committee for promotion of PFI”
- Jul. 2008 Revision of “VFM Guideline”



# Growth in Number and Cost of Projects

Cabinet Office, Government of Japan





# Number of Projects in Each Fields

Cabinet Office, Government of Japan

Fields	Administrator			Total
	State	Local	Other	
Education and Culture (e.g. school, library, etc.)	1 (1)	75 (40)	28 (27)	104 (68)
Life and Welfare (e.g. facility for social welfare for aged, etc.)	0	15 (12)	0	15 (12)
Health and Environment (e.g. hospital, waste disposal facility, etc.)	0	54 (35)	2	56 (35)
Industry (sightseeing facility, etc.)	0	14 (7)	0	14 (7)
Town Development (parks, etc.)	6 (2)	30 (23)	0	36 (25)
Public Safety (police office, prison, etc.)	6 (4)	13 (5)	0	19 (9)
Government building and accommodation	39 (16)	4 (3)	1 (1)	44 (20)
Others (e.g. complex facilities, etc.)	2	33 (19)	0	35 (19)
<b>Total</b>	<b>54</b> <b>(23)</b>	<b>238</b> <b>(144)</b>	<b>31</b> <b>(28)</b>	<b>323</b> <b>(195)</b>

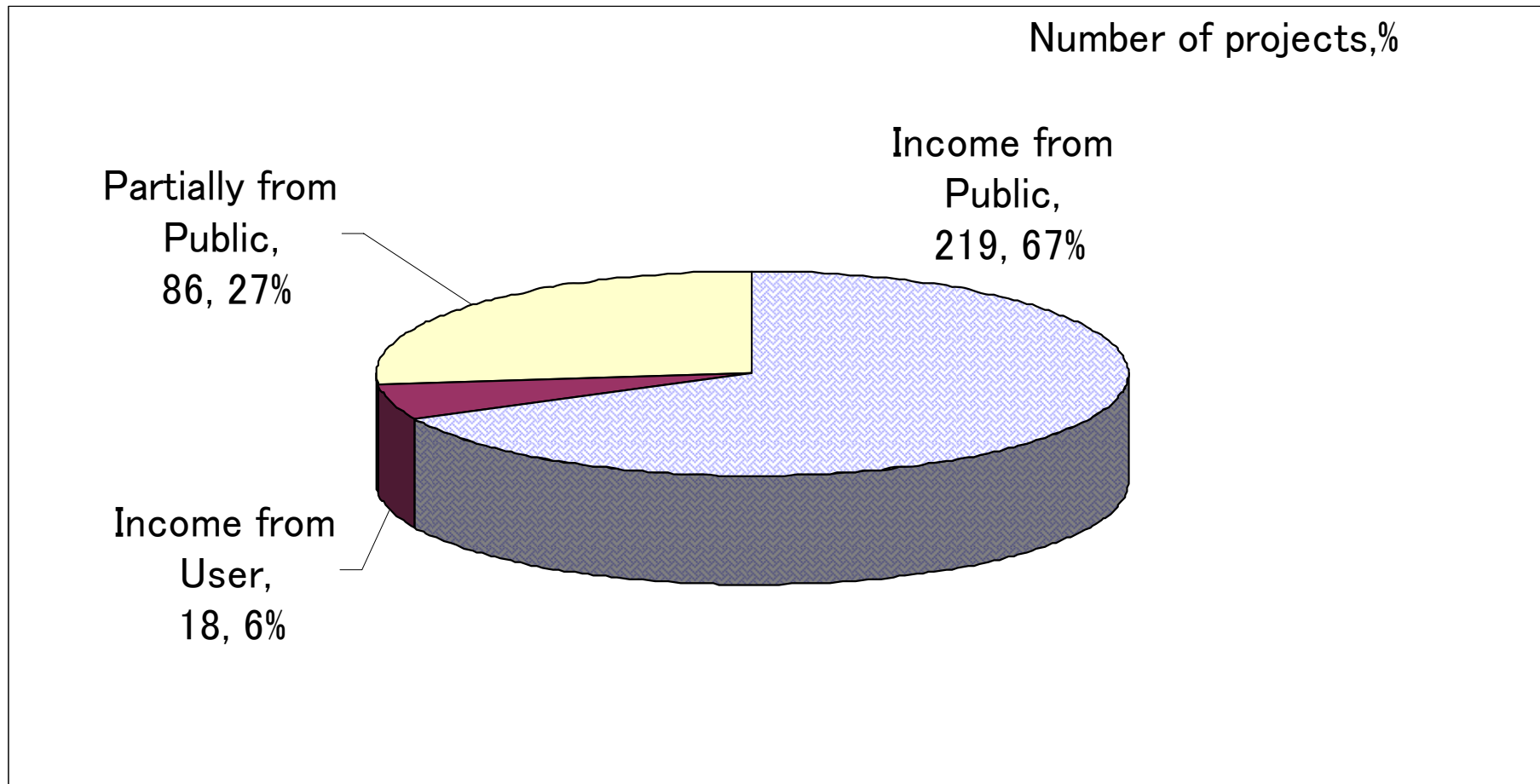
Number of facilities (number of projects in service)

