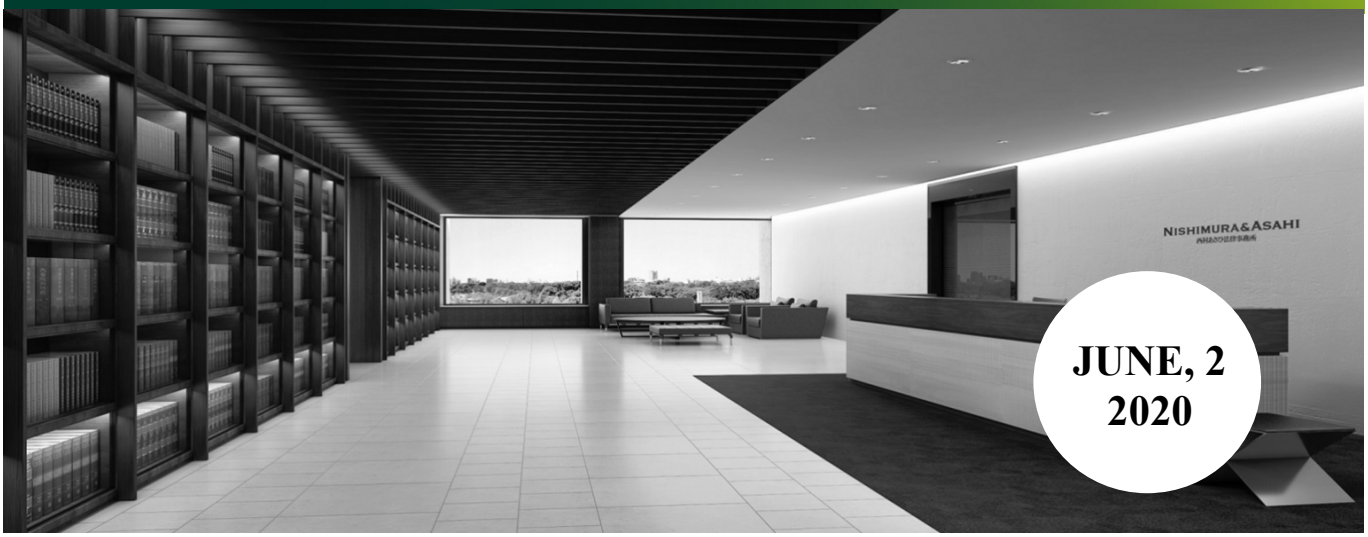
Finance Law Newsletter



Fundamental Amendment of Japan's Renewable Energy Act

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1. Proposed Amendment of the Renewable Energy Act by the Cabinet of Japan

On 25 February 2020 the Cabinet of Japan approved the "Proposal to Amend the Electricity Business Act, and Other Statues for the Purpose of Establishing a Resilient and Sustainable Electricity System" (the "**Amendment**"). It is a comprehensive legislative proposal which includes, among others, draft amendments to the Electric Business Act; the Act on Japan Oil, Gas and Metals National Corporation; and the Act on Special Measures Concerning Procurement of Renewable Energy Sourced Electricity by Electric Utilities (the "**Renewable Energy Act**"), which is the focus of this article.

2. Legislative Background

Japan's 2012 Renewable Energy Act introduced a feed-in tariff ("FIT") program to promote renewable energy as an independent power source. The FIT program is intended to provide predictable investment returns to developers of renewable energy projects by requiring utilities to enter long-term fixed-price purchase agreements for electricity generated using renewable sources. The Renewable Energy Act was also intended to reduce barriers of entry into the renewable energy sector through such means as reducing the costs of project development. Given its nature, the FIT program is only intended to be in place for a limited time. Indeed, when the Renewable Energy Act was enacted in 2012, it was stipulated that it would be "subject to substantial revisions" by 31 March 2021 (Article 2, paragraph 3 of the Supplementary Provision[1]).

[1] The number of Articles and paragraphs in this article refers to that of the Renewable Energy Act.

