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Update to Economic Security Promotion Act: Designation of supported materials (specified critical materials) in relation to supply chain resilience

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In May 2022, the Japanese Diet approved the "Act on the Promotion of National Security through Integrated Economic Measures" (the "**ESPA**"). August 1, 2022, saw the enforcement of Chapters 4 and 2 of the ESPA, respectively concerning (i) policy supporting the development of cutting-edge critical technologies, and (ii) "**Specified Critical Materials**."[1] In November of this year, after the government's supply chain survey and economic security expert discussion, the latter were clarified by a "**Draft Cabinet Order**"[2] containing the designation of 11 materials eligible for government assistance. In addition, an outline of the draft action policies for ensuring stable supply, which the competent Minister will establish to ensure the supply of each Specified Critical Material under the Act (Article 8, paragraph (1) of the ESPA, the "**Action Policy**") (the "**Outline of Draft Action Policy**"), was also released as materials of the expert committee meeting on economic security legislation held by the government on November 16, 2022.[3]

This newsletter provides as a timely commentary on the outline Draft Cabinet Order and the Draft Action

[1] According to Article 7 of the ESPA, such materials subject to the government's support measures to ensure stable supply (the "**Specified Critical Materials**") must: (i) be indispensable for the survival of the people or widely depended on by lives or economic activities of the people, (ii) be or may be excessively dependent on external parties, (iii) have a certain probability of experiencing supply disruption, etc., due to actions taken by external parties, and (iv) clarify the necessity of measures under this system. For more information, see Article 7 of the ESPA and Chapter 3 of the Basic Guidelines for Ensuring Stable Supply of Specified Critical Materials.

[2] The draft Order for Enforcement of the Act on the Promotion of Maintenance of Security Through Integrated Economic Measures (the "**Draft Cabinet Order**")) was released, and the public comment procedure for it began, on November 17, 2022 (until November 30, 2022).

[3] As of this newsletter (Nov. 23, 2022), although the Outline of Draft Action Policy was disclosed, no specific draft action policies which the competent Minister will establish for each Specified Critical Materials have been released. Therefore, it is based on the Outline of Draft Action Policy which was used for the expert committee meeting (i.e., the contents of the draft action policies to be released may differ).

Policy.[4]

1. Key Points of the Draft Cabinet Order

- The Specified Critical Materials listed in the Draft Cabinet Order are the following 11 materials (Article 1).[5]

> **(i) Antimicrobial preparations, (ii) fertilizer, (iii) permanent magnets, (iv) machine tools and industrial robots, (v) aircraft parts** (comprising aircraft engines and airframes)**, (vi) semiconductors** (semiconductor devices and integrated circuits)**, (vii) storage batteries, (viii) cloud programs, (ix) combustible natural gas (LNG), (x) metal minerals,**[6] and **(xi) marine parts** (marine engines, navigational tools, and propellers)

With regard to the 11 Specified Critical Materials above, and raw materials, parts, facilities, equipment, devices, or programs necessary for the production of such materials (together with the Specified Critical Materials, the "**Specified Critical Materials, etc.**"), operators also may receive government support, such as granting of subsidies or low-interest and long-term loans of funds from the Japan Finance Corporation through designated financial institutions, by submitting a written plan for ensuring stable supply to the government and receiving certification through government review (for example, in relation to not only semiconductors themselves, but also the production devices, components, etc., necessary for the production of semiconductors).

- The Draft Cabinet Order identifies financial institutions that provide loans through the Japan Finance Corporation (Articles 2 and 3), medium or small operators eligible to receive support, such as underwriting of shares by Tokyo Small and Medium Business Investment & Consultation Co., Ltd. and credit guarantees by the Small and Medium Business Credit Insurance Corporation (Article 5), and procedures for initiating investigation of trade remedy measures for the Specified Critical Materials, etc. (Article 7).

2. Key Points of the Outline of Draft Action Policy

- Operators applying for support from the government are required to submit a plan for ensuring supply of the Specified Critical Materials, etc., to the competent Minister for certification (Article 9, paragraph (1) of the ESPA), with one such criteria therefor being the competent Minister deeming it appropriate in light of their action guideline to ensure each of such material's stable supply (Article 9, paragraph (4), Item (i) of the ESPA). In the Outline of Draft Action Policy, the following matters are listed as common requirements across materials, which are planned to be prescribed in the Action Policies and Ministerial Orders. Therefore, it is expected that an explanation for each of the following items will be required in the application documents and the like for certification of the plans ensuring their supply.