(As of End of Aug. 2008) 3



# *Types of Gaining Income*

- Income-from-Public projects represent nearly 70 percent of all projects.





# *The Number of Projects in Each Fields*

## *(Fully / Partially Income from User)*

Cabinet Office, Government of Japan

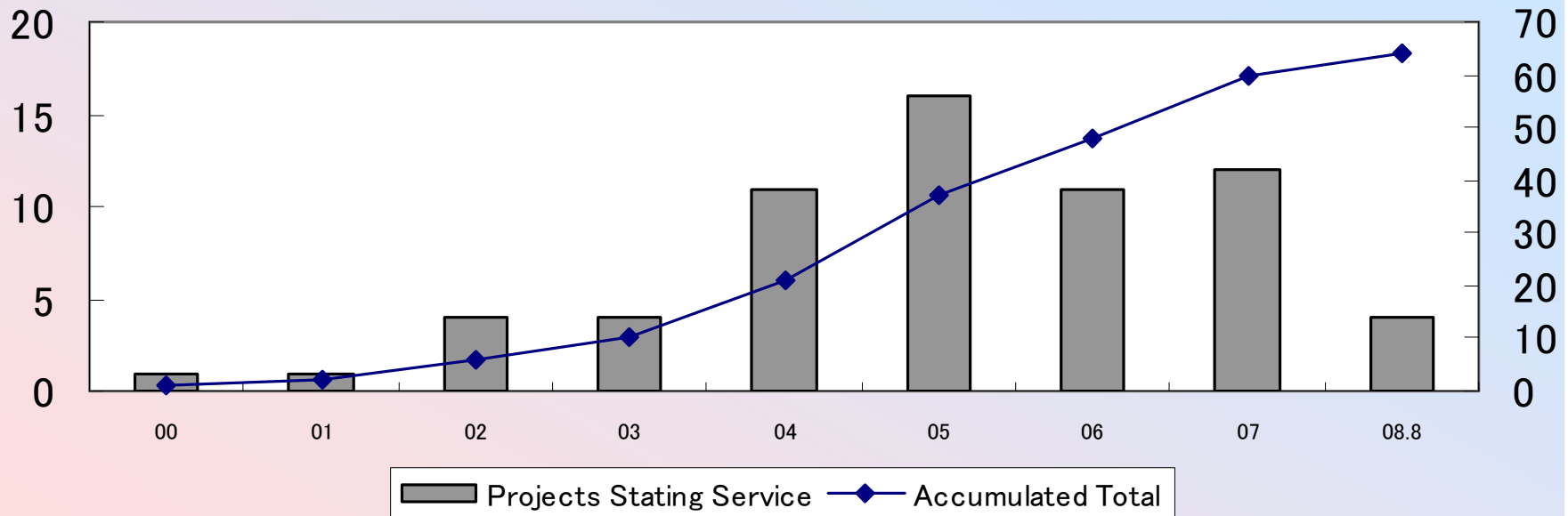
Fields	Administrator			Total
	State	Local	Other	
Education and Culture (e.g. school, library, etc)	0	23 (12)	3 (3)	26 (15)
Life and Welfare (e.g. facility for social welfare for aged, etc)	0	12 (10)	0	12 (10)
Health and Environment (e.g. hospital, waste disposal facility, etc.)	0	16 (11)	0	16 (11)
Industry (sightseeing facility, etc.)	0	7 (4)	0	7 (4)
Town Development (parks, etc.)	3 (1)	15 (14)	0	18 (15)
Public Safety (police office, prison, etc.)	2 (1)	5	0	7 (1)
Government Building and Accommodation	2	0	0	2
Others (e.g. complex facilities, etc.)	1	15 (8)	0	16 (8)
<b>Total</b>	<b>8 (2)</b>	<b>93 (59)</b>	<b>3 (3)</b>	<b>104 (64)</b>

