



R&I's Analytical Approach to Government Agencies

(This report is an English translation of the original report in Japanese.)

General View

R&I defines government agencies in Japan as corporations established based on laws stipulating their foundation, with investments from the central or municipal governments, and operating businesses of a highly public nature. Government agencies include special public corporations and independent administrative agencies. Special public corporations are established based on special laws with investments from the government, etc. Of these corporations, those taking the form of stock companies are called special companies. Independent administrative agencies were first established in 2001 with the aim of streamlining government operations in accordance with the objectives of the administrative and financial reforms. They were initially established by separating organizations of the government, but since then many special public corporations also have been transformed into independent administrative agencies. Among government agencies to which R&I assigns ratings, a majority are independent administrative agencies, which include the Japan Expressway Holding and Debt Repayment Agency, while Japan Finance Corporation and Narita International Airport Corporation are special companies. Special public corporations include the Promotion and Mutual Aid Corporation for Private Schools of Japan and others.

Government agencies also include fiscal investment and loan program agencies. These are corporations utilizing fiscal investment and loan program funds (fiscal loans, industrial investment and government guarantees). Fiscal investment and loan funds are procured by the government by leveraging its own creditworthiness. To be precise, government agencies that are not utilizing fiscal investment and loan funds are not called fiscal investment and loan program agencies. For example, Narita International Airport Corporation is a government agency of a highly public nature but it is currently not using fiscal investment and loan funds.

Government agencies implement large-sized, long-term projects that would be hard for the private sector to carry out, such as construction of expressways and dams. Such agencies also implement businesses that are essential from the policy perspective, but cannot be implemented by the private sector because of the profitability and other risk factors such as in the case of low-interest rate loans to small and medium-sized agencies. Irrespective of investment from the fiscal investment and loan program funds, the government agencies receive wide-ranging assistance necessary to implement policies from the government including permission and authorization for their businesses.

Rating Points for Government Agencies

Comprehensive evaluation of likelihood of the government providing required assistance and standalone creditworthiness

In addition to the fact that the government implements measures to ensure government agencies' cash flows, it is likely that the government would provide assistance to the agencies in a crunch situation. Upon assigning rating to a government agency, therefore, R&I comprehensively evaluates the likelihood of the government providing required assistance and the corporation's standalone creditworthiness.

R&I also assigns ratings to Chinese and Korean government agencies and the underlying concept is the same as the one for Japanese government agencies. However, the relationship between the government and government agencies differs from country to country and R&I assigns ratings to these agencies by giving thorough consideration to the differences in political institutions, legislation and level of economic development. R&I also apply the concept of rating government agencies to joint corporations of local governments including Japan Finance Organization for Municipal Enterprises.

Reflecting the government's intention to provide assistance and its capability but not taking implicit government guarantee for granted

Whether or not the government would provide assistance to the concerned project needs to be judged based on how important it is to implement the project from the policy perspective, in other words, how high it ranks from the policy viewpoint.

R&I makes judgment from qualitative perspectives of 1) the number and extent of people who benefit from the implementation of the project and 2) whether it could be implemented by other entities taking into consideration the investment and profitability.

At the same time, even if the project ranks high from the policy viewpoint and the government has strong intention to support the concerned government agency it may not be able to provide sufficient assistance if its capability to do so is low. In rating of government agencies, therefore, it is necessary to consider the government's capability to provide assistance. The government's capability to provide assistance as a rule reflects the country's creditworthiness. Currently, R&I affirms the sovereign rating of Japan as AAA and based on this rating, government agencies are given high credit ratings in AA or higher zones.

To be sure, R&I does not presume that there is an implicit guarantee that the government would completely assume the principal and interest payment of government agencies. This is because R&I believes that the government's stance on providing assistance may change as the government's priority in projects changes reflecting the social and economic changes. In fact, former Japan National Railways and Nippon Telegraph and Telephone Public Corporation were privatized and Japan Post also is in the process of privatization. Projects currently implemented by independent administrative agencies, policy finance institutions and special companies may also be privatized or scrapped in the future. In this regard, however, R&I judges that the

government attaches a certain level of significance from the policy perspective to those corporations that have come through the special corporation reforms of 2001, the series of policy finance reforms from 2002 and the independent administrative agency liquidation and streamlining plan of 2007.

Assessing standalone creditworthiness taking into account the policy priorities

R&I anticipates the following cases in which policy priority of businesses operated by government agencies declines: 1) the founding objective of the concerned government agency has been achieved, 2) policy priorities change due to changes in social and economic environment, and 3) existing policy measures get rejected by a new government.

