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One additional case of government support for a governmental agency

Around Y40-50bn in financial support for Hokkaido Railway

- There are no written rules regarding government support for governmental agencies
- East Japan Railway, West Japan Railway, Central Japan Railway, and Kyushu Railway were all fully privatized following the break-up and privatization of Japan National Railways, but some railways, including Hokkaido Railway, remain government agencies
- On 27 July, the government announced that it would offer financial support worth around Y40-50bn for FY19-20 only, based on the current law
- The government is considering establishing the necessary laws to facilitate continual support from FY21, thereby increasing the number of support cases

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Establishing a track record of past government support cases is important

A track record of past government support cases serves as a factor to reinforce future expectations

The creditworthiness of government agencies is assessed based on the expectation that the government will provide support in case the agency's business conditions become unstable. However, there are no written rules stipulating that the government will offer support in all cases. A track record of past support cases thus serves as a factor to reinforce expectations for support in the future.

Addition of a new case: government support for Hokkaido Railway

From that perspective, the recent addition of a government support case (for a governmental agency) is interesting. Specifically, on 27 July, the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) announced that it has ordered Hokkaido Railway to improve its business conditions and stated that it would offer financial support worth around Y40-50bn.

Hokkaido Railway is a government agency

Conditions for full privatization

When government agencies are fully privatized, they have to meet two conditions: (1) abolition of the governing laws on the establishment, and (2) the sale of all shares held by the government.

While East Japan Railway, West Japan Railway, Central Japan Railway, and Kyushu Railway were privatized, some (incl. Hokkaido Railway) remain government agencies

Regarding Japan Railway companies, the break-up and privatization of Japan National Railways was carried out in 1985, with six railway companies and one freight company newly established. At that time, all seven companies were government agencies. However, due to exclusion from the governing laws on the establishment (the Act on Passenger Railway Companies and Japan Freight Railway Company) and the sale of all shares held by the government (to be precise, the shares held by Japan Railway Construction, Transport and Technology Agency: JRTT), East Japan Railway, West Japan Railway, Central Japan Railway, and Kyushu Railway were privatized in 2002, 2003, 2006, and 2016, respectively. On the other hand, Hokkaido Railway, Shikoku Railway, and Japan Freight Railway are still covered under the Act on Passenger Railway Companies and Japan Freight Railway Company, and remain government agencies wholly owned by JRTT.

Chart 1: Path to Full Privatization of Japan Railway Companies

	East Japan Railway	West Japan Railway	Central Japan Railway	Kyushu Railway
Oct-93	Listing			
Oct-96		Listing		
Oct-97			Listing	
Dec-01	Exclusion from the governing laws on the establishment (the Act on Passenger Railway Companies and Japan Freight Railway Company)			
Jun-02	Sale of all shares (full privatization)			
Mar-03		Sale of all shares (full privatization)		
Apr-06			Sale of all shares (full privatization)	
Apr-16				Exclusion from the governing laws on the establishment (the Act on Passenger Railway Companies and Japan Freight Railway Company)
Oct-16				Listing/sale of all shares (full privatization)

Source: MLIT; compiled by Daiwa Securities.

Repeated government support for Hokkaido Railway

Operating losses are offset by gains from asset management in the management stabilization fund

As Hokkaido Railway, Shikoku Railway, and Kyushu Railway (which has recently been fully privatized) are operating in regions with low population densities, they were expected to incur operating losses when Japan National Railways was broken up and privatized. They thus did not take on any of the long-term debt from Japan National Railways. On top of this, a management stabilization fund was established to offset any operating losses using gains from asset management.

Repeated government support

Since the break-up and privatization of Japan National Railways, the authorities have assumed that gains from asset management would fluctuate depending on interest rates. Railway companies are thus required to offset lower gains from asset management via management efforts. That being said, the government has repeatedly provided support for Hokkaido Railway via (1) institutional measures for investment gains in the management stabilization fund, (2) de-facto accumulation of the management stabilization fund, and (3) subsidies for capex and interest-free loans. This is because (1) the initial assumption for investment returns was 7.3%, which was set based on the average for 10-year JGB yields over the past 10 years and (2) Hokkaido Railway's management conditions have been severe.

