

## Client Alert

August 2016

### Renewable Energy in Japan - Recent Developments (Newsletter No. 32)

#### FIT Rule Changes – New 3-Year Operational Deadline and Relaxation of Module Change and Other Restrictions

*The Act to amend the Act on Special Measures Concerning Procurement of Electricity from Renewable Energy Sources by Electricity Utilities (the "FIT Amendment Act") was promulgated on 3 June 2016<sup>1</sup>. The FIT Amendment Act makes various changes to the rules for the Japanese renewable energy feed in tariff program including:*

- to require certain categories of projects to commence operations within 3 years from 1 April 2017 (i.e. by 31 March 2020);
- to allow such projects to change their modules without triggering changes in the FIT rate; and
- to allow such projects to also reduce their project size by more than 20% without triggering a FIT rate reduction.

The changes will have a significant impact on renewable energy projects that did not enter into a grid connection agreement (i.e. construction cost allocation agreement<sup>2</sup>) with their offtaking utility by 31 July 2016. The changes follow a public comment period conducted by the Agency of Natural Resources and Energy ("ANRE") of the Ministry of Economy, Trade and Industry ("METI"). Due to the importance of the changes ANRE has also been holding various seminars to inform the public of how the changes will work in practice<sup>3</sup>.

This alert explains the above changes and other important amendments made by the FIT Amendment Act and provides comments on the potential impact of such changes.

#### New 3-year deadline

As noted in our Alert No. 31 issued in June 2016, 2 key deadlines have been set for renewable energy projects to enter into Grid Connection Agreements with utilities, namely:

<sup>1</sup> <http://www.meti.go.jp/press/2016/05/20160525005/20160525005.pdf>  
<http://www.meti.go.jp/press/2016/06/20160603009/20160603009.html>

<sup>2</sup> The various types of Grid Connection Agreements for each utility are set out on the ANRE website:

[http://www.enecho.meti.go.jp/category/saving\\_and\\_new/saiene/kaitori/legal\\_filename.html](http://www.enecho.meti.go.jp/category/saving_and_new/saiene/kaitori/legal_filename.html)

<sup>3</sup> [http://www.enecho.meti.go.jp/category/saving\\_and\\_new/saiene/kaitori/kaisei\\_kakaku.html](http://www.enecho.meti.go.jp/category/saving_and_new/saiene/kaitori/kaisei_kakaku.html)  
<http://search.e-gov.go.jp/servlet/Public?CLASSNAME=PCMMSTDETAIL&id=620116036&Mode=2>

- a 31 July 2016 deadline; and
- a 31 March 2017 deadline

Project holders that enter into grid connection agreements with utilities by either of the above deadlines will automatically receive approvals under the amended FIT law on 1 April 2017, i.e. when the new "business approval" system starts ("Deemed Business Approval Holders").

However, different requirements now apply to each of the above deadlines as follows:

- where a grid connection agreement is concluded by 31 July 2016 the project will not be subject to any deadline for development; and
- where a grid connection agreement is concluded between 1 August 2016 and 31 March 2017 the project will be subject to a 3 year development deadline.

Projects over 10kW in size that fall into the second category above must now commence commercial operations (i.e. electricity sales to their utility) within 3 years from 1 April 2017 (i.e. by 31 March 2020) (the "**3 Year Rule**"). If this deadline is not met, it is currently proposed that the term of the relevant power purchase agreement will be shortened or the FIT rate will be reduced at a certain rate every year (e.g. 5% per annum). In practice this is likely to mean that projects that start operation one year late (i.e. by 31 March 2021) will have their FIT rate reduced by 5% (with that rate applying for the full 20 year FIT period) or their FIT period shortened to 19 years. On the other hand, projects that start operation 2 years late (i.e. by 31 March 2022) are likely to either have their FIT rate for the 20 year FIT period reduced by 10% (2 x 5%) or their FIT period will be shortened to 18 years (i.e. a 10% reduction in the FIT period).

Further details in respect of these proposed measures will be discussed by the Procurement Price Calculation Committee and will be determined later this year. METI has stated that apart from projects that are subject to the grid connection bid process<sup>4</sup> there will be no other exceptions to the 3 Year Rule even if the delay in entering into the Grid Connection Agreement is due to hold ups in the environmental impact assessment or due to a protracted negotiation process with the utilities in relation to construction allocation costs.

