

Green Rush Hits Japan (Updated Version as of June 27, 2012)

The government has finally disclosed details of Japan's version of the Feed-in-Tariff ("FIT") to be enforced this July. The purchase price for the initial year has been fixed at ¥40/kWh (\$0.50/kWh excluding tax) for solar power and ¥22/kWh (\$0.28/kWh excluding tax) for wind power and the purchase period for the initial year is fixed at 20 years for both. Combined with Green Investment Tax Credit measures, Japan's renewable energy market is bracing for a "green rush" --- as opposed to a gold rush --- as it attracts wide attention both in Japan and abroad. This article discusses the formal details of the FIT scheme and updates our February and May newsletters on the major points of interest related to Japan's Green Rush phenomenon.

1. FIT Act

(1) How attractive is Japan's FIT scheme?

The Act on Purchase of Renewable Energy Sourced Electricity by Electric Utilities (August 30, 2011; Law No. 108), better known as the Feed-in-Tariff Act ("FIT Act"), was approved by the Diet in August 2011 and will be enforced starting in July of this year.

All of the ministerial ordinances as well as guidelines (in the form of responses from the Ministry of Economy, Trade and Industry to public comments) in relation to the FIT Act were disclosed on June 18, 2012.

The purchase price (procurement price) and purchase period (procurement period) under the Feed-in-Tariff scheme ("FIT Scheme") for solar power (PV) of 10 kW or greater and wind power of 20 kW or greater for the initial year have been officially determined as shown in the table below. Tax-exclusive pricing has been adopted on the assumption that the consumption tax rate may change in the future.

Power Source	Solar Power (10kW or greater)	Wind Power (20kW or greater)
IRR	6% before tax	8% before tax
Procurement Costs per 1kWh Tax-exclusive	¥40 (\$0.50)	¥22 (\$0.28)
Procurement Period	20 years	20 years

With these prices, Japan will be extremely attractive to power producers and projects even when compared to Europe, where FIT schemes have been commonly implemented to support renewable energy ("Renewable Energy").

FIT schemes have been introduced in 20 out of 27 EU countries¹. Prices range widely, but many countries have set wind power at around €0.1/kWh (¥10/kWh or \$0.13/kWh at current exchange rates), and solar power at around €0.3/kWh (¥30/kWh or \$0.39/kWh at current exchange rates). Solar power prices in Spain, which was referred to as a "renewable bubble" when it first launched a FIT scheme in 2007 with record high purchase prices, are between €0.24 and €0.47/kWh (¥24 to ¥47/kWh or \$0.32 to

Contact a Team Member

Yoichi Katayama
Partner
Tel: 03-3224-2921
ykatayama@orrick.com

Minako Wakabayashi
Of Counsel
Tel: 03-3224-2926
mwakabayashi@orrick.com

* This article is intended to provide a brief survey of certain laws and customs relevant to renewable energy in Japan. This is not intended to be legal advice. Individual legal and factual circumstances should be taken into consideration in consultation with professional counsel prior to taking any action related to the subject matter of this article.

¹ As of 2010.

\$0.62/kWh at current exchange rates)². The UK, which introduced a FIT scheme in 2010 as a supplement to other support schemes and which has an especially favorable purchase price for solar power 5MW or less, has set its purchase price at £0.30/kWh (¥37/kWh or \$0.47/kWh at current exchange rates)³. In comparison, Japan's purchase price is likely to be the highest globally.

With respect to the purchase period, longer terms are of course desirable especially when construction costs are financed through project finance. Japan's 20 year period is reasonably sufficient considering that standard project financing periods for Renewable Energy in the US and Europe range from around 15 to 20 years.

Thus, Japan's FIT scheme is very favorable for power producers and projects and the Japanese Renewable Energy market is extremely attractive to investors and other players in this field.

Below, we outline several major points under the FIT Act.

(2) Eligibility

Electricity eligible for purchase under the FIT Act includes electricity generated by solar PV, wind power, hydraulic power (small to medium hydraulic power of less than 30MW), geothermal energy, biomass, and any other energy separately set forth under applicable government ordinances.

A power generation company (electricity supplier) must have its Renewable Energy power generators approved by the Minister of Economy, Trade and Industry pursuant to ministerial ordinances ("FIT Approval"). It must further demonstrate that it is able to provide stable and efficient renewable energy power over the procurement period and that its power generation methods meet criteria set forth under ministerial ordinances.