The MLIT ordered Hokkaido Railway to improve its business conditions and become a self-sustaining firm

Part 2, Article 13 of the Act on Passenger Railway Companies and Japan Freight Railway Company says that "the minister of the MLIT has the authority to issue a supervisory order for operations at companies when he/she approves the special need in executing this act." This is the basis of the latest business improvement order at Hokkaido Railway. The MLIT ordered the railway to become a self-sustaining company via thorough management efforts (higher earnings and cost cutting) by FY31, when positive effects are expected to materialize thanks to the extension of the Hokkaido Shinkansen route to Sapporo station, which is scheduled for completion by the end of FY30 (see the upper part of Chart 2).

Chart 2: MLIT's Latest Order to Improve Business Conditions at Hokkaido Railway, as well as Support Measures

1. Measures to improve business conditions at Hokkaido Railway

Targeting independent management by FY31

- Maximization of earnings, including those in non-railway businesses in the Sapporo City area
- Strengthen the competitiveness of transport services to the New Chitose Airport (increased frequency of rapid trains)
- Enrichment of sightseeing trains to attract inbound tourists
- Cost reductions and improved awareness of the need to implement reforms, etc.

2. Support/cooperation from relevant parties

(1) Support for capex and repairs of railway facilities and train cars on routes with low usage frequency, for which the establishment of a sustainable maintenance structure is needed

(2) Support for capex and repairs on freight train routes

(3) Support for maintenance in the Seikan Tunnel

(4) Support for proactive capex, which should lead to a stronger management base

The total amount comes to Y40-50bn for two years (FY19-20)

(1)-(3): Fully covered by subsidies

(4): Evenly covered by subsidies and interest-free loans

The ministry is considering submission of the necessary bills to the Diet for continuing support in FY21 and beyond

Source: MLIT; compiled by Daiwa Securities.

The act stipulates support till FY20; separate bills to be submitted for support in FY21 and beyond

Meanwhile, the national government, local governments, and relevant parties will offer the necessary support and cooperation, assuming thorough management efforts at Hokkaido Railway (see the lower part of Chart 2). The latest support scheme is based on rules under the law on disposal of debts at Japanese National Railway Settlement Corporation, and it is to expire in FY20. The total support amount for two years (FY19-20) is thus set at around Y40-50bn. In addition, the government is considering submission of the necessary bills to the Diet for continuing support in FY21 and beyond. In other words, the government is clearly showing its intention to offer continued support.

Loss-making but sufficient internal reserves

According to its FY17 income statement, Hokkaido Railway incurred a recurring loss of Y10.6bn and a net loss of Y7.3bn as non-operating income (such as fund investment gains) was unable to cover operating losses. That being said, the company has been in the red at the recurring and net levels for only two years since FY16. As Hokkaido Railway has secured net assets of Y933.6bn, and given that the ratio of net assets to total liabilities plus net assets is 65.9% (liabilities plus net assets total Y1,417.6bn), the firm is not in a situation whereby management would find itself in a difficult position in the short term.

The government is increasing the number of cases that serve as a useful reference when we think of the creditworthiness of government agencies

Hokkaido Railway is still a government agency, although it was established together with the already fully privatized East Japan Railway, West Japan Railway, Central Japan Railway, and Kyushu Railway at the time of the break-up and privatization of Japan National Railways. While requiring self-sustainable operations, the government continues to support Hokkaido Railway at the stage where the firm has capacity as a business entity. We can say that the government has added a case that serves as a very useful reference when we think of the creditworthiness of other government agencies. We intend to continue to monitor the government’s future involvement with Hokkaido Railway, as the company faces a difficult challenge in its review of loss-making routes.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association