Number of facilities (number of projects in serves)

(As of End of Aug. 2008) 5



# *Increasing Number of Projects in Service (Fully / Partially Income from User)*



(As of end of Aug. 2008)



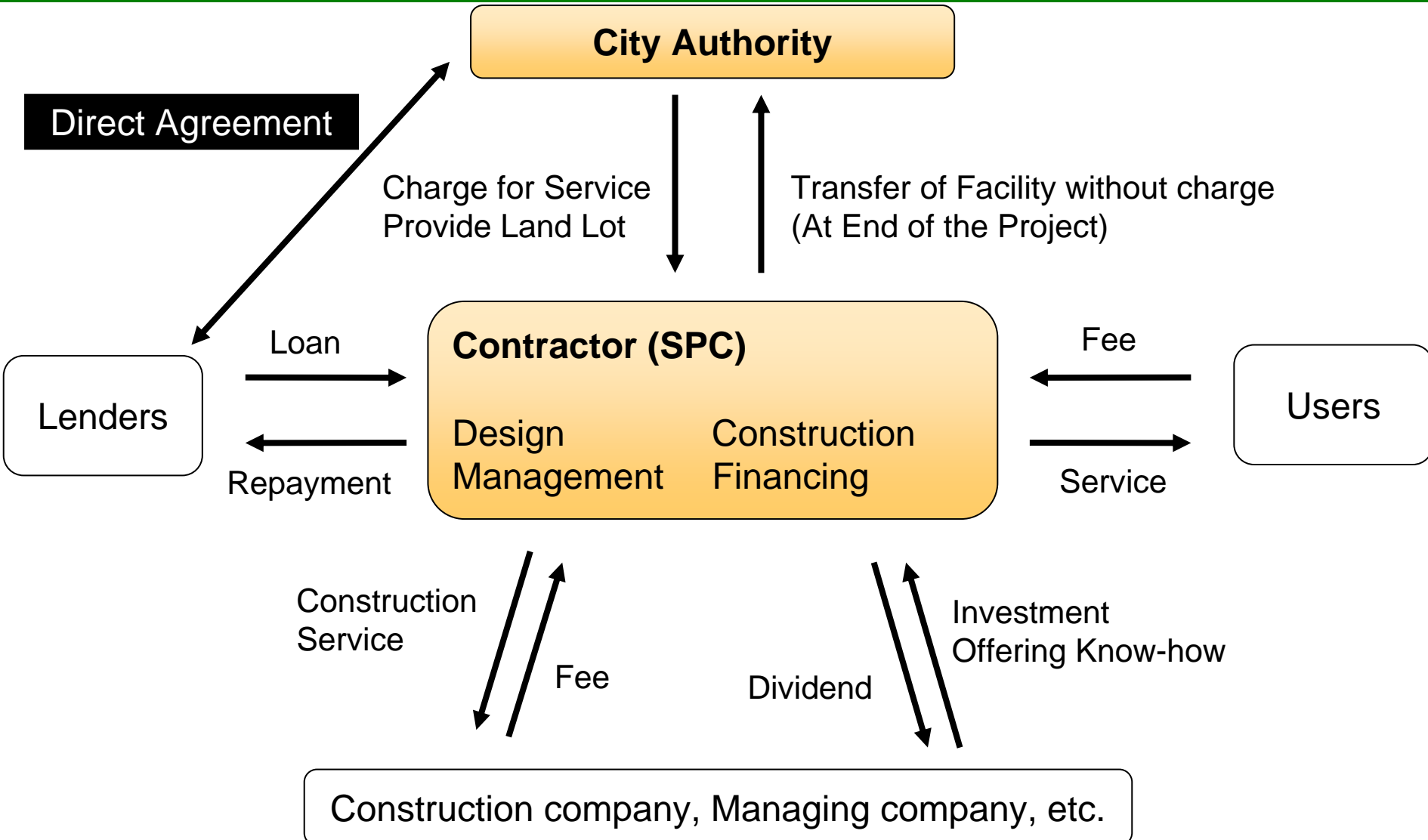
## *Case 1: Overview of the Project*

- The contractor was to design, build, maintain and operate a sports complex.
- BOT scheme: the SPC was to transfer the facility to the city at the end of project.
- The revenue of SPC consisted partially of fees from users and partially of charges by the city.
- The amount of the charge payable by the city was proposed by bidders.