Eligibility also extends to existing power generators that have already started their operations; however, they need to have their approval pursuant to the Act on Special Measures Concerning New Energy Use by Operators of Electric Utilities ("RPS Act") retracted in order to be eligible. When existing power generators are supported by subsidies, related adjustments will be made to the applicable purchase price.

(3) Purchase obligations

Unless there is a justifiable exception as set forth under ministerial ordinances, electric utilities are obligated to purchase electricity at the procurement price and may not refuse requests by power generation companies ("specific suppliers") to enter into an agreement (defined as a "specific agreement" under the FIT Act) to supply electricity generated from Renewable Energy-sourced power plants approved under the FIT Act ("Power Purchase Agreement").

The Act is structured so that power generation companies have a substantial degree of control over the substance of Power Purchase Agreements. That is, an "electric utility" must execute a Power Purchase Agreement at the request of a "specific supplier (power generation company)" unless "there is a risk that the substance of such agreement will unjustly harm the interests of such electric utility, or there are other justifiable reasons as set forth under the ministerial ordinances of METI." The details of what constitutes "justifiable reasons" are listed in the Act and the ministerial ordinances and are limited in scope to situations such as when the power generation company calls for extremely high compensation for damages or the electric utility is otherwise unfairly and materially disadvantaged, or when the power generation company refuses to allow necessary parties to enter or inspect the power plant or otherwise makes unreasonable demands that hinder the maintenance of appropriate performance standards. Other than in such limited situations, an electric utility is obligated to enter into a Power Purchase Agreement. Thus, it can be said that power generation companies will have quite a bit of control over the process of preparing Power Purchase Agreement formats. The key question is what sort of form of agreement to prepare and present to the electric utilities.

Finally, while electric utilities have purchase obligations under the FIT Act, power producers are not obligated to generate (supply) power. Therefore, even in cases where power producers cannot supply electricity as initially agreed, penalties will not be imposed unless separately set forth under the Power Purchase Agreement.

(4) Purchase price

² PV registered in the register of systems on or before September 29, 2008. Spain has subsequently become more restrictive and announced in January 2012 that it will suspend application of the FIT to new projects.

³ As of 2011 (stand-alone PV).

In principal, purchase prices (procurement prices) will be annually determined by the Minister of Economy, Trade and Industry prior to commencement of the fiscal year for each type, form of installation, and scale of Renewable Energy source. The Minister will give public notice of the decision based on an opinion from a FIT Committee that is to be appointed after authorization by the Diet and upon consultation with the ministers concerned. Procurement price will be determined based both on power generation costs normally required for stable supply of electricity using the Renewable Energy-sourced power plant and reasonable profit levels to be earned by the Renewable Energy-sourced power producers. The purchase prices for the initial year (i.e., until March 31, 2013) are as described on the first page of this article.

The FIT Act states that “the Minister shall give special consideration regarding profits to be received by specific suppliers when determining procurement price during the first three years of the FIT Act” to intensively promote the expansion of Renewable Energy. Therefore, the procurement price is expected to be especially favorable to power generators for the first three years because it will add a greater profit margin over the standard costs required for power generation.

The purchase price to be applied to a particular project will be determined at the later of (i) the date of the project’s FIT Approval or (ii) the date of the receipt by an electric utility of the application for an interconnection to the utility.

Unless the parties mutually agree otherwise, such purchase price (“PPA Price”) will be applied in a relevant Power Purchase Agreement (“PPA”) and must be maintained for the term of the PPA, which is not to exceed the procurement period designated pursuant to the FIT Act. That is, once the PPA is executed, the PPA Price cannot be reduced even if the procurement price declines as the result of future price revisions⁴.

In any case, the key for development will be whether power producers can secure procurement prices that are expected to be especially favorable during the initial three year period of the FIT Act.

To cover the cost of purchasing this electricity, utilities will collect surcharges in addition to regular electricity charges from electricity users.

(5) Purchase period/FIT period

The purchase period (procurement period) will also be determined annually by the Minister of Economy, Trade and Industry prior to commencement of the fiscal year for each type, form of installation, and scale of Renewable Energy source, in general. Likewise, the Minister will give public notice of the decision based on opinions by the FIT Committee and upon consultation with the ministers concerned.

The procurement period will reflect the typical period from installation of Renewable Energy-sourced power facility to the time when renewal of the major equipment becomes necessary.

Under the FIT Act, every time the national Basic Energy Plan is changed, or at least every 3 years, the government is required to review the current and projected volume of Renewable Energy-sourced power provided and the associated costs and consider changes in social and economic conditions in Japan and abroad. The government will conduct a major review of the Act before March 2021, at which time the Act itself may be abolished.