Once the objective at inception is achieved, there will be few reasons for the corporation to continue its existence. As private capital is accumulated, there is also the possibility of private sector companies coming into areas that used to be exclusive domains of government agencies because of the requirement for large amounts of investment and high risks involved. However, R&I does not believe that the likelihood of decline in policy importance is uniform for all projects. In assessing the project's priority within policy measures, R&I attaches importance to factors such as (1) existence of private sector alternative, (2) existence of debate within the government on whether to continue with the concerned project and (3) scale of benefits of the concerned project when considering the cost burden to the public.

If, for instance, the government deems that a business being operated by some government agency should “no longer be run by a government agency,” and stops all material and immaterial support, the certainty of payment of principal and interest by that agency would be influenced by its standalone creditworthiness. It is necessary to give more emphasis to the standalone creditworthiness of government agencies that handle projects for which the government's stance on support is highly likely to change. On the other hand, where such a possibility is low, an agency with low standalone creditworthiness still could get a relatively high rating.

Emphasizing on operating base in standalone creditworthiness assessment

In assessment of standalone creditworthiness, R&I analyzes business details and operating base, income and expenditure as well as financial details. When evaluating the operating base, R&I looks at the scope of beneficiaries, competition with other public corporations, and financing scheme including whether the agency is dependent on government grants and aids or operating the business with independent revenues such as fees.

In case of government agencies with independent sources of revenues such as fees received, R&I pays particular attention to the bottom line and the balance between cash flows and liabilities (borrowings and loans) from the income and expenditure and financial point of view. Unlike private sector companies, such agencies are not under pressure to generate huge profits, but if it is generating a certain amount of profit after deducting government grants and aids it would be highly likely to continue its operation even if, for instance, such assistance from the government is

reduced. Conversely, if the agency is posting a significant amount of loss even after receiving funding from the government, it may be pointing to issues with the business profile and institutional design. This could result in large-scale restructuring of the organization and the project and therefore requires close attention.

On the other hand, for government agencies involved primarily in financial operations such as lending, R&I looks mainly at the quality of their assets such as loan obligations. However, the impact of the asset quality on assessment is limited for those agencies which cannot be easily replaced by private-sector financial institutions in fields where the government agencies need to take a major role.

Standalone evaluation for fully privatized cases

The rating for a government agency reflects to a certain extent the creditworthiness of the government. The full privatization of the agency through the process of elimination of the law stipulating its inception, the government's sale of its stake in the agency and listing of the shares leads to weakening of relationship with the government, resulting in a negative evaluation.

If the special assistance from the government is completely cut, the government agency will be subject to standalone assessment similar to rating assessments of other general businesses and financial institutions. It would mean that the agency's rating may be downgraded drastically depending on the severity of the business risk or income and expenditure and financial status. On the other hand, government agencies with a strong operating base and ability to maintain high profits and sound financial profile even without government aid, may be able to maintain high creditworthiness as before. R&I carries out the post-privatization rating on a case-by-case basis depending on the status of the respective corporations. Also, due to their highly public nature, critical infrastructures such as airports tend to have some form of governmental involvement even after they are completely privatized and this fact would continue to be reflected on the rating.

Assessment during the transition period to complete privatization

In the case of privatization of government agencies, there usually is a transition period ahead of complete privatization during which there will be a certain level of governmental involvement. There may also be provisions for securing financing and financial base. In rating assessment during transition, in principle, "the relation with creditworthiness after privatization should be considered carefully while assessing the factors affecting the creditworthiness during transition which should then be factored in as much as possible at an early stage." In other words, in addition to the assessment of "standalone creditworthiness" reflecting factors such as the current business and financial base, details of the provisions for ensuring the creditworthiness during transition and their effectiveness and outlook of business operation and development of management structure for full privatization are taken into account to discern the creditworthiness after the privatization. R&I studies these factors and incorporates them into the rating.

Rating of joint corporations of local governments

Based on Reorganization and Rationalization Plan for Special Public Corporations, etc., joint corporations of local governments are “corporations established by the Civil Code, Commercial Code and a special law” and are “organizations implementing businesses that should be mainly assumed by municipal governments because of their features such as offering common benefits to municipal governments, but which are not significant enough for them to be implemented by central government policy implementation organizations.” They often operate projects that offer common benefits to municipal entities among government agencies and are established to succeed operations of special public corporations whose operations do not demand a major central government role.

In rating joint corporations of local governments, R&I comprehensively assesses the “standalone creditworthiness” and “the likelihood of assistance from municipal entities.” When a number of municipal entities are involved, whether there is a consensus among the entities to provide assistance and how municipal entities with high capability of providing assistance are getting involved, etc. assume greater importance.

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