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Client Alert

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First Mover Advantages Will Accrue to Investors in Japanese Renewables

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The Japanese government is poised to kick-start the renewable energy industry by establishing high feed-in tariffs for solar, wind, geothermal, small-scale hydro and biomass. Following the 3.11 nuclear crisis, Japan has shut down 53 of its 54 reactors. The last one will be shut down for mandatory maintenance in early May. While it is not likely that Japan will completely abandon nuclear energy in the near to medium term, due to local opposition, it is not at all clear when the reactors can be restarted. Power shortages are expected and renewables will undoubtedly play a much larger role in Japan's energy mix.

The Minister of the Ministry of Economy, Trade and Industry (METI) will make a final decision on feed-in tariff levels based on the recommendations of an independent advisory committee before July 1, 2012, when the Renewable Energy Act (REA) will come into force. On April 27, 2012, the committee made the following recommendations:

Solar	**42 yen per kWh**
Large-scale wind	**23.1 yen per kWh**
Small-scale wind	**57.75 yen per kWh**
Geothermal	**27.3 yen per kWh for projects generating in excess of 150,000 kilowatts**
Mid-to-small-scale hydro	**25.2 -35.7 per kWh**
Biomass	**13.65-40.95 per kWh**

The tariffs (inclusive of consumption tax) will have a term of 20 years for all the technologies, except geothermal, which will have a term of 15 years. While the prices and other terms of the feed-in tariff system will be fixed, the REA provides that METI may review the system once every three years, based upon actual experience and will review the price and its effective period twice per year. It is likely that the rates will be set at high levels for the first few years in order to encourage investment and perhaps to compensate for some of the risks inherent in the current structure. For example, as noted above, the tariff for solar is likely to be set at 42 yen per kWh. Expressed in US-dollar terms, that would translate into more than $0.50 per kWh. This is well above the rates in other countries (e.g., $0.08 per kWh in the US and $0.15 in India and China).

Japan is well-aware of the issues with some European feed-in tariff systems and seems willing to "play it by ear" until it gains more experience. The downside of this approach is that the uncertainty creates certain risks for potential investors.

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For example, the consumption tax is currently set at 5 percent but due to large government budget deficits, increases to the level of 8 percent in 2014 and 10 percent in 2015 are being considered. The amounts paid to the project developer as a feed-in tariff will not be exempt from the consumption tax. As it is possible or even likely that the consumption tax will be increased again during the term of the feed-in tariff scheme, it is unclear at the outset of the project how much the consumption tax burden will be over the project's entire life.

Other risks include the following:

- The REA provides that "all of the renewable power produced must be purchased" by the utilities, but there is no fixed quota as in the case of Renewable Portfolio Standards, so it is unclear how much power will actually be purchased.
- The terms and conditions for interconnection to the grid have not been established.
- Uniform national procurement rules which will clearly set out the criteria for project selection have not yet been determined. Some utilities are employing a "lottery system" which assigns random numbers to determine the priority for project consideration.

While specific rules will be worked over time, Japan has certain advantages when compared to other countries in Asia. It has a stable and predictable legal system in which contracts and property rights are respected and has a highly capable bureaucracy. Despite the "revolving door" aspects of Japan's prime ministers, the political environment is extremely stable and the political parties largely share the same basic principles—but disagree for tactical advantage. The population in this resource-poor but energy-dependant nation are in favor of renewable energy—even if it costs a bit more.

Due to the 3.11 disaster, Japan needs to retain the companies it has and recruit new entrants in order to boost employment. For the first time in post-War history, Japan is actively soliciting foreign direct investment, especially in the tsunami-stricken region. In addition, Japan has far fewer legal barriers to foreign investment as compared to other Asian countries. For example, under the REA, there are no restrictions on the ownership of renewable power generation assets at the SPV level nor are there restrictions on the sale of assets. In addition:

- Generally speaking, there are no minimum capital requirements for companies (however a utility will want assurance that a supplier is well-capitalized).
- Generally speaking, there are no restrictions on the ownership of land by foreigners.
- Foreigners can own 100 percent of renewable power generation assets although a license will be required if the facility will generate more than 2,000,000 kWh.
- There are no formal local content requirements (although components may need to meet certain specifications).

Foreign energy producers and investors have a heretofore unprecedented opportunity to participate in Japan's newly emerging energy market. Those who can manage the risks and move quickly will be rewarded.

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