Since the Renewable Energy Act's enforcement, various policymakers have raised concerns, such as the increasing costs paid by the general public to support the FIT regime, the need to prioritize cooperation with local communities in the vicinity of project sites, and grid connection limitations. The Amendment has been proposed in an effort to address these issues and as the "substantial revisions" envisioned at the initial implementation of the Renewable Energy Act.

3. Major Amendments to the Renewable Energy Act

The Amendment includes three major amendments to the Renewable Energy Act: (1) establishment of a new Feed-in Premium (FIP) system, (2) introduction of a system to reserve funds for costs related to the decommissioning of renewable power generation facilities, and (3) establishment of a FIT certification expiration framework for projects that do not commence operations by deadlines to be set through subsequent regulations.

(1) Introduction of the Feed-in Premium program

The FIP program envisioned in the Amendment adds a premium to revenue generated by renewable energy producers.

While the FIT program segregated renewable energy producers from the market by obligating utilities to purchase all of the electricity they generated at a fixed price, under the FIP program, renewable energy producers participate in the wholesale electricity market and receive an additional premium corresponding to sales volumes and market prices. This market reliance, inherent to the FIP program, is designed to gradually wean renewable energy off of government support.

The following will discuss the Amendment's provisions relative to the Renewable Energy Act:

A. Type of Renewable Energy subject to the FIP Program

The category, type, and size of renewable power generation facilities covered by the FIP program will be determined by the Minister of Economy, Trade, and Industry ("METI") (Article 2-2, paragraph 1). At the outset, METI has indicated that it is considering large-scale solar projects and wind projects that have a competitive outlook as targets for FIP program eligibility; however, the subject type, scale, and the like, of the renewable energy source will eventually be determined through discussions in the Procurement Price Calculation Committee of METI.

B. Premium (Subsidy for Supply Promotion)

The Amendment uses the term Supply Promotion Subsidy ("SPS") to describe the premiums granted under the FIP program and notes that they are determined through multiplication of the amount of electricity a renewable energy producer sells on the open market by an "SPS Unit Price" arrived at through the following formula (Article 2-4, paragraph 1):

SPS Unit Price = Standard Price – Reference Price

In this formula "Standard Price" is a pre-determined baseline (discussed in Part C, below) and "Reference Price", presented on a "per kWh" basis, is the average market price of electricity over a period prescribed by Ordinance of the Ministry of Economy, Trade and Industry ("METI Ordinance"; described in Part D, below) taking into consideration seasonal and daily fluctuations in electricity supply and other circumstances (Article 2, paragraph 4(2)).

The Standard Price (i) is important for renewable energy producers as it allows them to calculate their total revenue, based on the market price and premium. The price in (ii), referred to as the "Reference Price", is equally important and will be discussed in greater detail in Part D, below. For now, it is important to note that if the value of the Standard Price falls below the Reference Price, the SPS Unit Price will be set to zero (rather than a negative figure), as under the program

renewable energy producers will not be required to pay a negative premium (Article 2-4, paragraph 2).

C. Standard Price

Similar to the FIT program, there are two methods for determining the Standard Price: a method determined by METI, and a bidding system.

The Standard Price determined by METI is to be based on an evaluation of the usual costs required for efficient electricity generation by renewable energy sources, and the estimated volume of electricity supplied from renewable energy sources.

The bidding method to determine a Standard Price will be conducted in the same manner as the bidding process for FIT prices introduced for some types of solar power and biomass power generation under the FIT program.

In principle, the Standard Price will be revised on a yearly-basis (Article 2-3, paragraph 1), however it may be revised on a semiannual basis if METI deems it necessary, after taking into consideration changes in economic conditions (Article 2-3, paragraph 1). In addition, the Standard Price may be set in advance for several years as METI deems necessary (Article 2-3, paragraph (4)).