The 3 year rule is likely to have a major impact on the feasibility and bankability of many approved solar projects. In our experience, it typically takes longer to bring solar projects in Japan into operation compared to other countries. This is due to a number of factors including the time necessary to obtain required local development approvals (particularly forest development approvals), the length of time necessary to negotiate EPC and financing agreements and the often significant levels of site works that are needed to prepare project sites for construction. Projects in the northern areas of Japan also face the additional challenge of not being able to carry out construction during the winter months due to deep snow cover.

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<sup>4</sup> Projects that are participating in a grid connection bid process conducted by utilities (a process whereby several projects share the construction costs for grid connection enhancements), can avoid cancellation provided that they enter into Grid Connection Agreements within 6 months after the firm allocation of the grid improvement construction costs following completion of the auction process. Such projects will then be deemed approved from the date of the grid connection agreement, at which point the 3-year time limit will start. A further exception applies to 24-yen projects approved between 1 July 2016 and 31 March 2017. Such projects can avoid cancellation provided that they enter into Grid Connection Agreements within 9 months from the date of the relevant approval (even if such date occurs after 1 April 2017). These projects are deemed approved at the time of entering into their respective Grid Connection Agreements, at which point the 3-year time limit starts. Please refer to the attached time table for further details.

The above reasons mean that it is likely that any projects that are not already well advanced in their local development and EPC/financing processes will struggle to achieve operation within the new 3 year deadline. Buyers seeking to purchase such development stage projects will therefore need to be careful to conduct a detailed legal and technical due diligence to accurately assess the feasibility of meeting the 3 year deadline. It will also be important for such buyers to assess the willingness of project finance lenders to support such projects given the risk of not meeting the 3 year deadline and to understand what sponsor support (if any) such lenders may require from developers should the 3 year deadline not be met.

### Relaxation of module change rules

Until now, the FIT rules have restricted approval holders from changing the modules for approved projects. If such a change is made, this will generally trigger a reduction in the approved FIT rate for the project.

The FIT Amendment Act will relax this rule for projects in the second category above. Projects that are subject to the 3 Year Rule will therefore be permitted to change their modules without any FIT rate reduction. Developers of such projects may therefore have the chance to reduce their project costs by changing to cheaper modules to balance out possible losses if the project does not enter commercial operation within the 3 year deadline.

The ability for developers to change modules will however be subject to their ability to cancel their existing module purchase arrangements. In most cases this will depend on whether the already agreed purchase order or module supply agreement has a clause allowing termination or a change of modules. It will also be necessary to confirm with the relevant utility whether any change of modules will have an impact on the grid connection application / contract.

Module changes for projects that fall into the first category above will however still lead to a reduction of the FIT rate for the project.

### Capacity reductions of over 20%

In addition to the ability to make module changes, projects that become subject to the 3 Year Rule will also now be able to reduce their project size by more than 20% without triggering an FIT rate change. For example, a project that is currently approved at a capacity of 30MW could be developed as a 10MW project without losing its FIT rate.

This is a positive change that is likely to result in many projects now becoming feasible for development. This is because a common problem in the early years of the Japanese FIT program was that developers sought approvals for the maximum possible capacity that could be developed on a project site. In many cases this was done without developers having conducted detailed site surveys to assess the technical feasibility and maximum capacity of the project site. This has stalled the development of such projects as either the project site is not sufficiently large to accommodate at least 80% of the approved project capacity (which has been the limit below which the approved FIT rate will be lost) or prohibitively expensive site works are required to achieve such capacity.

This new rule change will now allow developers of such projects to readjust their project size down to a more feasible level. Such reductions may also assist the project to achieve operations within the new 3 year deadline (as smaller projects will typically take less time to develop than larger projects). A key issue will however be the developer's willingness to accept a lower sale price for a reduced size project. However if this is the only alternative to make

the project feasible, developers may have no choice but to consider this option.

### **Curtailment rule to be established by 31 March 2017**

METI has indicated that a new rule relating to curtailment will be established by 31 March 2017. The rule is likely to take into account the cancellation of large numbers of already approved projects that cannot execute grid connection contracts by 31 March 2017 (as such cancellation is likely to free up a significant amount of grid capacity). The exact scope and nature of the new curtailment rule is however not yet clear.

