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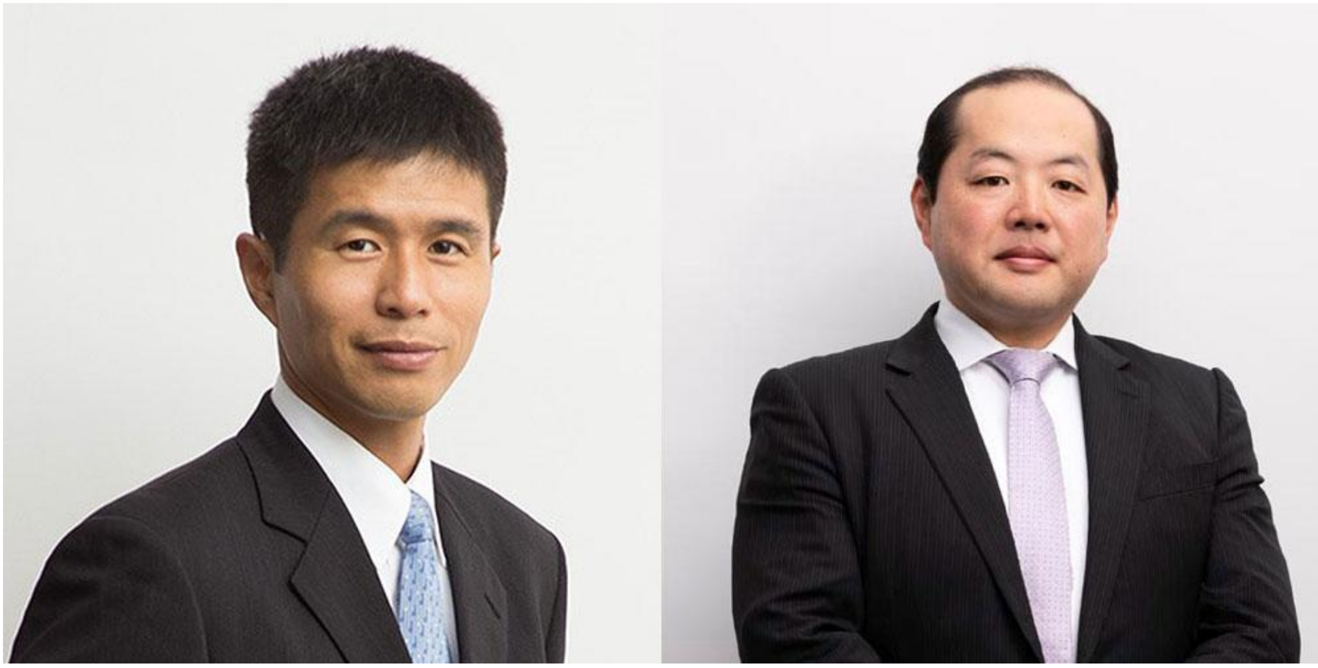
Project Finance

Kunihiro Yokoi, Teruma Naito
Anderson Mōri & Tomotsune

Published August 2021



Japan

Kunihiro Yokoi is a partner at Anderson Mori & Tomotsune and one of the few expert Japanese lawyers with a dedicated focus on the energy and infrastructure sector. His expertise covers power, renewable energy, natural resources, oil and gas, transportation, construction, PFI and PP,P and real-estate matters.

In the field of project finance, he has advised sponsors, lenders and contractors in numerous projects in Japan and other countries. He has substantial experience publishing articles and presenting lectures on renewable energy and its financing.

Teruma Naito is a partner in Anderson Mori & Tomotsune's finance group. His practice focuses on domestic and international project finance transactions in the area of power, water, oil and gas, shipping, infrastructure and export credit financings. He spent over 12 years working at a magic circle law firm in London and Tokyo before joining Anderson Mori & Tomotsune, and has a broad range of experience on cross-border project financings and corporate matters in Asia, Africa, the Middle East, South America and Europe.

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1 What have been the trends over the past year or so in terms of deal activity in the project finance sector in your jurisdiction?

While the past year has been marked by the onset of the covid-19 pandemic, March 2021 was the 10th anniversary of the Great East Japan Earthquake, which resulted in the shutdown of all of Japan's nuclear power plants. Even before 2011, Japan ranked among the lowest for energy self-sufficiency of countries in the Organisation for Economic Co-operation and Development. However, the events of 2011 placed Japan's energy policy for the next decade on a steep upwards climb for its reliance on the importation of fossil fuels.