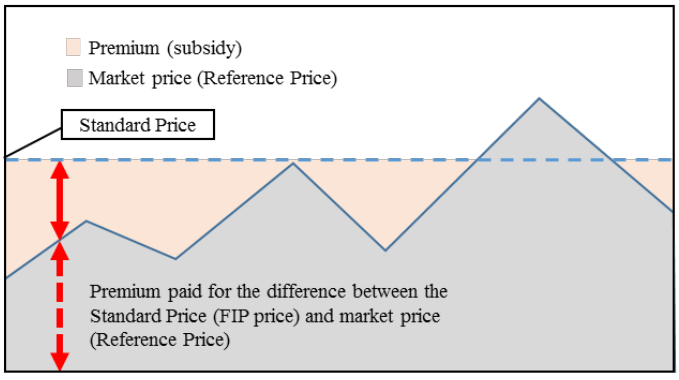
D. Reference Price

As noted, the Reference Price will be a per kWh amount that is to be determined through a method specified by METI Ordinance and based on the average price in the wholesale electricity market during a period specified by METI Ordinance, taking into consideration the seasonal and daily fluctuation of electricity supply, and other circumstances (Article 2-4, paragraph 2(2)).

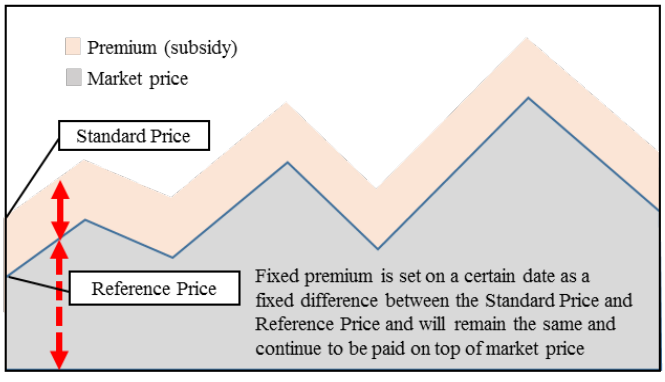
Under the FIP program, how frequently the Reference Price is reset becomes important in determining the characteristics of the FIP program. Specifically, if the Reference Price adjusts at an interval aligned with the period utilized in the wholesale electricity market (i.e., on a 30 minute-basis), it is described as a "variable" or "sliding" premium, whereas if the reference price remains constant over longer periods, it is referred to as a "fixed premium". The premium amount under a variable premium arrangement will frequently change in accordance with changes to the market price so that project owners will receive an adjusted premium amount not exceeding the Standard Price determined by METI. Under a fixed premium arrangement, project owners will receive a fixed premium amount in addition to the price of electricity sold at market value (See **Figure 1**, below). The government intends to introduce a balanced approach incorporating the merits of both variable and fixed premiums, but the details are to be prescribed in a METI Ordinance by the effective date of the amendment to the Renewable Energy Act.

Figure 1: Types of premiums contemplated under the FIP program

(1) FIP (variable premium)



(2) FIP (fixed premium)



E. Feed In Premium Period

The period for which the SPS is granted is referred to as the "grant period", which corresponds to the "procurement period" under the FIT program.

In principle, the grant period will be determined on a yearly-basis, as with the Standard Price. The grant period shall be determined by taking into consideration the standard period from the commencement of operation to the first renewal of a significant part of the renewable energy power generation facility (Article 2-3(5)).

F. Determination of the Standard Price and the Grant Period

The Standard Price and the grant period are determined according to the same procedures as the FIT procurement price and procurement period.

METI shall consult with the Procurement Price Calculation Committee in order to determine the standard price and the grant period (Article 2-3, paragraph 7).

Further, the standard price and grant period may be amended if "it is deemed particularly necessary due to significant fluctuations in commodity prices and other economic conditions" (Article 2-3, paragraph 10). This language is identical to language in the current Renewable Energy Act which allows METI to amend the procurement price and procurement period under the FIT program (Article 3, paragraph 10 of the current Act).

G. Temporary Procurement Agreements

In certain situations, renewable energy project owners may face difficulties supplying electricity through market transactions under the FIP program. As long as such difficulties are not attributable to the project owner, the Amendment provides safeguards against this situation by allowing temporary procurement agreements with electricity utilities (Article 2-7, paragraph 1). Once a temporary procurement agreement is executed, the related project owner will be able to sell power to the applicable utility at a fixed price, avoiding market participation during the procurement period, until such owner deems market participation to be feasible and decides to terminate the agreement. The criteria, period and the calculation method of the purchase price under the temporary procurement agreement shall be determined by METI Ordinance.

