

## *Japan Ramps Up Renewable Energy Generation*

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A new feed-in tariff regime (the "FIT Regime") for renewable energy power plants (solar, wind, hydro, geothermal and biomass) came into effect in Japan on July 1, 2012 under the Act on Special Measures Concerning the Procurement of Renewable Electric Energy by Operators of Electric Utilities (the "Act"). The Act is attracting significant interest from energy market participants, both in Japan and abroad, and may facilitate greater use in Japan of non-recourse or limited recourse financing structures in the renewable energy sector. The FIT Regime is widely expected to offer the most favorable terms to first-movers and may be less favorable for new projects in ensuing years, depending on how future procurement pricing is adjusted in accordance with the Act.

### **METI Approval of Project Companies**

Detail on how the FIT Regime operates is set out in an implementation order and associated announcements (the "Implementation Order") published by the Minister of Economy, Trade and Industry ("METI") on June 18, 2012. For a project company to qualify under the Act, it must apply to METI to become a designated approved renewable energy supplier (the "Specified Supplier"), meaning its project satisfies the criteria applicable to its energy generation method and the corresponding generation facilities. Once designated a Specified Supplier, a project company may incorporate into its power purchase agreement with an electrical utility operator ("Utility") the term (the "Procurement Period") and pricing (the "Procurement Price") published by METI. The Act in turn provides for Utilities being able to recover from end-users the additional costs incurred as a result of the Procurement Price tariffs.

The Utilities covered by the FIT Regime are any of the following types licensed or registered under existing legislation:

- electricity companies operating under a general electricity supplier license (*ippan denki jigyousha*) such as TEPCO and KEPCO;
- companies operating under a specific electricity supplier license (*tokutei denki jigyousha*) (currently, a very limited number of companies fall into this category); and
- companies registered as power producer and supplier (*tokutei kibo denki jigyousha*) that supply electricity to certain heavy consumers of electricity (this type is not subject to the obligation to enter into interconnection agreements).

### Determination of Procurement Periods and Prices

Under the Act, METI may set different Procurement Periods and Prices depending on the renewable energy category, installation method and scale of the generation facilities. METI does not have sole discretion in doing so; instead, it must consider the views of various governmental ministries as well as those of a newly established procurement price calculation committee (the "Price Calculation Committee") consisting of five members appointed by METI with the approval of the Diet.

In determining the Procurement Price, METI is to take into account, among other things:

- the expected cost of electricity generation by renewable energy power plants on the basis of efficient operation and the estimated amount of electricity to be supplied thereby;
- the aggregate capacity of renewable energy generation in Japan at such time;
- an adequate level of profit for the project company; and
- the burden of the surcharge imposed on end-users.

METI must also give particular consideration to the profitability of project companies during the first three years of the Act being in effect, so as to bring about an immediate increase in the number of renewable energy plants operating in Japan.

According to an opinion letter released by the Price Calculation Committee on April 27, 2012, Procurement Prices should be set to realize pre-tax internal rates of return of about 5 to 6% although to give particular consideration to the profitability of project companies during the first three years of the Act, an additional 1% or 2% return rate should be added for the first three years, suggesting that early moving project companies under the FIT Regime may have an advantage over those that invest later.

In determining the Procurement Period, which commences on the commercial operation date of the project, METI is to take into account the standard operational term of electricity generation facilities before any renewal of a material part of those facilities is needed.

### Qualifying for This Year's Procurement Periods and Prices

METI has published the Procurement Periods and Prices for fiscal year 2012. Going forward, METI is permitted to revise these annually (or, if necessary, semi-annually) for new projects. To qualify for this year's Procurement Period and Price, the project company must ensure that the date by which the following two requirements are both satisfied (the "Determination Date") falls on or before March 31, 2013:

- the project company obtains METI approval to become a Specified Supplier in respect of its renewable energy power plant; and
- the project company makes a written offer (meeting certain requirements) to a Utility for the entry into an interconnection agreement (for this purpose Utilities that are registered as power producer and supplier (*tokutei kibo denki jigyousha*) are excluded).

Note that the Act distinguishes between (A) an interconnection agreement, whereby a Utility agrees with the Specified Supplier to provide the interconnection to the electricity network, and (B) a power purchase agreement, whereby a Utility (which may or may not be the one that is party to the interconnection agreement) agrees with the Specified Supplier to purchase renewable energy at the Procurement Price during the Procurement Period. It is only the interconnection agreement that is relevant for determining the Determination Date, but once this is determined it is the power purchase agreement that will incorporate the applicable Procurement Period and Price.

