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JAPAN PASSES FEED-IN-TARIFF LAW

On August 26, 2011 the Japanese Diet enacted a law that requires the purchase of renewable energy by electric utility companies.

The fixed-price policy measure can be understood as a feed-in-tariff (FIT), but important details are still to be determined. The new law, which will become effective July 1, 2012, requires utilities to contract with renewable energy generators at a price and for a duration that will be determined by a third party independent commission and approved by the Minister of Economy, Trade and Industry this fall. Eligible renewable energy sources include, but are not limited to, solar, wind, hydro, geothermal and biomass. Technical standards for renewable energy facilities eligible for the program will be determined by the Ministry of Economy, Trade and Industry (METI).

The obligation of Japan's ten electric utilities to purchase is not limited to a fixed percentage of total generation capacity or other quantitative limit. Instead, the obligation to purchase at the fixed price will be subject to the ability to maintain stability of supply in the grid and to avoid any unduly burdensome increase of rates to ratepayers. The first limiting criterion (stability in the grid) will be a technical battle where the utilities have the upper hand due to their ownership and operation of the grid and obligation to reliably serve; but Japan's low integration of intermittent resources (see penultimate paragraph) combined with diminished public trust in the electric utilities suggests that this criterion should not be a limiting factor for some time.

The second limiting criterion (no unduly burdensome increase in rates) will be a political struggle that will test the resolve of renewable energy proponents. Last weekend it became known that The Tokyo Electric Power Company (TEPCO) would seek a 10% rate increase to cover its increased fuel expenses that became necessary after the loss of nuclear capacity this spring and further rate increases related to the unexpected costs of Fukushima may follow. For TEPCO customers, the surcharge for renewables would be an additional financial burden.

The arbiter and interpreter of the purchase obligation limitations will be METI; but METI's decisions will be influenced by battles in progress and soon to intensify among the various interest groups, including would-be renewable energy generators, equipment manufacturers (who in some cases have a stake in the new opportunities, as well as in the technologies that may be phased out), the electric utilities, industrial

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Please feel free to discuss any aspect of this Client Alert with your usual Milbank contact or with any member of the Renewable Group whose names and contact information are provided at the end of this alert.

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consumers of electricity, other ratepayers and the public at large who have recently experienced a dramatic shift in attitude about the appropriateness of Japan's reliance on nuclear energy as a pillar of its energy strategy.

Observers view the new law as a significant step in the transition to a low-carbon economy and to correct for Japan's relatively low penetration of renewable-sourced electricity into the grid. We spoke with Noriaki Yamashita of the Institute for Sustainable Energy Policies (ISEP), a non-profit organization that has been an influential advocate for policies promoting adoption of renewable generation in Japan. ISEP enthusiastically welcomes the passage of the FIT framework law. However, Mr. Yamashita noted that the previously mentioned third party independent commission must establish pricing that is sufficient to encourage renewable generators to develop projects in order to convert the promise of this first step to an appreciable change. Additionally, he noted that separation of transmission from generation is an important second step that must be taken to ensure truly open access to the grid is granted to renewable energy generators.

Japan's electricity is supplied by ten geographically divided and vertically integrated companies, who exclusively serve their captive customers and are regulated by METI. TEPCO is the largest of the electric utilities. In the 1990s, there was a movement to de-monopolize, deregulate, and liberalize the power markets in Japan, but the efforts fell short when the Enron bankruptcy and California power crisis shifted the balance of policy opinion in favor of the status quo. In the wake of the Great East Japan Earthquake and unimaginable consequences to TEPCO's Fukushima Dai-ichi nuclear power plant, a movement to separate transmission functions from the utilities has reawakened. This time the movement is driven by the need to organize the industry with a structure that will provide greater grid access to renewable generators and in the context of reorganizing TEPCO, which some in Japan argue is necessary or inevitable in consideration of its decommissioning and third party compensation liabilities related to the Fukushima complex.

Japan has the third largest electricity market in the world (behind the United States and China). Unlike jurisdictions with neighbors capable of selling excess capacity (such as Germany, where early shut-down nuclear production was replaced with imports), growth in demand or reductions in generating capacity at home must be offset with new generation or reductions in demand. Approximately five gigawatts of baseline capacity (Fukushima Dai-ichi) was permanently lost from the Japanese electricity grid and there may be accelerated decommissioning of even more nuclear capacity. Eastern Japan survived an electricity demand-supply imbalance this summer only with costly mandatory reductions on industrial electricity consumption and a high degree of voluntary demand reduction that history in other markets suggests will not be sustained. Japan is already highly energy efficient and does not have the same low hanging fruit opportunities in demand-reducing efficiency investments that exist in other markets such as the United States. Absent a radical downturn in industrial activity or policy-driven reductions to consumption patterns, Japan is in need of new generating capacity. In 2009, Japan's then Prime Minister, Yukio Hatoyama, publicly announced Japan's commitment to reduce carbon emissions by 25% by 2020. The loss of nuclear capacity has caused many to view this policy as unrealistic but assuming the spirit of such commitment is maintained, natural gas is not the sole solution for the lost nuclear capacity. The FIT law, if the pricing is attractive, will enable renewables to help fill the demand-supply gap.

Despite Japan's well-deserved reputation as a highly energy-efficient and low-carbon intensive economy, it has a surprisingly low penetration of renewables in the electrical grid. In 2009, hydropower produced 8.3% of the total power generated from the ten utilities and wholesale providers, while geothermal, wind and solar combined produced merely 1% (data from the Federation of Electric Power Companies of Japan, 2011). Hydropower in Japan is very reliable and can serve load-balancing functions, and the unused capability to absorb more intermittent resources such as wind and solar is high. Solar is viewed by many to be the immediate beneficiary of the FIT

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scheme. Last week METI Minister Banri Kaieda told a parliament committee that the bill was expected to help solar capacity in Japan expand to ten gigawatts, from the almost four gigawatts of present capacity, which is installed today mostly in small residential systems. The numbers indicated by Mr. Kaieda imply an installation of two gigawatts of capacity per year over the next three years, which is more than twice Japan's current internal manufacturing capability for PV panels. Some in Japan have complained that the new law will result in a flood of imports and fail to nurture Japanese companies. Regulation of the electricity sector is but one of METI's mandates and METI is responsible for fostering the health and expansion of Japanese companies who can compete globally in growth industries. Low-carbon energy technologies is viewed to be an area where Japan must maintain competitiveness; and one may therefore reasonably doubt whether Japan is likely to see the level of turbine and panel import penetration that the United States and Germany has seen.

Japan-based global heavyweights in the renewable energy sector are positioned to benefit from the new FIT law. However, the size of the market is such that non-Japanese companies with aspirations to be global leaders in clean energy are likely to take the view that they cannot afford not to compete here; and many in the industry predict the level of activity in Japan by American, European, and Chinese players in the renewable energy space to increase.

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