

Client Alert

June 2013

Renewable Energy in Japan - Important issues in M&A transactions involving solar power businesses (Newsletter No. 12)

With the period for obtaining the first feed-in tariff ("FIT") price under the "Law on Special Measures Concerning the Providers of Renewable Energy" (the "Renewable Energy Law") recently completed¹, M&A activity regarding photovoltaic energy ("PV") projects appears to be on the rise, with many local and international players looking to take advantage of the generous JPY42 (including VAT) price locked in by those projects over a 20 year period.

From a legal perspective, there are several key issues to focus on when considering undertaking an M&A transaction in Japan involving PV projects:

- (a) whether to structure the transaction as an asset or share purchase;
- (b) the effect of a share or asset purchase on the underlying FIT documents and the ability to implement changes post acquisition;
- (c) the importance of effective land due diligence; and
- (d) whether financing will be required for acquisition and/or construction purposes, and considering if the project is bankable.

Asset or Share Purchase?

As is the case with overseas renewable energy markets, it is typical in Japan to find a PV project housed by an operator under a special purpose vehicle ("SPV"), most commonly in the form of a limited liability company (*godo kaisha* or "GK", similar to a US LLC) in an effort to ensure bankruptcy remoteness, bankability with financiers and to provide easy exit strategies. When international players are involved, the GK is often combined with a "TK investor" (*tokumei kumiai* or silent partnership investor) located offshore, for tax planning purposes, in a favorable jurisdiction.

From a practical perspective, it is often seen as efficient to purchase the shares or membership interest (*shain mochibun*) in a PV project SPV rather than acquire its assets through a business transfer, and if applicable, the "TK interest" (*tokumei kumiai shusshi mochibun*) from the TK investor². This is subject to each party's intentions, the completion of due diligence and the existence of, for example, material, current or contingent liabilities.

This is generally because a share or membership interest purchase:

- (a) is likely to be less expensive;

¹ The new FIT price obtained by PV projects between 1 April 2013 - 31 March 2014 is secured in principal at JPY36 (excluding VAT) / JPY37.8 (including VAT) over a 20 year period.

² Purchase of the shares or interest in the TK investor itself may be appropriate depending on whether the acquirer is, among other things, happy with its domicile for tax planning purposes.

- (b) is not subject to consumption tax or other indirect/direct transfer taxes, and if it is well structured, may not trigger real property tax or registration tax liability;
- (c) allows any net losses, reserves and other allowances of the target SPV to be preserved; and
- (d) most importantly does not require:
 - a SPV's application for a connection agreement or the authorization of its facility (under Article 6 of the Renewable Energy Law) to be amended; or
 - the transfer of key project contracts such as the land lease agreement, power purchase agreement ("**PPA**"), EPC agreement and O&M agreement. Such agreements will however need to be checked for any restrictions on change of control.

Effect on FIT related documents and the ability to implement changes post acquisition

As set out in previous newsletters, the FIT price and procurement period applicable to a particular project is determined, pursuant to the "Notifications" under the Renewable Energy Law, by reference to a later date on which an operator:

- (a) applies for a connection agreement to one of the utilities setting out certain details including the type of generation system, the location, the connection point etc. ("**Connection Application**"); or
- (b) obtains authorization from the Ministry of Economy, Industry and Trade ("**METI**") for the generation facility under Article 6 of the Renewable Energy Law ("**METI Authorization**").

We note that while METI does not require a SPV to undertake any kind of action with regards to change of control in the event of a share purchase, it does require a simple notification from a SPV before the assignment of its METI Authorization is undertaken as an asset purchase.

It is important to note that Japan's utilities will have to be dealt with more carefully depending on the stage of a project, with regards to a SPV's Connection Application.

There is currently no consent requirement in relation to change of control under the METI model PPA. The position with regard to transfers is also clear under that PPA with prior consent required except in the case of assignment by way of security (allowing financiers to create and, if necessary, enforce their security interest with ease). The position before execution of a PPA is not clear however, with some utilities expressing concern about change of ownership or transfers when a project is still under consultation or the PPA negotiation process, due to administrative costs and time delays they may face having to explain. Examples of this include requisite connection construction work and associated costs to any new shareholders or third party transferees.

With regard to the effect of any changes to a project in general, only "material changes" undertaken by an operator will likely have an effect on the FIT price and procurement period applicable to a project. This is based on feedback received from METI, the Agency of Natural Resources and Energy ("**ANRE**")

and a number of major utilities. While potential investors may draw some comfort from comments provided by these entities as to what changes they consider "material", the market is still in flux and there is no clear guidance or regulations that presently define this.