(6) Restrictions in entrance of foreign capital

The FIT Act does not restrict foreign investments in Renewable Energy power businesses in Japan. However, investors may be required to complete necessary procedures under the Foreign Exchange and Foreign Trade Act depending on the form of investment.

One relevant point to note is that, in order to obtain FIT Approval, the ministerial ordinances require a project to maintain a repair and maintenance service arrangement within Japan for the duration of the purchase period that provides for repair within three months of the date of any accident causing damage.

⁴ Please note, however, that the FIT Act provides that the Minister of Economy, Trade and Industry may revise such purchase price in the future if a critical change to an economic situation that makes such revision especially necessary occurs. The Minister will give public notice of such decision based on an opinion from a FIT Committee and upon consultation with the ministers concerned. As METI officials informally explained, such provision was basically provided to cope with possible but unlikely macroeconomic changes such as hyper inflation. The provision would allow an increase in purchase price to match such inflation, but only in the event of a fundamental macroeconomic shift. The provision would not be triggered simply because consumers want to reduce surcharge costs and request the government to reduce the purchase price. Given this explanation, our view is that there is an extremely low chance of the purchase price changing due to this provision.

2. Green Investment Tax Credit and other favorable tax treatments⁵

(1) Green Investment Tax Credit

In June 2011, the Japanese government established a tax system to promote investment (“Green Investment”) in environmental related fields including Renewable Energy (“Green Investment Tax Credit”) under the “Law to Partially Amend Income Tax Law, etc., to Aim for Maintenance of Tax System to Correspond to Current Difficult Economic Situation and Employment Situation.”

Under this system, corporations and individual business persons that submit blue form income tax returns may receive favorable tax treatment in the form of either a special depreciation equivalent to 30% of the acquisition price or a 7% tax credit, provided that they acquire applicable facilities including “New Energy Facilities” between June 30, 2011 and March 31, 2014 and commence business use within one year.

Solar PV, wind power, hydrothermal, snow and ice based thermal energy, and biomass facilities all qualify as New Energy Facilities.

In addition, an amendment to the tax system for fiscal year 2012 now makes immediate depreciation of the entire acquisition price possible in cases where solar PV and wind power generators that qualify for FIT Approval are purchased between May 29, 2012 and March 31, 2013 and used in operations within one year of such purchase.

Specifically, if corporations and individual business persons that submit blue form income tax returns acquire an applicable facility during the relevant term and commence business use within one year, a special depreciation equivalent to 30% of the acquisition price and immediate depreciation of 100% of the acquisition price can be made during the fiscal year that includes the date when a facility first commences business use. Taking advantage of this requires a large tax position and detailed tax structuring. If the FIT Act is expanded to include existing power generators as well, there is a chance that immediate depreciation may also be applied when acquiring existing power generators, in which case, refinancing of existing power plants and various other developments may be possible.

The tax credit, on the other hand, applies only for small and medium enterprises and is equivalent to 7% of the standard acquisition price, with a maximum amount equal to 20% of the corporate tax amount for the relevant fiscal year. Corporations may use the green investment tax credit even when receiving subsidies⁶, and concurrently with local corporate enterprise and property tax treatments.

(2) Reduced tax base for solar PV power generation facilities (property tax)

An enterprise may qualify for a reduction of its property tax base to two-thirds of the standard base for power generation facilities for up to three fiscal years, including the initial year of taxation, if such enterprise acquired its power generation facilities with authorization under the FIT Scheme.

This tax treatment formerly applied only to solar PV power generation facilities, but was expanded to include other Renewable Energy.

Conclusion

The official announcement of the new FIT Scheme has affirmed our earlier expectations for highly favorable conditions for power producers and projects. As we discussed in our previous newsletters, the FIT Scheme, together with the Green Investment Tax Credit, is likely to make the Japanese Renewable Energy market extremely attractive for investors both in and outside of Japan, especially over the coming two to three years. In fact, many enterprises and funds are already actively trying to enter the market as newcomers and everyone has an eye on how Japan’s Green Rush will unfold as the FIT Scheme and other Renewable Energy policies go into force next month.

⁵ Descriptions regarding taxes in this section are based on the content of announcements by the Agency of Natural Resource and Energy. Orrick does not provide advice on Japanese tax law, but may introduce appropriate counsel upon request regarding the Green Investment Tax Credit and other favorable tax treatments.

⁶ However, as other government measures to promote renewable energy will be consolidated into the FIT Scheme, there will no longer be other government level subsidies for Renewable Energy projects that qualify for the FIT Scheme.