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COMMENTARY

Japan Approves Final Set of Power Market Reforms

On June 17, 2015, the Japanese Diet passed a bill amending the Electricity Business Act (the "Amendments") as the third and final stage of the electric power system reforms that began following the Great East Japan Earthquake of March 11, 2011. The Amendments will become effective as of April 1, 2020. They require that Japanese power companies operate their electricity transmission and distribution business separately from their electricity generation and retail businesses. In order to comply with the Amendments, power companies will be required to spin off their existing transmission and distribution business into separate entities. This *Commentary* provides an overview of the key features of the Amendments as well as background on the earlier stages of the reforms to Japan's electric power system.

Background

Weaknesses in the Japanese electric power system exposed by the Great East Japan Earthquake caused the Japanese government to begin a series of reforms to the system. For the past 60 years, the Japanese electric power system has been dominated by 10 vertically integrated utilities, each of which possessed a geographic monopoly. Although the Japanese government had tried to introduce competition in the electricity generation business and partial liberalization of the electricity retail market in the past, it did not promote competition among these 10 utilities between regions, and the market share of new entrants into the retail market remained very small. Following the Great East Japan Earthquake, certain areas of Japan suffered rolling blackouts due to a lack of coordination among the different regions. Following this experience, the Japanese government decided on a series of reforms to Japan's electric power system aimed at:

- Securing a stable supply of electricity using a cross-regional supply structure;
- Holding down electricity rates by encouraging competition through liberalization; and
- Increasing options for customers and opportunities for businesses.

Stage 1: Wide-Area Operations

The first stage of these reforms, approved in 2013, was to establish the "Organization for Cross-regional Coordination of Transmission Operators, Japan" ("OCCTO"), an independent institution to promote wide-area operations. The role of OCCTO is threefold. First, it is charged with assembling and coordinating, at a national level, information regarding supply and demand and the structure of the electricity market. Second, OCCTO seeks to enhance electricity transmission infrastructure in Japan, through such measures as increasing transverters and electric wires interconnected among regions. Finally, in the event of a natural disaster or other emergency, OCCTO would adjust the supply of electricity and provide instructions to utilities to create flexibility in the supply of electricity. These reforms were implemented, and the OCCTO was established on April 1, 2015.

Stage 2: Liberalization of Retail Market

The second stage of the reforms, approved in 2014, was to fully liberalize entry into the electricity retail business in Japan. The second stage marked the end of the series of liberalizations for entry into the electricity retail market in Japan that the Japanese government had implemented in a phased manner since 2000. Prior to this second-stage reform, general household customers were required to purchase electricity from local monopoly-holding utilities such as Tokyo Electric Power Company, Incorporated, known as TEPCO. Accordingly, the rates that could be charged by these utilities were heavily regulated. Starting on April 1, 2016, additional entities will be allowed to supply electricity to general households in order to promote competition in the electricity retail market and to lower electricity costs.

As a transitional measure so that the amendment would not result in increased electricity retail prices due to insufficient competition, large electric utility companies are required to provide retail price menus reviewed and approved by the Ministry of Economy, Trade and Industry ("METI"). However, they may also provide retail price menus that have been determined without METI's review and approval.

Stage 3 Reforms

The Amendments, the third and final stage of these reforms, were passed by the Diet on June 17, 2015. The goal of the Amendments is to neutralize the electricity distribution/transmission sector from the generation and retail sectors through the separation of legal entities conducting these businesses, with two ultimate principal purposes:

- Increase competition by making it easier for companies that have newly entered the market to access the existing transmission and distribution infrastructure; and
- Achieve fairness in the interconnection and supply agreements.

The current system in Japan heavily favors existing market participants. Currently, a single company may engage in (and large electric utility companies in fact do engage in) the three businesses—power generation, distribution, and retail—as long as the accounts for each of these businesses are separated. However, whether this accounting separation scheme is sufficient to maintain the neutrality and fairness of the electricity distribution/transmission business has for some time been a subject of debate. Some argue that electric utility companies may have an incentive to favorably treat their electricity generation and retail divisions, and may also have an incentive to utilize information obtained through their distribution/ transmission business for promoting their other businesses.