In October 2020, however, the Japanese government announced that, to achieve the targets of the Paris Agreement, Japan would commit to achieving carbon neutrality by 2050. This resulted in the Ministry of Economy, Trade and Industry announcing the government's 'Green Growth Strategy' in December 2020, which aims to facilitate and encourage the development of the production of renewable energies within Japan. Arguably, the lead up to, and subsequent coverage of, the Green Growth Strategy has defined the activity in Japan's project finance sector for the past year, and will also influence the direction of the project finance sector in Japan going forward.

The Green Growth Strategy features the following five cross-sectoral support measures: (1) granting funding, including a green innovation fund of ¥2 trillion over 10 years; (2) introducing tax incentives; (3) formulating a finance policy to attract global environmental, social and governance investment; (4) introducing regulatory reforms, including in the area of offshore wind, hydrogen, and mobility and battery storage; and (5) collaborating more closely with developed and emerging nations.

The support measures for the Green Growth Strategy will be targeted at 14 growth sectors in (1) energy (including offshore wind power; fuel ammonia; hydrogen; nuclear power), (2) transport and manufacturing (including, mobility and battery; semiconductors; maritime; logistics, people flow and infrastructure; foods agriculture, forestry and fisheries; aviation; and carbon recycling) and (3) home and office (including, housing and building, and next generation photovoltaic; resource circulation; and lifestyle-related industries).

Furthermore, the government has announced that it aims to have 40 per cent of its current energy source be renewable by 2030, which is significantly higher than its earlier target of 22 to 24 per cent. These ambitious targets illustrate the importance placed on renewable energy by the government as part of its goal to become more self-sufficient in this sector.

Accordingly, the general trend for project finance in Japan for the past year has been the continued increase in interest and demand for domestic renewable energy projects off the back of the government's initiatives and focus on the Green Growth Strategy. Furthermore, with a view to more long-term objectives, such as the future commercialisation of hydrogen in Japan and the move away from existing fossil fuel projects overseas, we are also seeing an increasing trend of a more diverse group of Japanese banks and corporations (including regional banks, utilities and funds) being proactive in finding opportunities in overseas renewable energy projects, or investing in or providing refinancing for existing overseas project finance projects (which were traditionally the bastion of the major Japanese banks and trading houses).

2 In terms of project finance transactions, which industry sectors have been the most active and what have been the most significant deals to close in your jurisdiction?

The renewable energy sector remains very active in Japan. There has also been a noticeable shift in attention away from new large-scale greenfield solar projects towards offshore wind, hydrogen, biomass, geothermal energy and other alternative green energy sources. In particular, there have been a number of notable large-scale biomass projects over the past year or so, including the US$525 million 74.95MW Sendai biomass power project, the US$420 million 75MW Ichihara Yawatafuto biomass project and the US$574.61 million 75MW Ishinomaki biomass project.

However, this is not to say that solar is less active as there are a large number of smaller-scale projects being constructed, and there has also been a continued increase in international and domestic entities looking to invest in or acquire portfolios of existing solar power projects that were financed or constructed over the past decade. Notable transactions over the past year have included the US$432.55 million sale of the Matsuzaka 98MW solar power plant, the acquisition by the Japan Infrastructure Fund of 10 solar power plants for approximately US$111.47 million, the US$500 million financing of the Wakayama 111MW solar facility and the US$275.13 million financing of the Aomori Shinjo Yamada 70MW solar project.

While still in its infancy, offshore wind in Japan continues to draw substantial attention and we are seeing a lot of activity from domestic and international players seeking opportunities to invest or take part in various upcoming offshore wind projects.

With Japan aiming to generate 10GW of offshore wind energy by 2030, and increasing this to 45GW of offshore wind energy by 2040 (which would make it the third-largest generator of offshore wind power in the world), deal activity in this area will increase over the coming years with a number of public auction bids. One of the notable offshore wind transactions in 2020 was the US$894.5 million financing of the 140MW offshore wind farms at Akita Port (54.6MW) and Noshiro Port (84MW) in Akita prefecture. The project is based on a 20-year power purchase agreement, with a feed-in tariff of ¥36 per kWh. Commercial operation is scheduled during 2022.

In relation to public-private partnership (PPP) and private finance initiative (PFI) projects, the PPP/PFI Promotion Office of the Japanese Cabinet Office announced that, as at 31 March 2020, PFI projects were up by 77 from the previous year to a total of 818 since the government enacted the Act on Promotion of Private Finance Initiative Funds (Act No. 117 of 1999, as amended) in 1999, and shows a continuing trend of increased activity in this sector. We expect the numbers for March 2021 to be updated by the PPP/PFI Promotion Office in due course and it will be interesting to see whether this trend has continued during the past year, particularly in the context of the covid-19 pandemic and the Green Growth Strategy. As the government continues its policy of restoring or replacing infrastructure that was built in the 1960s, PPP and PFI projects continue to be of major importance for Japanese infrastructure projects. Some notable transactions in the past year have been the US$629.88 million Haneda Airport redevelopment PPP and the US$579 million Kansai Airport terminal expansion.