### **Future Amendments to Procurement Periods and Prices**

The general rule under the FIT Regime is that the Procurement Period and Price, as determined with reference to the Determination Date, are to apply during the entire term of a power purchase agreement. However, provisions in the Act allow changes to existing power purchase agreements in the following ways:

- the Act permits changes if “necessary measures” are taken in light of changes to the Japanese Government’s Basic Energy Plan determined pursuant to the Basic Act on Energy Policy or in light of various factors, including renewable energy sector capacity, electricity charges and changing economic conditions; and
- METI is permitted to override the Procurement Period and Price set out in existing power purchase agreements if (a) material changes in prices and other economic conditions have occurred or have threatened to occur; and (b) METI considers an amendment to the Procurement Period and/or Procurement Price to be particularly necessary.

Further, there will be a fundamental reexamination of the Act by March 31, 2021.

While there is thus some uncertainty for sponsors and lenders given that the FIT Regime is designed to enable the amendment of Procurement Periods and Prices during the term of a power purchase agreement subject to the regime, prevailing commentary on these issues, including by METI itself, suggests that restraint is likely to be exercised and dramatic changes avoided absent significant unforeseen circumstances.

### **Entering into Power Purchase and Interconnection Agreements with Utilities**

The Act and Implementation Order have detailed provisions regarding the contractual arrangements between a project company and a Utility. The project company will be able to require the Utility to enter into a power purchase agreement and/or interconnection agreement incorporating the then applicable Procurement Period and Price, but there are a number of exemptions that allow the Utility to reject a project company’s offer. These exemptions vary according to the type of Utility and whether the offer relates to a power purchase agreement or an interconnection agreement.

Utilities may avoid entering into power purchase agreements if the terms of those agreements unreasonably impair their interests as an electric utility operator or if other exemptions in the Implementation Order apply. Foreign sponsors should note that one of the Implementation Order’s exemptions is that the power purchase agreement does not have appropriate provisions on governing language (in other words, the agreement can be avoided if it is not in Japanese).

Utilities may avoid entering into interconnection agreements if any of the following exemptions, among others, apply:

- the interconnection agreement is likely to cause the Utility to have difficulty in securing a smooth supply of electricity for its end-users;
- with respect to a solar or wind power project with a capacity of 500kW or more, the project company does not agree to a provision limiting its electricity generation without compensation for up to 30 days per annum, where supply exceeds demand (even after the Utility has taken certain preventative steps, such as reducing electricity generation at its own power plants);
- there is a reasonable prospect of over-capacity for interconnection, notwithstanding certain preventative steps being taken by the Utility;
- the project company does not agree to a provision limiting its electricity generation without compensation when the Utility's interconnection facilities have been adversely affected by natural disaster or when maintenance or repairs to the interconnection facilities need to be carried out;
- the interconnection agreement does not have appropriate provisions on governing language (in other words, the agreement can be avoided if it is not in Japanese).

## Transfer of Existing Projects

The Act allows existing projects to benefit from the FIT Regime, including projects that have been operating under the "Renewable Portfolio Standard" regime (the "Previous Regime"). However, project companies cannot simultaneously hold approvals from METI under the Act and the Previous Regime for the same renewable energy power plant, and thus, to become a Specified Supplier under the Act, any such project company must first cancel the approvals granted under the Previous Regime and apply under the Act, a process that must be completed by November 1st of this year to take advantage of the FIT Regime (and which is subject to further regulations concerning the applicable Procurement Period and Price).

## Conclusion

The Act clearly reflects a delicate balance between the interests of project companies and their lenders and those of Utilities, and it will necessarily require time to determine how well the FIT Regime operates in practice to facilitate development of new renewable energy projects in Japan. Many believe that the FIT Regime does reflect a significant advance for project companies, as it generally require Utilities to enter into power purchase and interconnection agreements that incorporate METI-determined Procurement Periods and Prices. This improved situation for project companies, especially insofar as changes to Procurement Periods and Prices under existing agreements with Utilities are minimized, may help to accelerate use of non- and limited-recourse financing structures for renewable energy projects in Japan.

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