H. Renewable Energy Act Name Change

With the introduction of the FIP program, the formal name of the Renewable Energy Act will be changed from the "Act on Special Measures Concerning Procurement of Electricity from Renewable Energy Sources by Electric Utilities," which contemplates the FIT program, to the "Act on Special Measures Concerning Promotion of Use of Electricity from Renewable Energy Sources."

The purpose of the current Renewable Energy Act (Article 1), which presupposes the FIT program, stipulates that "special measures shall be taken with regard to the price, period, and the like, of electricity procurement for electricity utilities from renewable energy sources". This language will also be changed to stipulating that "special measures shall be taken with regard to subsidies to promote the supply of electricity from renewable energy sources through market transactions", contemplating that the promotion of market transactions through the FIP program will be the central focus of the special measures.

(2) Introduction of a system to reserve funds for decommissioning

In December 2019, the Working Group on Securing Costs for Decommissioning and Disposal of Renewable Power

Generation Facilities published an interim report (the "Interim Report") regarding the decommissioning of solar power generation facilities and disposal of waste materials. Based on the Interim Report, the Amendment introduces a system to secure funds to cover the costs of decommissioning renewable power generation facilities after their operational period.

A. Facilities Subject to Reserve Requirements

METI will designate which renewable power generation facilities under the FIT and FIP programs are subject to the new reserve system based on category, type, and size (Article 15-6, paragraph 1).

According to the explanatory materials published at the time of the Cabinet's approval of the draft Amendment,[2] and as indicated in the Interim Report, it is expected that all solar power generation facilities with generation capacity of 10 kW or more that have been authorized under the Renewable Energy Act will be subject to the reserve requirement, regardless of whether the project has commenced operations.

Renewable power generation facilities other than solar projects with 10 kW or more generation capacity are not likely to be subject to the reserve requirement initially, i.e. when the bill is enacted, according to the Cabinet's explanatory materials and the Interim Report. However, under the Amendment, the number and types of facilities that are subject to the reserve requirements may be expanded by METI in the future.

B. Reserve System

Operators of renewable power generation facilities that are subject to the new reserve system are required to set aside "decommissioning costs" (Article 15-6, paragraph 2). Failure to set aside funds to address such costs may result in METI revoking the business plan approval required for such operators (Article 15, paragraph 4).

The Amendment provides that the full amount of the decommissioning costs must be set aside in a reserve account over a term that is to be determined by METI Ordinance (Article 15-6, paragraph 3). However, the Interim Report indicates that the funds should be reserved on a monthly-basis starting 10 years before the end of the procurement period.

In principle, METI will designate the Organization for Cross-regional Coordination of Transmission Operators ("OCCTO"), a third-party agency under METI, to withhold funds for external reserves (Article 15-6, paragraph 3). For projects under the FIT program, reserve funds are withheld through the electric utility as the counterparty to the specified contract (Article 15- 6, paragraph 4). For projects under the FIP program, reserves will be deducted from the SPS to be paid by OCCTO (Article 15, paragraph 8). In both cases, the monthly amount that is required to be reserved will be withheld by OCCTO from the proceeds of that month's energy sales and deposited into a reserve account maintained by OCCTO on behalf of the operator.

The Interim Report also indicates that it is appropriate to require project owners to reserve funds under the same conditions regardless of the existence or extent of preexisting reserves. Based on this, it is likely that the reserve requirements under the draft Amendment will apply to a renewable power generation facility regardless of whether other funds have been reserved to pay for its decommissioning costs (except in cases where internal reserves are permitted, as discussed below).