3 Which project sponsors have been most active in driving activity? Which banks have been most active in providing debt finance?

We are seeing increased activity and interest from major European and Asia-Pacific renewable energy players, investment funds and data centre operators seeking opportunities in Japan. While the traditional Japanese developers, trading houses, construction companies, utilities and real estate companies will continue to be heavily involved in the major projects, the involvement of major international players in Japanese project financings continues to rise and will do so for the foreseeable future. This is all the more prevalent in offshore wind and other renewable energy sectors and we expect that this trend will continue in light of the ambitious Green Growth Strategy.

The major financial institutions involved in Japanese project finance transactions continue to be the Japanese banks. Although there has been an increasing number of non-Japanese banks being involved in some of the major project financings in Japan, due to the liquidity and low-interest rates within the Japanese market, the trend of Japanese banks financing domestic projects will continue for the foreseeable future. Having said this, however, with the increasing complexity, size and involvement of international sponsors and developers, the involvement of non-Japanese banks (including export credit agencies) is becoming more frequent.

While foreign investments into Japan continue to be relatively open, the Foreign Exchange and Foreign Trade Act is updated from time to time to add certain industries or businesses to its list of priority areas to ensure scrutiny of any investments by non-Japanese entities. The Foreign Exchange and Foreign Trade Act places requirements on investments into businesses related to, among other things, public infrastructure projects, such as electricity, water, gas and telecommunications; national security businesses, such as communications, weapons and nuclear power; and public safety businesses, such as medical equipment, and vaccines and medicines. With the submission of notifications to the relevant ministries, the relevant investments will be reviewed to ensure that it does not threaten national security, disrupt public order or public safety, or have an adverse effect on the Japanese economy. It would be rare for submissions to be rejected, but this as an area that continues to be watched closely as non-Japanese players increasingly seek opportunities in the renewable energy sector.

4 What are the biggest challenges that your clients face when implementing projects in your jurisdiction?

From the perspective of non-Japanese entities taking part in domestic Japanese project financing transactions, renewable energy projects continue to be a particular focus. Infrastructure projects such as data centres and integrated resort (including casino) projects are also becoming an increasing focus for international players in Japan, and the Green Growth Strategy has firmly placed the Japanese renewables sector in the sights of domestic and international players. However, there are some bankability issues for these renewable energy projects.

The government intends to gradually adopt a feed-in premium regime from April 2022 and to expand its coverage to include various renewable energy projects. This will present challenges for developers of these renewable energy projects as the risk would generally be dictated by market forces unless they secure a very stable long-term power purchase agreements with offtakers. This is particularly the case where the proposed feed-in premium price will be determined by a bidding system, leading to unpredictable returns for potential investors and developers that are subject to market forces.

The New Energy Bill (referred to in question 5), which was introduced in June 2020, will introduce a nullification rule whereby certain delays to the commercial operation date or commencement of construction may lead to the removal of approvals provided by the relevant government authorities for the relevant renewable energy project. This makes certain development and construction delay risks fall upon the bidders. Accordingly, delays in commercial operation will need to be taken into account when considering potential project risks and negotiating any proposed dates for scheduled commercial operation.

The New Energy Bill has also proposes amounts to be reserved for the decommissioning of certain renewable energy projects. The draft regulations for the New Energy Bill will need to be monitored, but initial indications are that the decommissioning reserve would be calculated by multiplying a designated decommissioning price per 1kWh, by the volume of electricity of the relevant project. Subject to the draft regulations, potentially high amounts could increase tariffs but also deter potential investors and developers from taking on the decommissioning risk on top of other issues, such as the new feed-in premium that may potentially decrease their long-term returns.

As already mentioned, while the Japanese government has announced that it aims to have 40 per cent renewable energy from its current energy source by 2030 and to have 50 to 60 per cent renewable energy by 2050, Japan's grid capacity is insufficient to enable such targets to be achieved. In April 2021, the Ministry of Economy, Trade and Industry announced its intention to significantly increase the power grid capacity by connecting the northern island of Hokkaido to mainland Japan with undersea power cables, as well as developing the transmission lines nationwide to accommodate the increased capacity from renewable sources. Without such developments, the power grid would be incapable of processing the extra power from renewable energy projects, which would lead to curtailment issues, as seen in the solar market. Resolving this issue remains a priority to ensure the bankability of these renewable energy projects in the long term.