# Scheme of the Project

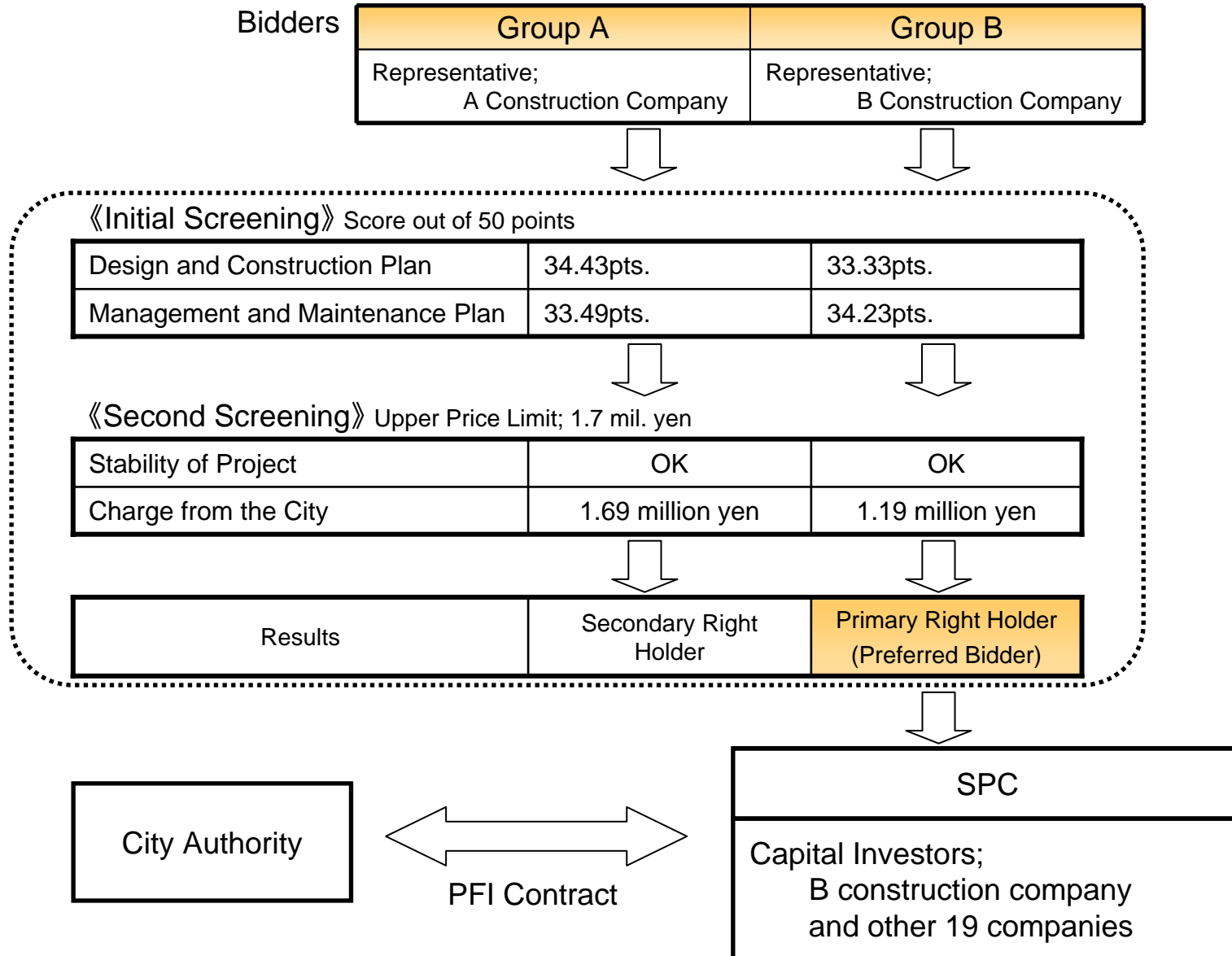
Cabinet Office, Government of Japan





# Process of Selection

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# *Estimated and Actual Number of Visitors and Sales*

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- Despite the optimistic estimation, actual number of visitors and sales were substantially smaller.

FY 2002

	Visitors	Sales
Planned	247 thousands	440 million yen
Actual	100 thousands	210 million yen

FY 2003

	Visitors	Sales
Planned	247 thousands	440 million yen
Actual	133 thousands	220 million yen



# Profit and Loss of SPC

Cabinet Office, Government of Japan

(unit; thousand yen)

	1st year	2nd year	3rd year	4th year
	2001.3	2002.3	2003.3	2004.3
Sales	0	10,995	204,745	218,295
Cost of sales	0	0	194,075	242,096
Gross profits	0	10,995	10,670	- 23,801
SGA	0	45,058	13,817	44,577
Business profits	- 0	- 34,063	- 3,146	- 68,378
Nonoperating profits	1	7	4,608	4,799
Nonoperating expenses	0	57,583	59,777	49,749
Current profits	1	- 91,639	- 58,316	- 113,328
Special profits	0	0	28,161	0
Special losses	0	0	0	8,146
Pretax profits	1	- 91,639	- 30,155	- 121,474
Corporation tax, etc.	0	54	326	322
Net profits	1	- 91,694	- 30,481	- 121,796
Cumulative profits/losses ①	1	- 91,693	- 122,174	- 243,970
Capital stock ②	10,000	175,000	175,000	175,000
①+②	10,001	83,307	52,826	- 68,970



# *Causes of Bankruptcy and Interruption of Service*

Cabinet Office, Government of Japan

- (a) Lack of understanding of the importance of demand risk management, and insufficient examination and assessment
- (b) Management of bankruptcy risk
- (c) The role of project financing in PFI projects



# *Causes of Bankruptcy and Interruption of Service*

Cabinet Office, Government of Japan

- (a) Lack of understanding of the importance of demand risk management, and insufficient examination and assessment
  - The contractor over-optimistically estimated the number of visitors and the cost of the project.
  - The city authority didn't substantially examine the feasibility of the proposal.
  - The city authority stuck with the service start date, and it did not reexamine the scheme of the project or its schedule.