C. Amount to be Reserved for Decommissioning Costs

The amount that must be reserved for decommissioning costs will be the product of multiplying (x) the "standard price for decommissioning costs" (on a kWh/yen basis) as determined by METI and (y) the actual amount of electricity sold by the operator (Article 15-7, paragraph 1). The timing and frequency of such withholding of decommissioning costs will be

[2] https://www.meti.go.jp/press/2019/02/20200225001/20200225001-6.pdf

prescribed by METI Ordinance (Article 15-7, paragraph 1). It is likely that OCCTO will withhold a portion of the funds from the proceeds of electricity sales on a monthly basis under the FIT and FIP programs.

Under the draft Amendment, prior to the start of each fiscal year, METI will determine and announce the "standard price for decommissioning costs" (on a kWh/yen basis) (Article 15-7, paragraph 2).[3] However, METI may revise this rate during the year if it determines that there is (or it expects) a significant change in the costs required for "decommissioning, and the like" (i.e., the decommissioning and other processing of waste materials resulting from decommissioning) or other circumstances (Article 15-7, paragraph 3).

While the standard rate of decommissioning costs will change year to year, once the applicable rate has been determined for an individual project, the same rate will apply throughout the procurement period and will not be affected by revision of the standard rate each year. This pricing method is identical to procurement pricing under the FIT program.

D. Withdrawal of Decommissioning Costs

Part or all of the reserve amount on deposit may only be withdrawn by the operator if (i) the reserves are to be appropriated to the costs required for decommissioning, or (ii) as specified by METI Ordinance in the cases where it is unnecessary to reserve decommissioning costs (Article 15-9).

The Amendment does not provide details concerning reserve withdraw requirements, which implies that they will be stipulated by METI Ordinance. According to the Interim Report, withdrawals of reserves, generally, will not be permitted during the procurement period; however, they may be permitted depending on the proportion of solar panels to be disposed when the project is terminated or decreased in size, and the cost for disposal exceeds a certain level. In addition, if the project continues operation even after the FIT procurement period, reserves may be available when a portion of the solar panels in a facility are disposed in the course of continuing the project, and the disposal costs of such solar panels exceeds a certain level. It is likely that reserves will not be available for solar panel replacements during the FIT procurement period.

E. Special Provisions for Private Reserves

Certified operators whose renewable energy power generation business plan indicates that it will internally reserve decommissioning costs are exempted from the requirement to reserve decommissioning costs externally; however, they must reserve decommissioning costs and other expenses in accordance with the manner stated in their business plan, and allocate such reserved costs to the costs required for decommissioning (Article 15, paragraph 11). Accordingly, such business plans may indicate an amount to be reserved for decommissioning costs, as well as the method of reserving the amount and other matters, in accordance with the applicable METI Ordinance (Article 9, paragraph 3). However, in order to include such matters in the business plan, the operator must conform to the criteria required for the appropriate decommissioning of a renewable energy power generation facility as specified by METI Ordinance (Article 9, paragraph 4(7)). Projects that have already submitted a business plan and have been certified by METI may also amend their respective business plans by including necessary information showing that it is eligible to internally reserve decommissioning costs (Article 10, paragraph 1).

The Amendment requires that METI determine the "method specified by METI Ordinance" by the effective date of the Amendment. According to the Interim Report, the conditions for permitting operators to internally reserve decommissioning costs will likely be specified in a METI Ordinance as follows:

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[3] The standard price for decommissioning costs in 2022 will be determined on the effective date of the Amendment as of April 1, 2022 (Article 5, paragraph 3 of the Supplementary Provisions).

Conditions for Approval of Internal Reserves

- Preparing and publishing business plans, etc., for the implementation of long-term and stable power generation projects, and

- satisfaction of the following:

1. the renewable power generation facility specified in the business plan upon FIT certification falls under "Electric Facilities for Business Use" under the Electricity Business Act;
2. the operator specified in the business plan upon FIT certification falls under the "power generation operator" under the Electricity Business Act, provided that if the certified operator is not a power generation operator, the FIT-certified power generation facility is deemed a specified Electric Facility for Business Use subject to certain obligations by other power generation operators under the Electricity Business Act;
3. the amount reserved for decommissioning costs exceeds the standard amount expected necessary to reserve such costs externally, and the operator consents to the publication of such costs;
4. the amount of reserves at the time of periodic reporting (once a year) exceeds the amount that should have been reserved at the time if such costs were externally reserved, and the operator consents to the publication of such projection, however, if such amount temporarily decreases due to repairs, etc., the amount should be fulfilled within one year in general;
5. it is confirmed on a regular-basis by a financial institution that the operator is able to secure decommissioning costs, or financial statements of the operator audited by a certified accountant are disclosed, as described in (i) or (ii) below:
    (i) special bank accounts are established under a contract with a financial institution for the payment of expenses, etc., strict fund management is required in accordance with the allocation order and conditions specified at the time of the loan contract, and reserve funds for decommissioning costs are managed in such special bank account;
    (ii) a) the certified operator is a listed company and the decommissioning costs of power generation facilities are recorded as asset retirement obligations and voluntary reserve funds, etc., in the financial statements, or
    b) other entity that is legally recognized as having strict financial and organizational integrity with the certified operator are listed, and the decommissioning cost of power generation facilities are recorded in the financial statements of the other entity, and the amount thereof is clearly stated;
6. the operator consents to reserve funds externally without delay in the event that requirements one to five above are not satisfied.

(3) Expiration of certification for non-operational projects

A number of business plans certified under the Renewable Energy Act represent renewable energy projects that have not yet commenced operations but, nevertheless, have reserved grid capacity by concluding an interconnection agreement. METI has indicated that it is concerned that if such projects continue such behavior for an extended period of time, this unused grid capacity will not be available for other businesses seeking to enter the market and thus hinder the introduction of renewable energy. While the current Renewable Energy Act stipulates a deadline for an operational start date to be set upon FIT certification, the consequence of not meeting the deadline is that the procurement period will be shortened on a monthly basis for the period exceeding the operational start date. As such, FIT certificates could be maintained under the applicable procurement price without initiating operations, allowing such projects to continue occupying grid capacity. METI's position is that this will cause increased public burden and impediments to grid capacity.

The Amendment provides that the FIT certification for a project will expire if it does not commence operations within the period specified by the applicable METI Ordinance (Article 14, paragraph 2). The details of the ordinance are currently being formulated by METI, as well as a certain grace period for projects that fail to begin operations by their scheduled start date. METI has indicated the purpose of the this new rule is to set expiration dates separately from operational start date deadlines, and to open up the grid capacity currently reserved for non-operational projects, thereby encouraging new entrants into the market. However, the explanatory materials published at the time of the Cabinet approval further elaborate that the "expiration date will be set by adding a certain grace period to the operational start date," which seems to imply that the expiration date will be a date that is after the operational start date (i.e., after a certain additional period). METI indicated in an answer to a public comment regarding an interim report of the Policy Reform Committee that "the details of the direction of the Interim Report will be determined by comprehensively considering the circumstances, such as the actual conditions of pre-existing certified projects, and the fairness in respect of new projects that will be subject to expiration immediately after METI certification."

No grandfathering measures are provided for the new expiration rule (i.e., no exemptions will be provided to pre-existing project owners that have obtained FIT certificates but have not commenced operations), and the Amendment is likely to apply to new projects and projects approved prior to the effective date of the Amendment.

In December 2018, METI introduced a rule which may reset the applicable FIT price for certain solar projects that have not reached operational status ("2018 Rule"). If a solar project falls within the scope of the rule, (i) the applicable FIT price will be reduced unless the project satisfies certain conditions by the applicable deadline, and (ii) the applicable FIT period will be shortened unless the project reaches operational status by the deadline. Attention needs to be paid to the details of the expiration date of the upcoming Amendment as it may adversely affect projects that have maintained the FIT price under the 2018 Rule.

4 Effective Date

If the proposed Amendment moves forward, it will be enacted at the current ordinary session of the Diet and will come into effect as of 1 April 2022 (Article 1 of the Supplementary Provisions). As many of the specific provisions under the Amendment are delegated to METI, government actions implementing the amendments will need to be carefully followed after enactment and through the effective date of the Amendment.

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