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4 Unless otherwise indicated, article numbers in this newsletter refer to the article numbers of the Draft Cabinet Order.

5 From the examples given as candidates at the time when the bill was discussed (semiconductors, rare earths, batteries, and pharmaceuticals), the number of target materials seems to have increased through the Diet deliberations and other processes.

6 They are limited to manganese, nickel, chromium, tungsten, molybdenum, cobalt, niobium, tantalum, antimony, lithium, boron, titanium, vanadium, strontium, rare earth metals, platinum group metals, beryllium, gallium, germanium, selenium, rubidium, zirconium, indium, tellurium, cesium, barium, hafnium, rhenium, thallium, bismuth, graphite, fluorine, magnesium, silicon, and phosphorus.

- Response to cybersecurity (implementation of appropriate inspections, assessments, and countermeasures against risks);
- Response to relevant laws and regulations (ensuring transparency of governance);
- Response to prevent technology leakage (establishment of information management systems);
- Establishment of a plan to ensure supply capacity and business continuity (formulation of a business continuity plan and the like); and
- Report to the competent Minister on the implementation status of the certified plan to ensure supply (every fiscal year).

- In addition, with regard to matters that should be considered in ensuring stable supply of individual Specified Critical Materials, etc. (Article 8, paragraph (2), item (vii) of the ESPA), which are planned to be prescribed in the Action Policy, the Draft Action Policy also sets forth the following items as common items that should be considered by the competent Minister across the materials. Therefore, in order to obtain certification for a plan to ensure supply, it is expected that operators may be required to explain matters such as whether the details of its efforts are consistent with the WTO Agreement and whether human rights are sufficiently taken into consideration, including:

  - consistency with international commitments (and international rules such as the WTO Agreement);
  - recommendations to respect human rights in the supply chain;
  - recommendations to ensure cyber security in the supply chain;
  - making information known to operators and the like and its release;
  - mutual cooperation with relevant administrative agencies; and
  - follow-up (review in response to technological developments and the like from time to time).

- In addition to the above, the following is a summary of the Action Policy for each Specified Critical Materials described in the Draft Action Policy.

Material	Reasons for Designation / Efforts to Ensure Stable Supply
Antimicrobial preparations	● The use of antimicrobial agents is essential for the prevention and treatment of infectious diseases in medical settings. Almost 100% of the raw materials for beta-lactam antibacterial agents, which are often used in injectable antimicrobial agents, are imported from overseas. When import of the active pharmaceutical ingredient was disrupted due to manufacturing problems in 2019, some medical institutions experienced serious issues, such as surgery postponement. ● Commence building facilities to manufacture and stockpile **raw materials (mother nucleus, side chain) and active pharmaceutical ingredients for beta-lactam antibacterial agents** in Japan from 2023, and establish a system by 2030 to ensure stable and uninterrupted supply of beta-lactam antibacterial agents to medical settings, even when supply from overseas is disrupted.
Fertilizer	● Fertilizer raw materials (such as ammonium phosphate and potassium chloride) are unevenly distributed in certain regions, while Japan is dependent on imports for most of its fertilizer raw materials. Since autumn of 2021, due to stagnation in exports from supplier countries and the impact of the Ukraine crisis, supply disruption risk has become apparent in relation to primary fertilizer raw materials. ● Strengthen stockpiling, including construction of storage facilities from 2023, with the aim to stockpile **ammonium phosphate and potassium chloride**, which are primary fertilizer raw materials, at an amount equivalent to three months of the annual demand by FY2027.
Permanent	● Amid growing demand and international competition, (i) domestic production