The Amendments are expected to remove these types of conflicts in order to achieve fairness with regard to connections to the distribution/transmission network, and to weaken these vertically integrated monopolies by prohibiting a single company from operating an electricity transmission and distribution business alongside an electricity generation or retail business. Accordingly, existing utilities will be required to spin off their transmission and distribution business into a separate legal entity. Importantly, the Amendments require a "legal separation" method, but this is different from an "ownership separation." The Amendments do not prohibit a company from operating these types of businesses through separate subsidiaries. Therefore, power transmission and distribution businesses spun off by existing utilities will likely remain under the control of these utilities as wholly owned subsidiaries.

Conduct Control

In addition to requiring legal separation between the electricity transmission and distribution business and the electricity generation and retail businesses, the Amendments also impose certain controls on conduct.

First, companies operating a transmission and distribution business may not have interlocking directors or officers with companies operating an electricity generation or retail business. Specifically, the directors and officers of a company operating a transmission and distribution business, including its affiliates, may not be a director, officer, or employee of a company operating an electricity generation or retail business, including its affiliates.

Second, companies that operate a transmission and distribution business are prohibited from entering into certain types of agreements with affiliates that operate an electricity retail business. These prohibited agreements include agreements that contain terms that are nonstandard, or otherwise indicate that the agreement was not negotiated at arms' length, and agreements that may limit fair competition.

Finally, the transmission and distribution companies must adopt an internal control system to ensure compliance with these conduct control regulations.

Retail Price Regulations

The Amendments will also allow METI to selectively exempt companies from electricity rate regulations. As discussed above, customers were permitted to choose the company from which they purchase electricity as part of the Stage 2 reforms to the electric power system. METI, however, could still review and regulate the prices and services offered by these companies.

The Amendments will amend these transitional measures starting April 1, 2020 or later, after confirmation of the progress of the electricity market's competitive status, and the Japanese government will designate the companies to which the price regulations do not apply. This revision will allow METI to exempt companies meeting certain criteria from rate regulations. Specifically, METI will exempt companies from rate regulations if it determines that the exemption would not harm the company's customers.

Repeal of Bondholder Preference

Finally, the Amendments will repeal the provisions of the Electricity Business Act that give preference to bondholders of electric utilities engaged in all three types of businesses (electricity generation, transmission and distribution, and retail). Prior to the Amendments, the Electricity Business Act granted an electric utility's bondholders a statutory lien, giving them priority over other unsecured creditors. Under the Amendments, this grant of a statutory lien will be repealed, and bondholders will rank in priority equal to other unsecured creditors.

Effect on Existing Contracts under the Feed-in Tariff System

The spin-off of existing transmission and distribution businesses described above will require that existing contracts under the feed-in tariff system (under the Act on Special Measures Concerning the Procurement of Renewable Energy by Operators of Electric Utilities) be restructured. Under this system, certain power generation facilities that generate electricity using renewable energy have entered into long-term power purchase agreements and transmission agreements with the existing utilities. The spin-off of the transmission business will require that the rights and obligations under the interconnection and transmission agreements be transferred to the spun-off business. The rights and obligations under the power purchase agreements will be held by the retail business company.

Conclusion

The Amendments will become effective as of April 1, 2020, to allow an adequate period of time for adopting additional rules and systems for the stable supply of electricity. When fully implemented, these reforms have the potential to fundamentally transform the Japanese electricity market, increase competition, and provide business opportunities to new entrants to the market. These reforms may also create new market opportunities for companies that provide analytical and logistical services to those in the energy industry, and also for foreign investors. However, Japan's electricity market is in a period of great transition, and the development of the electricity system is currently in progress. Investors should fully understand the legal framework and associated risks before they decide to enter the market. Finally, if effective, these reforms should create essential flexibility to the Japanese electric power system that will allow it to withstand future natural disasters or other emergencies.

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