Such a new rule may provide welcome clarity for project developers. In particular, whilst certain projects subject to unlimited curtailment with no compensation have already been considered by banks for project finance (and some have even managed to obtain project finance), fairer and clearer curtailment rules should lead to banks being more willing to provide financing to curtailed projects.

### **FIT auction system**

The stated goal of the FIT Amendment Act is to reduce electricity procurement costs through introducing more competitive processes. As such, the FIT Amendment Act will establish a reverse auction system under which developers can bid on a per kW basis to obtain new project approvals to supply electricity from renewable energy projects up to a pre-determined maximum price. The Procurement Price Calculation Committee will discuss (at its autumn session) whether to hold such competitive auctions for each category of renewable energy and the particulars of the auction system. The government's intention is to introduce this auction system for large scale solar projects.

### **Publication of approval information for solar projects over 20 kW**

Currently there is no public register for approved solar projects. It is therefore difficult to know the identity of holders of approved projects.

Following the FIT Amendment Act, solar power projects with over 20 kW of capacity approved after 1 April 2017 (including existing projects that continue under the amended FIT Act) will have the following information published on ANRE's website:

- the approval details;
- the approval holder's name;
- the category of the facility and its approved capacity; and
- the approved project location.

The above information is expected to promote secondary trading of approvals as it will be easier for potential buyers to make direct contact with approval holders.

This change may be particularly helpful in allowing bona fide buyers to bypass the large numbers of brokers that have placed themselves between bona fide buyers and sellers of project approvals to date and who have often frustrated possible sales through their attempts to make large commissions on such sales.

## Business owner change will not trigger FIT rate change

METI has announced that although changes of approval holders will need to be approved (as it may lead to significant change of the business plan), this will not trigger any changes in the FIT rate.

This is a welcome confirmation, particularly given previous indications from METI that it may have been considering a possible restriction on transfers of project approvals.

## Transmission operator's obligation to purchase electricity

Under the FIT Amendment Act, transmission operator's such as utilities (rather than electricity retailers) will have an obligation to purchase renewable energy electricity. Similar to the previous regime, reasons for refusing a connection are limited under the FIT Amendment Act, and utilities will in principle not be able to refuse a connection.

## Renewable energy supplies to JEPX

Utilities which procure renewable energy electricity from business approval holders based on specific contracts must supply a quantity of such electricity to the Japan Electric Power Exchange (JEPX) by trading at the spot market.

The quantity that is required to be supplied to JEPX is the amount of electricity purchased from renewable energy sources that still remains after the utility has:

- supplied electricity purchased from renewable energy sources to retailers under any direct supply contracts executed with such retailers, and
- consumed such electricity itself.

Such remaining excess amount should be supplied to JEPX for sale on the spot market.

Currently only 3% of total electricity sales in Japan are conducted through JEPX. The new system is therefore expected to significantly increase the role of JEPX in the Japanese electricity market.

## 270 day rule to secure land and module orders

Project approvals granted from April 2015 (i.e. 32 yen projects) have been subject to a requirement that the approval holder enter into land and module purchase agreements within 270 days from the METI approval date.

METI is now reviewing this rule to decide on new requirements for securing land and facilities which will be set by 1 April 2017. It is not clear at this stage on how the new requirements will apply.

## Summary

The changes introduced by the FIT Amendment Act will have a significant impact on development of approved solar projects in Japan. The new 3 Year Rule in particular is likely to negatively impact on the development of many approved projects, particularly projects that are still only in early stages of development.

Therefore, whilst the ability to change project modules will be welcomed by many developers, potential buyers for projects that have the ability to change modules will need to carefully consider the feasibility for such projects to be developed within a 3 year period.

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However, the ability for project developers to reduce their project size without loss of the approved FIT rate may lead to various projects that now face technical challenges becoming more feasible. This is because reductions in capacity may allow various projects to be built on sites which are too small to contain the currently approved project capacity. However this will require developers to make a realistic examination of their projects and to decide whether to accept a reduced project size in return for the projects becoming more feasible.

We expect that the changes may also increase the amount of solar project M&A activity leading up to the new 31 March 2017 deadline. This is because project sellers that are not able to finance payment of the grid connection costs (which are required to be made on signing of the construction cost allocation agreement) may need to secure buyers or investors to pay such costs for their projects before the 31 March 2017 deadline. The period between now and 31 March 2017 will therefore be a critical period for developers to take the necessary action to ensure their project approvals continue to survive under the new FIT rules.