# *Causes of Bankruptcy and Interruption of Service*

Cabinet Office, Government of Japan

## (b) Management of bankruptcy risk

- The city authority was not well aware of the risk of bankruptcy and interrupt of service.
- The city authority did not realize importance of financial monitoring.
- The city authority didn't take affirmative steps for continuing the project in earlier stages.



# *Causes of Bankruptcy and Interruption of Service*

Cabinet Office, Government of Japan

## (c) The role of project financing in PFI projects

- As lenders lent money within the amount that they could collect safely, the lenders were virtually risk-free.
- There was no financial expert in the evaluation committee for the project and the city authority couldn't know the risk allocation between the (senior) lenders and shareholders of SPC.
- The lenders didn't make an effort to restructure the project. The step-in mechanism of the project's financing didn't work.



## *Lessons Learned from This Case*

- (a) The needs for clear understanding of the risks which depend on the nature of the project
- (b) Government's proper assessment of proposals with clear understanding of the nature of the project
- (c) Establishment of the management system of bankruptcy risk
- (d) Clear assignment of roles between authority and lenders.



# *Lessons Learned from This Case*

Cabinet Office, Government of Japan

(a) The needs for clear understanding of the risks which depend on the nature of the project

-- The project adopted an unusual scheme and it was important to properly manage the risk based on sufficient understanding of the nature of the project.

-- In delivering PFI projects, we need to examine the proper method of the risk management based on detailed identification of risks.



# *Lessons Learned from This Case*

Cabinet Office, Government of Japan

(b) Government's proper assessment of proposals with clear understanding of the nature of the project

-- The government needs to establish assessment methods and a standard of assessment of proposals to evaluate the feasibility of the proposal.

-- For ensuring the soundness of projects, the following methods should be considered

Example 1) set a lower limit as an anti-dumping measure.

Example 2) adopt absolute criteria for important items such as reliability of financial projections to disqualify bidders.



## *Lessons Learned from This Case*

### (c) Establishment of the Management System of Bankruptcy Risk

-- The government needs to monitor not only service levels, but also financial standing of SPCs. In addition, the government needs to ask lenders to provide information on SPCs.

-- In case where the contractor is likely to cease to operate the facility, the government needs to take a proper action to avoid service interrupt.



## *Lessons Learned from This Case*

### (d) Clear Assignment of Roles between Authority and Lenders.

- Lenders who understand the nature of the project finance scheme should exert the ability in checking the contractor's capacity of carrying out the project and its creditworthiness.
- The terms of the direct agreement should be carefully examined to ensure that the lenders will properly monitor the project and, in the case of financial difficulty of the SPC, find a new contractor.
- Note that the interest of governments and lenders are not always identical. Thus, governments should not rely too much on the lenders' review.



## *Other cases of Insolvency*

- In most cases, the causes of insolvency are wrong estimation in demand and revenue from the project.
- Other than this reason, some factors are pointed out as follows;
  - insufficient independency of the SPC in financial aspect
  - insufficient monitoring
  - inconsistency in the business plan, and/or lack of the ability of SPC to carry out the project
  - etc.



# Report of the committee for promotion of PFI ~For realization of the true public-private partnership~

## Current 15 issues on PFI

<Issues that should be focused on, and have immediate measures taken for>

### Individual issues

1  
The need for guidance for risk analysis and risk management

2 Clarification of the output specifications

3 Realizing more transparent bidding process that can take advantage of the private creativity

4 Promotion of the standardization of agreements etc.

5 Appropriate handling of the issues at the operations stage

6 Share know how of, utilize, and make necessary adjustment with, other PPP methods

7 Steps for the prevention of global warming

8 The need for equal footing such as subsidies and taxes

<Issues that should be studied ongoing>

9 Ongoing study concerning VFM assessment

10 Study of financing

11 The need for further improvement in the roles of consultants

12 Study an efficient structure for sharing the know how between the public and private sectors

13 The need for expanding the players

14 Study for expanding the PFI market

15 Study on the disaster management and other current policy issues



# Thank you for your attention.

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Japan