In the area of offshore wind, international developers have identified issues with respect to the time taken to complete the requirements for environmental and social approvals for offshore wind projects. At this stage, the process takes a few years to complete, and the time taken to get the environmental and social approvals for each project requires further consultations with the relevant government authorities.

With the implementation of the Green Growth Strategy, government-level support for those taking part in or developing renewable energy products will continue to be prioritised. The direction this takes will be influenced, in part, by the participants of these projects and we can see the growing influence of domestic and international players on the market practice that is developing in the relevant industries.

5 Are there any proposed legal or regulatory changes that may give rise to new opportunities in project development and finance? Do you believe these changes will open the market up to a broader range of participants?

In June 2020, the bill on the Act of Partial Revision of the Electricity Business Act and Other Acts for Establishing Resilient and Sustainable Electricity Supply Systems (the New Energy Bill) was passed and is expected to come into effect from April 2022. The New Energy Bill will introduce a number of significant changes to renewable energy projects in Japan, including: the introduction of a feed-in premium regime; the requirement to have a decommissioning reserve; and the introduction of deadlines to commence commercial operations of the relevant projects. Each of these changes is aimed at addressing some key issues that the government identified as areas that require updating to enable Japan to effectively manage a sustainable energy supply from renewable energy projects. The details of the actual regulations to implement the New Energy Bill should be provided shortly, and further consideration and monitoring of these regulation will be required in the coming months.

Once the regulations to enact the New Energy Bill take effect from April 2022, the feed-in premium regime should be available in addition to the current feed-in tariff regime. The Minister of Economy, Trade and Industry will designate which regime applies in accordance with the recommendations of the government's Procurement Price Calculation Committee.

Based on discussions held to date by the Procurement Price Calculation Committee, the expectation is that once the feed-in premium regime in April 2022 commences, large-scale projects will adopt the feed-in premium regime and smaller-scale projects will apply the feed-in tariff regime. Although this is still under discussion, indications are that: the feed-in premium regime (auction) will apply for solar projects over 1MW; a choice of the feed-in premium regime (non-auction) or the feed-in tariff regime will be provided for solar projects between 50kW and under 1MW; a choice of the feed-in premium regime or feed-in tariff regime will be provided for onshore wind projects of 50kW or more (the Procurement Price Calculation Committee does not specifically address offshore wind projects); and a choice to transition to the feed-in premium regime may be provided for existing solar or wind projects. The specific details of the feed-in premium regime will require further consideration once the draft regulations are published.

The New Energy Bill also introduces the requirement to maintain a decommissioning reserve for renewable energy projects. Current discussions on the decommissioning reserve requirement indicates a requirement for solar projects of 10kW or more to establish reserves for decommissioning costs. The reserve amounts would be calculated by multiplying a designated decommissioning price per 1kWh, by the volume of electricity of the relevant project. This amount would be deposited on a monthly basis. The specific details of the decommissioning reserve requirements for renewable energy projects will require further consideration once the draft regulations are published.

Finally, the New Energy Bill introduces the requirement for renewable energy projects to commence commercial operations by a specific deadline. For certain renewable energy projects that do not commence operations within a certain period of time after the relevant approvals, the Ministry of Economy, Trade and Industry will have the right to invalidate the relevant approvals provided for that project. Certain public comments have indicated that such deadlines may be extended if the projects can be shown to have achieved demonstrable progress. While the impact of this proposed change is apparent (placing project risk on the bidders by a specific date), as the specifics of the proposed regulation have not been published, the details of this requirement will require further consideration and monitoring once the draft regulations are published.

6 What trends have you been seeing in terms of range of project participants? What factors have influenced negotiations on commercial terms and risk allocation? Are there any particularly innovative features?

We have seen an increase in the number of foreign investors and developers taking part in renewable energy projects and infrastructure projects. In particular, we have seen this trend in the acquisition of solar projects portfolios, the entry into offshore wind projects and the construction of data centre projects. For major offshore wind projects, we have also seen the prospect of overseas export credit agencies assisting international developers in their involvement in the offshore wind space.