While legal clarification is welcome in this area to add more stability to the market, in the interim, potential investors should tread carefully and seek specific advice when considering project acquisitions and their ability to implement changes post acquisition. As a starting point, we refer you to our most recent [newsletter](#) setting out rules released by the ANRE on March 27, 2013 regarding such changes.

The importance of effective land due diligence

Due diligence is particularly important in the context of PV projects in Japan due to the relative infancy of the market in terms of standardized processes and documentation, and the important role local rules and regulations play in determining the viability of a project site. In particular, we note the following land related areas potential investors should focus on when considering investing in or acquiring PV projects in Japan:

Does a SPV have registered rights over the project land?

While perhaps viewed as an elementary consideration, many projects in the market are still in the early phases of development. Often, developers do not have actual registered legal rights to the land, whether by way of lease, surface right or purchase agreement before they propose a full or partial sale to a potential investor.

Under these circumstances, it is important to confirm whether a SPV has obtained adequate exclusivity from the relevant landowner. An option agreement, letter of intent or memorandum of understanding should clarify whether the landowner has the legal right to exclusivity and if this exclusivity is still valid for a reasonable amount of time to enable the completion of due diligence, negotiations and the execution of necessary agreements. In this context, a share purchase agreement is another preferred alternative since exclusivity can be maintained without obtaining consent from the landowner provided there are no restrictions on change of control.

For PV projects with an output of 500 kW or more, METI requires the submission of the following additional items for an application for METI Authorization to be successful (pursuant to its new rules released on December 10, 2012):

- (a) an executed land lease agreement, surface right agreement or the like (if already executed); or
- (b) a certificate from the landowner which states that the landowner is planning to lease/transfer rights to the land.

It is important to note that the certificate template provided by METI for the purposes of (b) above is in no way binding on the landowner and does not evidence a SPV's rights or exclusivity over a particular project site.

Have additional land rights necessary for connection of the facility been obtained?

The location of adequate grid connection points are fundamental to the viability of a project. Under the Renewable Energy Law, there is no legal obligation on utilities to construct facilities necessary for connection or obtain

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rights over necessary land in order to do so. Whether or not utilities will undertake such activities on behalf of an operator (at that operator's cost) will be determined on a case-by-case basis. In light of this, it is recommended that potential investors check the status of these issues and whether there is ample documentation and other evidence to support a vendor's claims. The starting point for any inquiry with regards to a particular project will be a SPV's grid connection terms and conditions with the relevant utility.

What is the classification of the underlying project land?

One of the most important first steps before beginning negotiation is to check the classification (*chimoku*) of the underlying project land.

While there are many excellent project sites for PV in the Japanese market, investors should be cautious. A simple search on the central online land registry will provide a quick indication of the classification of any parcel of land. However it is important to note that while such results will serve as a useful primary guide to classification, consultation at the local level from an experienced and impartial advisor is also paramount to give full comfort to an investor and ensure the success of the project. The reason for this is because land classification in Japan is ultimately determined at the local level in accordance with idiosyncratic prefectural and city rules and regulations.

In general, land classified as miscellaneous land (*zasshuchi*) or wilderness land (*genya*) is usually favorable for PV projects while agricultural land (*nouchi*), mountain forest land (*sanrin*), woodland (*rinchi*) or land of cultural heritage (*bunkaisan*) is often affected by cumbersome legal regulations and should ideally be avoided as significant cost and time will be required for construction. It is important to note that if agricultural land, mountain forest land, woodland, or land of cultural heritage are found in the same plot of land as miscellaneous or wilderness land, this may affect the classification of this land at the local level.

Will financing be required and is the project bankable?

While a handful of project finance transactions have recently been successfully completed in relation to domestic Japanese PV projects (such as projects with a capacity of 80MW and 40MW), Japanese financiers are relatively cautious in their domestic approach to the financing of PV projects. Most will require the commitment of limited sponsor support, rather than financing on a full non-recourse basis as is the case in many overseas PV markets.

Further, many local landowners, developers and their representatives are still not coming to terms with several standard contractual protections required by globally experienced PV operators and their financiers. In particular, there appears to be some resistance from local landowners regarding the registration of lease rights.

In light of this, it will be important when investing in or acquiring a PV project to consider whether financing will be required and whether bankability issues can be satisfied.