magnets	capacity has not been increased to meet domestic demand, and there is a risk that stable supply cannot be maintained; (ii) Japan depends on external sources for rare earth metals, which are raw materials for permanent magnets; and (iii) recycling of permanent magnets collected from businesses and households has not progressed. In light of the aforementioned issues, the following efforts will be made: • Expand capacity of **permanent magnet manufacturing facilities** to increase production capacity according to the domestic demand as of 2030; • **Develop and introduce technologies for recycling raw materials of rare earth metals from** waste magnets in order to double the recycling capacity by 2030 compared to 2020; and • **Develop heavy rare earth-free magnets that** can be equipped on drive motors for electric vehicles and **develop neodymium magnets, etc.**, that use only half the amount of neodymium used currently.
Machine tools and industrial robots	● Control-related equipment is a component that has particularly large impact on the performance of machine tools and industrial robots. It is necessary to take actions including responding to expanding needs due to megatrends such as DX and carbon neutrality (CN). ● In order to reduce the risk of overseas dependence of the business base of Japan's manufacturing industry (i.e., machine tools and industrial robots) in the future, the following efforts will be made with the aim to strengthen domestic production capacity and technological capabilities and to maintain and enhance international competitiveness. • Enforce domestic production capacity for control-related equipment (capital investment for new plants and production line expansion, etc.) that will contribute to achieving the goal of ensuring a stable supply of machine tools and industrial robots by 2030 (machine tools: approximately 110,000 units/year, industrial robots: approximately 350,000 units/year); and • Research and development to meet the expanding needs for control-related equipment due to megatrends such as DX and CN.
Aircraft parts	● Stable supply of large forgings, CMCs (ceramic matrix composites), and carbon fibers, which are components of key parts of aircrafts, from Japan plays an important role in worldwide manufacture of aircraft; however, the risk of supply disruption is increasing due to changes in the international situation and other factors. ● The following efforts will be made with the aim to establish and strengthen Japan's position as a key player and contributor in the global aircraft supply chain by 2030, and to maintain normal and safe aircraft operations: • acquisition of certification and making of capital investment to reduce manufacturing costs for large forgings; • research and development and capital investment for mass production of CMCs; and • capital investment to increase carbon fiber production capacity (to increase nominal production capacity for carbon fiber, a raw material for CFRP (carbon fiber reinforced plastic) by 5,000 tons by 2027).
Semiconductors (semiconductor devices and	● As global demand increases and other countries make strategic and aggressive investments, the competitiveness of Japanese companies has declined. Some of the manufacturing equipment and raw materials are heavily dependent on

integrated circuits)	overseas sources. Japan has a certain strength in some goods, such as conventional semiconductors, manufacturing equipment, and components, which other countries expect supply from Japan; however, without implementing support, Japan may become more dependent on external sources for these materials. ● In addition to taking actions such as supporting the construction of production facilities for advanced logic and memory semiconductors under the 5G Promotion Act, support for capital investment, etc., will be provided for **conventional semiconductors (power semiconductors, etc.)** and **manufacturing equipment, components, and raw materials** that make up the semiconductor supply chain, in order for companies producing semiconductors in Japan to achieve total semiconductor-related sales of over 15 trillion yen by 2030.
Storage battery	● With regard to storage batteries for automotive and stationary applications, overseas manufacturers are rapidly expanding their supply, backed by government support, while Japan's share is declining. There are some storage battery components for which Japanese companies hold a certain market share in terms of safety and performance; however, overseas manufacturers are catching up in terms of cost and quality, and many components are becoming dependent on external sources. ● The following efforts will be made with the aim to, amongst others, establish a domestic production base of 150 GWh/year for **storage batteries and storage battery components** by 2030. • Support capital investment by operators that plan to invest in large-scale production expansion, by operators that have components of limited domestic production, or in unique technologies to strengthen the domestic production base for storage batteries and storage battery components; and • Support the development of cutting-edge manufacturing technologies by DX and GX, as well as technology development to establish and enhance such cutting-edge production base.
Cloud programs	● Although the cloud is expected to expand into areas such as mission-critical systems in the public and private sector and social infrastructure, operators with business bases in Japan have yet to sufficiently develop the basic cloud programs necessary for highly convenient, efficient, and secure cloud computing for users, and environments for the use of the advanced computers necessary for development of future basic cloud programs also are limited. ● The following actions will be implemented with the goal that operators with business bases in Japan establish a system which can provide basic cloud computing sustainably, and ensure cloud computing capable of autonomously managing important data by FY2027. • Subsidizing the cost for developing the basic cloud programs necessary for convenient, efficient, and secure cloud computing for users, whereby developing the relevant technology over a three-year period. • Subsidizing the costs for introducing a world-class supercomputer, etc., whereby establishing environments, where such computers can be used at low cost from FY2023.
Metal minerals	● Demand for battery metals (such as lithium, nickel, cobalt, and graphite), rare earth metals, and other important minerals necessary for manufacturing storage