In terms of financial institutions, banks continue to dominate the financing of domestic projects. Together with the continuing trend of the involvement of major life insurance companies and regional banks, the Japanese lenders continue to maintain strong liquidity in the market to fund various projects in the country. It is also for this reason that the use of financing from the capital markets may not be as prevalent in Japan as in other overseas markets; however, we are aware of a number of institutions that have been involved in providing financing through project bonds on solar projects over many years and are starting to look at the possibility of using project bonds for other renewables projects. Although the use of project bonds will not become prevalent in the immediate future, we understand that certain financial institutions apply an exception so that capital markets may come into play once certain projects begin commercial operations and there are opportunities to refinance certain projects in the future.

As a result of the increased number of international players in project finance matters in Japan, there is now an expectation or requirement to use international standard contracts and structures. However, due to engrained local market practices and forms of contract, the implementation of international standards for contracts and structures have been difficult to implement in most cases. Although it has not been impossible, the practicalities of introducing new contractual concepts to long-established market standards, and in a foreign language, has been difficult. In addition, Japanese law concepts and market practice in certain areas have affected the way in which contracts are negotiated, as well as how legal and commercial risks are allocated.

For example, one of the common contractual concepts in domestic contracts (particularly for construction and supply contracts) is resolving issues through good-faith discussions. This concept of mutual resolution permeates a number of Japanese legal practices and contractual provisions that international players often focus on. For example, force majeure provisions in standard Japanese construction contracts will allow delay extensions upon a force majeure event. However, whether the contractor can claim additional amounts to restart work is a matter for each of the parties to consult. Similar issues arise for contract price adjustments in the case of unforeseen changes to law and the extent of liability to third parties for breaches of contract and defects to work. Accordingly, whether to negotiate these provisions to bring them in line with FIDIC standards, for example, or another market practice is a matter for the parties to agree in each case, and more often than not, the conclusion will depend on whether the counterparties have been involved in other international transactions and are familiar with other international practices.

7 What are the major changes in activity levels or new trends you anticipate over the next year or so?

As in previous years, new large-scale solar projects are becoming limited due to less favourable feed-in tariff conditions compared to the initial rounds from 2012. However, as mentioned, the acquisitions and investments into portfolios of solar projects entered into during the favourable feed-in tariff schemes continues at pace. We expect that there will be some large-scale investments into such portfolios of assets (whether in solar or other renewable energy projects) in the coming year.

Activity in the offshore wind sector will also ramp up in the next year or so. In particular, auctions for the offshore wind projects in Noshiro, Yurihonjo and Choshi are expected to select preferred bidders later this year and another four areas have also been announced for development in Aomori, Akita and Nagasaki. While the covid-19 pandemic slightly delayed the roll out of these auctions last year, it is expected that auctions will be held annually over the coming years.

The Green Growth Strategy is also a clear indicator of the direction the Japanese project finance market will take in the coming decades. Solar, wind, biomass and geothermal will continue being active in one form or another, and the possibility of hydrogen will remain a priority for the Japan's energy policy. We are seeing a number of large Japanese institutions collaborating with other developers and institutions (both in overseas hydrogen markets and domestic research and development) to further collaborate and strengthen the hydrogen network with a view to eventually implementing commercially viable domestic sources of hydrogen in the long term.

The Inside Track

What three things should a client consider when choosing counsel for a complex project financing?

- Depth of resources at the law firm. It is often the case that law firms may be stretched for resources (eg, lawyers, translators, documentation specialists) and may not have the full range of specialist legal expertise at one firm (eg, tax, employment, regulatory, corporate, banking).
- International and domestic project finance experience and multilingual capabilities. All law firms will claim they have expertise in handling projects in

a particular field, but only a few law firms offer project finance specialists with native-level multilingual skills, together with domestic and international qualifications.

- Knowledge and experience of conducting the relevant project financing. Law firms that have been involved in the most transactions for the relevant project financing or lawyers who have direct connections with the relevant authorities will be able to best navigate complex issues, particularly for developing sectors such as offshore wind and hydrogen.

What are the most important factors for a client to consider and address to successfully implement a project in your country?

Understanding and appreciating local market practices is key, not only from a legal perspective but also from a moral, economic, political and social perspective. While it may be tempting to implement market practices and standards seen in other jurisdictions, parties should be flexible and open to complying with local practices. If this is not possible, parties should be patient and invest time in reaching a common understanding and compromise on a mutually acceptable position.

What was the most noteworthy deal that you have worked on recently and what features were of key interest?

Anderson Mori & Tomotsune recently advised a Japanese utility in the acquisition of a stake in a Middle Eastern independent power project, as well as in the financing of a number of renewable energy projects and major infrastructure projects in the UK, Belgium, Australia and Taiwan. Major Japanese investors and lenders are looking overseas to strengthen their collaboration with overseas players and gain technical know-how, and, in doing so, diversify their project financing portfolio outside Japan.