	batteries, motors, etc., which work toward carbon neutrality is growing, but almost all important minerals are imported from overseas. ● Support will be provided through the following actions with the aim of securing the demand necessary for supplying storage batteries and permanent magnets in Japan as of 2030. • Subsidies for coal mining and assessment of project feasibility. • Support for Japanese companies' acquisition of mining interests. • Support for beneficiation, refining, and other businesses. • Support for technological development to promote efficiency and cost reduction in beneficiation, refining, etc.
Combustible natural gas (LNG)	● As a result of dependence on foreign countries for the entire supply, the risk of supply disruptions is now apparent. In addition to the Asian countries of large demand that have been competing for LNG procurement, especially in winter, the recent international situation has brought other countries into the LNG procurement competition. ● Support actions will be introduced to secure LNG surpluses strategically, especially by private operators with superior procurement capabilities.
Marine-related equipment (engines, sonar, propellers)	● In order to maintain autonomous marine transport, it is necessary to stably produce marine equipment at home and ensure a stable supply of ships. However, in other countries and regions such as China and South Korea, large-scale public support is being provided, and handling by only the private sector is difficult. In particular, marine engines, nautical equipment (sonar), and propulsion units (propellers) are the main marine equipment whose specifications are considered and adjusted in conjunction with the design and construction of ships, so it is necessary to ensure their domestic stable supply. ● The following actions will be implemented with the goal of achieving a production capacity capable of supplying all domestic demand by 2027. • Support from 2023 for the introduction of equipment, etc., related to the test operation process, which is a bottleneck to strengthen the domestic production base for marine engines and their parts (crankshafts) in response to the spread of gas fuel, and support from 2023 for the introduction of automation equipment relating to the bottleneck process for crankshafts, etc. • Support for the introduction of production equipment for raw materials for nautical equipment (sonar), etc. • Support for introduction of automation equipment relating to casting and processing processes of propulsion units (propellers).

3. Future Schedule and Outlook

According to materials from the government's materials of the expert committee meeting on economic security legislation, which was released prior to the public comment on the Draft Cabinet Order, the Cabinet decision on the decree concerning the Draft Cabinet Order and the announcement of each Action Policy are scheduled

for late December.[7]
The operators who desire to receive subsidies or other support for ensuring stable supply of the Specified Critical Materials under this system need to gather information, including the results of public comments, etc., and consider whether to prepare a stable supply plan and submit it to the competent government agency (the minister with jurisdiction over the production, import or sales of each commodity (Article 86 of the ESPA)) for certification, based on the contents of the Action Policy scheduled to be announced in the future. As for operators, in particular, it is expected that they will be required to address cyber security (implementation of appropriate inspection, evaluation, and countermeasures against risks), compliance with related laws and regulations (ensuring transparency of governance), and prevention of technology leakage (establishment of information management system), as mentioned above, as requirements for support targets. They should make sure to confirm with the competent ministries and agencies what level of measures are specifically required through public comments on the Draft Action Policy and the application preparation process.
In addition, the Diet is about to approve a supplementary budget that includes support measures concerning supply chain resilience under this system of the ESPA.[8]

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[7] It is also stated that "application for support by the corporations/independent administrative agencies supporting the assurance of stable supply are scheduled to begin in March and thereafter, in sequence." It is not necessarily clear what this statement means, whether it refers to the designation of the corporations/independent administrative agencies that will provide subsidies, etc., or whether it refers to applications for stable supply plans to these corporations. In any case, it is expected that the application for certification will begin in earnest after March 2023.

[8] According to media reports, the FY2022 supplemental budget amount related to economic security is expected to be about 1 trillion yen, under the FY2022 supplemental budget (No. 2). Although the amount may not include the amount for the Specified Critical Materials related to the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) and the Ministry of Health, Labor and Welfare (MHLW), the Ministry of Economy, Trade and Industry (METI) has announced a budget of 958.2 billion yen for the "Support Project for Critical Material Supply Chain Resilience in Response to Changes in the Economic Environment in the budget of the METI-related portion."